CHAPTER - 8

PARTNERSHIP ACCOUNTS

Unit 1

Introduction to Partnership Accounts

© The Institute of Chartered Accountants of India

Learning objectives

After studying this unit, you will be able to :

- Understand the features of a partnership firm and the need for a Partnership Deed.
- Understand the points to be covered in a Partnership Deed regarding accounts.
- Learn the technique of maintaining Profit and Loss Appropriation Account.
- Familiarize with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.
- Note that Capital Account balance as per Fluctuating Capital method is just equal to the sum of the balances of Capital Account and Current Account as per Fixed Capital Method.
- Learn how to arrive at the corrected net profit figure which is to be taken to be Profit and Loss Appropriation Account after rectification of errors. Rectification of errors may be necessary to arrive at the net profit of the partnership and preparing Profit and loss Appropriation Account.
- Learn that interest on capital and drawings, salaries/commissions are to be shown in the Profit and Loss Appropriation Account and not in the Profit and Loss Account. Also learn that drawings by partners will not appear in the Appropriation Account.

1. INTRODUCTION

An individual i.e., a sole proprietor may not be in a position to cope with the financial and managerial demands of the present day business world. As a result, two or more individuals may decide to pool their financial and non-financial resources to carry on a business. The preparation of final accounts of sole proprietors have already been discussed in chapter 6. The final accounts of partnership firms including basic concepts of accounting for admission of a partner, retirement and death of a partner have been discussed in succeeding units of this chapter.

2. DEFINITION AND FEATURES OF PARTNERSHIP

The Indian Partnership Act defines partnership as "the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all." The essential features of partnership are :

1. An association of two or more persons;
2. An agreement entered into by all persons concerned;
3. Existence of a business;
4. The carrying on of such business by all or any one of them acting for all; and
5. Sharing of profits of the business (including losses).
6. Unlimited liability of all partners.

The persons who enter into such an agreement are called partners and the business is called a firm.

© The Institute of Chartered Accountants of India

3. LIMITED LIABILITY PARTNERSHIP

The Indian Partnership Act of 1932 provides for a general form of partnership which is the most prevalent form in India, but, over time the general form of partnership has lost its charm because of the inherent disadvantages in it, the most important shortcoming is the unlimited liability of all partners for business debts and legal consequences, regardless of their holding, as the firm is not a legal entity. General partners are also jointly and severally liable for tortuous acts of co-partners. Each partner has the exposure of their personal assets being appropriated and liquidated to meet partnership dues.

With the growth of the Indian economy, the role played by its entrepreneurs as well as its technical and professional manpower has been acknowledged internationally. Entrepreneurship, knowledge, risk and capital may be combined to provide a further impetus to India's economic growth. In this background, a need has been felt for a new corporate form that would provide an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statute-based governance structure of the limited liability company on the other. This would enable professional expertise and entrepreneurial initiative to combine, organize and operate in flexible, innovative and efficient manner.

The Government felt that with Indian professionals increasingly transacting with or representing multi-nationals in international transactions, the extent of the liability they could potentially be exposed to, is extremely high. Hence, in order to encourage Indian professionals to participate in the international business community without apprehension of being subject to excessive liability, the need for having a legal structure like the LLP is encouraged.

The Limited Liability Partnership (LLP) is viewed as an alternative corporate business proposal that provides the benefits of limited liability but allows its members, the flexibility of organizing their internal structure as a partnership, which is based on a mutually arrived agreement.

The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature. No partner would be liable on account of the independent or un-authorized actions of other partners or their misconduct. The liabilities of the LLP and partners who are found to have acted with intent to defraud Trade payables or for any fraudulent purpose shall be unlimited for all or any of the debts or other liabilities of the LLP.

The main benefit in an LLP is that it is taxed as a partnership, but has the benefits of being a corporate, or more significantly, a juristic entity with limited liability. An LLP has the special characteristic of being a separate legal personality distinct from its partners. The LLP is a body corporate in nature.

However, in the chapter the scope of discussion has been restricted to Partnership accounts as per the Indian Partnership Act, 1932 only.

4. MAIN CLAUSES IN A PARTNERSHIP DEED

From the accounting point of view, the main thing is that relations among the partners will be governed by mutual agreement. The agreement is known as Partnership Deed which is to be

© The Institute of Chartered Accountants of India

properly stamped. It should be comprehensive to avoid disputes later on. It is usual therefore, to find the following clauses in a Partnership Deed which may or may not be registered.

1. Name of the firm and the partners;
2. Commencement and duration of business;
3. Amount of capital to be contributed by each partner;
4. Amount to be allowed to each partner as drawings and the timings of such drawings;
5. Rate of interest to be allowed to each partner on his capital and on his loan to the firm, and to be charged on his drawings;
6. The ratio in which profits or losses are to be shared;
7. Whether a partner will be allowed to draw any salary;
8. Any variations in the mutual rights and duties of partners;
9. Method of valuing goodwill on the occassions of changes in the constitution of the firm ;
10. Procedure by which a partner may retire and the method of payment of his dues;
11. Basis of the determination of the executors of a deceased partner and the method of payment;
12. Treatment of losses arising out of the insolvency of a partner;
13. Procedure to be allowed for settlement of disputes among partners;
14. Preparation of accounts and their audit.

Registration of the firm is not compulsory, but non-registration restricts the partners or the firm from taking any legal action.

Often there is no written Partnership Deed or, if there is one, it may be silent on a particular point. In that case the relevant sections of the Partnership Act will apply. If on any point the Partnership Deed contains a clause, it will hold good; otherwise the provisions of the Act relating to the questions will apply.

5. POWERS OF PARTNERS

The Partners are supposed to have the power to act in certain matters and not to have such powers in others. In other words, unless a public notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners are binding and the provisions of the Act relating to the question will apply. In case of a trading firm, the implied powers of partners are the following:

(a) Buying and selling of goods;

(b) Receiving payments on behalf of the firm and giving valid recepit;

(c) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

(d) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;

(e) Engaging servants for the business of the firm.

© The Institute of Chartered Accountants of India

In certain cases an individual partner has no power to bind the firm. This is to say that third parties cannot bind the firm unless all the partners have agreed. These cases are :

(a) Submitting a dispute relating to the firm arbitration;

(b) Opening a bank account on behalf of the firm in the name of a partner;

(c) Compromise or relinquishment of any claim or portion of claim by the firm;

(d) Withdrawal of a suit or proceeding filed on behalf of the firm;

(e) Admission of any liability in a suit or proceedings against the firm;

(f) Acquisition of immovable property belonging to the firm;

(g) Entering into partnership on behalf of the firm.

The rights, duties and power of partners can be changed by mutual consent.

Students should remember that in the absence of any agreement to the contrary;

1. no partner has the right to a salary,
2. no interest is to be allowed on capital,
3. no interest is to be charged on the drawings,
4. interest at the rate of 6% is to be allowed on a partner's loan to the firm, and
5. profits and losses are to be shared equally.

Note : In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.

6. ACCOUNTS

There is not much difference between the accounts of a partnership firm and that of sole proprietorship (provided there is no change in the firm itself). The only difference to be noted is that instead of one Capital Account there will be as many Capital Accounts as there are partners. If, for instance, there are three partners; A, B, and C, then there will be a Capital Account for each one of the partners; A's Capital Account will be credited by the amount contributed by him as capital and similarly B's and C's Capital Accounts will be credited with the amounts brought in by them respectively as capital.

When a partner takes money out of the firms for his domestic purpose, either his Capital Account can be debited or a separate account, named as Drawings Account, can be opened in his name and the account may be debited. In a Trial Balance of a partnership firm, therefore, one may find Capital Accounts of partners as well as Drawings Accounts. Finally the Drawings Account of a partner may be transferred to his Capital Account so that a net figure is available. But, often the Drawings Account or Current Account (as it is usually called) remains separate.

6.1 Profit and Loss Appropriation : During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year. This is done exactly on the lines already given in the chapter 6. This is to say that final accounts of a sole proprietorship concern will not differ from the accounts of a partnership firm. The Profit and Loss Account will show the profit earned by the firm or loss suffered by it. This profit or loss has to be transferred to the Capital Accounts of partners according to the terms of the Partnership Deed or according

© The Institute of Chartered Accountants of India

to the provisions of the Indian Partnership Act (if there is no Partnership Deed or if the Deed is silent on a particular point). Suppose the Profit and Loss Account reveals a profit of ₹ 90,000. There are two partners, A and B. A devotes all his time to the firm; B does not. A's capital is ₹ 50,000 and B's is ₹ 20,000. There is no Partnership Deed. In such a case the profit will be distributed among A and B equally. This is irrespective of the fact that B does not work as much as A does and B's capital is much less than that of A. But if the Partnership Deed lays down that A is to get a salary and interest is to be allowed on the capital, then first of all, from the profit earned, A's salary must be deducted and interest on the Capital Accounts of both partners will be deducted. The remaining profit will be divided equally between A and B. Further if the Partnership Deed says that profits are to be divided in the ratio of, say, three-fourth to A and one-fourth to B, then this will be the ratio to be adopted.

The student can see for himself that if a salary is to be allowed to a partner, the Profit and Loss Appropriation Account will be debited and the Partner's Capital Account will be credited. Similarly, if interest is to be allowed on capital, the Profit and Loss Appropriation Account will be debited and the respective Capital Accounts will be credited.

Let us take an illustration to understand how to divide profits among partners.

Illustration 1

A and B start business on 1st January, 2011, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2011 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Give journal entries relating to division of profit.

Solution

Journal Entries

2011	Particulars		Dr. ₹	Cr. ₹
Dec. 31	Profit and Loss Appropriation Account	Dr.	6,000	
	To B's Capital Account			6,000
	(Salary due to B @ ₹ 500 per month)			
	Profit and Loss Appropriation Account	Dr.	3,000	
	To A's Capital Account			1,800
	To B's Capital Account			1,200
	(Interest due on Capital @ 6% per month)			
	Profit and Loss Appropriation Account	Dr.	16,000	
	To A's Capital Account			10,000
	To B's Capital Account			6,000
	(Remaining profit of ₹ 16,000 divided) between A and B in the ratio of 5:3)			

© The Institute of Chartered Accountants of India

Now, let us learn the preparation of profit and loss appropriation account with the help of same illustration of partnership firm consisting of partners A and B.

Illustration 2

Ram, Rahim and Karim are partners in a firm. They have no agreement in respect of profit-sharing ratio, interest on capital, interest on loan advanced by partners and remuneration payable to partners. In the matter of distribution of profits they have put forward the following claims :

(i) Ram, who has contributed maximum capital demands interest on capital at 10% p.a. and share of profit in the capital ratio. But Rahim and Karim do not agree.

(ii) Rahim has devoted full time for running the business and demands salary at the rate of ₹ 500 p.m. But Ram and Karim do not agree.

(iii) Karim demands interest on loan of ₹ 2,000 advanced by him at the market rate of interest which is 12% p.a.

How shall you settle the dispute and prepare Profit and Loss Appropriation Account after transferring 10% of the divisible profit to Reserve. Net profit before taking into account any of the above claims amounted to ₹ 45,000 at the end of the first year of their business.

Solution

There is no partnership deed. Therefore, the following provisions of the Indian Partnership Act are to be applied for settling the dispute.

(i) No interest on capital is payable to any partner. Therefore, Ram is not entitled to interest on capital.

(ii) No remuneration is payable to any partner. Therefore, Rahim is not entitled to any salary.

(iii) Interest on loan is payable @ 6% p.a. Therefore, Karim is to get interest @ 6% p.a. on ₹ 2,000 instead of 12%.

(iv) The profits should be distributed equally.

Profit and Loss Appropriation Account for the year ended…

Dr.	*Particulars*	₹		*Particulars*	*Cr.* ₹
To	Interest on Karim Loan A/c		By	Profit and Loss A/c -	
	(₹ 2,000 x 6/100)	120		(Net profit)	45,000
To	Reserve A/c – 10% of				
	₹ (45,000-120)	4,488			
To	Share of Profit A/c :				
	Ram: ₹ 13,464				
	Rahim: ₹ 13,464				
	Karim: ₹ 13,464	40,392			
		45,000			45,000

© The Institute of Chartered Accountants of India

Illustration 3

A and B start business on 1st January, 2011, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2011 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account

	₹		₹
To B's Capital Account-Salary	6,000	By Net Profit	25,000
To A's Capital Account-interest	1,800		
To B's Capital Account-interest	1,200		
To Profit transfer to :			
A's Capital Account (5/8)	10,000		
B's Capital Account (3/8)	6,000		
	25,000		25,000

Let us also learn the preparation of capital accounts of partners with the help of same illustration of partnership firm consisting of partners A and B.

Illustration 4

A and B start business on 1st January, 2011, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2011, the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Capital Accounts of Partners A and B.

© The Institute of Chartered Accountants of India

Solution

A's Capital Account

Dr. Cr.

2011		₹	2011		₹
Dec. 31	To Cash - (Drawings)	8,000	Jan. 1	By Cash	30,000
	To Balance c/d	33,800	Dec. 31	By Profit and Loss	
				A/c - Interest	1,800
				By Profit and Loss	
				A/c - (5/8 Profit)	10,000
		41,800			41,800
			2012		
			Jan. 1	By Balance b/d	33,800

B's Capital Account

Dr. Cr.

2011		₹	2011		₹
	To Cash - (Drawings)	10,000	Jan. 1	By Cash	20,000
	To Balance c/d	23,200	Dec. 31	By Profit and Loss A/c	
				- Salary	6,000
				- Interest	1,200
				By Profit and Loss A/c	6,000
				- (3/8 Profit)	
		33,200			33,200
			2012		
			Jan. 1	By Balance b/d	23,200

6.2 Fixed and Fluctuating Capital : You have seen in the above example that the Capital Account of A has changed from ₹ 30,000 at the beginning to ₹ 33,800 and B's Capital A/c from ₹ 20,000 to ₹ 23,200. This is because we have made entries in respect of interest, salary, profit earned during the year and money taken out by the partners in the Capital Account itself. If the Capital Accounts are prepared on this basis, capitals are said to be fluctuating. Some firms, however prefer to continue to show the Capital Accounts of the partners at the same old figure. This means that no entry is to be made in the Capital Account in respect of interest, salary, profit and drawings etc. A separate account is to be opened for this purpose. This account is known as the Current Account or even as Drawings Account. Under this system interest on capital if allowed, should be calculated only on the amount of the fixed capital. If the capital Accounts are prepared on this basis, capitals are said to be fixed.

