18

PARTNERSHIP GENERAL

You have already learnt about the sole proprietary business and preparation of its accounts. But, when a business expands, it goes beyond the capacity of one person to provide the capital and manage the affairs of the expanded business. A need is felt to combine his/her efforts and capital with those of another person/persons. This gives rise to the partnership form of organisation.

As far as recording of business transactions in the books of original entry, their posting to ledger and preparing financial statements are concerned there is no difference between a sole proprietor or a partnership firm. But there are certain issues which are specific to partnership firm and require separate accounting treatment. These issues are appropriation of profits of the firm, treatment of goodwill on various occasions and so on. This lesson focuses on such issues related to partnership firms.

OBJECTIVES

After going through this lesson, you will be able to :

- state the meaning and characteristics of partnership;
- explain the meaning of partnership deed;
- describe accounting treatment of specific issues related to partnership in the absence of partnership deed;
- state the meaning and preparation of capital account:
- distinguish between fluctuating and fixed capital account;
- calculate interest on capital and interest on drawings;
- state the meaning and purpose of Profit and Loss Appropriation account and its preparation.

18.1 PARTNERSHIP AND PARTNERSHIP DEED

Partnership is a form of business organisation, where two or more persons join hand and start and run a business. They share the profits and losses according to the agreement amongst them.

According to the Indian Partnership, Act 1932,

> "Partnership is relation between persons who have agreed to share profits of a business carried on by all or any of them acting for all".

For example, one of your friends has passed class XII from National Institute of Open Schooling (NIOS) and wants to start a business. He/she approaches you to join in this venture. He/she wants you to contribute some money and participate in the business activities. Both of you if join hands, constitute a partnership.

Following are the characteristics of partnership :

- **Agreement**

  A partnership is formed by an agreement. The agreement may be either oral or in writing. It defines the relationship between the persons, who agree to carry on business. It may contain the terms of sharing profit and the capital to be invested by each partner, etc. The written agreement is known as partnership deed.

- **Number of persons**

  There must be at least two persons to form a partnership. The maximum number of partners in a partnership firm can be ten in case of banking business and twenty in case of non-banking business.

- **Business**

  The Partnership is formed to carry on business with a purpose of earning profits. The business should be lawful, Thus, if two or more persons agree to carry on unlawful activities, it will not be termed as partnership.

- **Sharing Profits**

  The partners agree to share profits in the agreed ratio. In case of loss, all the partners have to bear it in the same agreed profit sharing ratio.

- **Mutual Agency**

  Every partner is an agent of the the other partners. Every partner can bind the firm and all other partners by his/her acts. Each partner will be responsible and liable for the acts of all other partners.

- **Unlimited liability**

  The liability of each partner, except that of a minor, is unlimited. Their liability extends to their personal assets also. If the assets of the firm are insufficient to pay off its debts, the partners' personal property can be used to satisfy the claim of the creditors of the partnership firm.

- **Management**

  All the partners have a right to mange the business. However, they may authorize one or more partners to manage the affairs of the business on their behalf.

- **Transferability of share**

  No partner can transfer his/her share to any one including his/her family member without the consent of all other partners.

Partnership deed

Agreement forms the basis of partnership. The written form of the agreement is the basis of a document of partnership. It contains terms and conditions regarding the conduct of the business. It also explains relationship amongst the partners. This document is called partnership deed.

Every firm can frame its own partnership deed in which the rights, duties and liabilities of the partners are stated in detail. It helps in settling the disputes arising among the partners in the general conduct of business.

Contents of Partnership Deed

The partnership deed generally contains the following :

(i) Name and address of the partnership firm;

(ii) Nature and objectives of the business;

(iii) Name and address of each partner;

(iv) Ratio in which profits is to be shared;

(v) Capital contribution by each partner;

(vi) Rate of Interest on capital if allowed;

(vii) Salary or any other remuneration to partners, if allowed;

(viii) Rate of interest on loans and advances by a partner to the firm;

(ix) Drawings of partners and interest thereon, if any

(x) Method of valuation of goodwill and revaluation of assets and liabilities on the reconstitution of the partnership i.e. on the admission, retirement or death of a partner;

(xi) Settlement of disputes by arbitration;

(xii) Settlement of accounts at the time of retirement or death of a partner;

(xiii) Circumstances in which the firm can be dissolved;

(xiv) Settlement of accounts at the time of dissolution of a firm.

In the absence of the partnership deed

The partnership deed lays down the terms and conditions of partnership in regard to right, duties and obligations of the partners. In the absence of partnership deed, there may arise a controversy on certain issues like profit sharing ratio, interest on capital, interest on drawings, interest on loan and salary of the partners. In such cases, the provisions of the Partnership Act becomes applicable:

(i) Distribution of Profit

Partners are entitled to share profits equally.

(ii) Interest on Capital

Interest on capital is not allowed.

(iii) Interest on Drawings

No interest on drawing of the partners is to be charged.

(iv) Interest on partner's loan

A Partner is allowed interest @ 6% per annum on the amount of loan given to the firm by him/her.

(v) Salary and commission to partner

A partner is not entitled to any salary or commission or any other remuneration for managing the business.

INTEXT QUESTIONS 18.1

I. Fill in the blanks with appropriate word/words :

(i) There must be at least ..... persons to form a partnership.

(ii) A partnership is formed by .....

(iii) Agreement of partnership can be ..... or .....

(iv) The written form of agreement of a partnership is called .....

(v) The liability of each partner is .....

II. Asha and Rahul are partners in a firm . If there is no partnership deed, how will you deal with the following? Give your answer in yes or no.

(i) Asha wants a salary of Rs.3000 per month to be paid to her. Can she claim the salary?

(ii) Rahul has advanced a loan to the firm. He claims interest @ 6% p.a. Is it permissible?

(iii) Asha and Rahul contribute Rs. 50,000 each as capital. Rahul wants more profit than Asha. Is it permissible?

(iv) Asha gets contracts for the firm. She wants 2% commission on the amount of contract. Is she entitled to such commission?

(v) Rahul withdraws Rs.500 p.m. for personal use. Asha wants interest to be charged on Rahul's drawings. Can it be charged?

18.2 CAPITAL ACCOUNT : MEANING AND PREPERATION

Partners contribute their share of capital in business. These are recorded in their respective accounts named as capital accounts. Suppose there are two partners A and B so there will be A's capital account and B's capital account. These accounts may be maintained in two ways :

(a) Fixed Capital Account

In fixed capital account, the closing balance of the capital account is same as that of opening balance except when additional capital is introduced or there is permanent withdrawal during the current accounting year. Items relating to capital account such as interest on capital, interest on drawings and share of profit etc, are recorded in capital account. In this case a separate account is opened for each partner to record these items. This account is

known as 'current account'. A current account may show a debit or a credit balance. Format of the fixed capital account and the current account is as under :

Partner's Capital Account

Dr. Cr.

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	Bank (Permanent withdrawal of Capital)		xxx		Balance b/d (Capital contribution opening balance)		xxx
	Balance c/d (Balance the end)		xxx		Bank (Additional Capital introduced)		xxx
			xxx				xxx

Partner's Current Account

Dr. Cr.

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	Balance b/d (in case of debit opening Balance)		xxx		Balance b/d (in case of credit Opening Balance)		xxx
	Drawings A/c		xxx		Salary		xxx
	Interest on Drawings A/c		xxx		Interest on capital		xxx
	Profit and Loss Appropriation (for share of loss)		xxx		Profit and loss Appropriation (for share of profit)		xxx
	Balance c/d (in case of credit closing balance)				Balance c/d (in case of debit closing balance)		
			xxx				xxx

(b) Fluctuating Capital account

When capital account for each partner is so maintained that in addition to the capital amount other items related to capital account such as interest on capital, drawings, net profit or net loss etc. are written in this account. It is termed as fluctuating capital. In this case there is no need to maintain a separate account for recording of these adjustments.

In the absence of any information, the capital account should be prepared by this method. The format of the fluctuating capital account is as follows:

Partners' Capital Account

Dr. Cr.

Date	Particulars	JF	Amount (Rs.)	Date	Particulars	JF	Amount (Rs.)
	Balance b/d (in case of Debit opening balance)		xxx		Balance b/d (in case of Credit opening balance)		xxx
	Drawings		xxx		Bank (Additional Capital introduced) A/c		xxx
	Interest on Drawings		xxx		Salaries A/c		xxx
	Profit and Loss Appropriation (for share of loss)		xxx		Profit and Loss Appropriation (for share of profit)		xxx
	Balance c/d (in case of credit closing balance)		xxx		Balance c/d (in case of debit closing balance)		xxx

Illustration 1

Rohan and Monika are partners in a firm. Following information is provided as on 31 December, 2006:

	Rohan (Rs.)	Monika (Rs.)
Capital (as on 1.01.2006)	40,000	30,000
Drawings	3,000	2,000
Interest on Capital	2,000	1,500
Interest on Drawings	360	180
Share of Profit	5,000	4,000

Prepare capital account of each partner if capital is :

(a) fixed, (b) fluctuating.

Solution:

(A) Fixed capital account

Capital Account

Dr. Cr.

Date	Particulars	JF	Rohan (Rs.)	Monika (Rs.)	Date	Particulars	JF	Rohan (Rs.)	Monika (Rs.)
	Balance c/d		40,000	30,000		Balance b/d		40,000	30,000
								40,000	30,000

Current Account

Dr. Cr.

Date	Particulars	JF	Rohan (Rs.)	Monika (Rs.)	Date	Particulars	JF	Rohan (Rs.)	Monika (Rs.)
	Drawings		3,000	2,000		Interest on capital		2,000	1,500
	Interest on drawings		360	180		Profit and Loss (Appropriation A/c)		5,000	4,000
	Balance c/d		3,640	3,320					
			7,000	5,500				7,000	5,500
						Balance b/d		3,640	3.320

(b) Fluctuating capital Account

Capital Account

Dr. Cr.

Date	Particulars	JF	Rohan (Rs.)	Monika (Rs.)	Date	Particulars	JF	Rohan (Rs.)	Monika (Rs.)
	Drawings		3,000	2,000		Balance b/d		40,000	30,000
	Interest on drawings		360	180		Interest on capital		2,000	1,500
	Balance c/d		43,640	33,320		Profit & Loss (Appropriation A/c)		5,000	4,000
			47,000	35,500				47,000	35,500
						Balance b/d		43,640	33,320

Distinction between Fixed and Fluctuating Capital Accounts

The main points of difference between the Fixed and Fluctuating capital accounts are as under:

Table 17.1 Difference between fixed capital and fluctuating capital accounts

S. No.	Basis of Distinction	Fixed Capital Account	Fluctuating Capital Account
1.	Number of accounts	Two separate accounts are kept for each partner i.e. 'capital account' and 'current account'.	Only one account for each partner is kept i.e. capital account.
2.	Adjustments	All adjustments are recorded in the current account and not in the capital account.	Adjustments are recorded directly in the capital accounts, as no current account is opened.
3.	Fixed balance	The capital account balance, normally remains, unchanged except under special circumstances.	The balance of the capital account fluctuates from period to period.
4.	Balance	Capital accounts always show a credit balance only.	The capital account can show a debit balance or a credit balance at the end of the period.

INTEXT QUESTION 18.2

Fill in the blanks with suitable word/words :

(i) Fixed Capital account always show ..... balance only.

(ii) A ..... capital account may show a debit or a credit balance.

(iii) Two separate accounts are kept for each partner, if capital is .....

(iv) Interest on capital is shown on the ..... side of the current account.

(v) Interest on drawings is shown on the ..... side of the current account.

18.3 ACCOUNTING TREATMENT OF INTEREST ON CAPITAL AND INTEREST ON DRAWINGS

Interest on capital

Let us now study about calculation of interest on capital. As you know that, interest on capital is allowed when it is provided in the Partnership Deed.

If it is so provided, the rate of interest will be as agreed upon by the partners. Interest is charged on the opening balance of the partner's capital account. When additional capital is introduced and some capital is withdrawn permanently, the interest will be calculated on the amount of the capital used in the business during a particular period. Interest is treated as an expense as it is a charge on the profits of the firm. The following journal entry will be made:

For Interest on Capital

Interest on Capital A/c Dr.

To Partner's Capital A/c (Individually)

(Crediting Interest on Capital to Capital Account)

Interest can be calculated directly i.e. simple interest is to be calculated by taking the principal amount, period and rate of interest. Alternately interest can be calculated by product method i.e. by converting the principal amount into monthly products depending upon number of months for which principal amount remained in business. Then the interest is calculated by taking monthly rate of interest. The following example will illustrate both the methods of calculating interest on capital.

Illustration 2

Shilpa and Sanju are partners with a capital of Rs.1,00,000 and Rs.1,60,000 on January 1,2006 respectively. Shilpa introduced additional capital of Rs.30,000 on July 1, 2006 and another Rs.20,000 on October 31,2006. Calculate interest on capital for the year ending 2006. The rate of interest is 9% p.a.

Solution:

Interest on Capital (Shilpa):

On Rs.1,00,000 for 12 month @ 9%	= 1,00,000 × 9/100 × 12/12
	= Rs. 9,000
On Rs.30,000 for 6 month @ 9%	= 30,000 × 9/100 × 6/12
	= Rs. 1,350
On Rs.20,000 for 2 month @ 9%	= 20,000 × 9/100 × 2/12
	= Rs.300
Total interest on shilpa capital	= Rs. 9,000 + Rs. 1350 + Rs. 300
	= Rs.10,650

By product method

Amount Rs	Months	Product
100000	12	1200000
30000	6	180000
20000	2	40000
Total product		1420000

Interest on capital $1420000 \times \frac{9}{100} \times \frac{1}{12}$

= Rs 10650

Interest on Capital (Sanju):

On Rs.1,60,000 for 12 month @ 9% = 1,60,000 × 9/100 × 12/12

= Rs.14,400

By product method : = 1,60,000 × 12 = 19,20,000

$= \frac{19,20,000 \times 9}{1200}$ = Rs 14,400

INTEREST ON DRAWINGS

When a partner withdraws cash from the firm for domestic use, the withdrawal of cash is termed as drawings. If the partnership deed has a provision of charging interest on drawings, the firm may charge interest on drawings from partners. Interest on drawing is a gain for the firm. It is calculated at the agreed rate. The amount of interest on drawings will be credited to Profit and Loss Appropriation Account and will be debited to partner's capital account/current account (Individually). The journal entry will be:

Partners Capital/Current A/c Dr.

To Interest on Drawings A/c

(Charging interest on drawings to Partner's Capital account)

Calculation of interest on Drawings :

There are two methods of calculating interest on drawings

- Simple Average method
- Product method

1. Simple Average method

A fixed amount may be withdrawn every month/ half yearly/ annually. The interest has to be calculated for the period for which the amount has been utilised for personal purposes by the partners. The calculation of amount of interest to be charged in different situations is shown as under :

I. When Fixed amounts are withdrawn at equal time intervals.

A fixed amount is withdrawn by the partners, at equal time interval, say each month or each quarter. The calculation of total time period, in such situations will depend upon whether the money was withdrawn at the beginning of the month, middle of the month or at the end of the month.

For example, Manisha withdrew Rs. 1,000 per month from the firm for her personal use during the year ending December 31, 2006. interest is charged at the rate of 12% per annum. The calculation of average period and the interest on drawings in different situations would be as follows:

(a) When money is withdrawn at the beginning of the period.

Date of drawings	Amount withdrawn	Period (in Month)
1 January 2006	1,000	12
1 February 2006	1,000	11
1 March 2006	1,000	10
1 April 2006	1,000	9
1 May 2006	1,000	8
1 June 2006	1,000	7
1 July 2006	1,000	6
1 August 2006	1,000	5
1September 2006	1,000	4
1 October 2006	1,000	3
1 November 2006	1,000	2
1 December 2006	1,000	1
	12,000	78 months

When money is withdrawn in the beginning of the month, the average period is calculated as under:

Average Period = Total of months/12

= 78months/12

= 6½ months

Interest on Drawings = Rs.

= Rs.780

(b) When money is withdrawn at the end of the period

Date of drawings	Amount withdrawn	Period (in Month)
31 January 2006	1,000	11
28/29 February 2006	1,000	10
31 March 2006	1,000	9
30April 2006	1,000	8
31 May 2006	1,000	$12{,}000 \times \frac{12}{100} \times \frac{13}{2} \times \frac{1}{12}$
30 June 2006	1,000	6
31July 2006	1,000	5
31 August 2006	1,000	4
30 September 2006	1,000	3
31 October 2006	1,000	2
30 November 2006	1,000	1
31December 2006	1,000	0
	12,000	66 months

When money is withdrawn at the end of the month, the average period is calculated as under:

Average Period = Total of months/12

= 66 months/12

= 5 ½ months

Interest on Drawings = Rs.12,000 × 12/100 × 11/2 × 1/12

= Rs.660

(c) When money is withdrawn in the middle of the month:

Date of drawings	Amount withdrawn	Period (in Month)
15 January 2006	1,000	11.5
14 February 2006	1,000	10.5
15 March 2006	1,000	9.5
15 April 2006	1,000	8.5
15 May 2006	1,000	7.5
15 June 2006	1,000	6.5
15 July 2006	1,000	5.5
15 August 2006	1,000	4.5
15 September 2006	1,000	3.5
15 October 2006	1,000	2.5
15 November 2006	1,000	1.5
15 December 2006	1,000	0.5
	12,000	72 months

When money is withdrawn in the middle of the month, the average period is calculated as under:

Average Period = Total of months/12

= 72 months/12

= 6 months

Interest on Drawings = Rs.12,000 × 12/100 × 6/12

= Rs.720

(d) withdrawal of Fixed amounts at equal time intervals

If the money is withdrawn by the partners in the beginning of each quarter, the interest is calculated on total money withdrawn during the year for an average period of seven and half months.

Illustration 3

Sunny and Himanshu are partners in a firms sharing profits and losses equally. During financial year 2006, Sunny withdrew Rs. 20,000 quarterly at the beginning of each quarter. If interest is to be charged on drawings @ 8% per annum, calculate the amount of interest to be charged at the end of the year.

Solution.

Statement showing calculation of interest on Drawings

Date	Amount (Rs.)	Time Period	Interest (Rs.)
Jan. 1, 2006	20,000	12 months	$20{,}000 \times \frac{8}{100} \times$ = Rs. 1,600
April 1, 2006	20,000	9 months	$20{,}000 \times$ = Rs. 1,200
July 1, 2006	20,000	6 months	$20{,}000 \times \frac{6}{12} \times \frac{8}{100}$ = Rs. 800
Oct. 1, 2006	20,000	3 months	$20{,}000 \times \frac{3}{12} \times \frac{8}{100}$ = Rs. 400
Total	80,000		= Rs. 4,000

Alternatively, the interest can be calculated on the total sum withdrawn during the accounting year, which is Rs. 80,000 in this case, for a period of 7½ months (12 + 9 + 6 + 3)/4 = $7\frac{1}{2} = \frac{15}{2}$

Thus Interest on Drawings = Total sum withdrawn × Rate × $7\frac{1}{2} \times \frac{1}{12}$

$$= \text{Rs. } 80{,}000 \times \frac{8}{100} \times \frac{15}{2} \times \frac{1}{12} = \text{Rs. } 4{,}000.$$

(e) When fixed amount is withdrawn at the end of each quarter

When the amounts are withdrawn at the end of each quarter the amount of interest is calculated on total drawings for a period of four and a half months.

In the previous illustration, if the money is withdrawn at the end of each quarter, the average period for calculation of interest will be taken as four and half months. The calculation of interest can be shown as follows:

Statement of Calculation of Interest on Drawings

Date	Amount (Rs.)	Time Period	Interest (Rs.)
March. 31	20,000	9 months	$20{,}000 \times \frac{8}{100} \times 9/12$ = Rs. 1,200
June 30	20,000	6 months	$20{,}000 \times$ = Rs. 800
September 30	20,000	3 months	$20{,}000 \times \frac{3}{12} \times \frac{8}{100}$ = Rs. 400
December 31	20,000	0 months	Rs 0
Total	**80,000**	**18 months**	**= Rs. 2,400**

Alternatively, the interest on Rs. 80,000 $\frac{6}{12} \times \frac{8}{100}$ for a period 4½ months

$$(9 + 6 + 3 + 0)/4 = 4\frac{1}{2} = \frac{9}{2}$$

Interest on Drawings = Rs. 80,000 × $\frac{8}{100} \times \frac{9}{2} \times \frac{1}{12}$ = Rs. 2,400

Product Method

When different amounts are withdrawn at different intervals.

Under the product method, for each withdrawal, the money withdrawn is multiplied by the period for which it remained withdrawn during the financial year. The period is calculated from the date of the withdrawal to the last day of the accounting year. The products so calculated are totalled and interest for 1 month at the specified rate is found out on the total of the products. The calculation of interest can be explained with the help of the preceding illustration.

Statement showing calculation of interest on Drawings

Date	Amount (Rs.)	Time Period	Product (Rs.)
Jan. 1, 2006	20,000	12 months	2,40,000
April 1, 2006	20,000	9 months	1,80,000
July 1, 2006	20,000	6 months	1,20,000
Oct. 1, 2006	20,000	3 months	60,000
Total	80,000		6,00,000

Interest on drawing = Total of Product x interest rate x1/12

= Rs.6,00,000 × 8/100 × 1/12

= Rs.4,000

INTEXT QUESTIONS 18.3

1. Fill in the blanks with appropriate word/words :
   (i) Interest on capital is ……. in partner's capital account.
   (ii) Interest on drawings is ……. in partner's capital account.
   (iii) Interest is charged on the ……. of the partner's capital account.
   (iv) When money is withdrawn in the beginning of the each month, the average period is ……. for charging interest.
   (v) When product method is used, interest is calculated for ……
2. Reema and Anish are partners with a capital of Rs 50,000 and Rs. 80,000 on April 2005, respectively. Reema introduced additional capital of Rs. 50,000 on 1st Jan 2006. Calculate interest on capital @10 p.a. on March 31, 2006.
3. Ashu withdrew Rs. 2000 p.m. from business for personal use at the end of every month during the year. Calculate interest on Drawing @10 p.a.

18.4 PROFIT AND LOSS APPROPRIATION ACCOUNT: MEANING AND PREPARATION

Profit and Loss Appropriation Account is merely an extension of the Profit and Loss Account of the firm. The profit of the firm has to be distributed

amongst the partners in their respective profit sharing ratio. But before its distribution it needs to be adjusted. All Adjustments like partner's salary, partner's commission, interest on capital, interest on drawings etc. are made in this account. These adjustments will reduce the amount of profit for distribution. This adjusted profit will be distributed amongst the partners in their profit sharing ratio. To prepare it at first the balance of Profit and Loss Account is transferred to this account. The journal entries for the preparation of Profit and Loss Appropriation Account are given below:

1. For transfer of the balance of Profit and Loss Account to Profit and Loss Appropriation Account.

   (a) In case of Net Profit:

   Profit and Loss A/c Dr.

   To Profit and Loss Appropriation A/c

   (Net Profit transferred to Profit and Loss Appropriation A/c)

   (b) In case of Net Loss:

   Profit and Loss Appropriation A/c Dr.

   To Profit and Loss A/c

   (Net Loss transferred to Profit and Loss Appropriation A/c)

2. For Interest on Capital

   For transfer of Interest on Capital :

   Profit and Loss Appropriation A/c Dr.

   To Interest on Capital A/c

   (Interest on capital transferred to Profit & Loss Appropriation A/c)

3. For Charging Interest on Drawings:

   For transferring Interest on Drawings:

   Interest on Drawings A/c Dr.

   To Profit and Loss Appropriation A/c

   (Interest on drawing transferred to Profit & Loss Appropriation A/c)

4. For Partner's Salary

   Profit and Loss Appropriation A/c Dr.

   To Salary A/c

   (Salary transferred to profit & Loss Appropriation A/c)

5. Partner's Commission

   For transferring commission

   Profit and Loss Appropriation A/c Dr.

   To Commission A/c

   (Commission transferred to Profit and Loss Appropriation A/c)

6. For Transfer of balance to General Reserve:

   Profit and Loss Appropriation A/c Dr.

   To General Reserve A/c

   (Transfer of balance to General Reserve)

7. For share of Profit or Loss on appropriation

   (a) If Profit:

   Profit and Loss Appropriation A/c Dr.

   To Partner's Capital/Current A/c

   (Profit transferred to capital/current A/c)

   (b) If Loss:

   Partner's Capital/ Current A/c Dr.

   To Profit and Loss Appropriation A/c

   (Loss transferred to capital/current A/c)

The format of Profit and Loss Appropriation Account is given as follows.

Profit and Loss Appropriation Account

Dr Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Profit and Loss A/c (if there is loss)	xxx	Profit and Loss A/c (if there is profit)	xxx
Interest on Partners' Capital's A/c	xxx	Interest on Drawings	xxx
Partners' Salary A/c	xxx	Partner's capital A/c (distribution of loss)	xxx
Partners' Commission A/c	xxx		
Interest on Partners' Loan A/c	xxx		
Partners' Capital A/c (distribution of profit)	xxx		
	xxx		**xxx**

Illustration 5

Monika and Krishan are partners with a capital of Rs.80,000 and Rs.1,00,000 respectively. They agree on the followings:

(a) To share profit equally.

(b) Interest allowed on capital @ 9% p.a.

(c) Interest charged on drawing @ 6% p.a.

(d) Salary to be paid to krishan @ 600 per month.

(e) Monika withdrew Rs.8,000 and Krishan Rs.6,000 during the year.

Interest on drawing is charged for Profit for the year ending December 31, 2006 is Rs.56,000. You are required to prepare Profit and Loss Appropriation account.

Solution

Working notes:

First you should calculate the interest on capital and the interest on drawings.

Interest on Capital

Monika	=	Rs. 80,000 × 9/100
	=	Rs.7,200
Krishan	=	Rs. 1,00,000 × 9/100
	=	Rs.9,000

Interest on Drawings

Monika Drawings	=	Rs.8,000
Interest	=	Rs.8,000 × 6/100
	=	Rs.480
Krishan Drawings	=	Rs.6,000
Interest	=	Rs.6,000 × 6/100
	=	Rs.360

Profit and Loss Appropriation Account

Dr. Cr.

Particulars		Amount (Rs.)	Particulars		Amount (Rs.)
Interest on Capital's A/c			Profit and Loss		56,000
Monika	7,200		Interest on Drawings		
Krishan	9,000	16,200	Monika	480	
Krishan Salary		7,200	Krishan	360	840
Profit transferred to Partners' Capital A/c					
Monika	16,720				
Krishan	16,720	33,440			
		56,840			**56,840**

INTEXT QUESTIONS 18.4

(i) List the items which usually appear on the debit side of Profit and loss appropriation account.

(ii) If, balance of profit and loss account is debit, what entry to be recorded for transferring the amount to Profit and Loss Appropriation account?

(iii) When interest on drawings is to be transferred to Profit and Loss Appropriation account, What journal entry is to be recorded in the books?

WHAT YOU HAVE LEARNT

- Characteristics of partnership are:

  (i) Agreement (ii) Number of persons

  (iii) Business (iv) Sharing of Profits

  (v) Unlimited liability (vi) Management

  (vii) Mutual Agency (viii) Transfer of interest

- **Partnership deed**

  The written form of the agreement is a document in which the terms and conditions regarding the conduct of the business and the relationship between the partners are laid down. If there is no partnership deed or it is silent on certain issues, the Partnership Act becomes applicable. These issues are:

  (i) Distribution of Profit (ii) Interest on capital .

  (iii) Interest on drawings (iv) Interest on partner's loan

  (v) Salary and commission to partners

- **Capital account**

  The contribution made by the partner's in a business is called capital. This capital may be fixed or fluctuating.

  (a) Fixed Capital Account- Two separate accounts are kept for each partner i.e. 'capital account' and 'current account'.

  (b) Fluctuating Capital Account – Only one account for each partner is kept i.e. capital account,

- **Profit and Loss Appropriation Account**

  All adjustments such as partner's salary, partner's commission, interest on capital, interest on drawings etc. are made through this account.

TERMINAL QUESTIONS

1. Explain the characteristics of a partnership.
2. In absence of any partnership deed, what is the partnership Act that are the provisions that become applicable?
3. Distinguish between fixed and fluctuating capital accounts.
4. Why the Profit and Loss Appropriation is prepared?
5. A and B are partners in a firm. On January 1, 2006 their capital is Rs.3,00,000 and Rs.2,00,000 respectively. Their drawings during the year were Rs.3,000 per month each. They allowed 6% interest on capital. The profit for the year Rs.4,00,000. Calculate interest on capital when capital are fixed.
7. X and Y are equal partners. They withdrew Rs.4,000 each per month. Calculate interest 4% p.a. on drawing in the following cases:

(i) if they withdrew in the beginning of each month:

(ii) if they withdrew at the end of each month:

(iii) if they withdrew in the middle of each month:

8. Naman and Asmeta started business with capital of 1,00,000 each on January 1,2006. their drawings during the year were Rs.1,000 and Rs.500 per month respectively. The interest on drawing was Rs.200 and Rs.100 respectively. They are allowed interest on capital at 8% p.a. Naman is allowed a salary of Rs.2,000 per month. They earned a profit of Rs.94,000 before interest and salary. They share profit is the ratio of 2.1.

   Prepare Profit and Loss Appropriation Account and Capital accounts of partners.

9. Rohan and Bhanu were partners in a firm and their balances on March 1, 2006 are as under:

	Rohan (Rs.)	Bhanu (Rs.)
Capital accounts	90,000	1,20,000
Current account	8,000 (Cr)	4,000 (Dr.)
Drawings	5,000	6,000

   Net profit before charging interest on capital and partners salary was Rs.25,600. They agree on the following:

   (i) Profit and losses to be shared equally.

   (ii) 6% interest is to be allowed on capital.

   (ii) Bhanu will be paid a monthly salary Rs. 9,00.

   Prepare Profit and Loss Appropriation Account and partners capital accounts.

10. The partnership agreement of M and R provides that:

   (i) Profit will be shared is the ratio of 3 : 2.

   (ii) M will be allowed a salary of Rs.500 p.m.

   (iii) 8% interest will be allowed on partner's fixed capital accounts.

   (iv) 6 % interest to be charged on partners drawings.

   (v) The fixed capital of M and R is Rs.2,00,000 and Rs.1,50,000 respectively. Their drawings were Rs.10,000 and Rs.12,000 respectively. The net profit for the year ending December 2006 amounted to Rs.62,000.

   Prepare Profit and Loss Appropriation Account.

ANSWERS TO INTEXT QUESTIONS

Intext Questions 18.1

I. (i) Two (ii) agreement (iii) written, oral

(iv) partnership deed (v) unlimited

II. (i) No (ii) Yes (iii) No

(iv) No (v) No

Intext Questions 18.2

(i) Credit (ii) Current (iii) fixed

(iv) Credit (v) Debit

Intext Questions 18.3

1. (i) credited (ii) Debited (iii) pening balance

(iv) 6½ months (v) month

2. Interest on capital Reema Rs 6250 and Anish Rs 8,000

3. Interest on Rs. 1100 drawing

Intext Questions 18.4

(i) Partner's salary, partner's commission, interest on capital, interest on partners loan

(ii) Profit and Loss Appropriation A/c Dr.

To Profit and Loss A/c

(iii) Interest on Drawings A/c Dr.

To Profit and Loss Appropriation A/c

Answers to Practical Terminal Questions

5. Interest on Capital to 'A' Rs.18,000 and 'B' Rs.12,000.

6. (i) Rs.1,040, (ii) Rs.880, (iii) Rs.960.

7. Profit distributed to Naman Rs.36,200 and Asmeta Rs.18,100

Balance in Capital A/c Naman Rs.1,56,00 and Asmeta Rs.1,20,000.

8. Profit distributed to Rohan Rs.1,100 and Bhanu Rs.1,100

Balance in current A/c Rohan Rs.9,500 and Asmeta Rs.9,100.

9. Profit distributed to M Rs.17,592 and R Rs.11,728

***Activity* :** Make use of your communication skills to obtain Partnership Deed of five firms. Go through partnership deed of such firms. Identify the provisions which are not common. Also find out the important items that you would like to include in one of the partnership deeds.

Name of the firm	Items that are exclusive to the firm	Items to be included
1.		
2.		
3.		
4.		
5.		

List of the item you suggest to included in ırtnership deeds

1. .....
2. .....
3. .....
4. .....
5. .....

Do you know?

Can a person get AIDS from a dentist?

Again, there is some risk of getting HIV from a dentist's instruments as these are frequently contaminated with blood. However, if you visit a good and reputable dentist who uses properly sterilized or disposable instruments, the risk is minimal. So always choose a dentist who follows high levels of hygiene and sterilization.

19

ADMISSION OF A PARTNER

Kapil and Krish are running a partnership firm dealing in toys. They are one of the most successful businessmen in the locality. They now decide to start manufacturing toys that are electronically operated to diversify their busmess. For this they need more capital and also technical expertise. Mohit; their friend is an electronic engineer and has capital also. They have persuaded him to join their firm. In case, he joins the partnership firm, this will be a case of admission of a partner. As a result, he may need to bring in capital and share of goodwill. In this lesson, you will learn about goodwill and other ajustments at the time of admission of a partner. Mohit will bring in capital and share of goodwill. Some changes in the value of some assets and liabilities of the existing firm are need to bring them at their realistic value, on his admission. There may be other issues involing finance on his admission. All this need accounting treatment. In this lesson you will learn accounting treatment and adjustments to be made on the admission of a partner.

OBJECTIVES

After studying this lesson, you will be able to :

- state the meaning of admission of a partner;
- calculate new profit sharing ratio and sacrificing ratio;
- state the meaning and factors affecting goodwill;
- explain the methods of valuation of goodwill;
- describe accounting treatment of goodwill;
- explain the need for revaluation of assets and reassessment of liabilities;

- illustrate the accounting treatment of changes arising from revaluation of assets and reassessment of liabilities;
- describe accounting treatment of undistributed profits and reserves;
- explain the treatment of various adjustments in partners' capitals ;
- prepare Revaluation Account, Partners' Capital Accounts and balance sheet of the reconstituted firm.

19.1 ADMISSION OF A PARTNER

Meaning, New Profit Sharing Ratio and Sacrificing Ratio

Meaning

An existing partnership firm may take up expansion/diversification of the business. In that case it may need managerial help or additional capital. An option before the partnership firm is to admit partner/partners, when a partner is admitted to the existing partnership firm, it is called admission of a partner.