6.2.1 Interest on Capital : Interest is generally allowed on capitals of the partners. Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business. Normally, it is charged for full year on the balance of capital at the beginning of the

© The Institute of Chartered Accountants of India

year unless some fresh capital is introduced during the year. On the additional capital introduced, interest for the relevant period of utilisation is calculated. For example, A has ₹ 30,000 capital in the beginning of the year and introduces ₹ 10,000 during the year. If rate of interest on capial is 20 % p.a., interest on A's capital is calculated as follows:

$$\left[30{,}000 \text{x} \frac{20}{100}\right] + \left[10{,}000 \text{x} \frac{20}{100} \text{x} \frac{6}{12}\right] = ₹\ 6{,}000 + ₹\ 1{,}000 = ₹\ 7{,}000$$

In case of fixed capital accounts, interest is calculated on the balance of capital accounts only and no interest is payable / chargeable on the balance of current accounts.

Net loss and Interest on Capital : *Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.*

6.2.2 Interest on Drawings : Sometimes interest is not only allowed on the capitals, but is also charged on drawings. In such a case, interest will be charged according to the time that elapses between the taking out of the money and the end of the year. Suppose X, a partner, has drawn the following sum of money –

	₹
On 29th February, 2011	500
On 31st March, 2011	400
On 30th June, 2011	600
On 31st October, 2011	800

Accounts are closed on 31st December every year. Interest is chargeable on drawings at 6% per annum. The interest on X's drawings will be calculated as shown below :

		₹
1.	On ₹ 500 for 10 months, i.e.	25
2.	On ₹ 400 for 9 months, i.e.	18
3.	On ₹ 600 for 6 months, i.e.	18
4.	On ₹ 800 for 2 months, i.e.	8
		Total 69

Alternatively, it can be calculated as follows :

Amount	*Number of months*	*Product*
500	10	5,000
400	9	3,600
600	6	3,600
800	2	1,600
2,300		13,800

Interest on ₹ 13,800 for one month at 6% per annum is ₹ 69.

© The Institute of Chartered Accountants of India

If the dates on which amounts are drawn are not given, the student will do well to charge interest for six months on the whole of the amount on the assumption that the money was drawn evenly through out the year. In the above example, the total drawings come to ₹ 2,300; and at 6% for 6 months, the interest comes to ₹ 69. The entry to record interest on drawings is- debit the Capital Account of the partner concerned (or his Current Account if the capital is fixed) and credit the Profit and Loss Appropriation Account.

If withdrawals are made evenly in the beginning of each month, interest can be calculated easily for the whole of the amount of 6-1/2 months; if withdrawals are made at the end of each month, interest should be calculated for 5-1/2 months.

6.2.3 Guarantee of Minimum Profit : Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

There are three possibilities as far as share of deficiency by other partners is concerned. These are as follows :

- Excess is payable by one of the remaining partners.
- Excess is payable by atleast two or all the partners in an agreed ratio.
- Excess is payable by remaining partners in their mutual profit sharing ratio.

If the question is silent about the nature of guarantee , the burden of guarantee is borne by the remaining partners in their mutual profit sharing ratio.

Illustration 5

A and B are partners sharing profits and losses in the ratio of their effective capital. They had ₹ 1,00,000 and ₹ 60,000 respectively in their Capital Accounts as on 1st January, 2011.

A introduced a further capital of ₹ 10,000 on 1st April, 2011 and another ₹ 5,000 on 1st July, 2011. On 30th September, 2011 A withdrew ₹ 40,000.

On 1st July, 2011, B introduced further capital of ₹ 30,000.

The partners drew the following amounts in anticipation of profit.

A drew ₹ 1,000 per month at the end of each month beginning from January, 2011. B drew ₹ 1,000 on 30th June, and ₹ 5,000 on 30th September, 2011.

12% p.a. interest on capital is allowable and 10% p.a. interest on drawings is chargeable. Date of closing 31.12.2011. Calculate: (a) Profit-sharing ratio; (b) Interest on capital; and (c) Interest on drawings.

© The Institute of Chartered Accountants of India

Solution

(a) Calculation of Effective Capital

A		B	
₹ 1,00,000 invested for 3 months i.e.,		₹ 60,000 invested for 6 months i.e.,	
₹ 3,00,000 invested for 1 month	3,00,000	₹ 3,60,000 invested for 1 month	3,60,000
₹ 1,10,000 invested for 3 months i.e.,		₹ 90,000 invested for 6 months, i.e.,	
₹ 3,30,000 invested for 1 month.	3,30,000	₹ 5,40,000 invested for 1 month	5,40,000
			9,00,000
₹ 1,15,000 invested for 3 months i.e.,			
₹ 3,45,000 invested for 1 month.	3,45,000		
₹ 75,000 invested for 3 months, i.e.,			
₹ 2,25,000 invested for 1 month.	2,25,000		
	12,00,000		

(b) Calculation of Interest on Capital

A = ₹ 12,00,000 x 12/100 x 1/12 = ₹ 12,000	B = ₹ 9,00,000 x 12/100 x 1/12 = ₹ 9,000

(c) Calculation of Interest on Drawings

A = ₹ 12,000 x 10/100 x 5.5/12 = ₹ 550	B = ₹ 1,000 x 10/100 x 6/12 = ₹ 50
	₹ 5,000 x 10/100 x 3/12 = ₹ 125

Illustration 6

Ram and Rahim start business with capital of ₹ 50,000 and ₹ 30,000 on 1st January, 2011. Rahim is entitled to a salary of ₹ 400 per month. Interest is allowed on capitals and is charged on drawings at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year, Ram withdrew ₹ 8,000 and Rahim withdrew ₹ 10,000. The profit for the year before allowing for the terms of the Partnership Deed came to ₹ 30,000. Assuming the capitals to be fixed, prepare the Profit and Loss Appropriation Account and the Capital and Current Accounts relating to the partners.

© The Institute of Chartered Accountants of India

Solution

Profit & Loss (Appropriation) Account

Dr. Cr.

2011		₹	2011		₹
Dec. 31	To Rahim's Current A/c		Dec. 31	By Net Profit	30,000
	Salary	4,800		By Sundries-Interest on	
	To Sundries-Interest on			Drawings :	
	Capitals :			Ram's Current A/c	
	Ram's Current A/c	3,000		(6% on ₹ 8,000 for	
	Rahim's Current A/c	1,800		6 months)	240
	To Profit transferred to			Rahim's Current A/c	
	Ram's Current A/c (1/2)	10,470		(6% on ₹ 10,000 for	
	Rahim's Current A/c (1/2)	10,470		6 months)	300
		30,540			30,540

Illustration 7

With the help of same information given in illustration 6, let us prepare the Capital and Current Accounts of Ram and Rahim.

Solution

Ram's Capital Account

2011		₹	2011		₹
Dec. 31	To Balance c/d	50,000	Jan. 1	By Cash	50,000
			2012		
			Jan. 1	By Balance b/d	50,000

Rahim's Capital Account

2011		₹	2011		₹
Dec. 31	To Balance c/d	30,000	Jan. 1	By Cash	30,000
			2012		
			Jan. 1	By Balance b/d	30,000

Ram's Current Account

2011		₹	2011		₹
Dec. 31	To Cash (Drawings)	8,000	Dec. 31	By Profit and Loss A/c -	
	To Profit and Loss A/c -			Interest	3,000
	Interest on Drawings	240		By Profit and Loss A/c -	
	To Balance c/d	5,230		1/2 profit	10,470
		13,470			13,470
			2012		
			Jan. 1	By Balance b/d	5,230

© The Institute of Chartered Accountants of India

Rahim's Current Account

2011		₹	2011		₹
?	To Cash (Drawings)	10,000	Dec. 31	By Profit and Loss A/c	
Dec. 31	To Profit and Loss A/c			Salary	4,800
	Interest on Drawings	300		Interest	1,800
	To Balance c/d	6,770		By Profit and Loss A/c	
				Profit	10,470
		17,070			17,070
			2012		
			Jan. 1	By Balance b/d	6,770

Illustration 8

Weak, Able and Lazy are in partnership sharing profits and losses in the ratio of 2:1:1. It is agreed that interest on capital will be allowed @ 10% per annum and interest on drawings will be charged @ 8 % per annum. (No interest will be charged/allowed on Current Accounts).

The following are the particulars of the Capital and Drawings Accounts of the partners:

	Weak	**Able**	**Lazy**
	₹	₹	₹
Capital (1.1.2011)	75,000	40,000	30,000
Current Account (1.1.2011)	10,000	5,000	(Dr.) 5,000
Drawings	15,000	10,000	10,000

The draft accounts for 2011 showed a net profit of ₹ 60,000 before taking into account interest on capitals and drawings and subject to following rectification of errors :

(a) Life Insurance premium of Weak amounting to ₹ 750 paid by the firm on 30th June, 2011 has been charged to Miscellaneous Expenditure A/c.

(b) Repairs of Machinery amounting to ₹ 10,000 has been debited to Plant Account and depreciation thereon charged @ 20%.

(c) Travelling expenses of ₹ 3,000 of Able for a pleasure trip to U.K. paid by the firm on 30th June, 2011 has been debited to Travelling Expenses Account.

You are required to prepare the Profit and Loss Appropriation Account for the year ended 31st December, 2011.

© The Institute of Chartered Accountants of India

Solution

WEAK, ABLE & LAZY
Profit and Loss Appropriation Account for the year ended 31st December, 2011

	₹	₹		₹	₹
To Interest on Capital :			ByNet Profit (Adjusted)		55,750
Weak	7,500		By Interest on Drawings :		
Able	4,000		Weak	630	
Lazy	3,000	14,500	Able	520	
			Lazy	400	1,550
To Partner's Current A/cs -					
Share of profit :					
Weak	21,400				
Able	10,700				
Lazy	10,700	42,800			
		57,300			57,300

Working Notes :

1. Adjusted Profit

		₹
Net Profit as per Profit & Loss A/c		60,000
Add : Drawings by Weak : Life Insurance Premium of Weak charged to Miscellaneous Expenditure A/c of the Firm		750
Drawings by Able : Travelling expenses of Able in connection with pleasure trip to U.K. charged to travelling expenses A/c of the firm		3,000
		63,750
Less : Repairs to Machinery wrongly capitalised	10,000	
Less : Depreciation charged @ 20%	(2,000)	(8,000)
		55,750

2. Interest on Drawings :

	Weak	Able	Lazy
	₹	₹	₹
Drawings	15,000	10,000	10,000
Add : Rectificatory adjustments	750	3,000	–
	15,750	13,000	10,000
Interest @ 8% p.a. for 6 months	630	520	400

© The Institute of Chartered Accountants of India

Illustration 9

After preparation of Profit and Loss Appropriation Account for the year ended 31st December, 2011 let us prepare Current Accounts of partners Weak, Able and Lazy for the year ended 31st December, 2011.

Solution

Partners' Current Accounts

	Weak	Able	Lazy		Weak	Able	Lazy
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	5,000	By Balance b/d	10,000	5,000	–
To Drawings	15,000	10,000	10,000	By Profit & Loss App. A/c	7,500	4,000	3,000
To Life Insurance Premium	750	–	–	(Int. on capital)			
				By Profit & Loss App. A/c	21,400	10,700	10,700
To Travelling Exps.	–	3,000	–	(Share of profit)			
To Profit & Loss App. A/c (Int. on drawings)	630	520	400	By Balance c/d	–	–	1,700
To Balance c/d	22,520	6,180					
	38,900	19,700	15,400		38,900	19,700	15,400

Illustration 10

Ram and Rahim are in partnership sharing profits and losses in the ratio of 3:2. As Ram, on account of his advancing years, feels he cannot work as hard as before, the chief clerk of the firm, Ratan, is admitted as a partner with effect from 1st January, 2011, and becomes entitled to 1/10th of the net profits and nothing else, the mutual ratio between Ram and Rahim remaining unaltered.

Before becoming a partner, Ratan was getting a salary of ₹ 500 p.m. together with a commission of 4% on the net profits after deducting his salary and commission.

It is provided in the partnership deed that the share of Ratan's profits as a partner in excess of the amount to which he would have been entitled if he had continued as the chief clerk, should be taken out of Ram's share of profits.

The net profit for the year ended December 31, 2011 is ₹ 1,10,000. Show the distribution of net profit amongst the partners.

© The Institute of Chartered Accountants of India

Solution

Amount due to Ratan as a Chief Clerk	₹
Salary	6,000
Add: Commission 4/104 (₹ 1,10,000 - ₹ 6,000)	4,000
	10,000
Less: Share of Profit as a partner (1/10th of 1,10,000)	(11,000)
Excess chargeable to Ram	(1,000)

Profit and Loss Appropriation Account for the year ended 31.12.2011

Dr. **Cr.**

	Particulars	₹	Particulars	₹
To	Share of Profit A/c		By Profit and Loss	
			A/c (Net profit)	1,10,000
	Ram [3/5 of (₹ 1,10,000 –			
	₹ 10,000) – ₹ 1,000]	59,000		
	Rahim [2/5 of (₹ 1,10,000 –			
	₹ 10,000)]	40,000		
	Ratan [1/10 of ₹ 1,10,000]	11,000		
		1,10,000		1,10,000

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices:

1. Following are the essential elements of a partnership firm except:

   (a) Atleast two persons. (b) There is an agreement between all partners.

   (c) Equal share of profits and losses. (d) Partnership agreement is for some business.

2. Following is the difference between partnership deed and partnership agreement:

   (a) Partnership deed is in writing and partnership agreement is oral.

   (b) Partnership deed is signed by all the partners but partnership agreement is signed by majority of the partners.