> According to the Partnership Act 1932, a person can be admitted into partnership only with the consent of all the existing partners unless otherwise agreed upon.

On admission of a new partner, the partnership firm is reconstituted with a new agreement. For example, Rekha and Nitesh are partners sharing profit in the ratio of 5:3. On April 1, 2006 they admitted Nitu as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Nitu as partner, the firm stands reconstituted.

On the admission of a new partner, the following adjustments become necessary:

(i) Adjustment in profit sharing ratio;

(ii) Adjustment of Goodwill;

(iii) Adjustment for revaluation of assets and reassessment of liabilities;

(iv) Distribution of accumulated profits and reserves; and

(v) Adjustment of partners' capitals.

Adjustment in Profit sharing Ratio

When a new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The

incoming partner acquires his/her share of future profits either incoming from one or more existing partner. The existing partners sacrifice a share of their profit in the favour of new partner, hence the calculation of new profit sharing ratio becomes necessary.

Sacrificing Ratio

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by the new partner to the existing partner for acquiring the share of profit which they have surrendered in the favour of the new partner.

Sacrificing Ratio is calculated as follows:

Sacrificing Ratio = Existing Ratio – New Ratio

Following cases may arise for the calculation of new profit sharing ratio and sacrificing ratio:

(i) Only the new partner's share is given

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

Illustration 1

Deepak and Vivek are partners sharing profit in the ratio of 3 : 2. They admit Ashu as a new partner for 1/5 share in profit. Calculate the new profit sharing ratio and sacrificing ratio.

Solution:

Calculation of new profit sharing ratio:

Let total Profit = 1

New partner's share = 1/5

Remaining share = 1 – 1/5 = 4/5

Deepak's new share = 3/5 of 4/5 i.e. 12/25

Vivek's new share = 2/5 of 4/5 i.e. 8/25

Ashu's Share = 1/5

The new profit sharing ratio of Deepak, Vivek and Ashu is :

= 12/25 : 8/25 : 1/5 = 12 : 8 : 5/25 = 12 : 8 : 5

So Deepak Sacrificed = 3/5 – 12/25 = 15 – 12/25 = 3/25

Vivek Sacrificed = 2/5 – 8/25 = 10 – 8/25 = 2/25

Sacrificing Ratio = 3 : 2

Sacrificing ratio of the existing partners is same as their existing ratio.

(ii) The new partner purchases his/her share of the profit from the Existing partner in a particular ratio.

In this case : the new profit sharing ratio of the existing partners is to be ascertained after deducting the sacrifice agreed from his share. It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Illustration 2

Neha and Parteek are partners, sharing profit in the ratio of 5 : 3. They admit Nisha as a new partner for 1/6 share in profit. She acquires this share as 1/8 from Neha and 1/24 share from Parteek. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

Neha's and Parteek existing ratio is 5 : 3

Neha's new share = 5/8-1/8 = 4/8 or 12/24

Parteek's new share = 3/8-1/24 = 8/24

Nisha's share = 1/8+1/24 =4/24

The new profit sharing ratio of Neha, Parteek and Nisha is

12/24 : 8/24 : 4/24

= 12 : 8 : 4 = 3 : 2 : 1

(ii) Sacrifice ratio = 1/8 : 1/24 or 3 : 1

(iii) Existing partners surrender a particular portion of their share in favour of a new partner.

In this case, sacrificied share of the each partner is to be ascertained. This ascertained by multiplying the existing partner share in the ratio of their

sacrifice. The share sacrificed by the existing partners should be deducted from his existing share. Therefore, the new share of the existing partners is determined. The share of the incoming partner is the sum of sacrifice by the existing partners.

Illustration 3

Him and Raj shared profits in the ratio of 5:3. Jolly was admitted as a partner. Him surrendered 1/5 of his share and Raj 1/3 of his share in favour of Jolly. Calculate the new profit sharing ratio.

Solution :

Him surrenders 1/5 of his share, i.e., = 1/5 of 5/8 = 1/8

Raj surrenders 1/3 of his share, i.e., = 1/3 of 3/8 = 1/8

So, sacrificing ratio of Him and Raj is 1/8 : 1/8 or equal.

Him's new share = 5/8 – 1/8 = 4/8

and Raj's new share = 3/8 – 1/8 = 2/8

Jolly's New share = 1/8 + 1/8 = 2/8

New profit sharing ratio of Him's, Raj's and Jolly's is

= 4/8 : 2/8 : 2/8 or 4 : 2 : 2 or 2 : 1 : 1.

INTEXT QUESTIONS 19.1

I. Fill in the blanks with appropriate word/words :

(i) Sacrificing ratio is calculated by deducting ..... share of profit from ..... share of profit of the existing partners.

(ii) On admission of a new partner, the partnership firm is .....

(iii) The ratio in which partners surrender their profits is known as .....

(iv) The new ratio of existing partners is calculated by dividing remaining share of the profit in their .....

II. If Tarun and Nisha are partners sharing profits in the ratio of 5:3. What will be their sacrificing ratio if Rahul is admitted for 1/8 share of profit in the firm?

19.2 GOODWILL : MEANING, FACTORS AFFECTING GOODWILL AND VALUATION

Meaning of Goodwill

Over a period of time, a business firm develops a good name and reputation among the customers. This help the business earn some extra profits as compared to a newly set up business. In accounting capitalised value of this extra profit is known as goodwill. For example, your firm earns say Rs 1200 and the normal profit was expected from your firm Rs 700. The rate of return is @ 10%. In this case goodwill is ascertained as under :

Step 1 : Excess profit = Actual profit – Desired normal profit
1200 – 700 = 500

Step 2 : Goodwill $= 500 \times \frac{100}{10}$ = Rs 5000

In other words, goodwill is the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit. It may also be defined as the present value of the capacity to earn future profits. This means that a firm can be said to have goodwill only if it has capacity to earn profit in future. A firm earning only normal profits like similar firms cannot claim to have any goodwill.

Factors affecting the Goodwill

The factors affecting goodwill are as follows:

1. **Location :** If the firm is located at a central place, resulting in good sale, the goodwill tends to be high.
2. **Nature of Business :** A firm that produces high value products or having a stable demand is able to earn more profits and therefore has more goodwill.
3. **Efficient management :** A well managed firm earns higher profit and so the value of goodwill will also be high.
4. **Quality :** If a firm is known for the quality of its products the value of goodwill will be high.
5. **Market Situation :** The monopoly condition to earn high profits which leads to higher value of goodwill.
6. **Special Advantages :** The firm has special advantages like importing licenses, long term contracts for supply of material, patents, trademarks, etc. enjoy higher value of goodwill.

Methods of valuation of Goodwill

The methods of valuation of goodwill are generally decided by the partners among themselves while preparing partnership deed. The following are the important methods of valuing the goodwill of a firm :

(i) Average Profit Method

(ii) Super Profit Method

(iii) Capitalisation Method

Let us learn about these methods.

1. **Simple Average Profit Method :** Under this method, average of the profits of certain given years is calculated. The value of the goodwill is calculated at an agreed number of years purchase of the average profit. Thus the goodwill is calculated as follows :

   Value of goodwill = Average Profit × Number of year of purchase

   For example, the average profits of a firm of say 3 years and the goodwill is to be calculated at 2 years purchase of the average profits works out at Rs.25,000 and it is assumed that the same profits will be the value of the goodwill will be Rs.50,000[Rs.25,000 × 2]. Thus the goodwill is calculated as goodwill = average profits × Number of years purchase.

Illustration : 4

The profit for the last five years of a firm were as follows Year 2001 Rs. 1,20,000: Year 2002 Rs.1,50,000: Year 2003 Rs.1,70,000: Year 2004 Rs.1,90,000: Year 2005 Rs.2,00,000. Calculate goodwill of the firm on the basis of 3 years purchases of 5 years average profits.

Solution :

Year	Profit (Rs.)
2001	1,20,000
2002	1,50,000
2003	1,70,000
2004	1,90,000
2005	2,00,000
Total	**8,30,000**

Average Profit = Total Profit/No. of Years

= Rs.8,30,000/5 = Rs.1,66,000

Goodwill = Average Profits × No. of years purchased

= Rs.1,66,000 × 3 = Rs.4,98,000

2. **Super Profit Method** : Super profits is the excess of actual profit over the normal profits. If a new business earns certain percentage of the capital employed, it is called 'normal profit'. The value of the goodwill is calculated at an agreed number of years purchase is multiplied by the Super profit. Normal profit is that profit which is, earned by other business unit of the same business. Normal profit will be calculated as follows:

Normal profit = Capital employed × normal rate of return/100

Actual Profit : These are the profit earned during the year or it is also taken as the average of the last few years profit.

Super Profit = Actual Profit – Normal Profit

For example, A firm earns profit of Rs.65,000 on a capital of Rs.4,80,000 and the normal rate of return in similar business is 10%. Then the normal profit is Rs.48,000[10% of the Rs.4,80,000]. The actual profit is Rs.65,000. Thus,

Super profit = Actual profit – Normal profit

= Rs.65,000 – Rs.48,000

= Rs.17,000

If value of Goodwill is calculated by 3 years' purchase of super profit then goodwill is equal to Rs.51,000[Rs.17,000 × 3].

(b) **Weighted average method :** This method is a modified version of average profit method. In this method each year profit is assigned a weight i.e. 1, 2, 3, 4 etc. Thereafter each year profit is multiplied by the weight and find product. The total of products is divided by the total of weight. As a result we find the weighted average profit. After this the value of goodwill is calculated to multiplied the weight average profit into the agreed number of year's purchase. Thus the goodwills calculated as follows

$$\text{Weighted average profit} = \frac{\text{Total product of profit}}{\text{Total of weights}}$$

Value of goodwill = Weighted average profit × number of year of purchase

(Note : This method is used when we observe that there is a tendency to increase the annual profits. Latest year profit is assigned the highest weight.

Illustration : 5

The profit of firm for past years were as follow :

	Profit Rs.
2002	80,000
2003	85,000
2004	90,000
2005	1,00,000
2006	1,10,000

The weight to be used are 1, 2, 3, 4, and 5 for the years from 2002- 2006.

Calculate the value of goodwill on the basis of two year's purchase of weighted average profit.

Solution

Year	Profit	Weight	Products
2002	80,000	1	80,000
2003	85,000	2	170000
2004	90,000	3	270000
2005	1,00,000	4	400000
2006	1,10,000	5	550000
		15	1470000

$$\text{Weighted Average Profit} = \frac{14,70,000}{15} = \text{Rs } 98,000$$

Goodwill = Rs 98000 × 2 = Rs 1,96,000

Illustration : 6

A firm earned the following net profits during the last 4 years

	Rs.
2003	90,000
2004	1,20,000
2005	1,60,000
2006	1,80,000

Capital employed in the firm is Rs.10,00,000. The normal rate of profit is 10%. Calculate the value of the goodwill on the basis of 4 year purchase.

Solution:

Total profit of 4 years = Rs. 90,000 + Rs. 1,20,000 + Rs. 1,60,000 + Rs. 1,80,000

= Rs.5,50,000

Average annual profit = Rs.5,50,000/4

= Rs.1,37,500

Normal Profit = Rs.10% of Rs.10,00,000 = Rs.10,00,000 × 10/ 100

= Rs.1,00,000

Super profit = Rs. 1,37,500 – Rs. 1,00,000

= Rs.37,500

Value of goodwill at 4 years' of purchase = Rs. 37,500 × 4 = Rs. 1,50,000

3. **Capitalisation Method :** In this method, goodwill is the amount of capital saved. Normally businessmen invest capital to operate business activities, and earn profit with the efficient utilisation of capital. If the business earns more profit by investing lesser amount of capital as compared to other business, who earned same amount of profit with more amount of capital, the saved amount is assumed to be goodwill.

   Under this method, the Goodwill is calculated in two ways:

   1. Capitalisation of Average profit
   2. Capitalisation of Super profit

1. Capitalisation of Average profit

In this method, the value of goodwill is assumed to be excess of the capital value of average profit over the actual capital employed.

Following formula is applied for Calculation of capital employed:

Capital employed = Total assets – outsider liabilities
Following formula is applied for calculation of capitalised value of profit:
Capitalised value of profit = Average Profit × 100/ Normal rate of profit
Goodwill = Capitalised value of profits – Capital cimployed

Illustration : 7

A firm earned average profit during the last few years is Rs.40,000 and the normal rate of return in similar business is 10%. The total assets is Rs.3,60,000 and outside liabilities is Rs.50,000. Calculate the value of goodwill with the help of Capitalisation of Average profit method.

Solution:

Capital employed = Total assets - Outside liabilities

= Rs.3,60,000 - Rs.50,000

= Rs.3,10,000

Capitalised value of average profit = Average Profit × 100/ Normal rate of profit

= Rs. 40,000 × 100/10

= Rs. 4,00,000

Goodwill = Capitalised value – Capital employed

= Rs. 4,00,000 – Rs. 3,10,000

= Rs. 90,000

Illustration : 8

The capital invested in a firm is Rs.4,60,000 and the rate of return in the similar business is 12%. The firm earns the following profit in the last 4 years:

2003	Rs. 60,000	2005	Rs. 80,000
2004	Rs. 70,000	2006	Rs. 90,000

Calculate the value of goodwill by Capitalisation method.

Solution

Total Profit = Rs.60,000 + Rs.70,000 + Rs.80,000 + Rs.90,000/4

Average Profit = Rs.3,00,000/4

= Rs.75,000

Capitalised Value = Average profit × 100/12

= Rs.75,000x100/12

= Rs.6,25,000

Goodwill = Capitalised value – Capital employed

= Rs.6,25,000 – Rs.4,60,000

= Rs.1,65,000

2. Capitalisation of Super profit

In this method, the value of goodwill is calculated on the basis of super profit method. Following formula is applied for Calculation of capital employed:

Goodwill = Super profit × 100/normal rate of profit

Illustration : 9

A firm earns a profit of Rs.26,000 and has invested capital amounting to Rs.2,20,000. In the same business normal rate of earning profit is 10%. Calculate the value of goodwill with the help of Capitalisation of super profit method.

Solution

Actual profit = Rs. 26,000

Normal profit = Rs. 2,20,000 x 10/ 100 = Rs.22,000

Super Profit = Actual Profit – Normal Profit

= Rs. 26,000 – Rs.22,000

= Rs. 4,000

Goodwill = Super profit × 100/normal rate of profit

= Rs. 4,000 × 100/10

= Rs. 40,000

INTEXT QUESTIONS 19.2

I. Fill in the blanks with appropriate word/words :

(i) Goodwill is an ..... asset.

(ii) The amount of goodwill is generally brought in by ..... Partner.

(iii) Super Profit = Actual Profit – .....

(iv) The methods of calculating goodwill are ..... and .....

(v) Capital employed = Total assets minus .....

II. (a) From the following information, Calculate average profit : year

Year	Profit (Rs)	Loss (Rs)
2001	80,000	
2002	90,000	
2003	—	30,000
2004	1,10,000	

Average Profit = Rs.

(b) Calculate value of goodwill at two year's purchase of average profit, ascertained in 2(a) above.

19.5 TREATMENT OF GOODWILL

The new partner acquires his/her share profit from the existing partners. This will result in the reduction of the share of existing partners. Therefore, he/she compensates the existing partners for the sacrifices. He/she compensates them by making payment in cash or in kind. The payment is equal to his/her share in the goodwill.

As per Accounting Standard 10(AS-10) that goodwill should be recorded in the books only when some consideration in money has been paid for it. Thus, if a new partner does not bring necessary cash for goodwill, no goodwill account can be raised in the books. He/she should pay for goodwill in addition to his/her contribution for capital.

If, he/she does not pay for goodwill, then amount equal to his/her share of goodwill will be deducted from the capital. The amount brought in by him/her as goodwill or amount of goodwill deducted from his/her capital and

divided between the existing partners in their sacrificing ratio. At the time of admission of a new partner any goodwill appearing in the books, will be written off in existing ratio among the existing partners.

There are different situations relating to treatment of goodwill at the time of admission of a new partner. These are discussed as under:

1. When the amount of goodwill is paid privately by the new partner.
2. When the new partner brings his/her share of goodwill in cash.
3. When the new partner does not bring his/her share of goodwill in cash.

1. The amount of goodwill is paid privately by the new partner

If the amount of goodwill is paid by the new partner to the existing partner privately, no journal entries are made in the books of the firm.

2. The new partner brings his/her share of goodwill in cash and the amount of goodwill is retained in the Business:

When, the new partner brings his/her share of goodwill in cash. The amount brought in by the new partner is transferred to the existing partner in the sacrificing ratio. If there is any goodwill account in the balance sheet of existing partner, it will be written off immediately in existing ratio among the partners. The journal entries are as follows:

(i) The existing goodwill in the books of the firm will be written off in existing profit ratio as;

Existing Partners Capital A/c Dr. [individually]

To Goodwill A/c

(Existing goodwill written off)

(ii) For bringing cash for Capital and goodwill

Cash/Bank A/c Dr.

To Goodwill A/c

To New partner's Capital A/c

(Cash brought in for capital and goodwill)

(iii) For amount of goodwill transferred to existing partner capital account:

Goodwill A/c Dr.