   (c) Partnership deed is registered in the court of law whereas partnership agreement is not registered.

   (d) Partnership deed is not subject to changes unless all partners agrees to it.

   Partnership agreement can be amended with the consent of more than 50% partners.

© The Institute of Chartered Accountants of India

3. If a firm prefers Partners' Capital Accounts to be shown at the amount introduced by the partners as capital in firm then entries for salary, interest, drawings, interest on capital and drawings and profits are made in

   (a) Trading Account (b) Profit and Loss Account

   (c) Balance Sheet (d) Partners' Current Account.

4. In the absence of any agreement, partners are liable to receive interest on their Loans @

   (a) 12% p.a. (b) 10% p.a.

   (c) 8% p.a. (d) 6% p.a.

5. A partner acts as ……… for a firm.

   (a) Agent. (b) Third Party. (c) Employee. (d) None of the above.

6. Bill and Monica are partners sharing profits and losses in the ratio of 3:2 having the capital of ₹ 80,000 and ₹ 50,000 respectively. They are entitled to 9% p.a. interest on capital before distributing the profits. During the year firm earned ₹ 7,800 after allowing interest on capital. Profits apportioned among Bill and Monica is:

   (a) ₹ 4,680 and ₹ 3,120. (b) ₹ 4,800 and ₹ 3,000.

   (c) ₹ 5,000 and ₹ 2,800. (d) None of the above.

7. Ram and Shyam are partners with the capital of ₹ 25,000 and ₹ 15,000 respectively. Interest payable on capital is 10% p.a. Find the interest on capital for both the partners when the profits earned by the firm is ₹ 2,400.

   (a) ₹ 2,500 and ₹ 1,500. (b) ₹ 1,500 and ₹ 900.

   (c) ₹ 1,200 and ₹ 1,200. (d) None of the above.

8. Seeta and Geeta are partners sharing profits and losses in the ratio 4:1. Meeta was manager who received the salary of ₹ 4,000 p.m. in addition to a commission of 5% on net profits after charging such commission. Profits for the year is ₹ 6,78,000 before charging salary. Find the total remuneration of Meeta.

   (a) ₹ 78,000. (b) ₹ 88,000. (c) ₹ 87,000. (d) ₹ 76,000.

9. The relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all is known as ………

   (a) Partnership. (b) Joint Venture.

   (c) Association of Persons. (d) Body of Individuals.

10. Features of a partnership firm are:

    (a) Two or more persons carrying common business under an agreement.

    (b) Sharing profits and losses in the fixed ratio.

    (c) Business carried by all or any of them acting for all.

    (d) All of the above.

© The Institute of Chartered Accountants of India

11. Firm has earned exceptionally high profits from a contract which will not be renewed. In such a case the profit from this contract will not be included in ....

    (a) Profit sharing of the partners. (b) Calculation of the goodwill.

    (c) Both. (d) None.

12. In the absence of an agreement, partners are entitled to

    (a) Salary. (b) Commission.

    (c) Interest on Loan and Advances. (d) Profit share in capital ratio.

13. Interest on capital will be paid to the partners if provided for in the agreement but only from ....

    (a) Current Profits. (b) Reserves. (c) Accumulated Profits. (d) Goodwill.

14. Partners are suppose to pay interest on drawings only when .... by the ....

    (a) Provided, Agreement. (b) Permitted, Investors.

    (c) Agreed, Partners. (d) Both (a) & (c) above.

15. When a partner is given a guarantee by the other partner, loss on such guarantee will be borne by

    (a) Partnership firm. (b) All the other partners.

    (c) Partner who gave the guarantee. (d) Partner with highest profit sharing ratio.

16. Guarantee given to a partner 'A' by the other partners 'B & C' means

    (a) In case of loss 'A' will contribute towards that loss.

    (b) In case of insufficient profits 'A' will receive only the share of profit and not minimum guaranteed amount.

    (c) In case of loss or insufficient profits 'A' will withdraw the minimum guaranteed amount.

    (d) All of the above.

17. What would be the profit sharing ratio if the partnership act is complied with?

    (a) As per agreement. (b) Equally.

    (c) In Capital Ratio. (d) None of the above.

18. Would interest on loan be allowed in the absence of any agreement or when partnership deed is silent?

    (a) No interest allowed.

    (b) Allowed only if agreed by all the other partners.

    (c) Will be paid only when there are sufficient profits.

    (d) Allowed @ 6% p.a.

19. Profit & Loss Appropriation Account is prepared

    (a) For Proprietorship firm. (b) For partnership firm.

    (c) Both 'a' and 'b' (d) None of the above.

© The Institute of Chartered Accountants of India

20. What time would be taken into consideration if equal monthly amount is drawn as drawings at the beginning of each month?

    (a) 7 months. (b) 6 months. (c) 5 months. (d) 6.5 months.

21. Where will you record interest on drawings?

    (a) Debit side of Profit & Loss Appropriation Account.

    (b) Credit side of Profit & Loss Appropriation Account.

    (c) Credit side of Profit & Loss Account.

    (d) Credit side of Capital/Current Account only.

22. What balance does a Partner's Current Account has?

    (a) Debit balance. (b) Credit balance. (c) Either 'a' or 'b'. (d) None of the above.

23. Is rent paid to a partner is appropriation of profits.

    (a) Yes. (b) No.

    (c) If partner's contribution as capital is maximum.

    (d) If partner is a working partner.

24. How would you close the Partner's Drawings Account?

    (a) By transfer to Capital or Current Account debit side.

    (b) By transfer to Capital Account credit side.

    (c) By transfer to Current Account credit side.

    (d) Either 'b' or 'c'.

25. A, B and C had capitals of ₹ 50,000; ₹ 40,000 and ₹ 30,000 respectively for carrying on business in partnership. The firm's reported profit for the year was ₹ 80,000. As per provisions of the Indian Partnership Act, 1932, find out the share of each partner in the above amount after taking into account that no interest has been provided on an advance by A of ₹ 20,000, in addition to his capital contribution.

    (a) ₹ 26,267 for Partner B and C & ₹ 27,466 for partner A.

    (b) ₹ 26,667 each partner.

    (c) ₹ 33,333 for A, ₹ 26,667 for B and ₹ 20,000 for C.

    (d) ₹ 30,000 each partner.

26. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and X wanted interest on capital @ 20% as his capital contributions was ₹ 1,00,000 as compared to that of Y and Z which was ₹ 75,000 and ₹ 50,000 respectively.

    (a) Profits of ₹ 6,000 will be distributed equally with no interest on either Capital.

    (b) X will get the interest of ₹ 20,000 and the loss of ₹ 14,000 will be shared equally.

    (c) All the partners will get interest on capital and the loss of ₹ 39,000 will be shared equally.

    (d) None of the above.

© The Institute of Chartered Accountants of India

27. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Y determined interest @ 24% p.a. on his loan of ₹ 80,000. There was no agreement on this point. Calculate the amount payable to X, Y and Z respectively.
    (a) ₹ 2,000 to each partner.
    (b) Loss of ₹ 4,400 for X and Z & Y will take home ₹ 14,800.
    (c) ₹ 400 for X, ₹ 5,200 for Y and ₹ 400 for Z.
    (d) ₹ 2,400 to each partner.
28. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Z demanded minimum profit of ₹ 5,000 as his financial position was not good. However, there was no written agreement. Profits to be distributed to X, Y and Z will be
    (a) Other partners will pay Z the minimum profit and will suffer loss equally.
    (b) Other partners will pay Z the minimum profit and will suffer loss in capital ratio.
    (c) X & Y will take ₹ 500 each and Z will take ₹ 5,000.
    (d) ₹ 2,000 to each of the partners.
29. Following are the differences between Capital Account and Current Account except:
    (a) Capital Account is prepared under fixed capital method whereas current account is prepared under fluctuating capital method.
    (b) In capital account only capital introduced and withdrawn is recorded, all other transactions between the firm and partner is recorded in the current account.
    (c) Interest is sometimes paid on capital account balance but no such interest is payable on current account balances.
    (d) 'b' and 'c' above.
30. Following are the differences between Partnership and Joint Venture except:
    (a) Joint venture is essentially planned for short term mainly for one contract/deal. However, partnerships are normally undertaken as going concerns and are expected to last for a very long period.
    (b) The persons involved in a joint venture are called co-venturers whereas persons involved in a partnership are called partners.
    (c) Any specific statute of the Government does not govern joint ventures but the Indian Partnership Act, 1932, governs partnerships.
    (d) Memorandum of Understanding is mandatory to be drafted to spell the relationship between the co-venturers whereas the basic relationship between the partners is defined by the partnership deed.

© The Institute of Chartered Accountants of India

ANSWERS

1.	(c)	2.	(c)	3.	(d)	4.	(d)	5.	(a)	6.	(a)
7.	(b)	8.	(a)	9.	(a)	10.	(d)	11.	(b)	12.	(c)
13.	(a)	14.	(d)	15.	(c)	16.	(c)	17.	(b)	18.	(d)
19.	(b)	20.	(d)	21.	(b)	22.	(c)	23.	(b)	24.	(a)
25.	(a)	26.	(a)	27.	(c)	28.	(d)	29.	(a)	30.	(d)

© The Institute of Chartered Accountants of India

PARTNERSHIP ACCOUNTS

Unit 2

Treatment of Goodwill in Partnership Accounts

© The Institute of Chartered Accountants of India

Learning objectives

After studying this unit, you will be able to :

- Understand when does the need for valuation of goodwill arise.
- Learn the accounting of goodwill.

1. GOODWILL

Goodwill is the value of reputation of a firm in respect of profits expected in future *over and above* the normal rate of profits. The implication of the term *over and above* is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, personal reputation of the partner or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases :

a) When the profit sharing ratio amongst the partners is changed;

b) When a new partner is admitted;

c) When a partner retires or dies; and

d) When the business is dissolved or sold.

2. METHODS FOR GOODWILL VALUATION

There are four methods for valuation of goodwill

1) Average profit basis,

2) Super profit basis,

3) Annuity basis, and

4) Capitalisation basis

(1) Average Profit Basis : In this case the profits of the past few years are averaged and adjusted for any expected change in future. For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.

Let us suppose profits of a partnership firm for the last five years were ₹ 30,000, ₹ 40,000, ₹ 50,000, ₹ 60,000 and ₹ 70,000. In this case, a clear increasing trend is noticed

© The Institute of Chartered Accountants of India

and therefore, average profit may be arrived at by assigning appropriate weights as shown below :

1 Year	2 Profit ₹	3 Weight	4 = 2 × 3 Weighted Profit ₹
1	30,000	1	30,000
2	40,000	2	80,000
3	50,000	3	1,50,000
4	60,000	4	2,40,000
5	70,000	5	3,50,000
		15	8,50,000

So, Weighted Average Profit = $\frac{₹\ 8,50,000}{15}$ = ₹ 56,667

If goodwill is valued at three years' purchase of profit, then in this case the value of goodwill is ₹ 56,667 × 3 = ₹ 1,70,000.

However, if any such trend is not visible from the figures of past profits, then one should take simple average profit and calculate goodwill accordingly. Let us suppose, profits of a partnership firm for five years were ₹ 30,000, ₹ 25,000, ₹ 20,000, ₹ 30,000 and ₹ 28,000. In this case, there is no clear increasing or decreasing trend of profit. So average profit comes to ₹ 26,600 (arrived at by taking simple average). If the goodwill is valued by taking three years' of purchase of profit, then in this case, value of goodwill becomes ₹ 79,800.

(2) Super Profit Basis : In case of average profit basis, goodwill is calculated on the basis of average profit multiplied by certain number of years. The implication is that such profit will be maintained for so many number of years and the partner(s) who gains in terms of profit sharing ratio should contribute for such gains in profit to the partners who make the sacrifice. On the other hand, super profit means, excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because normal profit he can earn by joining any partnership firm. Under super profit method, what excess profit a partnership firm can earn is to be determined first. The steps to be followed are given below :

a. Identify the capital employed by the partnership firm;

b. Identify the average profit earned by the partnership firm based on past few years' figures;

c. Determine normal rate of return prevailing in the locality of similar firms;

d. Apply normal rate of return on capital employed to arrive at normal profit;

e. Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

© The Institute of Chartered Accountants of India

Let us suppose, total capital employed by a partnership firm was ₹ 1,00,000 and its average profit was ₹ 25,000. Normal rate of return is 22% in case of similar firms working under similar conditions. So, normal profit is ₹ 22,000 and average profit is ₹ 25,000. The partnership firm earns ₹ 3,000 super profit.

Goodwill is generally valued by multiplying the amount of super profit by certain number of years depending upon the expectation about the maintence of such profit in future. If it is expected that the super profit can be maintained for another five years in future, then value of goodwill may be taken as ₹ 3,000 × 5 = ₹ 15,000.

(3) Annuity Method : In the super profit method explained above, time value of money is not considered. Although it was expected that super profit would be earned in five future years, still no devaluation was done on the value of money for the time difference. In fact when money will be received in different points of time, its value should be different depending upon the rate of interest. If 15% rate of interest is considered appropriate, then discounted value of super profit to be earned in different future years will be as follows :

Year	*Super Profit* ₹	*Discount Factor @ 15%*	*Discounted value of Super Profit*
1	3,000	.8696	2,608.80
2	3,000	.7561	2,268.30
3	3,000	.6575	1,972.50
4	3,000	.5718	1,715.40
5	3,000	.4972	1,491.60
		3.3522	10,056.60

So, under the annuity method, discounted value of total super profit becomes ₹ 10,056.60 and not ₹ 15,000 as was done under super profit method.

The word annuity is used to mean identical annual amount of super profit. So, for discounting it is possible to refer to annuity table. As per the annuity table, present value of Re. 1 to be received at the end of each year for n year @ 15% interest p.a. is 3.3522. So value of goodwill under annuity method is ₹ 3,000 × 3.3522 = ₹ 10,056.60.