To Existing Partner's Capital/current A/c [individually]

(The amount of goodwill credited to existing partner's capitals in sacrificing ratio)

Illustration : 10

Tanaya and Sumit are partners in a firm sharing profit in the ratio 5 : 3. They admitted Gauri as a new partner for 1/4th share in the profit. Gauri brings Rs. 30,000 for her share of goodwill and Rs.1,20,000 for capital. Make journal entries in the books of the firm after the admission of Gauri. The new profit sharing ratio will be 2 : 1 : 1.

Solution :

Books of Tanaya, Sumit and Gauri

Date	Particulars	LF	Debit Amount (Rs)	Credit Amount (Rs)
1.	Bank A/c Dr.		1,50,000	
	To Goodwill A/c			30,000
	To Gauri's Capital A/c			1,20,000
	(cash brought by Gauri for her share of goodwill and capital)			
	Goodwill A/c Dr.			
	To Tanaya's Capital A/c		30,000	
	To Sumit's Capital A/c			15,000
	(Goodwill transferred to existing partners capital account in their profit sharing ratio)			15,000

Working Note:

Calculation of sacrificing ratio [existing ratio – new ratio]

Partners	Existing ratio	New ratio	Sacrifice	Sacrificing ratio
Tanaya	5/8	2/4	5/8 – 2/4 = 1/8	Tanaya : Sumit
Sumit	3/8	1/4	3/8 – 1/4 = 1/8	1 : 1

The amount of goodwill is withdrawn by the existing partners:

(iv) Existing Partners Capital/current A/c Dr. [individually]

To Cash/Bank A/c

(The amount of goodwill withdrawn by the existing partners)

It is to be noted that sometimes partner's withdraw only 50% or 25% amount of goodwill. In such a case, entry will be made for the withdrawn amount only.

I1lustration : l1

In previous illustration, it is assumed that the full amount of goodwill is withdrawn by the Tanaya and Sumit . Make journal entry in the books of the firm.

Solution:

Books of Tanaya, Sumit and Gauri

Date	Particulars		LF	Debit amount Rs	Credit amount Rs
	Tanaya's Capital A/c	Dr.		15,000	
	Sumit's Capital A/c	Dr.		15,000	
	To Bank A/c				30,000
	(Amount of Goodwill is withdrawn by them)				

3. New partner does not bring his/her share of goodwill in cash:

When the goodwill of the firm is calculated and the new partner is not able to bring his/her share of goodwill in cash, goodwill will be adjusted through new partner's capital accounts. In this case new partner's capital account is debited for his/her share of goodwill and the existing partner's capital accounts are credited in their sacrificing ratio. The journal entry is as under:

New Partner's Capital A/c Dr.

To Existing Partner's Capital A/c [individually in sacrificing ratio]

(New partner's share in goodwill credited to exisitng partner's in sacrificing ratio)

Goodwill appears in the books of the firm and new partner does not bring his/her share of goodwill in cash:

If the goodwill account appears in the books of the firm, and the new partner is not able to bring goodwill in cash. In this case, the amount of goodwill existing in the books is written off by debiting the capital account of existing partners in their existing profit sharing ratio.

Illustration 12

Ashmita and Sahil are partners sharing profit in the ratio of 3 : 2. They agree to admit Charu for 1/5 share in future profit. Charu brings Rs. 2,50,000 as capital and enable to bring her share of goodwill in cash, the goodwill of

the firm to be valued at Rs. 1,80,000. At the time of admission goodwill existed in the books of the firm at Rs.80,000. Make necessary journal entries in the books of the firm.

Solution:

Books of Ashmita, Sahil and Charu

Date	Particulars	LF	Debit amount Rs	Credit amoun Rs
	Bank A/c Dr.		2,50,000	
	To Charu's Capital A/c			2,50,000
	[Cash brought by Charu for her capital]			
	Ashmita's Capital A/c Dr.		48,000	
	Sahil's Capital A/c Dr.		32,000	
	To Goodwill A/c			80,000
	[Goodwill written off before Charu's admission]			
	Charu's Capital A/c Dr.		36,000	
	To Ashmita's Capital A/c			21,600
	To Sahil's Capital A/c			14,400
	[Existing partners capital a/c credited for goodwill on Charu's admission in sacrificing ratio]			

Working Note :

Ashmita and Sahil sacrifice their profit in favour of Charu in their existing profit sharing ratio i.e. 3 : 2. Therefore, the sacrificing ratio is 3 : 2.

Value of Goodwill = Rs.1,80,000

Charu's share in Profit = 1/5

Charu's share of Goodwill = Rs. 1,80,000 × 1/5 = Rs. 36,000

New partner brings in only a part of his share of goodwill

When new partner is not able to bring the full amount of his/her share of goodwill in cash and brings only a part of cash. In this case, the amount

of goodwill brought by him is credited to goodwill account. At the time of goodwill transferred to capital account of existing partner's, new partner's capital account is debited with his unpaid share of goodwill besides debiting goodwill account with the amount of goodwill is paid by him. The journal entries is as

Bank A/c Dr.

To Goodwill A/c

[Part Amount of goodwill brought by new partnerI

Goodwill A/c Dr.

New Partner's Capital A/c Dr.

To Existing Partner's Capital A/c [individually in sacrificing ratio]

[Credit given to sacrificing partner by new partner's in full share of goodwill]

Illustration 13

Tanu and Puneet are partners sharing profit in the ratio of 5 : 3. They admit Tarun into the firm for 1/6 share in profit which he takes 1/ 18 from Tanu and 2/ 18 from Puneet. Traun brings Rs.9,000 as goodwill out of his share of Rs. 12,000. No goodwill account appears in the books of the firm. Make necessary journal entries in the books of the firm.

Solution:

JOURNAL

Date	Particulars	LF	Debit Amount Rs	Credit Amount Rs
	Bank A/c Dr		9,000	
	To Goodwill A/c			9,000
	[A part of his share of goodwill brought in by Tarun]			
	Goodwill A/c Dr.		9,000	
	Tarun Capital A/c Dr.		3,000	
	To Tanu's Capital A/c			4,000
	To Puneet's Capital A/c			8,000
	[Goodwill credited to Tanu and Puneet in their sacrificing ratio i.e 1 : 2]			

INTEXT QUESTIONS 19.3

1. Fill in the blanks with appropriate word/words

   (a) When Goodwill is paid privately, ... will be made.

   (b) If the new partner brings amount of goodwill, the amount of goodwill brought by him is ..... to goodwill account.

   (c) The amount brought in by the new partner is transferred to the existing partner in the ..... ratio

   (d) Goodwill appearing in the books of the firm is ..... at the time of admission of a new partner.

   (e) If the new partner is not able to bring his share of goodwill, The new partner's capital account is ..... for his share of goodwill

2. Match the appropriate entry of Column B with that of Column A. by writing the correct numbers of the column B in the space provided.

Column A	Column B
1. Goodwill is paid privately	I. Existing Partners Capital A/c To Goodwill A/c
2. New partner is not able to bring cash for Goodwill.	II Goodwill A/c Dr. To Existing partner's Capital A/c
3. At the time of admission the goodwill appearing in the books is written off.	III New Partner's Capital A/c Dr To Existing Partner's Capital A/c To Existing Partner's Capital A/c
4. At the time of admission the amount of goodwill brought by the new partner is transferred to Capital A/c existing partners capital	IV No Entry

19.6 REVALUATION OF ASSETS AND LIABILITIES

On admission of a new partner, the firm stands reconstituted and consequently the assets are revalued and liabilities are reassessed. It is necessary to show the true position of the firm at the time of admission of a new partner. If the values of the assets are raised, gain will increase the capital of the existing partners. Similarly, any decrease in the value of assets, i.e. loss will decrease the capital of the existing partners. For this purpose a'Revaluation Account' is prepared. This account is credited with all increases in the value

of assets and decrease in the value of liabilities. It is debited with decrease on account of value of assets and increase in the value of liabilities. The balance of this account shows a gain or loss on revaluation which is transferred to the existing partner's capital account in existing profit sharing ratio The following journal entries made for this purpose are:

(i) For increase in the value of assets:

Asset A/c Dr. (individually)

To Revaluation A/c

(ii) For decrease in the value of Asset

Revaluation A/c Dr. (individually)

To Asset A/c

[Decrease in the value of assets]

(iii) For increase in the value of Liabilities:

Revaluation A/c Dr. (individually)

To Liabilities A/c

[Increase in the value of Liabilities]

(iv) For decrease in the value of Liabilities:

Liabilities A/c Dr.

To Revaluation A/c

[Decrease in the value of Liabilities]

(v) For unrecorded Assets

Asset A/c [unrecorded] Dr.

To Revaluation A/c

[Unrecorded asset recorded at actual value]

(vi) For unrecorded Liability :

Revaluation A/c Dr.

To Liability A/c [unrecorded]

[Unrecorded Liability recorded at actual value]

(vii) For transfer of gain on revaluation:

Revaluation A/c Dr.

To Existing Partner's Capital/Current A/c

[Profit on revaluation transferred to capital account in existing ratio]

(viii) For transfer of loss on revaluation:

Existing Partner's Capital/Current A/c Dr.

To Revaluation A/c

[Loss on revaluation transferred to capital account in existing ratio]

Proforma of Revaluation account is given as under:

Revaluation account

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Assets		Assets	
[decrease in value]		[Increase in value]	
Liabilities		Liabilities	
[increase in value]		[Decrease in value]	
Liabilities[unrecordcd]		Assets [unrecorded]	
Profit transferred to		Loss transferred to	
Capital A/c		Capital A/c	
[Individually in existing ratio]		[Individually in existing ratio]	

Illustration 14

Karan and Tarun are partners sharing profit and losses in the ratio of 2 : 1. Their Balance Sheet was as follows:

Balance Sheet of Karan and Tarun as on December 31,2006

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Creditors		10,000	Cash in hand	7,000
Bills payable		7,000	Debtors	26,000
Building	20,000			
Capitals:			Investment	15,000
Karan	40,000		Machinery	13,000
Tarun	30,000		Stock	6,000
		70,000		
		87,000		87,000

Nikhil is admitted as a partner and assets are revalued and liabilities reassessed as follows:

(i) Create a Provision for doubtful debt on debtors at Rs.800.

(ii) Building and investment are appreciated by 10%.

(iii) Machinery is deprecated at 5%

(iv) Creditors were overestimated by Rs.500.

Make journal entries and Prepare revaluation account before the admission of Nikhil.

Solution

Journal

Date	Particulars	LF	Debit Amount (Rs.)	Credit Amount (Rs.)
	Revaluation A/c Dr.		800	
	To Provision for Doubtful Debts			800
	[Provision made for doubtful debts]			
	Building A/c Dr.			
	Investment A/c Dr.		2,000	
	To Revaluation A/c		1,500	
	[Increase in the value of Building & Investment]			3,500
	Revaluation A/c Dr.		650	
	To Machinery A/c			650
	[Decrease in the value of machinery]			
	Creditor A/c Dr.		500	
	To Revaluation A/c			500
	[Value of creditors reduced by Rs.500]			

Revaluation account

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Provision for Doubtful Debts	800	Building	2,000
Machinery	650	Investment	1,500
Profit transferred to		Creditors	500
Karan's Capital 1,700			
Tarun's Capital 850			
	2,550		
	4,000		4,000

19.7 ADJUSTMENTS OF RESERVES AND ACCUMULATED PROFIT OR LOSSES

Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, is credited in the existing partner's capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partner in the existing ratio. For this purpose the following journal entries are made as:

(i) For distribution of undistributed profit and reserve.

Reserves A/c Dr
Profit & Loss A/c(Profit) Dr.
To Partner's Capital A/c [individually]
[Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio]

(ii) For distribution of loss

Partner's Capital A/c Dr. [individually]
ToProfit and Loss A/c [Loss]
[Profit & Loss (loss) transferred to all partners capitals A/c in existing profit sharing ratio]

Illustration 15

Rohit and Soniya are partners sharing profit in the ratio of 4:3. On lst April 2006 they admit Meena as as new partner for 1/4 shares in profits. On that date the balance sheet of the firm shows a balance of Rs.70,000 in general reserve and debit balance of Profit and Loss A/c of Rs.21,000. make the necessary journal entries.

Solution

Journal

Date	Particulars	LF	Debit Amount (Rs.)	Credit Amount (Rs.)
	General Reserve Dr		70,000	
	To Rohit's Capital A/c			40,000
	To Soniya's Capital A/c			30,000
	[Transfer of general reserve to the existing partner's capital accounts]			
	Rohit's Capital A/c Dr.		12,000	
	Soniya's Capital A/c Dr.		9,000	
	To Profit & Loss A/c			21000
	[transfer of accumulated Loss to existing partner's capital A/c]			

Illustration : l6

Bhanu and Etika are partners sharing profit and losses in the ratio of 3:2 respectively. Their Balance Sheet as on March 31, 2006 was as under:

Balance Sheet of Bhanu and Etika as on December 31,2006

Particulars		Amount (Rs.)	Particulars	Amount (Rs.)
Creditors		28,000	Cash in hand	3,000
Capitals:			Cash at Bank	23,000
Bhanu	70,000		Debtors	19,000
Etika	70,000	1,40,000	Buildings	65,000
			Furniture	15,000
			Machinery	13,000
			Stock	30,000
		1,68,000		1,68,000

On that date, they admit Deepak into partnership for 1/3 share in future profit on the following terms:

(i) Furniture and stock are to be depreciated by 10%.

(ii) Building is appreciated by Rs.20,000.

(iii) 5% provision is to be created on Debtors for doubtful debts.

(iv) Deepak is to bring in Rs.50,000 as his capital and Rs.30,000 as goodwill.

Make necessary ledger account and balance sheet of the new firm.

Solution :

Revaluation account

Dr. Cr.

Particulars		Amount (Rs.)	Particulars	Amount (Rs.)
Provision for Doubtful Debts		950	Building	20,000
Furniture		1,500		
Stock		3,000		
Profit transferred to				
Bhanu's Capital A/c	8,730			
Etika's Capital A/c	5,820	14,550		
		20,000		20,000

Capital account

Dr. Cr.

Particulars	Bhanu (Rs)	Etika (Rs)	Deepak (Rs)	Particulars	Bhanu (Rs)	Etika (Rs)	Deepak (Rs)
Balance c/d (closing)	96,730	87,820	50,000	Balance b/d (closing)	70,000	70,000	—
				Revaluation (Profit)	8,730	5,820	—
				Bank A/c	—	—	50,000
				Goodwill A/c	18,000	12,000	—
	96,730	87,820	50,000		96,730	87,820	50,000

Balance Sheet of Bhanu , Etika and Deepak as on December 31, 2006

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Creditors		28,000	Cash in hand		3,000
Capitals:			Cash at Bank		1,03,000
Bhanu	96,730		Debtors	19,000	
Etika	87,820		Less Provision	950	18,050
Deepak	50,000	2,34,550	Stock		27,000
			Furniture		13,500
			Machinery		13,000
			Building		85,000
		2,62,550			2,62,550

Illustration: 17

Ashu and Pankaj are partners sharing profit in the ratio of 3 : 2, their Balance sheet on March 31, 2007 was as follows:

Balance Sheet of Ashu and Pankaj as on March 31,2007

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Creditors		38,000	Cash in hand	15,000
Bills Payable		40,000	Cash at Bank	62,000
Salaries outstanding		5,000	Debtors	58,000
Profit & Loss		40,000	Stock	85,000
Capitals:			Machinery	1,45,000
Ashu	1,50,000		Goodwill	38,000
Pankaj	1,30,000	2,80,000		
		4,03,000		4,03,000

They admitted Gurdeep into partnership on the following terms on March 31, 2007.

(a) New profit sharing ratio is agreed as 3 : 2 : l.

(b) He will bring in Rs.1,00,000 as his shared capital and Rs.30,000 as his share of goodwill.

(c) Machinery is appreciated by 10%

(d) Stock is valued at Rs. 87,000.

(e) Creditors are unrecorded to the extent of Rs.6,000.

(f) A provision for doubtful debts is to be created by 4% on debtors.

Prepare Revaluation account, Capital Accounts, Bank account and Balance Sheet of the new firm after admission of Gurdeep.

Solution

Revaluation account

Dr. Cr.

Particulars		Amount (Rs.)	Particulars	Amount (Rs.)
Provision for Doubtful Debts		2,320	Machinery	14,500
Creditors	6,000		Stock	2,000
Profit transferred to				
Ashu's Capital A/c	4,908			
Pankaj's Capital A/c	3,272	8,180		
		16,500		16,500

Capital account

Dr. Cr.

Particulars	Ashu (Rs)	Pankaj (Rs)	Gurdeep (Rs)	Particulars	Ashu (Rs)	Pankaj (Rs)	Gurdeep (Rs)
Goodwill A/c	22,800	15,200	—	Balance b/d	1,50,000	1,30,000	—
Balance c/d	1,74,108	1,46,072	1,00,000	Profit & Loss A/c	24,000	16,000	—
				Revaluation A/c (Profit)	4,908	3,272	
				Bank A/c	—	—	1,00,000
				Goodwill A/c	18,000	12,000	—
	1,96,908	1,61,272	50,000		1,96,908	1,61,272	1,00,000

Balance Sheet of Ashu Pankaj and Gurdeep as on March 31,2007

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Creditors		44,000	Cash in hand		15,000
Bills Payable		40,000	Cash at Bank		1,92,000
Salaries outstanding		5,000	Debtors	58,000	
Capitals:			Less Provision	(2,320)	
Ashu	1,74,108		of doubtful debts		55,680
Pankaj	1,46,072		Stock		87,000
Gurdeep	1,00,000	4,20,180	Machinery		1,59,500
		5,09,180			5,09,180

Bank account

Dr Cr

Particulars	Amount (Rs}	Particulars	Amount (Rs)
Balance b/d	62,000	Balance c/d	1,92,000
Gurdeep's Capital A/c	1,00,000		
Goodwill A/c	30,000		
	1,92,000		1,92,000

$$\frac{18-15}{30} = \frac{3}{30}$$

Working Note:

Sacrificing Ratio = Existing Ratio – New Ratio

Partners	Existing ratio	New ratio	sacrifice	Sacrificing ratio
Ashu	3/5	3/6		Ashu:Pankaj
Pankaj	2/5	2/6	$\frac{12-10}{30} = \frac{2}{30}$	3 : 2

Illustration: 18

Himani and Harsha are partners in a firm. Their Balance Sheet on March 31, 2006 was as follows:

Balance Sheet of Himani and Harsha as on March 31,2006

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Provision for Doubtful		3,000	Cash	20,000
Debts			Sundry Debtors	90,000
Creditors		36,000	Stock	45,000
Bills Payable		15,000	Machinery	41,000
Outstanding Expenses		2,000	Building	1,10,000
Capitals:			Goodwill	40,000
Himani	1,70,000			
Harsha	1,20,000	2,90,000		
		3,46,000		3,46,000

On April 1, 2006 they admitted Charu as a Partner on the following terms:

(i) Charu brings Rs.90,000 as her share of capital and she is unable to bring any amount for goodwill.

(ii) Goodwill is valued at 2 Years purchase of the average profit of last 4 years. The Profit of last 4 years amounted to Rs.20,000: Rs.30,000: Rs.30,000: Rs.40,000 Respectively.

(iii) New Profit sharing ratio between Himani's, Harsha's and Charu are 3 : 2 : 1.

(iv) Outstanding Expenses to be brought down to Rs.500.

(v) The provision for doubtful debts is to be increased upto 5% on Debtors.

(vi) Machinery is depreciated by 10% and Stock is valued at Rs.47,000.

Prepare Revaluation Account, Partners Capital account and opening Balance sheet of the New firm.

Solution:

Revaluation account

Dr. Cr.

Particulars	Amount (Rs.)	Particulars		Amount (Rs.)
Provision for Doubtful Debts	1,500	Outstanding Expenses		1,500
		Stock		2,000
Machinery	4,100	Loss on revaluation transferred to		
		Himani's Capital A/c	1,050	
		Harsha's Capital A/c	1,050	2,100
	5,600			5,600

Capital account

Dr. Cr.

Particulars	Himani (Rs)	Harsha (Rs)	Charu (Rs)	Particulars	Himani (Rs)	Harsha (Rs)	Charu (Rs)
Goodwill A/c	20,000	20,000	—	Balance b/d	1,70,000	1,20,000	—
Revaluation A/c	1,050	1,050		Charu's Capital A/c	—	10,000	—
(loss)				Bank A/c	—	—	90,000
Harsha,s Capital			10,000				
Balance c/d	1,48,950	1,08,950	80,000				
	1,70,000	1,30,000	90,000		1,70,000	1,30,000	90,000

Balance Sheet of Himani,Harsha and Charu as on March 31,2007

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Provision for Doubtful Debts		4,500	Cash	70,000
			Bank	90,000
			Sundry Debtors	90,000
Creditors		36,000	Stock	47,000
Bills Payable		15,000	Machinery	36,900
Outstanding Expenses		500	Building	1,10,000
Capitals:				
Himani	1,48,950			
Harsha	1,08,950			
Charu	80,000	2,90,000		
		3,93,900		3,93,900

Working Note:

(i) Valuation of Goodwill:

Total Profit = Rs.20,000 + Rs.30,000 + Rs.30,000 + Rs.40,000

Average Profit = Rs.1,20,000/4 = Rs.30,000

Goodwill = Rs.30,000 × 2 = Rs.60,000

Charu's Share of Goodwill = Rs.60,000 × 1/6 = Rs.10,000

(ii) Sacrificing Ratio = Existing Ratio – New Ratio

Himani's = $\frac{3-3}{6} = 0$

Harsha's = $\frac{3-2}{6} = \frac{1}{6}$

Only Harsha sacrificed his share of profit.

INTEXT QUESTIONS 19.4

Fill in the blanks with suitable word/words :

(i) Revaluation account is debited for an increase in the value of .....

(ii) Revaluation account is credited for an increase in the value of .....

(iii) Revaluation account is credited for an decrease in the value of .....

(iv) Revaluation account is debited for an decrease in the value of .....

(v) Profit on revaluation is transferred to the ..... of the partners' capital account.

(vi) Reserve should be distributed amongst the existing partners in .....

(vii) Accumulated Losses are ..... in the existing partner's capital account in existing profit sharing ratio.

19.8 ADJUSTMENT OF PARTNER'S CAPITAL

Sometime, at the time of admission, the partners' agree that their capitals be adjusted in proportion to their profit sharing ratio. For this purpose, the capital accounts of the existing partners are prepared, making all adjustments, on account of goodwill, general-reserve, revaluation of assets and resettlement of liabilities. The actual capital so adjust will be compared with the amount of capital that should be kept in the business after the admission of the new partner. The excess if any, of adjusted actual capital over the proportionate capital will either be withdrawn or transferred to current account and vice versa.

The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner's Capital and his profit sharing ratio or on the basis of the existing partner's capital account balances.

1. Adjustment of existing partner's capital on the basis of the capital of the new partner:

If the capital of the new partner is given, the entire capital of the new firm will be determined on the basis of the new partner's capital and his profit sharing ratio. Therefore the capital of other partners is ascertained by dividing the total capital as per his profit sharing ratio.

If the existing capital of the partner after adjustment is in excess of his new capital, the excess amount is withdrawn by partner or transferred to the credit of his current account. If the existing capital of the partner is less than his new capital, the partner brings the short amount or makes transfer to the debit of his current account. The journal entries are made as under:

(i) when excess amount is withdrawn by the partner or transferred to current account.

Existing Partner's Capital A/c Dr.

To Bank A/c or Partner Current A/c

(Excess amount is withdrawn by the partner or transferred to current account]

(ii) For bringing in the Deficit amount or Balance transferred to current account.

Bank A/c or Partner Current A/c Dr.

To Existing Partner's Capital A/c

(Bringing the Deficit amount or Balance transferred to current account)

Illustration 19

Asha and Boby are partners sharing profit in the ratio of 5:3 with capital of Rs.80,000 and Rs.70,000 respectively. They admit a new partner Nitin. The new profit sharing ratio of Asha, Boby and Nitin is 5:3:2 respectively. Ntin brings Rs.40,000 as capital. The profit on revaluation of assets and reassessment of liabilities is Rs.6,400. it is agreed that capitals of the partner's should be in the new profit sharing ratio. Calculate new capital of each partner.

Solution:

Actual Capital of Asha and Boby

	Asha (Rs.)	Boby (Rs.)
Balance in Capital A/c	80,000	70,000
Add Profit on Revaluation (5 : 3)	4,000	2,400
Capital after Adjustment	84,000	72,400

Calculation of new capital of the firm and existing partner's capital

Nitin's Share in the firm = 2/10

Nitin's brings 40,000 for 2/10 Share

Total capital of the new firm in terms of Nitin's capital

= 40,000 × 10/2

= Rs.2,00,000

Asha's share in New Capital = 2,00,000 × 5/10 = Rs.1,00,000

Boby's share in New Capital = 2,00,000 × 3/10 = Rs.60,000

On comparing Asha's adjusted capital with the new capital we find that the Asha brings Rs.16,000 [Rs.1,00,000 - Rs.84,000] or the amount may be debited to her current account.

On comparing the Boby's adjusted capital with the new capital, we find that the Boby is to withdraw Rs. 12,400 [Rs.72,400 - Rs.60,000] or the amount may be credited to his current account.

2. When the capital of the new partner is calculated in proportion to the total capital of the new firm.

Sometimes the capital of the new partner is not given. He/she is required to bring an amount proportionate to his/her share of profit. In such a case,

new partner's capital will be calculated on the basis of adjusted capital of the existing partners.

For example, the capital account of Sumit and Anu show the balance after all adjustments and revaluation are Rs.90,000 and Rs.60,000 respectively. They admit Rohit as a new partner for 1/4 share in the profits. Rohit's capital is calculated as follows:

Total share = 1

Rohit's share in the profit = 1/4

Remaining share = 1 – 1/4 = 3/4

3/4 share of profit combined capital of Sumit and Anu

= Rs.90,000+Rs.60,000 = Rs.1,50,000

Total Capital of the firm = Rs.1,50,000 × 4/3

= Rs.2,00,000

Rohit's capital for 1/4 share of profits = Rs.2,00,000 × 1/4 = Rs.50,000

Rohit brings in Rs.50,000 as his Capital

Illustration : 20

Manoj and Hema are partner sharing profit and losses in the ratio of 7 : 3. On March 31,2006, their Balance Sheet was as follows:

Balance Sheet of Manoj and Hema as on March 31,2006

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Capital :			Bank	12,000
Manoj	88,00		Sundry Debtors	45,000
Hema	64,00	1,52,000	Bills Receivable	30,000
Sundry creditors		32,000	Stock	35,000
Bills Payable		38,000	Investment	13,000
Reserve		18,000	Machinery	40,000
			Building	45,000
			Goodwill	20,000
		2,40,000		2,40,000

They admit Tarun into partnership on the following terms:

(i) Stock is revalued at Rs.40,000.

(ii) Building, Machinery and Investment are depreciated by 12%.

(iii) Prepaid Insurance is Rs. 1,000.

(iv) Tarun brings Rs.40,000 as his capital and Rs. 12,000 for goodwill for 1/6 share of profit of the firm.

(v) Capital of the partners shall be proportionate to their profit sharing ratio. Adjustment of Capitals to be made by Cash.

Prepare Revaluation Account, Partners' Capital Account , Cash Account and Balance Sheet of the new firm.

Solution:

Revaluation account

Dr. Cr.

Particulars	Amount (Rs.)	Particulars		Amount (Rs.)
Building	5,400	Stock		5,000
Machinery	4,800	Prepaid Insurance		1,000
Investment	1,560	Loss transferred to		
		Manoj's Capital	4,032	
		Hema's Capital	1,728	5,760
	11,760			11,760

Capital account

Dr. Cr.

Particulars	**Manoj (Rs)**	**Hema (Rs)**	**Tarun (Rs)**	**Particulars**	**Manoj (Rs)**	**Hema (Rs)**	**Tarun (Rs)**
Goodwill	14,000	6,000	—	Balance b/d	88,000	64,000	—
Revaluation A/c (loss)	4,032	1,728	—	General Reserve	12,600	5,400	—
(loss)				Goodwill A/c	8,400	3,600	
Bank A/c	—	5,272	—	Bank A/c	—	—	40,000
Balance c/d	1,40,000	60,000	40,000	Bank A/c (Profit)	49,032	—	—
	1,58,032	73,000	90,000		1,58,032	73,000	90,000

Balance Sheet of Manoj, Hema and Tarun as on March 31, 2006

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Bills Payable		38,000	Bank	1,07,760
Sundry creditors		32,000	Bills Receivable	30,000
Capitals A/c:			Sundry Debtors	45,000
Manoj	1,40,000		Stock	40,000
Hema	60,000		Investment	11,440
Tarun	40,000	2,40,000	Prepaid Insurance	1,000
			Machinery	35,200
			Building	39,600
		3,10,000		3,10,000

Bank account

Dr Cr

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Balance b/d	12,000	Hema's Capital A/c	5,272
Manoj's Capital A/c	49,032	Balance c/d	1,07,760
Goodwill A/c	12,000		
Tarun's Capital A/c	40,000		
	1,13,032		1,13,032

Working Note:

(a) Calculation of New profit Sharing Ratio:

Total Profit = 1

Tarun gets = 1/6

Remaining Profit = 1 – 1/6 = 5/6 share by Manoj and Hema in their existing profit sharing ratio.

Manoj's new share = 5/6 × 7/10 = 7/12

Hema's new shares = 5/6 × 3/10 = 3/12

New profit sharing ratio of Manoj, Hema and Tarun

= 7/12 : 3/12 : 1/6 or 7 : 3 : 2.

(b) Adjustment of Capital:

Tarun brought capital for 1/6 share = Rs.40,000

Total Capital of the firm = Rs. 40,000 × 6/1 = Rs.2,40,000

Manoj's Capital = Rs. 2,40,000 × 7/12 = Rs. 1,40,000

Hema's Capital = Rs. 2,40,000 × 3/12 = Rs.60,000

Tarun's Capital = Rs. 2,40,000 × 2/12 = Rs.40,000

INTEXT QUESTIONS 19.5

Tanu and Anu are partner's sharing profit in the ratio 3:2. They admit Sumit as a new partner of 1/5 share in the profit and brings Rs.50,000 for his capital. The Capital of Tanu and Anu after all the adjustments are Rs.95,000 and 90,000 respectively. Calculate the total capital of the new firm and capital of the each partner on the basis of the new partner's capital.

WHAT YOU HAVE LEARNT

Admission of a partner – Meaning

When a partner so admitted to the existing partnership firm, it is called admission of a partner.

On the admission of a new partner, the following adjustments become necessary:

(i) Adjustment in profit sharing ratio;

(ii) Adjustment of Goodwill;

(iii) Adjustment for revaluation of assets and reassessment of liabilities;

(iv) Distribution of accumulated profits and reserves; and

(v) Adjustment of partners' capitals.

Adjustment in Profit sharing Ratio

When new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner.

Sacrificing Ratio

At the time of admission of an incoming partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they surrender their profits is known as sacrifice ratio.

Meaning of Goodwill:

A established firm develops wide business connections. This helps the firm to earn more profits as compared to a new firm. The monetary value of such advantage is known as "Goodwill".

Methods of valuation of Goodwill

(i) Average Profit Method

(ii) Super Profit Method

(iii) Capitalisation Method

Revaluation of assets and liabilities

On admission of a new partner, the firm is reconstituted and the assets are revalued and liabilities are reassessed. It is necessary to show the true position of the firm at the time of admission of a new partner.

Adjustments of reserves and accumulated profit or losses

Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, are credited in the existing partner's capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partner in the existing ratio.

Adjustment of partner's capital

Sometime, at the time of admission, the partners' agreed that their capitals are adjusted to the proportionate to their profit sharing ratio. The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner's Capital and his profit sharing ratio or on the basis of the existing partner's capital accounts.

TERMINAL QUESTIONS

1. State the meaning of Sacrificing Ratio.

2. State the meaning of Goodwill.

3. Explain the methods of valuation of goodwill.

4. Explain 'Revaluation Account'. Why assets are liabilities are revalued at the time of admission of a new partner?

5. Explain the treatment of accumulated profit or losses and Reserves at the time of admission of a new partner.

6. Explain the calculation of the proportionate capital of the new partner in case of admission of a partner.

7. A and B are partners sharing profit in the ratio of 5 : 3 is admitted to the partnership for 1/4 share of future profit . Calculate the new profit sharing ratio and sacrificing ratio.

8. Rohit and Meena are partners sharing and losses in the ratio of 7 : 3. Rohit surrenders 1/7 of his share and Meena surrenders 1/3 of his share in favour of Teena,a new partner. Calculate the new profit sharing ratio.

9. A firm has earned Rs.3,00,000 as average profit for the last few year. Normal rate of return in the class of business is 15%. Find out goodwill according to Capitalisation of Super profit, if the value of net assets amounted to Rs. 16,00,000.

10. The following is the Balance Sheet of Tarun and Ashima sharing profit and losses in the ratio of 2 : 1.

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Capitals:			Cash	12,000
Tarun	50,000		Sundry Debtors	60,000
Ashima	40,000	90,000	Stock	12,000
Sundry creditors	20,000		Furniture	6,000
			Building	20,000
		1,10,000		1,10,000

They agreed to admit Sunita into partnership on the following terms:

(i) Sunita tp pay Rs.9,000 as Goodwill.

(ii) Sunita bring Rs. 11,000 as her Capital for 1/4 share of profit in the business.

(iii) Building and furniture to be depreciated at 5%. Stock is reduced by Rs. 1,600 and Bad Debt Reserve Rs.1,300 to be provided for.

Prepare necessary ledge account and balance sheet after admission.

11. A and B are partner in a firm sharing profit in the ratio 2 : 1. C is admitted into the firm with 1/4 share in profits. He will bring in Rs.60,000 as capital and capital of A and B are to be adjusted in the profit sharing ratio. The Balance sheet of A and B as on March 31, 2006 was as under:

Balance Sheet of A and B as on March 31,2006

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Sundry creditors		16,000	Cash in Hand	4,000
Bills Payable		8,000	Cash at Bank	20,000
General Reserve	12,000		Sundry Debtors	16,000
Capitals:			Stock	20,000
A	1,00,000		Furniture	10,000
B	64,000	1,64, 000	Machinery	50,000
			Building	80,000
		2,00,000		2,00,000

Other terms of agreement are as under:

1. C will bring in Rs.24,000 as his share of Goodwill.
2. Building was valued at Rs.90,000 and Machinery at Rs.46,000
3. A provision for bad debts is to be created @ 6% on Debtors.
4. The capital account of A and B are to be adjusted through cash.