(4) Capitalisation Basis : Under this basis, value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill. The steps to be followed under this method are given below :

a. Determine the normal rate of return.

b. Find out the average profit of the partnership firm for which goodwill is to be determined.

c. Determine the capital employed by the partnership firm for which goodwill is to be determined.

© The Institute of Chartered Accountants of India

d. Find out normal value of the business by dividing average profit by normal rate of return.

e. Deduct average capital employed from the normal value of the business to arrive at goodwill.

Let us suppose capital employed by a partnership firm is ₹ 1,00,000. Its average profit is ₹ 20,000. Normal rate of return is 15%.

Normal Value of business = $\frac{₹\ 20,000}{15\%}$ = ₹ 1,33,333

Value of goodwill = ₹ 1,33,333 – ₹ 1,00,000 = ₹ 33,333

Illustration 1

Lee and Lawson are in equal partnership. They agreed to take Hicks as one-fourth partner. For this it was decided to find out the value of goodwill. M/s. Lee and Lawson earned profits during 2008-2011 as follows :

Year	*Profits* ₹
2008	1,20,000
2009	1,25,000
2010	1,30,000
2011	1,50,000

On 31.12.2011 capital employed by M/s. Lee and Lawson was ₹ 5,00,000. Rate of normal profit is 20%.

Find out the value of goodwill following various methods.

Solution

Average Profit :

Year		*Profit*	*Weight* ₹	*Weighted Profit* ₹
2008		1,20,000	1	1,20,000
2009		1,25,000	2	2,50,000
2010		1,30,000	3	3,90,000
2011		1,50,000	4	6,00,000
			10	13,60,000

Weighted Average Profit = $\frac{₹\ 13,60,000}{10}$ = ₹ 1,36,000

Method (1) : Average Profit Basis

Assumption : Goodwill is valued at 3 year's purchase

Value of Goodwill : ₹ 1,36,000 × 3 = ₹ 4,08,000

© The Institute of Chartered Accountants of India

Method (2) : Super Profit Basis

Average Profit	₹ 1,36,000
Less : Normal Profit	
20% on ₹ 5,00,000	₹ 1,00,000
	₹ 36,000

Assumption : Goodwill is valued at 3 years' purchase.

Value of Goodwill = ₹ 36,000 × 3 = ₹ 1,08,000

Method (3) : Annuity Basis

Assumptions :

(a) Interest rate is equivalent to normal profit rate i.e. 20% p.a.

(b) Goodwill is valued at 3 years' purchases

Valuation of Goodwill : ₹ 36,000 × 2.1065 = ₹ 75,834

Method (4) : Capitalisation Basis

Normal Value of business :

$$\frac{₹\ 1{,}36{,}000}{20} \times 100 = ₹\ 6{,}80{,}000$$

Less: Capital Employed in M/s. Lee and Lawson	=	(₹ 5,00,000)
Goodwill	=	₹ 1,80,000

Illustration 2

The following particulars are available in respect of the business carried on by Rathore

			₹
(1)	Capital Invested		1,50,000
(2)	Trading Results :		
	2008	Profit	40,000
	2009	Profit	36,000
	2010	Loss	6,000
	2011	Profit	50,000
(3)	Market Rate of interest on investment	10%	
(4)	Rate of risk return on capital invested in business	2%	
(5)	Remuneration from alternative employment of the proprietor (if not engaged in business).	₹ 6,000 per annum	

© The Institute of Chartered Accountants of India

You are requested to compute the value of goodwill on the basis of 5 years' purchase of super profit of the business calculated on the average profits of the last four years.

Solution

Average maintainable profits :		₹
Trading profit during	2008	40,000
	2009	36,000
	2011	50,000
		1,26,000
Less : Loss during	2010	(6,000)
Total		1,20,000
Average Profits		30,000
Less : Remuneration for the proprietor		(6,000)
Average maintainable Profit		24,000
Less : Normal Profit (12% on capital employed)		(18,000)
Super Profit		6,000
Goodwill at 5 year's purchase of super Profit		30,000

3. NEED FOR VALUATION OF GOODWILL

Whenever there is any change in the existing relationship of the partners inter se, some partners have to sacrifice their future profit and some others would gain. Those who are sacrificing future profit should be compensated by the others who are gaining. This adjustment of the partnership rights may arise due to admission of a new partner, change in the profit sharing ratio, retirement or death of a partner and a dissolution of the partnership. The partners, who gain in terms of profit sharing ratio, have to pay for such gain as a proportion to the value of goodwill. The partners, who lose in terms of profit sharing ratio, receive payments for the sacrifice as a proportion to the value of goodwill. Dissolution of partnership firms is not covered in this study material and will be discussed in the Intermediate (IPC) Course Study Material.

4. VALUATION OF GOODWILL IN CASE OF ADMISSION OF A PARTNER

When a new partner is admitted into a partnership, certain adjustments in accounts become necessary. Chiefly, this is because the new partner will acquire a share in the profits of the firm and because of this, the old partners will stand to lose. Suppose, A and B are partners sharing profits in the ratio of 3:2. If their profits are ₹ 20,000, A will get ₹ 12,000 and B will get ₹ 8,000. If C is admitted and given one fourth share in profits, then out of ₹ 20,000 he will get ₹ 5,000. The remaining ₹ 15,000 will be divided between A and B; A will get ₹ 9,000 and B will get ₹ 6,000. Thus on C's admission A loses ₹ 3,000 per year and B loses ₹ 2,000 per year. C will have to compensate A and B for this loss. It is no argument to say that on C's admission the profits will not remain at ₹ 20,000; extra profits will arise and therefore, A and B will both get more than what they

© The Institute of Chartered Accountants of India

previously got. But it should be noted that the additional profits will be earned by the combined efforts of all the partners A, B and C. Therefore, if A and B get a share of the extra profits they are not particularly obliged to C. Out of the present profits of ₹ 20,000 they have to give up a share in favour of C and, therefore, they are entitled to a compensation. The problem of compensation is the chief problem while dealing with admission of a partner. This is tackled through goodwill.

But one point should be made clear here. Goodwill is a compensation to old partners for their sacrifice in connection with admission of a new partner. So it is to be credited to the partners according to their profit sacrificing ratio. Whatever share the new partner is getting, it may be sacrificed by the old partners in proportion to their old profit sharing ratio or in different proportion. For example, Nigam and Dhameja are in partnership sharing profits and losses equally. They agreed to take Ghosh as one-third partner. Now one-third share of Ghosh may come out of sacrifice made by Nigam and Dhameja equally (i.e. at their old profit sharing ratio). See the following profit sharing pattern :

Profit Sharing Pattern

Partners	Old Share	New Share	Sacrifice	Gain
Nigam	$\frac{1}{2}$	$\frac{1}{2}\left[1-\frac{1}{3}\right]=\frac{2}{3} \times \frac{1}{2}=\frac{1}{3}$	$\frac{1}{2}-\frac{1}{3}=\frac{1}{6}$	–
Dhameja	$\frac{1}{2}$	$\frac{1}{2}\left[1-\frac{1}{3}\right]=\frac{2}{3} \times \frac{1}{2}=\frac{1}{3}$	$\frac{1}{2}-\frac{1}{3}=\frac{1}{6}$	–
Ghosh	–	$\frac{1}{3}$	–	$\frac{1}{3}$

In other words, one-third share of Ghosh was borne by Nigam and Dhameja at their old profit sharing ratio. By this process Nigam sacrificed 1/2–1/3=1/6 in share and Dhameja sacrificed 1/2–1/3=/1/6 in share. So the profit sacrificing ratio becomes :

Nigam = Dhameja

1/6 = 1/6

1 : 1

which is the same as old profit sharing ratio.

But if the new profit sharing ratio of Nigam, Dhameja and Ghosh becomes 4:2:3, then profit sacrificed by Nigam and Dhameja on Ghosh's admission is not at the old profit sharing ratio. In this case profit sacrificing ratio is as follows :

Nigam = 1/2–4/9 = 1/18

Dhameja = 1/2–2/9 = 5/18

i.e. 1 : 5

If Ghosh pays goodwill of ₹ 24,000, then in the first case, Nigam and Dhameja should share it equally; but in second case Nigam should get ₹ 4,000 and Dhameja should get ₹ 20,000.

Take another example : Nigam and Dhameja are equal partners. They agreed to take Ghosh as one-third partner. The new profit sharing ratio is 4:2:3. Nigam and Dhameja agreed ₹ 27,000 as value of goodwill.

© The Institute of Chartered Accountants of India

Journal Entries :

		₹	₹
Ghosh's Capital Account	Dr.	9,000	
To Nigam's Capital Account			1,500
To Dhameja's Capital Account			7,500
(Goodwill adjustment in the profit sacrificing ratio –			
Nigam - ₹ 27,000 × 1/18			
Dhameja - ₹ 27,000 × 5/18)			

As per the Accounting Standard, it is not recommended to raise goodwill account but to show the adjustment of goodwill through partners' capital accounts.

5. ACCOUNTING TREATMENT OF GOODWILL IN CASE OF ADMISSION OF A NEW PARTNER

The goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Therefore, only purchased goodwill should be recorded in the books of the firm. In case of admission of a partner, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth is paid for it. If the incoming partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed to other existing partners. When a new partner is admitted to a firm, the old partners generally sacrifice in favour of the new partner in terms of lower profit sharing ratio in the future. Therefore, the premium for goodwill brought in by the new partner shall be given to the existing partners on the basis of profit sacrificing ratio. The profit sacrificing ratio is computed by deducting the new profit sharing ratio from the old profit sharing ratio. If the difference is positive, then there is a profit sacrifice and in case the difference is negative, then there is a gain in terms of higher future profit sharing ratio. In case of admission of a partner, only those existing partners are entitled to a share for goodwill who have sacrificed a part of their profits in favour of the new partner. Sometimes, goodwill may be evaluated in case of admission of a partner when incoming partner is unable to bring in cash any premium for goodwill. In that situation also, the value of goodwill should not be raised in the books since it is inherent goodwill. Rather it is preferable that such value of goodwill should be adjusted through partners' capital accounts. It may also be noted that when the incoming partner pays any premium for goodwill privately to the existing partners, no entry is required in the books of the firm. In that case, the amount to be paid to each partner should be calculated as per the profit sacrificing ratio.

Example 1 : A, B & C are in partnership sharing profits and losses in the ratio 2:2:1. They want to admit D into partnership with one-fifth share. D brings in ₹ 30,000 as capital and ₹ 10,000 as premium for goodwill.

© The Institute of Chartered Accountants of India

The necessary journal entry will be:

Bank A/c	Dr.	₹	40,000		
To A's Capital A/c				₹	4,000
To B's Capital A/c				₹	4,000
To C's Capital A/c				₹	2,000
To D's Capital A/c				₹	30,000
(Amount brought in by D as Capital and premium for goodwill which is credited to the old partners' capital accounts in profit sacrificing ratio)					

Example 2 : A & B are equal partners. They wanted to take C as a third partner and for this purpose goodwill was valued at ₹ 1,20,000. The journal entry for adjustment of value of goodwill through partners' capital accounts will be :

C's Capital A/c	Dr.	₹	40,000		
To A's Capital A/c				₹	20,000
To B's Capital A/c				₹	20,000
(Adjustment for goodwill)					

The net effect in partners' capital accounts is shown on the basis of profit sacrificing ratio:

A = 1/6 × ₹ 1,20,000 = ₹ 20,000 (Cr.)

B = 1/6 × ₹ 1,20,000 = ₹ 20,000 (Cr.)

C = 1/3 × ₹ 1,20,000 = ₹ 40,000 (Dr.)

Example 3 : A & B are equal partners. They wanted to admit C as 1/6th partner who brought ₹ 60,000 as goodwill. The new profit sharing ratio is 3:2:1. Profit sacrificing ratio is to be computed as follows :

Old Share - New Share = Share Sacrificed

A = 1/2 less 3/6 = 0

B = 1/2 less 2/6 = 1/6

So the entire goodwill should be credited to B's Capital A/c.

Cash A/c	Dr.	₹	60,000		
To B's Capital A/c				₹	60,000
(Goodwill brought in by C credited to B's Capital A/c)					

© The Institute of Chartered Accountants of India

Example 4 : A, B & C are equal partners. They decided to take D who brought in ₹ 36,000 as goodwill. The new profit sharing ratio is 3:3:2:2.

Old Share - New Share = Share Sacrificed

A = 1/3 less 3/10 = 1/30

B = 1/3 less 3/10 = 1/30

C = 1/3 less 2/10= 4/30

So goodwill should be shared in the ratio 1:1:4

Cash A/c	Dr.	₹	36,000		
To A's Capital Account				₹	6,000
To B's Capital Account				₹	6,000
To C's Capital Account				₹	24,000
(Goodwill brought in by D credited to old partners' accounts in their profit sacrificing ratio 1:1:4)					

Illustration 2

The following is the Balance Sheet of Yellow and Green as at 31st December, 2011 :

Liabilities	₹	*Assets*	₹
Trade payables	20,000	Cash at Bank	10,000
Capital :		Sundry Assets	55,000
Yellow	25,000		
Green	20,000		
	65,000		65,000

The partners shared profits and losses in the ratio 3:2. On the above date, Black was admitted as partner on the condition that he would pay ₹ 20,000 as Capital. Goodwill was to be valued at 3 years' purchase of the average of four years' profits which were :

	₹		₹
2007	9,000	2009	12,000
2008	14,000	2010	13,000

© The Institute of Chartered Accountants of India

The new profit sharing ratio is 6:5:5.

Give journal entries and Balance Sheet if goodwill is adjusted through partners' capital accounts.

Solution

			₹	₹
(i)	Bank Account	Dr.	20,000	
	To Black's Capital Account			20,000
	(Amount brought in by Black as capital)			
(ii)	Black's Capital Account	Dr.	11,250	
	To Yellow's Capital Account			8,100
	To Green's Capital Account			3,150
	(Black's share of goodwill adjusted through old partners' capital accounts in the profit sacrificing ratio 18:7)			

Balance Sheet as on...................