Prepare necessary account and Balance Sheet after C's admission.

ANSWERS TO INTEXT QUESTIONS

Intext Questions 19.1

I. (i) New, Existing (ii) reconstituted (iii) sacrifice ratio
(iv) existing ratio

II. Sacrificing ratio 5 : 3.

Intext Questions 19.2

I. (i) intangible (ii) incoming (iii) Normal Profit
(iv) Average profit, super profit and Capitalisation
(v) Outsider liabilities

II. (a) Rs. 62,500 (b) Rs.1,25,000

Intext Questions 19.3

I. (i) no entry (ii) credited (iii) sacrificing
(iv) debited (v) debited

II. 1. IV 2. III 3. I 4. II.

Intext Questions 19.4

(i) Liabilities, (ii) Assets, (iii) Liabilities,

(iv) Assets, (v) Credit side. (vi) Existing ratio

(vi) debited

Intext Questions 19.5

Total Capital of the new firm Rs.2,50,000

Capital of Tanu's Rs.1,20,000, capital of Anu's Rs.80,000

Answers to Practical Terminal Questions

7. New profit sharing ratio 15 : 9 : 8, Sacrificing ratio 5 : 3.
8. New profit sharing ratio 3 : 1 : 1
9. Goodwill Rs. 4,00,000
10. Loss on Revaluation Rs. 4,200, Total of Balance Sheet Rs. 1,25,800
11. Profit on Revaluation Rs. 5,040, Capital of A Rs. 1,20,000, B & C Rs.60,000 each, Balance sheet Total Rs. 2,64,000

***Activity* :** Talk to the owners of five such business organisations which are doing good business and have built up good reputation in the market. Write against each firm the factor that have contributed to its goodwill

Name of the firm	Nature of Business	Factors contributing to the goodwill of the firm

20

RETIREMENT AND DEATH OF A PARTNER

If you look around, you must have noticed people in your relation and in your neighbourhood running business in partnership. You must have seen people quitting partnership firm or a person dies while in partnership. These are the events that take place during the lifetime of a partnership firm. Some issues arise on the happening of these events involving finance. Some assets and liabilities may need revaluation, goodwill is to be treated and amount of joint life policy is distributed and soon accounting adjustment are required to be made. Whenever such events take place, the firm has to calculate the dues of a partner leaving the firm or that of the deceased. In this lesson you will learn the accounting treatment in the books of the firm in these two cases i.e. retirement of a partner and death of a partner.

OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning of retirement/death of a partner;
- calculate new profit sharing ratio and gaining ratio;
- make adjustments relating to goodwill, accumulated reserves and undistributed profits at the time of retirement/death of a partner;
- explain the need for revaluation of assets and reassessment of liabilities at the time of retirement/death;
- prepare the revaluation account relating to retirement/death of a partner;
- illustrate the various methods of settling the claim of retiring partner and the related accounting treatment;
- illustrate the accounting treatment of partners capital and its adjustment;
- ascertain profit up to the date of death of a partner;
- prepare the account of the deceased partner's executor.

20.1 RETIREMENT – MEANING, CALCULATION OF NEW PROFIT SHARING RATIO AND GAINING RATIO

When one or more partners leaves the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Amit, Sunil and Ashu are partners in a firm. Due to some family problems, Ashu wants to leave the firm. The other partners decide to allow him to withdraw from the partnership. Thus, due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions. At the time of retirement the retiring partner's claim is settled.

A partner retires either :

(i) with the consent of all partners, or

(ii) as per terms of the agreement; or

(iii) at his or her own will.

The terms and conditions of retirement of a partner are normally provided in the partnership deed. If not, they are agreed upon by the partners at the time of retirement. At the time of retirement the following accounting issues are dealt :

(a) New profit sharing ratio and gaining ratio.

(b) Goodwill

(c) Adjustment of changes in the value of Assets and liabilities

(d) Treatment of reserve and accumulated profits.

(e) Settlement of retiring partners dues,

(f) New capital of the continuing partners.

New profit sharing ratio and gaining ratio

As soon as a partner retires the profit sharing ratio of the continuing partners get changed. The share of the retiring partner is distributed amongst the continuing partners. In the absence of information, the continuing partners take the retiring partner's share in their profit sharing ratio or in an agreed ratio. The ratio in which retiring partner's share is distributed amongst continuing partners is known as gaining ratio. It is

$$\text{Gaining Ratio} = \text{New Ratio} - \text{Existing Ratio}$$

Various cases of new ratio and gaining ratio are illustrated as follows:

(i) Retiring partner's share distributed in Existing Ratio :

In this case, retiring partner's share is distributed in existing ratio amongst the remaining partners. The remaining partners continue to share profits and losses in the existing ratio. The following example illustrates this :

Tanu, Manu and Rena are partners sharing profits and losses in the ratio of = 4 : 3 : 2. Tanu retires and remaining partners decide to take Tanu's share in the existing ratio i.e. 3 : 2. Calculate the new ratio of Manu and Rena.

Existing Ratio between Manu and Rena = 3/9 and 2/9

Tanu's Ratio (retiring partner) = 4/9

Tanu's share taken by the Manu and Rena in the ratio of 3 : 2

Manu's gets = 4/9 × 3/5 = 12/45

Manu's New Share = 3/9 + 12/45 = 27/45

Rena's gets = 4/9 × 2/5 = 8/45

Rena's New Share = 2/9 + 8/45 = 18/45

New ratio between Manu and Rena is 27/45 : 18/45 = 27 : 18 = 3 : 2.

Gaining Ratio = New Ratio – Existing Ratio

Manu Gain = 27/45 – 3/9 = 12/45

Rena Gain = 18/45 – 2/9 = 8/45

12/45 : 8/45

3 : 2

You may note that the new ratio is similar to existing ratio that existed between Manu and Rena before Tanu's retirement.

Note: In absence of any information in the question, it will be presumed that retiring partner's share has been distributed in existing ratio.

(ii) Retiring partner's share distributed in Specified proportions:

Sometimes the remaining partners purchase the share of the retiring partner in specified ratio. The share purchased by them is added to their old share and the new ratio is arrived at. The following example illustrates this:

A B and C are partners in the firm sharing profits in the ratio of 3 : 2 : 1. B retired and his share was divided equally between A and C. Calculate the new profit sharing ratio of A and C.

B's Share = 2/6

B's share is divided between A and C in the ratio of 1 : 1.

A gets 1/2 of 2/6 = 2/6 × 1/2 = 1/6

A's New Share = 3/6 + 1/6 = 4/6

C's gets 1/2 of 2/6 = 2/6 × 1/2 = 1/6

C's New share = 1/6+1/6 = 2/6

Gaining Ratio

Gaining Ratio = New Ratio – Existing, Ratio

Gain of A = 4/6 – 3/6 = 1/6

Gain of C = 2/6 – 1/6 = 1/6

1/6 : 1/6

1 : 1 i.e, equal.

(iii) Retiring Partner's share is taken by one of the partners

The retiring partner's share is taken up by one of the remaining partners. In this case, the retiring partner's share is added to that of partner's existing share. Only his/her share changes. The other partners continue to share profit in the existing ratio. An example illustrating this point is given below:

Anuj, Babu and Rani share profit in the ratio of 5 : 4 : 2. Babu retires and his share is taken by Rani, So Rani's share is 2/11 + 4/11 = 6/11, Anuj share will remain unchanged i.e, 5/11. Thus, the new profit sharing ratio of Anuj and Rani is 5 : 6.

Illustration 1

Neru, Anu and Ashu are partners sharing profit in the ratio of 4 : 3 : 2. Ashu retires. Find the new ratio of Neru and Anu if terms for retirement provide the following :

(i) ratio is not given

(ii) equal distribution of Ashu's share

(iii) Ashu's share is taken by Neru and Anu in the ratio of 2 : 1

(iv) Anu take over the share of Ashu.

Solution:

(i) New profit sharing ratio of Neru and Anu is 4 : 3.

(ii) Ashu's share = 2/9

Neru gets = 1/2 of 2/9 = 2/9 × 1/2 = 1/9

Neru's New share = 4/9 + 1/9 = 5/9

Anu gets = 1/2 of 2/9 = 2/9 × 1/2 = 1/9

Anu's New Share = 3/9 + 1/9 = 4/9

New profit sharing ratio of Neru and Anu is 5/9 : 4/9 or 5 : 4

Gaining ratio is equal 1/9 : 1/9 = 1 : 1 $\left[\text{i.e. } \frac{5}{9}-\frac{4}{9}=\frac{1}{9};\ \frac{4}{9}-\frac{3}{9}=\frac{1}{9}\right]$

(iii) Ashu's Share = 2/9

Neru gets = 2/3 of 2/9 = 2/9 × 2/3 = 4/27

Neru's new share = 4/9 + 4/27 = 16/27

Anu gets = 1/3 of 2/9 = 2/9 × 1/3 = 2/27

Anu's new share = 3/9 + 2/27 = 11/27

New profit sharing ratio of Neru and Anu is 16 : 11.

Gaining ratio is 4/27 : 2/27 = 4 : 2 = 2 : 1

$$\left[\text{i.e. } \frac{16}{27}-\frac{4}{9}=\frac{4}{27};\ \frac{11}{27}-\frac{3}{9}=\frac{2}{27};\ 4:2=2:1\right]$$

(iv) Anu takes over Ashu share fully.

Ashu's share = 2/9

Anu gets = 2/9

Anu's new share = 3/9 + 2/9 = 5/9

New profit sharing ratio of Neru and Anu is 4 : 5

Only Anu gains.

Illustration 2

Ashish, Barmon, and Chander are partners sharing profits and losses in the ratio of 2 : 1 : 2 respectively. Chander retires and Ashish and Barman decide to share the profits and losses equally in future. Calculate the gaining ratio.

Solution:

Gaining ratio = New Ratio – Existing Ratio

Hence, Ashish gets = 1/2 – 2/5

= 1/10

Barman gets = 1/2 – 1/5

= 3/10

Gaining ratio between Ashish and Barman is 1 : 3

INTEXT QUESTIONS 20.1

I. Give any three circumstances under which a partner may retire from partnership.

(a) .....

(b) .....

(c) .....

II. New ratio of remaining partner.....

III. Gaining Ratio = New Ratio – ?

IV. A B and C were sharing profit in the ratio of 3 : 2 : 1 and A retires. His share is taken by B and C in the ratio of 2 : l. Which of the following is the new ratio of B and C after A's retirement?

(a) 3 : 2 (b) 2 : 1 (c) 1 : 2

20.2 TREATMENT OF GOODWILL

The retiring partner is entitled to his/her share of goodwill at the time of retirement because the goodwill is the result of the efforts of all partners including the retiring one in the past. The retiring partner is compensated for his/her share of goodwill. As per Accounting Standard 10 (AS-10), goodwill is recorded in the books only when some consideration in money is paid for it. Therefore, goodwill is recorded in the books only when it is purchased and the goodwill account cannot be raised on its own.

Therefore, in case of retirement of a partner, the goodwill is adjusted through partner's capital accounts. The retiring partner's capital account is

credited with. his/her share of goodwill and remaining partner's capital account is debited in their gaining ratio. The journal entry is made as under:

Remaining Partners' Capital A/c Dr. (individually)

To Retiring Partner's Capital A/c

(Retiring partner's share of goodwill adjusted to remaining partners in the gaining ratio)

Illustration 3

Mitu, Udit and Sunny are partners sharing profit equally. Sunny retires and the goodwill of the firm is valued at Rs 54,000. No goodwill account appears in the books of the firm. Mitu and Udit share future profit in the ratio of 3 : 2. Make necessary journal entry for goodwill.

Solution:

Journal

Date	Particulars	LF	Debit Amount (Rs.)	Credit Amount (Rs.)
	Mitu's Capital A/c Dr		14,400	
	Udit's Capital A/c Dr.		3,600	
	To Sunny's Capital A/c			18,000
	(Sunny's share of goodwill adjusted to remaining partners in their gaining ratio 4 : 1]			

Note : Sunny's share of goodwill = Rs.54,000 × 1/3 = Rs.18,000

Gaining Ratio = New Ratio – Existing Ratio

Mitu Gains = 3/5 – 1/3 = 9 – 5/15 = 4/15

Udit Gains = 2/5 - 1/3 = 6 – 5/ 15 = 1/15

Gaining Ratio between Mitu and Udit = 4 : 1

When the Goodwill Account already appears in the Books

Normally the goodwill is not shown in the books of the firm. If at the time of retirement/death of a partner, goodwill appears in the Balance Sheet of the firm, it will be written off by debiting all the partners' capital account

in their existing profit sharing ratio and crediting the goodwill account. In such a case, the following journal entry is made:

Partners' Capital A/c Dr (including retiring partner's capital A/c)

To Goodwill A/c

(Existing goodwill written-off)

Illustration 4

Tanu, Priya and Mayank are partners' sharing profit in the ratio of 3 : 2 : l. Priya retires and on the date of Priya's retirement goodwill is valued at Rs.90,000. Goodwill already appears in the books at a value of Rs.48,000. New ratio of Tanu and Mayank is 3 : 2. Make the necessary journal entries.

Solution:

Journal

Date	Particulars		LF	Debit Amount (Rs.)	Credit Arnount (Rs.)
	Tanu's Capital A/c	Dr		24,000	
	Priya's Capital A/c	Dr		16,000	
	Mayank's Capital A/c	Dr		8,000	
	To Goodwill A/c				48,000
	(Existing goodwill written-off in the books)				
	Tanu's Capital A/c	Dr		9,000	
	Mayank's Capital A/c	Dr		21,000	
	To Priya's Capital A/c				30,000
	(Priya's share of goodwill adjusted to remaining partners in their gaining ratio 3 : 7				

Note : Priya's share of goodwill = Rs.90,000 × 2/6 = Rs.30,000

Gaining Ratio = New Ratio – Existing Ratio,

Tanu Gains = 3/5 – 3/6 = 18 – 15/30 = 3/30

Mayank Gains = 2/5 – 1/6 = 12 – 5/30 = 7/30

Gaining Ratio between Tanu. and Mayank = 3 : 7

INTEXT QUESTIONS 20.2

State whether the following statements are True or False :

(i) Retiring partner's share of goodwill is debited to his/her capital account at the time of retirement.

(ii) Goodwill is recorded in the books only when it is purchased.

(iii) The retiring partner's capital account is debited with his/her share of goodwill and remaining partner's capital account is credited in their gaining ratio.

(iv) In case goodwill account is written off the capital account of all partners is credited.

20.3 REVALUATION OF ASSETS AND LIABILITIES

At the time of retirement of a partner the assets and liabilities of the firm are revalued and Revaluation Account is prepared in the same way as in case of admission of a partner. This is done to adjust the changes in value of assets and liabilities at the time of retirement/death of a partner. Any profit or loss due to revaluation is divided amongst all the partners including retiring/deceased in their existing profit sharing ratio. Following journal entries are made for this purpose :

(i) For increase in value of assets:

Assets A/c	Dr.	[Individually]
To Revaluation A/c		
(Increase in the value of assets)		

(ii) For decrease in value of assets:

Revaluation A/c	Dr.	
To Assets A/c		(Individually)
(decrease in the value of asset)		

(iii) For increase in value of Liabilities:

Revaluation A/c	Dr.	
To Liabilities A/c		[Individually]
(Increase in the value of liabilities)		

(iv) For decrease in value of Liabilities:

Liabilities A/c Dr. [Individually]

To Revaluation A/c

(decrease in the value of liabilities)

Revaluation account is prepared to record the change in the value of assets or liabilities. It will reveal profit or loss on revaluation. This profit or loss is divided amongst all partners including the retiring/deceased partner in existing profit sharing ratio.

(v) For Profit on Revaluation :

Revaluation A/c Dr. (Individually)

To Partner's Capital A/c

(Profit on revaluation divided amongst all partners in their existing profit sharing ratio)

[v] For loss on Revaluation:

Partner's Capital A/c Dr. (Individually)

To Revaluation A/c

(Loss on revaluation borne by all partners in their existing profit sharing ratio)

Illustration 5

Mudit, Mohit and Sonu are partners sharing profit in the ratio 3 : 2 : 1. Mudit retires from the partnership. In order to settle his claim, the following revaluation of assets and liabilities was agreed upon:

(i) The value of Machinery is increased by Rs.25,000.

(ii) The value of Investment is increased by Rs 2,000.

(iii) A provision for outstanding bill standing in the books at Rs. 1,000 is now not required.

(iv) The value of Land and Building is decreased by Rs.12,000.

Give journal entries and prepare Revaluation account.