Liabilities	₹	₹	*Assets*	₹
Trade payables		20,000	Cash at Bank	30,000
Capital :			Sundry Assets	55,000
Yellow	33,100			
Green	23,150			
Black	8,750			
		65,000		
		85,000		85,000

Note : Calculation of Profit Sacrificing Ratio

Old Share - New Share = Share Sacrificed

Yellow 3/5 – 6/16 = 18/80

Green 3/5 – 5/16 = 7/80

Illustration 3

With the information given in illustration 2, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash.

Solution

Goodwill brought in cash

Bank Account	Dr.	31,250	
To Black's Capital Account			20,000
To Yellow's Capital Account			8,100
To Green's Capital Account			3,150

(Amount brought in by Black as capital and as goodwill; goodwill credited to Yellow and Green's

© The Institute of Chartered Accountants of India

Capital accounts in the profit sacrficing ratio)

Balance Sheet as on....................

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	41,250
Capital :			Sundry Assets	55,000
Yellow	33,100			
Green	23,150			
Black	20,000	76,250		
		96,250		96,250

Illustration 4

Continuing with the same illustration 2, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash, but withdrawn.

Solution

Goodwill brought in cash, but withdrawn

In addition to the treatment under Illustration 3 the following additional entry will be made:

Yellow's Capital Account	Dr.	8,100	
Green's Capital Account	Dr.	3,150	
To Bank Account			11,250
(Amount withdrawn by Yellow and Green in respect of goodwill credited to them)			

Balance Sheet as on....................

Liabilities	₹	₹	*Assets*	₹
Trade payables		20,000	Cash at Bank	30,000
Capital :			Sundry Assets	55,000
Yellow	25,000			
Green	20,000			
Black	20,000	65,000		
		85,000		85,000

Illustration 5

On the basis of information given in illustration 2, let us give journal entries and prepare balance sheet assuming that goodwill is paid privately.

Solution

There will be no entry for goodwill but Black will pay ₹ 8,100 to Yellow and ₹ 3,150 to Green. For capital brought in by Black, the entry is :

Bank Account	Dr.	20,000	
To Black's Capital Account			20,000
(Amount brought in by Black as capital)			

© The Institute of Chartered Accountants of India

Balance Sheet as on....................

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	30,000
Capital :			Sundry Assets	55,000
Yellow	25,000			
Green	20,000			
Black	20,000	65,000		
		85,000		85,000

6. ACCOUNTING TREATMENT OF GOODWILL IN CASE OF CHANGE IN PROFIT SHARING RATIO

In case of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners on the basis of profit sacrificing ratio.

Illustration 6

A, B & C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. Make the necessary journal entries.

Solution

Journal Entry

		₹	₹
A's Capital	Dr.	10,000	
To C's Capital A/c			10,000

In this case due to change in profit sharing ratio

A's gain is = 4/9 less 1/3 = 1/9

B's gain is = 1/3 less 1/3 = 0

C's loss is = 1/3 less 2/9 = 1/9

So, A should compensate C to the extent of 1/9th of goodwill i.e.

₹ 90,000 × 1/9 = ₹ 10,000

Illustration 7

A, B and C are in partnership sharing profits and losses in the ratio of 4:3:3. They decided to change the profit sharing ratio to 7:7:6. Goodwill of the firm is valued at ₹ 20,000. Calculate the sacrifice/gain by the partners and make the necessary journal entry.

© The Institute of Chartered Accountants of India

Solution

Partner	*New Share*		*Old Share*		*Difference*
A	$\frac{7}{20}$	−	$\frac{4}{10}$	=	$-\frac{1}{20}$
B	$\frac{7}{20}$	−	$\frac{3}{10}$	=	$\frac{1}{20}$
C	$\frac{6}{20}$	−	$\frac{3}{10}$	=	0

Thus, B gained 1/20th share while A sacrificed 1/20th share i.e. ₹ 20,000 x $\frac{1}{20}$ = ₹ 1,000. For C there was no loss no gain.

Journal Entry

		₹	₹
B's Capital A/c	Dr.	1,000	
To A's Capital A/c			1,000
(Being goodwill adjusted through partners' capital A/cs at sacrificing / gaining ratio)			

Illustration 8

A, B, C and D are in partnership sharing profits and losses equally. They mutually agreed to change the profit sharing ratio to 3:3:2:2. Give necessary journal entry.

Solution

A gains by $\frac{3}{10}-\frac{1}{4}=\frac{1}{20}$

B gains by $\frac{3}{10}-\frac{1}{4}=\frac{1}{20}$

C loses by $\frac{1}{4}-\frac{2}{10}=\frac{1}{20}$

D loses by $\frac{1}{4}-\frac{2}{10}=\frac{1}{20}$

So if goodwill is valued at ₹ 20,000, A and B should pay @ ₹ 1,000 each (i.e., ₹ 20,000 × 1/20) as compensation to C and D respectively for their sacrifice.

© The Institute of Chartered Accountants of India

Journal Entry

		₹	₹
A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	
To C's Capital Account			1,000
To D's Capital Account			1,000
(Being goodwill adjusted through partners' capital A/cs at sacrificing / gaining ratio)			

7. ACCOUNTING TREATMENT OF GOODWILL IN CASE OF RETIREMENT OR DEATH OF A PARTNER

In case of retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. Therefore they have to pay to retiring partner for his share of goodwill in the firm in the gaining ratio. Similarly, in case of death of the partner, the continuing partners should bear the share of goodwill due to the heirs of the deceased partner. For this purpose, the goodwill is valued on the date of the retirement or death and adjusted through the capital accounts of the partners.

Example : A, B & C are equal partners. C wanted to retire for which value of goodwill is considered as ₹ 90,000. The necessary journal entry will be :

A's Capital A/c	Dr.	₹ 15,000	
B's Capital A/c	Dr.	₹ 15,000	
To C's Capital A/c			₹ 30,000
(C's share of goodwill adjusted to existing partners' capital accounts in profit gaining ratio)			

Illustration 9

Wise, Clever and Dull were trading in partnership sharing profits and losses 4:3:3 respectively. The accounts of the firm are made upto 31st December every year.

The partnership provided, inter alia, that :

On the death of a partner the goodwill was to be valued at three years' purchase of average profits of the three years upto the date of the death after deducting interest @ 8 per cent on capital employed and a fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2011, Wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet.

It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be ₹ 15,000 per annum and that the capital employed would be ₹ 1,56,000. Clever and Dull were to continue the partnership, sharing profits and losses equally after the death of Wise.

© The Institute of Chartered Accountants of India

The following were the amounts of profits of earlier years before charging interest on capital employed.

	₹
2008	67,200
2009	75,600
2010	72,000
2011	62,400

You are requested to compute the value of goodwill and show the adjustment thereof in the books of the firm.

Solution

Computation of the value of goodwill :

(i) Average Profit for three years, ending 30th June; before death:

	₹	₹
Year ending 30th June, 2009 :		
1/2 of 2008 profits	33,600	
1/2 of 2009 Profits	37,800	71,400
Year ending 30th June, 2010 :		
1/2 of 2009	37,800	
1/2 of 2010 Profits	36,000	73,800
Year ending 30th June, 2011 :		
1/2 of 2010	36,000	
1/2 of 2011 Profits	31,200	67,200
Total		2,12,400
Average Profits		70,800

(ii) Average future maintainable profit :

Average profits earned		70,800
Less : Partner's remuneration	45,000	
: 8% on capital employed	12,480	57,480
		13,320

(iii) Goodwill @ three years' purchase 39,960

Adjustment entry for Goodwill

Journal

		Dr. ₹	*Cr.* ₹
Clever's Capital Account	Dr.	7,992	
Dull's Capital Account	Dr.	7,992	
To Wise's Capital Account			15,984
(Adjusting entry passed for share of goodwill of Wise through remaining partners' capital accounts in gaining ratio)			

© The Institute of Chartered Accountants of India

Working Note:

Partner	*New Share*		*Old Share*		*Difference*
Wise	-	–	$\frac{4}{10}$	=	$-\frac{4}{10}$
Clever	$\frac{1}{2}$	–	$\frac{3}{10}$	=	$\frac{2}{10}$
Dull	$\frac{1}{2}$	–	$\frac{3}{10}$	=	$\frac{2}{10}$

SELF EXAMINATION QUESTIONS

I. PICK UP THE CORRECT ANSWER FROM THE GIVEN CHOICES:

1. The profits of last five years are ₹ 85,000; ₹ 90,000; ₹ 70,000; ₹ 1,00,000 and ₹ 80,000. Find the value of goodwill, if it is calculated on average profits of last five years on the basis of 3 years of purchase.

   (a) ₹ 85,000. (b) ₹ 2,55,000. (c) ₹ 2,75,000. (d) ₹ 2,85,000.

2. The profits of last three years are ₹ 42,000; ₹ 39,000 and ₹ 45,000. Find out the goodwill of two years' purchase.

   (a) ₹ 42,000. (b) ₹ 84,000. (c) ₹ 1,26,000. (d) ₹ 36,000.

3. Find the goodwill of the firm using capitalization method from the following information:

   Total Capital Employed in the firm ₹ 8,00,000

   Reasonable Rate of Return 15%

   Profits for the year ₹ 12,00,000

   (a) ₹ 82,00,000. (b) ₹ 12,00,000. (c) ₹ 72,00,000. (d) ₹ 42,00,000

4. The capital of B and D are ₹ 90,000 and ₹ 30,000 respectively with the profit sharing ratio 3:1. The new ratio, admissible after 01.04.2011 is 5:3. The goodwill is valued ₹ 80,000 as on that date. Amount payable by a gaining partner to a sacrificing partner is:

   (a) B will pay to D ₹ 10,000. (b) D will pay to B ₹ 10,000.
   (c) B will pay to D ₹ 80,000. (d) D will pay to B ₹ 80,000.

5. A, B and C are equal partners. D is admitted to the firm for one-fourth share. D brings ₹ 20,000 capital and ₹ 5,000 being half of the premium for goodwill. The value of goodwill of the firm is

   (a) ₹ 10,000 (b) ₹ 40,000. (c) ₹ 20,000. (d) None of the above.

© The Institute of Chartered Accountants of India

6. The profits for 2008-2009 are ₹ 2,000; for 2009-2010 is ₹ 26,100 and for 2010-2011 is ₹ 31,200. Closing Inventory for 2009-2010 and 2010-11 includes the defective items of ₹ 2,200 and ₹ 6,200 respectively which were considered as having market value NIL. Calculate goodwill on simple average profit method.

   (a) ₹ 23,700. (b) ₹ 17,700. (c) ₹ 13,700. (d) ₹ 17,300.

7. A and B are partners with capitals of ₹ 10,000 and ₹ 20,000 respectively and sharing profits equally. They admitted C as their third partner with one-fourth profits of the firm on the payment of ₹ 12,000. The amount of hidden goodwill is .

   (a) 6,000. (b) 10,000. (c) 8,000. (d) None of the above.

8. X and Y share profits and losses in the ratio of 2 : 1. They take Z as a partner and the new profit sharing ratio becomes 3 : 2 : 1. Z brings ₹ 4,500 as premium for goodwill. The full value of goodwill will be

   (a) ₹ 4,500. (b) ₹ 18,000. (c) ₹ 27,000. (d) ₹ 24,000.

9. Under average profit basis goodwill is calculated by:

   (a) No. of years purchased multiplied with average profits.

   (b) No. of years purchased multiplied with super profits.

   (c) Summation of the discounted value of expected future benefits.

   (d) Super profit divided with expected rate of return.

10. Under super profit basis goodwill is calculated by:

    (a) No. of years purchased multiplied with average profits.

    (b) No. of years purchased multiplied with super profits.

    (c) Summation of the discounted value of expected future benefits.

    (d) Super profit divided with expected rate of return.

11. Under annuity basis goodwill is calculated by:

    (a) No. of years purchased multiplied with average profits.

    (b) No. of years purchased multiplied with super profits.

    (c) Summation of the discounted value of expected future benefits.

    (d) Super profit divided with expected rate of return.

12. Under capitalisation basis goodwill is calculated by:

    (a) No. of years purchased multiplied with average profits.

    (b) No. of years purchased multiplied with super profits.

    (c) Summation of the discounted value of expected future benefits.

    (d) Super profit divided with expected rate of return.

© The Institute of Chartered Accountants of India

13. The following particulars are available in respect of the business carried on by a partnership firm:

    Trading Results:

2008	Loss	₹ 5,000
2009	Loss	₹ 10,000
2010	Profit	₹ 75,000
2011	Profit	₹ 60,000

    You are required to compute the value of goodwill on the basis of 5 year's purchase of average profit of the business.

    (a) ₹ 1,25,000. (b) ₹ 1,50,000. (c) ₹ 10,000. (d) ₹ 1,20,000.

14. The profits and losses for the last years are 2007-08 Losses ₹ 10,000; 2008-09 Losses ₹ 2,500; 2009-10 Profits ₹ 98,000 & 2010-11 Profits ₹ 76,000. The average capital employed in the business is ₹ 2,00,000. The rate of interest expected from capital invested is 12%. The remuneration of partners is estimated to be ₹ 1,000 per month not charged in the above losses/profits. Calculate the value of goodwill on the basis of two years purchase of super profits based on the average of four years.

    (a) ₹ 9,000. (b) ₹ 8,750. (c) ₹ 8,500. (d) ₹ 8,250.

15. A, B and C are partners sharing profits and losses in the ratio 3:2:1. They decide to change their profit sharing ratio to 2:2:1. To give effect to this new profit sharing ratio they decide to value the goodwill at ₹ 30,000. Pass the necessary journal entry if Goodwill not appearing in the old balance sheet and should not appear in the new balance sheet.

		Dr.	Cr.
(a)	B's Capital Account Dr.	₹ 2,000	
	C's Capital Account Dr.	₹ 1,000	
	To A's Capital Account		₹ 3,000
(b)	Goodwill Account Dr.	₹ 30,000	
	To A's Capital Account		₹ 15,000
	To B's Capital Account		₹ 10,000
	To C's Capital Account		₹ 5,000
(c)	A's Capital Account Dr.	₹ 12,000	
	B's Capital Account Dr.	₹ 12,000	
	C's Capital Account Dr.	₹ 6,000	
	To Goodwill Account		₹ 30,000
(d)	A's Capital Account Dr.	₹ 3,000	
	To B's Capital Account		₹ 2,000
	To C's Capital Account		₹ 1,000

© The Institute of Chartered Accountants of India

16. Goodwill brought in by incoming partner in cash for joining in a partnership firm is taken away by the old partners in their ……… ratio.