Solution

Date	Particulars		LF	Debit Amount (Rs.)	Credit Arnount (Rs.)
	Machinery A/c	Dr.		25,000	
	Investments A/c	Dr.		2,000	
	Provision for Outstanding Bill	Dr.		1,000	
	To Revaluation A/c				28,000
	(Increase in value of Assets i.e. Machinery and investment and reduction in provision)				
	Revaluation A/c	Dr.		12,000	
	To Land and Building A/c				12,000
	(Decrease in value of assets)				
	Revaluation A/c	Dr.		16,000	
	To Mudit's Capital A/c				8,000
	To Mohit's Capital A/c				5,333
	To Sonu's Capital A/c				2,667
	(Profit on revaluation credited to all partners capital A/c in old profit sharing ratio i.e. 3 : 2 : 1)				

Revaluation account

Dr Cr

Particulars		Amount (Rs)	Particulars	Amount (Rs)
Land and Building		12,000	Machinery	25,000
Profit transferred to :			Investments	2,000
Mudit Capital	8,000		Provision for	1,000
Mohit Capital	5,333		Outstanding Bill	
Sonu Capital	2,667	16,000		
		28000		28000

Treatment of accumulated reserves and undistributed profit

All the balances of Accumulated Reserves, funds and undistributed amount of Profit or Loss appearing in the balance sheet of the firm on the date of retirement/death is distributed amongst all partners including retiring/deceased partner in their old profit sharing ratio, The following entries are made:

(i) For distribution of undistributed profit and reserve.

Reserves A/c	Dr	
Profit & Loss A/c (Profit)	Dr.	
To Partners' Capital A/c		(individually)

(Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio)

(ii) For distribution of undistributed loss

Partners' Capital A/c	Dr.	(individually)
To Profit & Loss A/c (Loss)		

(Profit & Loss (loss) transferred to all partners Capitals A/c in old profit sharing ratio)

INTEXT QUESTIONS 20.3

I. Fill in the blanks with suitable word or words:

(a) The credit balance of Revaluation account shows .....

(b) Reserve shown in the Balance sheet are transferred to the ..... side of ..... at the time of retirement of a partner.

(c) The value of the assets has been decreased at the time of retirement of a Partner ..... Account will be debited and ..... account will be credited with the decrease.

II. There was an increase in the value of a creditor at the time of retirement of a partner. What will be the journal entry for the above?

20.4 SETTLEMENT OF RETIRING PARTNER'S CLAIM

The amount due to the retiring partner is paid according to the terms of partnership agreement. The retiring partners' claim consists of

(a) The credit balance of Capital Account;

(b) His/her share in the Goodwill of the firm;

(c) His/her share in the Revaluation Profit:

(d) His/her share in General Reserve and Accumulated Profit;

(f) Interest on Capital

But, the following deductions are made from his/her Capital Account on account of :

(a) His/her share in the Revaluation loss;

(b) His/her Drawings and Interest on Drawings up to the date of retirement

(c) His/her share of any accumulated losses

(d) Loan taken from the firm.

The total amount so calculated is the claim of the retiring partner. He/she is interested in receiving the amount at the earliest. Total payment may be made immediately after his/her retirement. However, the resources of the firm may not be adequate to make the payment to the retiring partner in lumsum. The firm makes payment to retiring partner in instalments.

(i) Payment in Lump Sum

Retiring partners' claim is paid either out of the funds available with the firm or out of funds brought in by the remaining partners.

The following journal entry is made for disposal of-the amount payable to the retiring partner :

On payment of cash in lump sum.

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

(Amount paid to the retiring partner)

Illustration 6

Om, Jai and Jagdish are partners sharing profit in the ratio of 3 : 2 : l. Their balance sheet as on December 31st 2006 is as under :

Balance sheet as on December 31st, 2006

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Creditors		80,000	Building		1,80,000
Bills Payable		26,000	Plant		1,40,000
General reserve		24,000	Motor Car		40,000
Capital :			Stock		1,00,000
Om	1,60,000		Debtors	63,000	
Jai	1,20,000	4,00,000	Less Provision	3,000	60,000.
Jagdish	1,20000		for Bad debts		
			Cash at Bank		10,000
		5,30,000			5,30,000

Jai retires on that date on the following terms:

(a) The Goodwill of the firm is valued at Rs.60,000.

(b) Stock and Building to be appreciated by 10%.

(c) Plant is depreciated by 10%

(d) Provision for Bad debts is increased upto Rs.5,000.

(e) Jai's share of goodwill adjusted through remaining partners capital account,

The amount due to Jai is paid out of the fund brought in by Om and Jagdish for that purpose in their new profit sharing ratio. Jai is paid full amount.

Prepare Revaluation Account and Partner's Capital account.

Solution :

It is assumed that Om and Jagdish gaining ratio remains 3 : l.

(a) Gaining ratio = 3 : 1.

Om gets = 2/6 × 3/4 = 1/4

Om's new share = 3/6 + 1/4 = 3/4

Jagdish gets 2/6 × 1/4 = 1/12

Jagdish's new share = 1/6 + 1/12 = 3/12 = 1/4

New profit sharing ratio between Om and Jagdish is 3/4 : 1/4 = 3 : 1.

(b) Jai' Share of goodwill

60,000 × 2/6 = 20,000

Adjusted through the remaining partners capital account:

Om Capital A/c	Dr.	15,000	
Jagdish Capital A/c	Dr.	5,000	
To Jai Capital A/c			20,000

(Jai's share of goodwill debited to remaining partners' capital A/c)

Revaluation Account

Dr. Cr.

Particulars		Amount (Rs.)	Particulars	Amount (Rs.)
Provision for Bad debts		2,000	Stock	10,000
Plant		14,000	Building	18,000
Profit transferred to				
Capital Accounts:				
Om	6,000			
Jai	4,000			
Jagdish	2,000	12,000		
		28,000		28,000

Capital account

Dr. Cr.

Particulars	Om (Rs)	Jai (Rs)	Jagdish (Rs)	Particulars	Om (Rs)	Jai (Rs)	Jagdish (Rs)
Capital	15,000	—	5,000	Balance b/d	1,60,000	1,20,000	1,20,000
Bank		1,52,000		General Reserve	12,000	8,000	4,000
Balance c/d	2,77,000	—	1,59,000	Revaluation (Profit)	6,000	4,000	2,000
				Om Capital	—	15,000	—
				Jagdish Capital	—	5,000	
				Bank	1,14,000		38,000
	2,92000	1,52,000	164,000		2,92000	1,52,000	164,000

(ii) Payment in instalments

In this case the amount due to retiring partner is paid in instalments. Usually, some amount is paid immediately on retirement and the balance is transferred to his loan account. This loan is paid in one or more instalments The loan amount carries some interest. In the absence of any agreement the rule under Section 37 of the Indian Partnership Act 1932 applies.

> According to this rule, if the amount due to him is not paid immediately on his retirement, he can claim interest @ 6% p.a. on the amount due.

An instalment consists of two parts :

(i) Principal Amount of instalment due to retiring partner.

(ii) Interest at an agreed rate,

Interest due on loan amount is credited to retiring partners' loan account. Instalment inclusive of interest then is paid to the retiring partner as per schedule agreed upon.

(i) On part payment in cash and balance transferred to his/her loan account.

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

To Retiring Partner's Loan A/c

(Part payment made and balance transferred to loan A/c)

(ii) Total amount due transferred to loan A/c

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

(Total amount due transferred to loan A/c)

(iii) For interest due

Interest on loan A/c Dr.

To Retiring Partners' Loan A/c

(Interest due on loan)

(iv) For payment of instalment

Retiring Partners' Loan A/c

To Cash/Bank A/c

(Instalment inclusive of interest paid)

Illustration 7

Taking the figures of the pervious illustration, assuming that he is paid 40% of the amount due immediately and the balance in three equal yearly instalments. The interest payable is 12% p.a.

Solution:

The amount due to Jai = Rs.1,52,000

Amount paid immediately = Rs.1,52,000 × 40/100

= Rs.60,800

Amount of three equal instalments = Rs.1,52,000 – Rs.60,800 × 3

= Rs.91,200 ÷ 3 = Rs.30,400

1st Instalment at the end of 1st Year = Rs.30,400 + Rs. 10,944

= Rs.41,344

Interest @ 12% pa. = Rs.91,200 × 12/100

= Rs.10,944

2nd Instalment at the end of 2nd Year = Rs.30,400 + Rs.7,296

= Rs.37,344

Interest @ 12% pa. = Rs.60,800x1.2/ 100

= Rs.7,296

3rd Instalment at the end of 3rd Year = Rs.30,400 + Rs.3,648

= Rs.34,048

Interest @ 12% pa. = Rs.30,400 × 12/100

= Rs.3,648

INTEXT QUESTIONS 20.4

I. List the various claims of a retiring partner:

l. ..... 2. ..... 3. ..... 4. .....

II. Mention the modes of settling the total claims of the retiring partner:

l. ..... 2. .....

III. Find the total amount due to Munish, who is retiring as a partner:

1. Credit balance in Munish capital account Rs.20,000.
2. Munish's share of goodwill Rs.7,000
3. General reserve balance shown in Balance sheet Rs.10,000
4. Profit on Revaluation of Assets /liabilities Rs.3,000
5. Interest on drawings Rs.5,00.
6. Munish share in the profit of the firm 1/2

20.5 ADJUSTMENT OF REMAINING PARTNER'S CAPITAL ACCOUNT AFTER RETIREMENT

After retirement of a partner the remaining partners may decide to adjust their capital. Often the remaining partners determine the total amount of capital of the reconstituted firm and decide to keep their respective capital accounts in proportion to the new profit sharing ratio. The total capital of the firm may be more or less than the total of their capital at the time of retirement. The new capitals of the partners are compared with the balance standing to the credit of respective partner's capital account. If there is a surplus in the capital account, the amount is withdrawn by the concerned partner. The partner brings cash in case the balance in the capital account is less than the calculated amount.

Illustration 8

Roopa, Sunder and Shalu are partners sharing profit in the ratio of 5 : 3 : 2. Roopa retired, when their capitals were: Rs.46,000, Rs.42,000 and Rs.38,000 respectively after making all adjustments on retirement. Sunder and Shalu decided to have a total capital of the firm at Rs.84,000 in the proportion of 7 : 5. Calculate actual cash to be paid or brought in by each partner and make necessary journal entries.

Solution:

Total Capital of the New firm	= Rs.84,000
Sunder's share in the new capital	= Rs.84,000 × 7/12
	= Rs.49,000
Shalu's share in the new capital	= Rs.84,000 × 5/12
	= Rs.35,000

On comparing Sunder's share in the new capital of the firm with the amount standing to the credit of his capital, It is observed that he has to bring Rs.7,000 the deficit amount (Rs.49,000 – 42,000) in Cash.

Similarly, Shalu's share in the new capital of the firm is Rs.35,000 while Rs.38,000 stands credited to her capital account. So she is allowed to withdraw Rs.3,000, the surplus amount (Rs.38,000 – Rs.35,000) from the firm so as to make her capital in proportion to her new profit share ratio.

journal

Date	Particulars		LF	Debit Amount (Rs.)	Credit Arnount (Rs.)
	Bank A/c	Dr.		7,000	
	To Sunder's Capital A/c				7,000
	(The deficit amount brought in by the partner)				
	Shalu's Capital A/c	Dr.		3,000	
	To Bank A/c				3,000
	(The surplus amount withdrawn by the partner)				

Adjustment of remaining partner's capital in their profit sharing ratio, when the total capital of the new firm is not pre-determined.

In this case the total amount of adjusted capital of the remaining partners is rearranged as per agreed proportion in which they share profit of the reconstituted firm. The following steps may be adopted:

(i) Add the balance standing to the credit of the remaining partners' capital accounts.

(ii) The total so obtained is the total capital of the firm.

(iii) This capital is divided according to the new profit sharing ratio.

Illustration 9

Sumit, Amit and Neha are partners sharing profit in the ratio of 4 : 3 : 1. when Amit retired , their adjusted capitals were Rs.76,000: Rs.45,000 and Rs.34,000 respectively. Sumit and Neha decided to have their total capital of the firm in the ratio of 3 : 2. The necessary adjustments were to be made in cash only. Calculate actual cash to be paid off or brought in by each partner.

Solution:

Total of the adjusted capitals of the remaining partners.

Sumit = Rs. 76,000

Neha = Rs. 34,000

Total = Rs.110,000

Total capital of the firm which is divided in the new ratio of 3 : 2.

New capital of Sumit = 1,10,000 × 3/5 = Rs. 66,000

New Capital of Neha = 1,10,000 × 2/5 = Rs.44,000

Sumit's share in the new capital of the firm is Rs.66,000 while Rs.76,000 stands credited to his capital account. So he will withdraw Rs.10,000 (Rs.76,000 – Rs.66,000) from the firm so as to make his capital in proportion to his new profit sharing ratio.

Similarly, Neha's share in the new capital of the firm is Rs.44,000 while Rs.34,000 stands credited to her capital account, She has to bring Rs,10,000 (Rs,44,000 – 34,000) in Cash to make up the deficit in the capital account.

Illustration 10

The Balance Sheet of Rohit, Nisha and Sunil who are partners in a firm sharing profits according to their capitals as on 31st March 2006 was as under:

Liabilities		Amount (Rs.)	As.sets		Amount (Rs.)
Creditors		25,000	Machinery		40,000
Bills Payable		13,000	Building		90,000
General Reserve		22,000	Debtors	30,000	
Capital			Less Provision for	1.000	29,000
Rohit	60,000		Bad debts		
Nisha	40,000		Stocks		23,000
Sunil	40,000	1,40,000	Cash at Bank		18,000
		2,00,000			2,00,000

On the date of Balance Sheet, Nisha retired from the firm, and following adjustments were made:

(i) Building is appreciated by 20%.

(ii) Provision for bad debts is increased to 5% on Debtors.

(iii) Machinery is depreciated by 10%.

(iv) Goodwill of the firm is valued at Rs.56,000 and the retiring partner's share is adjusted.

(v) The capital of the new firm is fixed at Rs.1,20,000.

Prepare Revaluation Account, Capital Accounts of the partner and Balance sheet of the new firm after Nisha's retirement.

Solution:

Revaluation Account

Dr. Cr.

Particulars		Amount (Rs.)	Particulars	Amount (Rs.)
Provision for Bad debt A/c		500	Building A/c	18,000
Machinery A/c		4,000		
Profit transferred to				
Capital Accounts (3 : 2 : 2)				
Rohit	5,786			
Nisha	3,857			
Sunil	3,857	13,500		
		18,000		18,000

Capital account

Dr. Cr.

Particulars	Rohit (Rs)	Nisha (Rs)	Sunil (Rs)	Particulars	Rohit (Rs)	Nisha (Rs)	Sunil (Rs)
Sunil Capital	9,600	—	6,400	Balance b/d	60,000	40,000	40,000
Bank		66,143		General : Reserve	9,428	6,286	6,286
Balance c/d	72,000	—	48,000	Revaluation (Profit)	5,786	3,857	3,857
				Rohit Capital	—	9,600	—
				Sunil Capital		6,400	
				Bank	6,386		4,257
	81,600	66,143	54,400		81,600	66,143	54,400

Balance Sheet as on 31st March 2006

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Creditors		25,000	Building		1,08,000
Bank overdraft		37,500	Machinery		36,000
Bills Payable		13,000	Debtors	30,000	
Capital:			Less Provision for	1,500	28,500
Rohit	72,000		Bad debts		
Sunil	48,000	1,20,000	Stock		23,000
		1,95,500			1,95,500

Working Notes :

(i) (a) Profit sharing ratio is 60,000:40,000:40,000 i.e. = 3:2:2

(b) Gaining Ratio: Rohit = 3/5 – 3/7 = 21/35 – 15/35 = 6/35

Sunil = 2/5-2/7 = 14/35 – 10/35 = 4/35

= 6/35 : 4/35

= 6 : 4 = 3 : 2

(c) Nisha Share of Goodwill = 56,000 × 2/7 = Rs.16,000.

Share of Goodwill in the gaining ratio by the existing partner, i.e.

Rohit = 16,000 × 3/5 = Rs.9,600

Sunil = 16,000 × 2/5 = Rs.6,400

The journal entry is

Rohit's Capital A/c Dr	9,600	
Sunil's Capital A/c Dr	6,400	
To Nisha's Capital A/c		16,000

(Share of Goodwill divided into gaining ratio}

Bank account

Dr | Cr

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Balance b/d	18,000	Nisha's Capital A/c	66,143
Rohit's Capital A/c	6,386		
Sunil's Capital A/c	4,257		
Balance c/d (Bank overdraft)	37,500		
	66,143		66,143

(ii) Bank overdraft is taken to pay the retiring partner amount.

(iv) New Capital of the firm is fixed at Rs.1,20,000.

	Rohit (Rs.)	Sunil (Rs.)
New Capital (Rs.1,20,000 in the ratio of 3 : 2)	72,000	48,000
Existing Capital (After Adjustments) i.e. partner capitals	65,614	43,743
Cash to be brought by the remaining partners	6.386	4,257

Illustration 11

Chauhan Triphati and Gupta are partners in a firm sharing profit and losses in the ratio of 1/2, 1/6 and 1/3 respectively. The Balance Sheet on March 31, 2006 was as follows :

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Sundry Creditors		36,000	Freehold Premises		80,000
Bills Payable		24,000	Machinery		60,000
General Reserve		24,000	Furniture		24,000
Capitals:			Debtors	40000	
Chauhan	60,000		Less Provision for	2,000	38,000
Triphati	60,000		Bad debts		
Gupta	56,000	1,76,000	Stock		44,000
			Cash		14,000
		2,60,000			2,60,000

Gupta retires from the business and the partners agree to the following revaluation:

(a) Freehold premises and stock are to be appreciated by 20% and 15%. respectively

(b) Machinery and furniture are to be depreciated by 10% and 7% respectively

(c) Bad debts reserve is to be increased to Rs.3,000.