    (a) Capital. (b) New Profit Sharing. (c) Sacrificing. (d) Old Profit Sharing.

17. A & B are partners sharing profits and losses in the ratio 5:3. On admission, C brings ₹ 70,000 cash and ₹ 48,000 against goodwill. New profit sharing ratio between A, B and C are 7:5:4. Find the sacrificing ratio of A:B.

    (a) 3:1. (b) 4:7. (c) 5:4. (d) 2:1.

18. Following are the factors affecting goodwill except:

    (a) Nature of business. (b) Efficiency of management.

    (c) Technical know how. (d) Location of the customers.

19. Weighted average method of calculating goodwill should be followed when:

    (a) Profits are uneven. (b) Profits has increasing trend.

    (c) Profits has decreasing trend. (d) Either 'b' or 'c'.

20. In the absence of any provision in the partnership agreement, profits and losses are shared

    (a) In the ratio of capitals. (b) Equally.

    (c) In the ratio of loans given by them to the partnership firm. (d) None of the above.

21. The profits and losses for the last years are 2007-08 Losses ₹ 10,000; 2008-09 Losses ₹ 2,500; 2009-10 Profits ₹ 98,000 & 2010-11 Profits ₹ 76,000. The average capital employed in the business is ₹ 2,00,000. The rate of interest expected from capital invested is 12%. The remuneration of partners is estimated to be ₹ 1,000 per month. Calculate the value of goodwill on the basis of four years purchase of super profits based on the annuity of the four years. Take discounting rate as 10%.

    (a) ₹ 13,500. (b) ₹ 13,568. (c) ₹ 13,668. (d) ₹ 13,868.

ANSWERS

1.	(b)	2.	(b)	3.	(c)	4.	(b)	5.	(b)	6.	(b)
7.	(a)	8.	(c)	9.	(a)	10.	(b)	11.	(c)	12.	(d)
13.	(b)	14.	(b)	15.	(a)	16.	(c)	17.	(a)	18.	(d)
19.	(d)	20.	(b)	21.	(d)						

© The Institute of Chartered Accountants of India

PARTNERSHIP ACCOUNTS

Unit 3

Admission of a New Partner

© The Institute of Chartered Accountants of India

Learning Objectives :

After studying this unit, you will be able to :

- Understand the reasons for which revaluation of assets and recomputation of liabilities is required in case of admission of a new partner. Also understand the logic of revaluation of assets and recomputation of liabilities at the time of admission of a partner.
- Learn the accounting treatments under two circumstances :
- (a) When revalued assets and recomputed liabilities are shown in the Balance Sheet, and
- (b) When revalued assets and recomputed liabilities are not shown in the Balance Sheet
- Learn the technique of treating reserve balance on admission of a partner.
- See the technique of arriving at new profit-sharing ratio.
- Observe the technique of inferring goodwill although figure of goodwill is not mentioned clearly.

1. INTRODUCTION

New partners are admitted for the benefit of the partnership firm. New partner is admitted either for increasing the partnership capital or for strengthening the management of the firm. When a new partner joins a firm, it is desirable to bring all appreciation or reduction in the value of assets into accounts as on the date of admission. Similarly, if the books contain any liability which has not been paid or if the books do not contain a liability which has to be paid, suitable entries should be passed. The purpose of such entries is to make an updated Balance Sheet on the date of admission. Also, all profits which have accrued but not yet brought into books and similarly, all losses which have occurred but not recorded, should now be brought into books so that the Capital Accounts of the old partners reflect the proper figure. As a result of passing of such entries, any subsequent profits or losses will be automatically shared by the incoming partner along with old partners.

Also the value of goodwill is to be assessed and proper accounting treatment is required to bring the value of goodwill into books of accounts. Treatment for goodwill has already been discussed in unit 2 of this chapter.

2. REVALUATION ACCOUNT OR PROFIT AND LOSS ADJUSTMENT ACCOUNT

When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio. The entries to be passed are :

© The Institute of Chartered Accountants of India

1. Revaluation Account Dr.
   To Assets Account with the reduction in the value of the assets
   (individually which show a decrease)
   To the Liabilities Accounts(Individually which with the increase in the liabilities.
   have to be increased)
2. Assets Account (Individually) Dr. with the increase in the value of the of assets
   Liabilities Accounts Dr. with the reduction in the amount liabilities
   To Revaluation Account
3. Revaluation Account Dr. with the profit in the old profit sharing ratio.
   To Capital A/cs of the old partners
   or
   Capital A/cs of the old partners Dr. with the loss in old profit sharing ratio.
   To Revaluation Account

As a result of the above entries, the capital account balances of the old partners will change and the assets and liabilities will have to be adjusted to their proper values. They will now appear in the Balance Sheet at revised figures.

Alternatively, the partners may agree that revalued figures will not be shown in the Balance Sheet and Assets and liabilities would appear in the Balance Sheet at their old values.

In this case, Memorandum Revaluation Account is opened. Any increase in the value of assets and/or decrease in the liabilities is credited to Memorandum Revaluation Account. The journal entry will be:

Assets Accounts Dr (with increase in the value of individual assets)
Liabilities Accounts Dr. (with decrease in the value of individual liabilities)
To Memorandum Revaluation Account

Similarly, any decrease in the value of assets and/or increase in the liabilities is debited to Memorandum Revaluation Account. The journal entry will be:

Memorandum Revaluation Account Dr.
To Assets Accounts (with increase in the value of individual assets)
To Liabilities Accounts (with decrease in the value of individual liabilities)

If the credit side of the Memorandum Revaluation Account is more than the debit side, there is a profit. This profit should be transferred to old Partner's Capital Accounts in the old profit sharing ratio. The journal entry will be:

Memorandum Revaluation Account Dr.
To Old Partner's Capital Accounts

If the debit side of the Memorandum Revaluation Account is more than the credit side, there is a loss which is transferred to old Partner's Capital Accounts in the old profit sharing ratio. The journal entry will:

© The Institute of Chartered Accountants of India

Old Partners' Capital Accounts Dr.

To Memorandum Revaluation Account

After completing the above procedure, reverse entries are made for increase in the values of assets and/or decrease in the liabilities, and decrease in the values of assets and/or increase in the liabilities) in the later portion of the Memorandum Revaluation Account. The profit on revaluation is to be transferred to all Partners' Capital Accounts in the new profit sharing ratio. The journey entry will be:

Memorandum Revolution Account Dr.

To All Partners' Capital Accounts (New profit and loss sharing ratio)

The loss on revaluation should be transferred to all Partners' Capital Accounts in the new profit sharing ratio. The journal entry will be:

All Partners' Capital Accounts Dr. (New profit and loss sharing ratio)

To Memorandum Revaluation Account

It should be noted that if there is a profit in the first half of the Memorandum Revaluation Account, the later half of the Memorandum Revaluation Account must show a loss. Conversely, if the first half of the Memorandum Revaluation Account shows a loss, the later half of the Memorandum Revaluation Account must show a profit.

When a Memorandum Revaluation Account is prepared, the book values of assets and liabilities do not change. In effect, the resultant profit or loss on revaluation is adjusted through the Partners' Capital Accounts. In this way, the amount invested as a capital by the incoming partner may be set at a level that reflects the current fair value of the partnership, even though the book values of assets and liabilities of the existing partnership remain unchanged in the books of accounts.

In case partners desire to disclose assets and liabilities in the balane sheet at old figures without opening Revaluation account then the change (i.e. increase or decrease) in the value of assets and liabilities may be adjusted through Partners' Capital Accounts directly.

Illustration 1

The following is the Balance Sheet of Ram and Mohan, who share profits in the ratio of 3:2 as on 1st January, 2011:

Liabilities	₹	*Assets*	₹
Trade payables	15,000	Buildings	18,000
Ram's Capital	20,000	Plant and Machinery	15,000
Mohan's Capital	25,000	Inventories	12,000
		Trade receivables	10,000
		Bank	5,000
	60,000		60,000

© The Institute of Chartered Accountants of India

On this date Shyam was admitted on the following :

1. He is to pay ₹ 25,000 as his capital and ₹ 10,000 as his share of goodwill for one fifth share in profits.
2. The new profits sharing ratio will be 5:3:2.
3. The assets are to be revalued as under :

	₹
Building	25,000
Plant and Machinery	12,000
Inventories	12,000
Trade receivables (because of doubtful debts)	9,500

4. It was found that there was a liability for ₹ 1,500 for goods received but not recorded in books.

Give journal entries to record the above.

Solution

Journal Entries

2011			*Dr.* (₹)	*Cr.* (₹)
Jan. 1	Bank Account	Dr.	35,000	
	To Shyam's Capital Account			35,000
	(Being amount brought in by Shyam for capital and goodwill)			
	Shyam's Capital Account	Dr.	10,000	
	To Ram's Capital Account			5,000
	To Mohan's Capital Account			5,000
	(Being Shyam's share of goodwill adjusted to existing partners' capital accounts in the profit sacrificing ratio 1:1)			
	Revaluation Account	Dr.	5,000	
	To Plant and Machinery Account			3,000
	To Provisions for Doubtful Debts Account			500
	To Trade payables Account			1,500
	(Being recording of the reduction in the value of assets and the liability which had been previously omitted)			
	Building Account	Dr.	7,000	
	To Revaluation Account			7,000
	(Being increase in the value of building brought into account)			

© The Institute of Chartered Accountants of India

Revaluation Account	Dr.	2,000	
To Ram's Capital Account			1,200
To Mohan's Capital Account			800
(Being profit on revaluation credited to Ram and Mohan in the old profit sharing ratio)			

Working Note:

Profit sacrificing ratio:

Ram = 3/5 less 1/2 = 1/10

Mohan = 2/5 less 3/10 = 1/10

Illustration 2

Continuing with the same illustration 1, let us also give the Balance Sheet of the partnership firm after Shyam's admission .

Solution

Balance Sheet of Ram, Mohan and Shyam as at January 1, 2011

Liabilities	₹	₹	*Assets*	₹	₹
Trade payables		16,500	Buildings		25,000
Capital Account			Plant and Machinery		12,000
Ram	26,200		Inventories		12,000
Mohan	30,800		Trade receivables	10,000	
Shyam	25,000	82,000	*Less :* Provision for		
			Doubtful Debts	(500)	9,500
			Bank		40,000
		98,500			98,500

Illustration 3

A and B are partners sharing profits and losses in the ratio of 3:2. Their Balance Sheet as on 31.3.2011 is given below:

Liabilities	₹	*Assets*	₹
Trade payables	50,000	Freehold premises	2,00,000
Capital Accounts:		Plant	40,000
A	2,00,000	Furniture	20,000
B	1,00,000	Office equipment	25,000
		Inventories	30,000
		Trade receivables	25,000
		Bank	10,000
	3,50,000		3,50,000

© The Institute of Chartered Accountants of India

On 1.4.2011 they admit C on the following terms:

(1) C will bring ₹ 50,000 as a capital and ₹ 10,000 for goodwill for 1/5 share;

(2) Provision for doubtful debts is to be made on Trade receivables @ 2%

(3) Inventory to be written down by 10%

(4) Freehold premises is to be revalued at ₹ 2,40,000, plant at ₹ 35,000, furniture ₹ 25,000 and office equipment ₹ 27,500.

(5) Partners agreed that the values of the assets and liabilities remain the same and, as such, there should not be any change in their book values as a result of the above mentioned adjustments.

You are required to make necessary adjustment in the Capital Accounts of the partners and show the Balance Sheet of the New Firm.

Solution

Dr. **Memorandum Revaluation Account** *Cr.*

	Particulars	₹		*Particulars*	₹
To	Provision for Bad Debts A/c	500	By	Freehold premises A/c	40,000
To	Inventory A/c	3,000	By	Furniture A/c	5,000
To	Plant A/c	5,000	By	Office equipment A/c	2,500
To	Profit on Revaluation A/c				
	A's Capital-3/5	23,400			
	B's Capital-2/5	15,600			
		47,500			47,500
To	Freehold premises A/c	40,000	By	Provision for Bad Debts A/c	500
To	Furniture A/c	5,000	By	Inventory A/c	3,000
To	Office equipment A/c	2,500	By	Plant A/c	5,000
				Loss on Revaluation A/c	
				A's Capital -12/25	18,720
				B's Capital-8/25	12,480
				C's Capital-5/25	7,800
		47,500			47,500

© The Institute of Chartered Accountants of India

Partners' Capital Accounts

Dr. Cr.

	Particulars	A ₹	B ₹	C ₹		*Particulars*	A ₹	B ₹	C ₹
To	A's Capital A/c B's Capital A/c			6,000 4,000	By	Balance b/d	2,00,000	1,00,000	-
To	Loss on revaluation A/c	18,720	12,480	7,800	By	Bank A/c			60,000
To	Balance c/d	2,10,680	1,07,120	42,200	By	C's Capital A/c	6,000	4,000	-
					By	Profit on revaluation A/c	23,400	15,600	-
		2,29,400	1,19,600	60,000			2,29,400	1,19,600	60,000

Balance Sheet as at 1.4.2011

Liabilities	₹	*Assets*	₹
Trade payables	50,000	Freehold premises	2,00,000
		Plant	40,000
Capital A/c		Furniture	20,000
A	2,10,680	Office equipment	25,000
B	1,07,120	Inventories	30,000
C	42,200	Trade receivables	25,000
		Bank (₹ 10,000 + ₹ 50,000 + ₹ 10,000)	70,000
	4,10,000		4,10,000

Illustration 4

A and B are partners in a firm, sharing profits and losses in the ratio of 3:2. The Balance Sheet of A and B as on 1.1.2009 was as follows:

Liabilities	₹	*Amount* ₹	*Assets*	₹	*Amount* ₹
Trade payables		17,000	Building		26,000
			Furniture		5,800
Bank overdraft		9,000	Inventories		21,400
Capital accounts:			Trade receivables	35,000	
A	44,000		Less: Provision	200	34,800
B	36,000	80,000	Investment		2,500
			Cash		15,500
		1,06,000			1,06,000

© The Institute of Chartered Accountants of India

'C' was admitted to the firm on the above date on the following terms:

(i) C is admitted for 1/6 share in the future profits and to introduce a capital of ₹ 25,000.

(ii) The new profit sharing ratio of A, B and C will be 3:2:1 respectively.

(iii) 'C' is unable to bring in cash for his share of goodwill, they decide to calculate goodwill on the basis of C's share in the profits and the capital contribution made by him to the firm.

(iv) Furniture is to be written down by ₹ 870 and Inventory to be depreciated by 5%. A provision is required for trade receivables @ 5% for bad debts. A provision would also be made for outstanding wages for ₹ 1,560. The value of buildings having appreciated be brought upto ₹ 29,200. The value of investments is increased by ₹ 450.

(v) It is found that the trade payables included a sum of ₹ 1,400, which is not to be paid off.

Prepare the following:

(i) Revaluation account.

(ii) Partners' capital accounts.

Solution

Revaluation Account

Dr.		₹		*Cr.* ₹
To	Furniture	870	By Building	3,200
To	Inventory	1,070	By Trade payables	1,400
To	Provision for doubtful debts		By Investment	450
	(₹ 1,750 - ₹ 200)	1,550		
To	Outstanding wages	1,560		
		5,050		5,050

Partners' Capital Accounts

Dr.							*Cr.*
	A ₹	*B* ₹	*C* ₹		*A* ₹	*B* ₹	*C* ₹
To A			4,500	By Balance b/d	44,000	36,000	–
To B			3,000	By Cash A/c	–	–	25,000
To Balance c/d	48,500	39,000	17,500	By C			
				(working note 2)	4,500	3,000	–
	48,500	39,000	25,000		48,500	39,000	25,000

© The Institute of Chartered Accountants of India

Working Notes :

1. *Calculation of goodwill:*

   C's contribution of ₹ 25,000 consists of only 1/6th of capital.

   Therefore, total capital of firm should be ₹ 25,000 x 6 = ₹ 1,50,000

   But combined capital of A, B and C amounts ₹ 44,000 + 36,000 + 25,000 = ₹ 1,05,000

   Thus, the hidden goodwill is ₹ 45,000 (₹ 1,50,000 - ₹ 1,05,000).

   Goodwill will be shared by A & B in their sacrificing ratio.

2. Calculation of sacrificing ratio

Partners	New share	Old share	Sacrifice	Gain
A	$\frac{3}{6}$	$\frac{3}{5}$	$-\frac{3}{30}$	
B	$\frac{2}{6}$	$\frac{2}{5}$	$-\frac{2}{30}$	
C	$\frac{1}{6}$			$\frac{1}{6}$

Therefore, A will get = ₹ 45,000x$\frac{3}{30}$ = ₹ 4,500;

B will get = ₹ 45,000x$\frac{2}{30}$ = ₹ 3,000; and

C will be debited on account of goodwill = ₹ 45,000x$\frac{1}{6}$ = ₹ 7,500

3. RESERVES IN THE BALANCE SHEET

Whenever a new partner is admitted, any reserve etc. lying in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio. (In examination problems it should be done even if there are no instructions on this point).

Illustration 5

Dalal, Banerji and Mallick are partners in a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March, 2011 is as below :

Liabilities		₹	*Assets*	₹
Trade payables		12,850	Land and Buildings	25,000
Outstanding Liabilities		1,500	Furniture	6,500
General Reserve		6,500	Inventory of goods	11,750
Capital Account :			Trade receivables	5,500
Mr. Dalal	12,000		Cash in hand	140
Mr. Banerji	12,000		Cash at Bank	960
Mr. Mallick	5,000	29,000		
		49,850		49,850

© The Institute of Chartered Accountants of India

The partners have agreed to take Mr. Mistri as a partner with effect from 1st April, 2011 on the following terms :

(1) Mr. Mistri shall bring ₹ 5,000 towards his capital.

(2) The value of Inventory should be increased by ₹ 2,500 and Furniture should be depreciated by 10%.

(3) Reserve for bad and doubtful debts should be provided at 10% of the Trade receivables.

(4) The value of land and buildings should be enhanced by 20% and the value of the goodwill be fixed at ₹ 15,000.

(5) The value of the goodwill be fixed at ₹ 15,000.

(6) General Reserve will be transferred to the Partners' Capital Accounts.

(7) The new profit sharing ratio shall be : Mr. Dalal 5/15, Mr. Banerji 5/15, Mr. Mallick 3/15 and Mr. Mistri 2/15.

The outstanding liabilities include ₹ 1,000 due to Mr. Sen which has been paid by Mr. Dalal. Necessary entries were not made in the books.

Prepare (i) Revaluation Account, and (ii) The Capital Accounts of the partners.

Solution

Revaluation Account

2011			₹	2011		₹
April 1	To Provision for bad and doubtful debts		550	April 1	By Inventory in trade	2,500
	To Furniture and fittings		650		By Land and Building	5,000
	To Capital A/cs: (Profit on revaluation transferred)					
	Dalal	2,520				
	Banerji	2,520				
	Mallick	1,260	6,300			
			7,500			7,500

© The Institute of Chartered Accountants of India

Partners' Capital Accounts

Dr. Cr.

Particulars	Dalal ₹	Banerji ₹	Mallick ₹	Mistri ₹	Particulars	Dalal ₹	Benerji ₹	Mallick ₹	Mistri ₹
To Dalal				1,000	By Balance b/d	12,000	12,000	5,000	–
To Banerji				1,000	By General				
To Balance c/d	19,120	18,120	7,560	3,000	Reserve	2,600	2,600	1,300	
					By Cash	–	–	–	5,000
					By Mistri	1,000	1,000	–	–
					By Outstanding				
					Liabilities	1,000	–	–	
					By Revaluation A/c	2,520	2,520	1,260	–
	19,120	18,120	7,560	5,000		19,120	18,120	7,560	5,000

Working Note:

Calculation of sacrificing ratio

Partners	New share	Old share	Sacrifice	Gain
Dalal	$\frac{5}{15}$	$\frac{2}{5}$	$-\frac{1}{15}$	
Banerji	$\frac{5}{15}$	$\frac{2}{5}$	$-\frac{1}{15}$	
Mallick	$\frac{3}{15}$	$\frac{1}{5}$	No gain No loss	–
Mistri	$\frac{2}{15}$			$\frac{2}{15}$

Sacrifice by Mr. Dalal and Mr. Banerji = ₹ 15,000 x $\frac{1}{15}$ = ₹ 1,000 each

Illustration 6

With the information given in illustration 4, after preparing revaluation account and partners' capital accounts, prepare the Balance Sheet of the firm after admission of Mr. Mistri.

© The Institute of Chartered Accountants of India

Solution

Balance Sheet of M/s. Dalal, Banerji, Mallick and Mistri as on 1-4-2011

Liabilities	₹	₹	*Assets*	₹	₹
Trade payables		12,850	Land and Buildings		30,000
Outstanding Liabilities		500	Furniture		5,850
Capital Accounts of Partners :					
			Inventory of goods		14,250
Mr. Dalal	19,120		Trade receivables	5,500	
Mr. Banerji	18,120		*Less :* Provisions	(550)	4,950
Mr. Mallick	7,560		Cash in hand		140
Mr. Mistri	3,000	47,800	Cash at Bank		5,960
		61,150			61,150

4. COMPUTATION OF NEW PROFIT SHARING RATIO

When a new partner is admitted and there is no agreement to the contrary, it is supposed that old partners will continue to have inter se at the old profit sharing ratio.

For example, A and B are in partnership sharing profits and losses at the ratio of 3:2. They admitted C as 1/5 partner. For computation of new profit sharing ratio.

(i) Firstly, deduct the share offered to new partner from 1.

$1 - 1/5 = 4/5$

(ii) Divide the balance of share between A and B in the ratio of 3:2.

$A = 4/5 \times 3/5 = 12/25$

$B = 4/5 \times 2/5 = 8/25$

(iii) New profit sharing ratio is

	A :	B	: C
	12/25 :	8/25	: 1/5
or	12/25 :	8/25	: 5/25
	i.e. 12 : 8 : 5		

Illustration 7

A and B are in partnership sharing profits and losses at the ratio 3:2. They take C as a new partner. Calculate the new profit sharing ratio if -

(i) C purchases 1/10 share from A

(ii) A and B agree to sacrifice 1/10th share to C in the ratio of 2 : 3

(iii) Simply gets 1/10th share of profit.

© The Institute of Chartered Accountants of India

Solution

(i) New profit sharing ratio :

A = 3/5 – 1/10 = 5/10

B = 2/5 i.e. 4/10

C = 1/10

i.e. 5 : 4 : 1

(ii) A's sacrifice 1/10× 2/5 = 2/50

B's sacrifice 1/10 × 3/5 = 3/50

New profit sharing ratio

A = 3/5 – 2/50 = 28/50

B = 2/5 – 3/50 = 17/50

C = 1/10 i.e. 5/50

i.e. 28 : 17 : 5

(iii) Balance of share to be divided between A and B :

1 – 1/10= 9/10

Distribution :

A = 9/10 × 3/5 = 27/50

B = 9/10 × 2/5 = 18/50

C = 1/10. i.e. = 5/50

i.e. 27 : 18 : 5

Illustration 8

A and B are in the partnership sharing profits and losses in the proportion of three-fourth and one-fourth respectively. Their balance sheet as on 31st March, 2011 was as follows:

Cash ₹ 1,000; trade receivables ₹ 25,000; Inventory ₹ 22,000: plant and machinery ₹ 4,000; trade payables ₹ 12,000; bank overdraft ₹ 15,000; A's capital ₹ 15,000; B's capital ₹ 10,000.

On 1st April, 2011, they admitted C into partnership on the following terms:

(i) C to purchase one–third of the goodwill for ₹ 2,000 and provide ₹ 10,000 as capital. Goodwill not to appear in books.

(ii) Further profits and losses are to be shared by A, B and C equally.

(iii) Plant and machinery is to be reduced by 10% and ₹ 500 is to be provided for estimated bad debts. Inventory is to be taken at a valuation of ₹ 24,940.

(iv) By bringing in or withdrawing cash and capitals of A and B are to be made proportionate to that of C on their profit-sharing basis.

© The Institute of Chartered Accountants of India

Set out entries to the above arrangement in the firm's journal and give the partners' capital accounts in tabular form.

Solution

Journal Entries
as on 1st April, 2011

		Dr. (₹)	Cr. (₹)
Revaluation Account	Dr.	900	
To Plant and machinery Account			400
To Provision for bad debts Account			500
(Plant & machinery reduced by 10% and ₹ 500 provided for bad debts)			
Inventory Account	Dr.	2,940	
To Revaluation Account			2,940
(Value of Inventory increased by ₹ 2,940)			
Revaluation Account	Dr.	2,040	
To A's capital Account			1,530
To B's capital Account			510
(Profit on revaluation transferred)			
Cash Account	Dr.	12,000	
To C's capital Account			12,000
(Cash brought in by C as his capital)			
C's Capital Account	Dr.	2,000	
B's capital Account	Dr.	500	
To A's capital Account			2,500
(Entry for goodwill purchased by B and C)			
A's capital Account	Dr.	9,030	
B's capital Account	Dr.	10	
To Cash Account			9,040
(Excess amount of capital withdrawn)			

© The Institute of Chartered Accountants of India

Partners' Capital Accounts

Dr. *Cr.*

	A ₹	*B* ₹	*C* ₹		*A* ₹	*B* ₹	*C* ₹
To A's capital A/c	-	500		By Balance b/d	15,000	10,000	–
To Cash	9,030	10		By Revaluation A/c	1,530	510	–
To Balance c/d	10,000	10,000	10,000	By Cash	2,000	–	10,000
				By B's Capital A/c	500		
	19,030	10,510	10,000		19,030	10,510	10,000

Working Note:

Calculation of goodwill

C pays ₹ 2,000 on account of goodwill for 1/3rd share of profit/loss. Total goodwill is ₹ 2,000 x 3 = ₹ 6,000.

Gaining ratio:

B: 1/3-1/4 = 1/12

C: 1/3

Goodwill to be paid to A:

By B ₹ 6,000 x 1/12 =	₹ 500
By C ₹ 6,000 x 1/3 =	₹ 2,000
Total	₹ 2,500

Illustration 9

A and B are partners of X & Co. sharing profits and losses in 3:2 ratio between themselves. On 31st March, 2011, the balance sheet of the firm was as follows:

Balance Sheet of X & Co. as at 31.3.2011

Liabilities	₹	₹	*Assets*	₹
Capital accounts:			Plant and machinery	20,000
A	37,000		Furniture and fittings	5,000
B	28,000			
		65,000	Inventories	15,000
Trade payables		5,000	Trade receivables	20,000
			Cash in hand	10,000
		70,000		70,000

© The Institute of Chartered Accountants of India

X agrees to join the business on the following conditions as and from 1.4.2011:

(a) He will introduce ₹ 25,000 as his capital and pay ₹ 15,000 to the partners as premium for goodwill for 1/3rd share of the future profits of the firm.

(b) A revaluation of assets of the firm will be made by reducing the value of plant and machinery to ₹ 15,000, Inventory by 10%, furniture and fitting by ₹ 1,000 and by making a provision of bad and doubtful debts at ₹ 750 on trade receivables.

Prepare profit and loss adjustment account, capital accounts of partners including the incoming partner X assuming that the relative ratios of the old partners will be in equal proportion after admission.