(d) On Gupta retirement, the goodwill is valued at Rs.42,000.

(e) The remaining partners have decided to adjust their capitals in their new profit sharing ratio after retirement of Gupta. Surplus/deficit, if any in their capital account will be adjusted through cash.

Prepare necessary ledger accounts and Balance Sheet of reconstituted firm.

Solution:

Revaluation Account

Dr. Cr.

Particulars		Amount (Rs.)	Particulars	Amount (Rs.)
Provision for Bad debts		1,000	Freehold Premises	16,000
Machinery		6,000	Stock	6,600
Furniture		1,680		
Profit transferred to				
Capital Accounts:				
Chauhan	6,960			
Triphati	2,320			
Gupta	4,640	13,920		
		22,600		22,600

Capital Account

Dr. Cr.

Particulars	Chauhan (Rs)	Triphati (Rs)	Gupta (Rs)	Particulars	Chauhan (Rs)	Triphati (Rs)	Gupta (Rs)
Gupta Capital	10,500	3,500	–	Balance b/d	60,000	60,000	56,000
Gupta Loan			82,640	General Reserve	12,009	4,000	8,000
Cash		30,000		Revaluation (Profit)	6,960	2,320	4,640
Balance c/d	98,460	32,820		Chauhan Capital	—	—	10,500
				Tirphati Capital			3,500
				Cash	30,000		
	1,08,960	66,320	82,640		1,08,960	66,320	82,640

Balance Sheet as on March 31, 2006

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Creditors		36,000	Freehold Premises		96,000
Bills Payable		24,000	Machinery		54,000
Gupta's Loan		82,640	Furniture		22,320
Capital:			Debtors	40,000	
Chauhan	98,460		Less Provision for	3,000	
Tirphati	32.820	1,31,280	Bad debts		37,000
			Stock		50,600
			Cash		14,000
		2,73,920			2,73,920

Working Note:

(a) In the absence of agreement, retiring partner's capital account is transferred to his loan account.

(b) In the absence of agreement, existing ratio of remaining partners is gaining ratio i.e. 3 : 1

(c) Calculation of Cash brought in (or paid off) by remaining partner.

	Chauhan	Tirphati
(a) Total Capital of Chauhan and Tirphati (Rs.68,460 + 62,820 = Rs.1,31,280 in the ratio of 3 : 1)	98,460	32,820
Adjusted existing Capital	68,460	62,820
Excess or Deficit	(Excess) 30,000	(Deficit) 30,000

INTEXT QUESTION 20.5

I. Surinder, Mahinder and Tarun are partners in a firm. After Surinder's retirernent, the profit sharing ratio between Mahinder and Tarun is 5 : 3.

They also decide to fix the firm's capital at Rs.80,000. Find the individual capitals of Mahinder and Tarun.

Mahinder's Capital Rs .....

Tarun Capitals Rs .....

II. Sohan, Amisha and Neena are partners sharing profit in the ratio of 3 : 2 : 1. when Sohan retired, their adjusted capitals were Rs.90,000, Rs.60,000 and Rs.70,000 respectively. Amisha and Neena decided to have their total capital of the firm in the ratio of 5 : 3. Find the capital of each partner and the total capital of firm.

Amisha Capital Rs ..... Neena Capital Rs .....

20.6 DEATH OF A PARTNER

On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner, When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings :

(a) The amount standing to the credit to the capital account of the deceased partner

(b) Interest on capital, if provided in the partnership deed upto the date of death:

(c) Share of goodwill of the firm;

(d) Share of undistributed profit or reserves;

(e) Share of profit on the revaluation of assets and liabilities;

(f) Share of profit upto the date of death;

(g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner's legal representatives:

(i) Drawings

(ii) Interest on drawings

(iii) Share of loss on the revaluation of assets and liabilities;

(iv) Share of loss that have occurred till the date of his/her death.

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor.

The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment.

Calculation of profit upto the date of death of a partner.

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death. Such profit is ascertained by any of the following methods:

(i) Time Basis

(ii) Turnover or Sales Basis

(i) Time Basis

In this case, it is assumed that profit has been earned uniformly through out the year. For example:

The total profit of previous year is Rs. 2,25,000 and a partner dies three months after the close of previous year, the profit of three months is Rs. 31,250 i.e. 1,25,000 × 3/12, if the deceased partner took 2/10 share of profit, his/her share of profit till the date of death is Rs. 6,250 i.e. Rs. 31,250 × 2/10

(ii) Turnover or Sales Basis

In this method, we have to take into consideration the profit and the total sales of the last year. Thereafter the profit upto the date of death is estimated on the basis of the sale of the last year. Profit is assumed to be earned uniformly at the same rate.

Illustration 12

Arun, Tarun and Neha are partners sharing profits in the ratio of 3 : 2 : 1 Neha dies on 31st May 2006. Sales for the year 2005-2006 amounted to Rs.4,00,000.and the profit on sales is Rs.60,000. Accounts are closed on 31 March every year. Sales from lst April 2006 to 31st May 2006 is Rs.1,00,000.

Calculate the deceased partner's share in the profit upto the date of death.

Solution :

Profit from 1st April 2006 to 31st May 2006 on the basis of sales:

If sales are Rs.4,00,000, profit is Rs.60,000

If the sales are Rs.1,00,000 profit is : 60,000/4,00,000 × 1,00,000

= Rs.15,000

Neha's share = 15,000 × 1/6 = Rs.2,500

Alternatively profit is calculated as

$$\text{Rate of profit} = \frac{60000}{400000} \times 100 = 15\%$$

$$\text{Sale upto date of death} = 1,00,000$$

$$\text{Profit} = 1,00,000 \times \frac{15}{100} = \text{Rs } 15000$$

Illustration 13

Nutan, Sumit and Shiba are partners in a firm sharing profits in the ratio 5 : 3 : 2. On 31st December 2006 their Balance Sheet was as under:

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Creditors		52,000	Building	60,000
Reserve Fund		15,000	Plant	50,000
Capitals :			Stock	27,000
Nutan	60,000		Debtors	25,000
Sumit	45,000		Cash	10,000
Shiba	30,000	1,35,000	Bank	30,000
		2,02,000		2,02,000

Nutan died on 1 July 2007. It was agreed between her executor and the remaining partners that:

(i) Goodwill to be valued at 2½ years purchase of the average profits of the last Four years, which were: 2003 Rs. 25,000; 2004 Rs.20,000; 2005 Rs.40,000 and 2006 Rs.35,000.

(ii) Building is valued at Rs.70,000; Plant at Rs.46,000 and Stock at Rs.32,000.

(iii) Profit for the year 2006 be taken as having accrued at the same rate as that of the previous year.

(iv) Interest on capital is provided at 9% p.a.

(v) On 1 July 2007 her drawings account showed a balance of Rs.20,000.

(vi) Rs.25,950 are to be paid immediately to her executor and the balance is transferred to her Executors Loan Account.

Prepare Nutan's Capital Account and Nutan's Executor's Account as on 1st July 2007.

Solution

(i) Valuation of Goodwill:

Total Profit = Rs.25,000 + Rs.20,000 + Rs.40,000 + Rs.35,000

= Rs. 1,20,000

Average Profit = 1,20,000/4 = Rs.30,000

Hence, Goodwill at 2½ year's purchase = Rs.30,000 × 2½ = Rs.75,000

Nutan's share of goodwill = 75,000 × 5/10 = Rs.37,500

It is adjusted into the Capital Accounts of Sumit and Shiba in the gaining ratio of 3 : 2 i.e. Rs 22,500 and Rs 15000 respectively.

(ii) Share of Profit payable to Nutan [upto the date of death]

= Rs.35,000 × 6/12 × 5/10

= Rs.8,750

(iii) Nutan's Share of Reserve Fund = Rs.15,000 × 5/10

= Rs.7,500

(iv) Interest on Nutan's Capital = 60,000 × 9/100 × 6/12

= Rs.2,700

Revaluation account

Dr Cr

Particulars		Amount (Rs)	Particulars	Amount (Rs)
Plant		4,000	Building	10,000
Profit transferred to			Stock	5,000
Nutan Capital	5,500			
Sumit Capital	3,300			
Shiba Capital	2,200	11,000		
		15,000		15,000

Nutan's Capital account

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Drawings	20,000	Balance b/d	60,000
Nutan's Executor's	1,01,950	Reserve fund	7,500
		Sumit's Capital (Goodwill)	15,000
		Shiba's Capital (Goodwill)	22,500
		Profit & Loss (Suspense)	8,750
		Revaluation A/c	5,500
		Interest on Capital	2,700
	1,21,950		1,21,950

Nutan's Executor's accounts

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Bank	25,950	Nutan's Capital	1,01,950
Nutan's Executor's Loan Transfer	76,000		
	1,01,950		1,01,950

INTEXT QUESTION 20.6

I. Fill in the blanks with suitable words :

(a) The Executor is entitled to all the right of a .....

(b) Share of goodwill of the deceased partner is ..... to his capital account.

(c) In case of death of a partner, the profit may be estimated on the basis of ..... and .....

(d) The balance in the capital account of the deceased partner is transferred to his ..... account.

(d) Interest on drawing due from deceased partner till the date of the death is ..... to his capital account.

WHAT YOU HAVE LEARNT

I. Retirement

1. Due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions.

2. At the time of retirement the following accounting issues are dealt:

   (a) New profit sharing ratio and gaining ratio.

(b) Goodwill

(c) Adjustment of changes in the value of Assets and liabilities

(d) Treatment of reserve and accumulated profits.

(e) Settlement of retiring partner's dues,

(f) New capital of the continuing partners.

II. Death

1. When the partner dies, the amount payable to him is paid to his/her legal representatives.

2. The representatives of deceased partner is entitled to the followings:

   (a) The amount standing to the credit to the capital account and the deceased partner.

   (b) Interest on capital, if provided in the partnership deed, upto the date of death:

   (c) share of the value of goodwill of the firm; '

   (d) share of undistributed profit or reserves;

   (e) share of profit on the revaluation of assets and liabilities;

   (f) share of profit upto the date of death;

   (g) share of Joint Life Policy.

   The following amounts are debited to the account of the deceased partner's legal representatives:

   (i) Drawings

   (ii) Interest on drawings

   (iii) share of loss on the revaluation of assets and liabilities;

   (iv) share of loss that have occurred till the date of his/her death

3. Calculation of Profit upto the date of death Two Methods

   (i) Time basis

   (ii) Sales basis

TERMINAL QUESTIONS

1. What is meant by retirement of a partner?
2. Explain the gaining Ratio.
3. Explain the accounting treatment of goodwill on retirement of a partner.
4. What problems arise when a partner dies? How would you deal with them as an accountant?
5. Seema, Mohit and Meenakshi were partners in a firm sharing profit in the ratio of 7 : 6 : 7. Mohit retired and his share was divided equally between Seema and Meenakshi. Calculate the new profit sharing ratio of Seema and Meenakshi.
6. Ashu, Ashmita and Metu are partners sharing profits in the ratio of 4 : 3 : 2. Ashu retires, assuming Ashmita and Metu will share profits in future in the ratio 5 : 3, determine the gaining ratio.
7. Anu Beena and Chander are partners in a firm, sharing profit in the ratio of 3 : 2 : 1. Their Balance Sheet as on March 31, 2006 was as follows:

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors		3,200	Cash in hand	1,200
General Reserve		12,000	Cash at Bank	2,000
Capitals:			Debtors	18,000
Anu	20,000		Stocks	14,000
Beena	20,000		Machinery	12,000
Chander	20,000	60,000	Building	28,000
		75,200		75,200

On the date of Balance Sheet Chander retires from firm. It is agreed to adjust the value of assets as follows:

(a) Provide a reserve of 5% on Sundry Debtors for Doubtful Debts.

(b) Building to be revalued at Rs.30,200.

(c) Depreciate stock by 5% and Machinery by 10%.

Prepare Revaluation account, Partners Capital account and Balance Sheet of Anu and Beena.

8. Ashok, Babu and Chinu are partners sharing profit and losses in the ratio of 3 : 2 : 1 respectively. The firm's Balance Sheet on March 31, 2006 was as follows:

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Sundry Creditors		38,000	Plant & Machinery		70,000
Bills Payable		10,000	Building		90000
General Reserve		24,000	Motor Car		16,000
Capitals:			Debtors	32,000	
Ashok	80,000		Less Provision for	1,000	31,000
Babu	60,000		Bad debts		
Chinu	50,000	1,90,000	Stock		50,000
			Cash		5,000
		2,62,000			2,62,000

Babu retires on that date, subject to the following adjustments:

(a) The Goodwill of the firm to be valued at Rs.36,000.

(b) Plants and Machinery to b depreciated by 10% and Motor Car by 15%.

(c) Stock to be appreciated by 20% and Building by 10%.

(d) Provision for Doubtfull debts to be increased by Rs.3,900.

Prepare Revaluation account and Babu's Capital account.

9. Dhruv, Raja and Lela are partners sharing profit and losses in the ratio of 3 : 2 : 1 respectively. The Balance Sheet as on March 31, 2006 was as follows:

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Sundry Creditors		31,200	Plant & Machinery		37,600
Dhruv Loan		10,000	Building		24,000
Capitals:			Debtors	24,800	
Dhruv	51,840		Less Provision for	2,400	22,400
Raja	27,360		Bad debts		
Lela	14 240	93,440	Stock		18,400
			Cash		32,240
		1,34,640			1,34,640

Dhruv retired on March 31, 2006 and Raja and Lela continued in partnership sharing profits and losses in the ratio of 2 : 1. Dhruv was repaid Rs 20000 on 1.4.2006 and it was agreed that the remaining balance due to him should be kept as his loan to the firm,

For the purpose of Dhruv's retirement it was agreed that

(a) Building be revalued at Rs.48,000 and Plant and Machinery at Rs.31,600.

(b) The provision for bad debts was to be increased by Rs.800.

(c) A provision of Rs.1,000 included in creditor was no longer required.

(d) Rs.2,400 was to be written off from the stock in respect of damaged items included therein.

(e) A provision of Rs. 8,480 made in respect of outstanding legal charges.

(f) The goodwill of the firm to be valued at Rs. 28,800.

Prepare Revaluation Account, Capital A/c of partners and Balance sheet of the reconstituted firm.

10. Sunny Honey and Rupesh are partners in a firm. Their Balance sheet as on December 31,2005 is as under:

liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Creditors		20,000	Plant & Machinery	40,000
General Reserve		20,000	Furniture & Fittings	5,000
Capitals:			Debtors	30,000
Sunny	40,000		Stock	21,000
Honey	30,000		Investment	24,000
Rupesh	10,000	80,000		
		1,20,000		1,20,000

Honey died on 30.06.2006. The partnership deed provides that the representative of the deceased partner shall be entitled to:

(i) Balance of the capital account of deceased partner.

(ii) Interest on Capital at 8% p.a. upto date of death.

(iii) His share of profit upto date of death on the average of last three years profit.

(iv) His share of any undistributed profit and losses as per last balance sheet.

(v) Profit for the last three years was Rs.30,000, Rs.40,000 and Rs.50,000.

Ascertain the amount payable to the legal representatives of Honey.

ANSWERS TO INTEXT QUESTIONS

Intext Questions 20.1

I. (a) Old age (b) Poor health (c) Bad relations

II. Existing ratio + Gaining ratio

III. Existing ratio

IV. 2 : 1

Intext Questions 20.2

(i) False, (ii) True, (iii) False, (iv) False.

Intext Questions 20.3

I. (a) Profit, (b) Credit : Partners' Capital A/c,

(c) Revaluation, Assets

II. Revaluation A/c Dr.

To Creditors A/c

(Increase in value of creditors)

Intext Questions 20.4

I. 1. The balance of his/her Capital Account;

2. His/her share in the Goodwill of the firm;

3. His/her share in the Revaluation Profit:

4. His/her share in General Reserve and Accumulated Profit;

5. Interest on Capital OR any other

II. 1. Lumpsum 2. Instalments

III. Rs.33,000.

Intext Questions 20.5

I. Mahinder's Capital Rs.50,000, Tarun's Capital Rs.30,000

II. Amisha Capital Rs.1,37;500, Neena Capital Rs.82,500 Total Capital Rs.2,20,000.

Intext Questions 20.6

1. (a) Deceased partner, (b) credited, (c) Time, Sales,

   (d) Executor's (e) debited

Answers to Practical Terminal Questions

5. New Ratio l : 1
6. Gaining Ratio 21 : 11
7. Loss on Revaluation Rs.600

   Total of Balance Sheet Rs.74,600
8. Profit on Revaluation Rs.5,700,

   Balance of Babu Capital Account Rs.81,900.
9. Profit on Revaluation Rs.7,320

   Total of Balance Sheet Rs.1,22,680.
10. Amount payable to Honney's Executor Rs. 44,534.

Do you know?

Can a person get HIV from a swimming pool?

One cannot get HIV infection from a swimming pool. It is important to know that chlorine, which is widely used to treat the water in swimming pools, is an extremely effective way of destroying HIV.

Any common household bleach mixed in water is also an effective antiseptic. For example, one part of bleaching power/liquid mixed with nine parts of water or hydrogen peroxide can be effective. However, low-level disinfectants such as Dettol and Lysol do not kill HIV.