Solution

Profit and Loss Adjustment Account

Dr. *2011*	₹	*2011*		Cr. ₹
April 1		April 1		
To Plant and machinery A/c	5,000	By Partners' capital accounts		
To Inventory A/c	1,500	- Loss on revaluation		
To Furniture and fitting A/c	1,000	A (3/5)	4,950	
To Provision for bad and doubtful debts	750	B (2/5)	3,300	8,250
	8,250			8,250

Partners' Capital Accounts

Dr. Cr.

	A ₹	*B* ₹	*X* ₹		*A* ₹	*B* ₹	*X* ₹
To Profit & loss adjustment A/c	4,950	3,300	–	By Balance b/d	37,000	28,000	–
				By Cash A/c	–	–	40,000
To A's & B's capital A/cs	–	–	15,000	By X's capital A/c [W. N.(ii)]	12,000	3,000	–
To Balance c/d	44,050	27,700	25,000				
	49,000	31,000	40,000		49,000	31,000	40,000

© The Institute of Chartered Accountants of India

Working Notes:

(i) New profit sharing ratio :

On admission of X who will be entitled to 1/3rd share of the future profits of the firm. A and B would share the remaining 2/3rd share in equal proportion i.e. 1:1.

A: 2/3 x 1/2 = 1/3

B: 2/3 x 1/2 = 1/3

X:1/3

A, B and X would share profits and losses in equal ratio.

(ii) Adjustment of goodwill :

X pays ₹ 15,000 as premium for goodwill for 1/3rd share of the future profits.

Thus, total value of goodwill is ₹ 15,000 x 3 i.e. ₹ 45,000

Sacrificing ratio:

A: 3/5 - 1/3 = 4/15

A: 2/5 - 1/3 = 1/15

Hence, sacrificing ratio is 4:1

Adjustment of X's share of goodwill through existing partners' capital accounts in the profit sacrificing ratio:

	₹
A: 15,000 x 4/5 =	12,000
B: 15,000 x 1/5 =	3,000
	15,000

5. HIDDEN GOODWILL

When the value of the goodwill of the firm is not specifically given, the value of goodwill has to be inferred as follows:

	₹
Incoming partner's capital x Reciprocal of share of incoming partner	xxx
Less: Total capital after taking into consideration the capital brought in by incoming partner	xxx
Value of Goodwill	xxx

Illustration 10

A and B are partners with capitals of ₹ 7,000 each. They admit C as a partner with 1/4th share in the profits of the firm. C brings ₹ 8,000 as his share of capital. Give the necessary journal entry to record goodwill.

© The Institute of Chartered Accountants of India

Solution:

Journal Entry

Particulars		Dr. (₹)	Cr. (₹)
C's Capital A/c [₹ 10,000 x 1/4]	Dr.	2,500	
To A's Capital A/c			1,250
To B's Capital A/c			1,250
(Being the share of C in the hidden goodwill adjusted through capital accounts by crediting sacrificing partners in their sacrificing ratio)			

Note: Hidden Goodwill = $\left(8{,}000 \times \frac{4}{1}\right)$-(₹ 7,000 + ₹ 7,000+8,000) = ₹ 10,000

Illustration 11

A and B are in partnership sharing profits and losses equally. The Balance Sheet M/s. A and B as on 31.12.2011, was as follows :

Liabilities	₹	*Assets*	₹
Capital A/cs		Sundry Fixed Assets	60,000
A	45,000	Inventories	30,000
B	45,000	Bank	20,000
Trade payables	20,000		
	1,10,000		1,10,000

On 1.1.2012 they agreed to take C as 1/3rd partner to increase the capital base to ₹ 1,35,000. C agrees to pay ₹ 60,000. Show the necessary journal entries and prepare partners' capital accounts.

Solution

In the Books of M/s. A, B and C

Journal Entries

		₹	₹
Bank A/c	Dr.	60,000	
To C's Capital A/c			60,000
(Cash brought in by C for 1/3rd share)			
C's Capital A/c	Dr.	15,000	
To A's Capital A/c			7,500
To B's Capital A/c			7,500
A's Capital A/c	Dr.	7,500	
B's Capital A/c	Dr.	7,500	
To Bank A/c			15,000
(Amount of goodwill due to A and B withdrawn)			

Workings :

© The Institute of Chartered Accountants of India

(1) Old Profit Sharing Ratio : 1 : 1

(2) New Profit Sharing Ratio : 1:1:1

(3) C's share of capital ₹ 1,35,000 × 1/3 = ₹ 45,000

(4) Goodwill ₹ 60,000 – ₹ 45,000 = ₹ 15,000 for 1/3rd share.

Total Goodwill : ₹ 15,000 × 3 = ₹ 45,000

Partners' Capital A/cs

Dr. *Cr.*

Particulars	*A* ₹	*B* ₹	*C* ₹	*Particulars*	*A* ₹	*B* ₹	*C* ₹
To A			7,500	By Balance b/d	45,000	45,000	–
To B			7,500	By Bank	–	–	60,000
To Bank	7,500	7,500	–	By C	7,500	7,500	–
To Balance c/d	45,000	45,000	45,000				
	52,500	52,500	60,000		52,500	52,500	60,000

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices :

1. A and B are partners sharing profits and losses in the ratio 5:3. They admitted C and agreed to give him 3/10th of the profit. What is the new ratio after C's admission?

   (a) 35:42:17. (b) 35:21:24. (c) 49:22:29. (d) 34:20:12.

2. A and B are partners sharing profits in the ratio 5:3, they admitted C giving him 3/10th share of profit. If C acquires 1/5 from A and 1/10 from B, new profit sharing ratio will be:

   (a) 5:6:3. (b) 2:4:6. (c) 18:24:38. (d) 17:11:12

3. C was admitted in a firm with 1/4th share of the profits of the firm. C contributes ₹ 15,000 as his capital, A and B are other partners with the profit sharing ratio as 3:2. Find the required capital of A and B, if capital should be in profit sharing ratio taking C's as base capital:

   (a) ₹ 27,000 and ₹ 16,000 for A and B respectively.

   (b) ₹ 27,000 and ₹ 18,000 for A and B respectively.

   (c) ₹ 32,000 and ₹ 21,000 for A and B respectively.

   (d) ₹ 31,000 and ₹ 26,000 for A and B respectively.

4. A, B and C are partners sharing profits and losses in the ratio 6:3:3, they agreed to take D into partnership for 1/8th share of profits. Find the new profit sharing ratio.

   (a) 12:27:36:42. (b) 14:7:7:4. (c) 1:2:3:4. (d) 7:5:3:1.

5. X and Y are partners sharing profits in the ratio 5:3. They admitted Z for 1/5th share of profits, for which he paid ₹ 1,20,000 against capital and ₹ 60,000 against goodwill. Find the capital balances for each partner taking Z's capital as base capital.

© The Institute of Chartered Accountants of India

(a) ₹ 3,00,000; ₹ 1,20,000 and ₹ 1,20,000. (b) ₹ 3,00,000; ₹ 1,20,000 and ₹ 1,80,000.
(c) ₹ 3,00,000; ₹ 1,80,000 and ₹ 1,20,000. (d) ₹ 3,00,000; ₹ 1,80,000 and ₹ 1,80,000.

6. A and B are partners sharing profits and losses in the ratio of 3:2 (A's Capital is ₹ 30,000 and B's Capital is ₹ 15,000). They admitted C and agreed to give 1/5th share of profits to him. How much C should bring in towards his capital?
(a) ₹ 9,000. (b) ₹ 12,000. (c) ₹ 14,500. (d) ₹ 11,250.

7. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who brings in ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. In what ratio will this amount will be shared among the old partners A & B.
(a) ₹ 8,000: ₹ 2,000. (b) ₹ 5,000: ₹ 5,000.
(c) Old partners will not get any share in the goodwill brought in by C.
(d) ₹ 6,000: ₹ 4,000.

8. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who is supposed to bring ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. C is able to bring ₹ 30,000 only. How this will be treated in the books of the firm.
(a) A and B will share goodwill brought by C as ₹ 4,000: ₹ 1,000.
(b) Goodwill not brought, will be adjusted to the extent of ₹ 5,000 in sacrificing ratio.
(c) Both. (d) None.

9. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who is supposed to bring ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. C is able to bring only his share of capital. How this will be treated in the books of the firm?
(a) A and B will share goodwill bought by C as 4,000:1,000.
(b) Goodwill not brought, will be adjusted to the extent of ₹ 10,000 in sacrificing ratio.
(c) Both. (d) None.

10. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who is supposed to bring ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. C brought cash for his share of Capital and agreed to compensate to A and B outside the firm. How this will be treated in the books of the firm.
(a) Cash brought in by C will only be credited to his capital account.
(b) Goodwill will be raised to full value in old ratio.
(c) Goodwill will be raised to full value in new ratio.
(d) Cash brought by C will be credited to his account and debited with his share of goodwill, which will be debited to A and B's account in sacrificing ratio.

11. Profit or loss on revaluation is shared among the partners in ……… ratio.
(a) Old Profit Sharing. (b) New Profit Sharing.
(c) Capital. (d) Equal.

12. Amit and Anil are partners of a partnership firm sharing profits in the ratio of 5:3 respectively. Atul was admitted on the following terms: Atul would pay ₹ 50,000 as capital and ₹ 16,000 as Goodwill, for 1/5th share of profit. Machinery would be appreciated by 10% (book value ₹ 80,000) and building would be depreciated by 20% (₹ 2,00,000). Unrecorded trade receivables of

© The Institute of Chartered Accountants of India

₹ 1,250 would be brought into books now and a trade payables amounting to ₹ 2,750 died and need not to pay anything to its estate. Find the distribution of profit/loss on revaluation between Amit, Anil and Atul.

(a) Loss – ₹ 17,500: ₹ 10,500:0. (b) Loss – ₹ 14,000: ₹ 8,400: ₹ 5,600.

(c) Profits – ₹ 17,500: ₹ 10,500:0. (d) Profits – ₹ 14,000: ₹ 8,400: ₹ 5,600.

13. Amit and Anil are partners of a partnership firm sharing profits in the ratio of 5:3 with capital of ₹ 2,50,000 & ₹ 2,00,000 respectively. Atul was admitted on the following terms: Atul would pay ₹ 50,000 as capital and ₹ 16,000 as Goodwill, for 1/5th share of profit. Find the balance of capital accounts after admission of Atul.

(a) ₹ 2,60,000: ₹ 2,06,000: ₹ 50,000. (b) ₹ 2,20,000: ₹ 1,82,000: ₹ 66,000.

(c) ₹ 2,92,500: ₹ 2,25,500: ₹ 50,000. (d) ₹ 2,82,500: ₹ 2,19,500: ₹ 66,000.

14. A and B shares profits and losses equally. They admit C as an equal partner and assets were revalued as follow: Goodwill at ₹ 30,000 (book value NIL). Inventory at ₹ 20,000 (book value ₹ 12,000); Machinery at ₹ 60,000 (book value ₹ 55,000). C is to bring in ₹ 20,000 as his capital and the necessary cash towards his share of Goodwill. Goodwill Account will not be shown in the books. Find the profit/loss on revaluation to be shared among A, B and C.

(a) ₹ 21,500: ₹ 21,500:0. (b) ₹ 6,500: ₹ 6,500:0.

(c) ₹ 14,333: ₹ 14,333: ₹ 14,333. (d) ₹ 4,333: ₹ 4,333: ₹ 4,333.

15. A and B shares profit and losses equally. They admit C as an equal partner and goodwill was valued as ₹ 30,000 (book value NIL). C is to bring in ₹ 20,000 as his capital and the necessary cash towards his share of Goodwill. Goodwill Account will not remain in the books. What will be the final effect of goodwill in the partner's capital account?

(a) A & B's account credited with ₹ 5,000 each.

(b) All partners' account credited with ₹ 10,000 each.

(c) Only C's account credited with ₹ 10,000 as cash bought in for goodwill.

(d) Final effect will be nil in each partner.

16. A and B having share capital of ₹ 20,000 each, share profits and losses equally. They admit C as an equal partner and goodwill was valued as ₹ 30,000 (book value NIL). C is to bring in ₹ 20,000 as his capital and the necessary cash towards his share of Goodwill. Goodwill Account will not be shown in the books. If profit on revaluation is ₹ 13,000, find the closing balance of the capital accounts.

(a) ₹ 31,500: ₹ 31,500: ₹ 20,000. (b) ₹ 31,500: ₹ 31,500: ₹ 30,000.

(c) ₹ 26,500: ₹ 26,500: ₹ 30,000. (d) ₹ 20,000: ₹ 20,000: ₹ 20,000.

17. Balance sheet prepared after the new partnership agreement, assets and liabilities are recorded at:

(a) Original Value. (b) Revalued Figure.

(c) At realisable value. (d) At current cost.

18. P and Q are partners sharing Profits in the ratio of 2:1. R is admitted to the partnership with effect from 1st April on the term that he will bring ₹ 20,000 as his capital for 1/4th share and pays ₹ 9,000 for goodwill, half of which is to be withdrawn by P and Q. How much cash can P & Q withdraw from the firm (if any).

(a) ₹ 3,000: ₹ 1,500. (b) ₹ 6,000: ₹ 3,000.

(c) NIL. (d) None of the above.

© The Institute of Chartered Accountants of India

19. P and Q are partners sharing Profits in the ratio of 2:1. R is admitted to the partnership with effect from 1st April on the term that he will bring ₹ 20,000 as his capital for 1/4th share and pays ₹ 9,000 for goodwill, half of which is to be withdrawn by P and Q. If profit on revaluation is ₹ 6,000 and opening capital of P is ₹ 40,000 and of Q is ₹ 30,000, find the closing balance of each capital.
    (a) ₹ 47,000: ₹ 33,500: ₹ 20,000.
    (b) ₹ 50,000: ₹ 35,000: ₹ 20,000.
    (c) ₹ 40,000: ₹ 30,000: ₹ 20,000.
    (d) ₹ 41,000: ₹ 30,500: ₹ 29,000.
20. Adam, Brain and Chris were equal partners of a firm with goodwill ₹ 1,20,000 shown in the balance sheet and they agreed to take Daniel as an equal partner on the term that he should bring ₹ 1,60,000 as his capital and goodwill, his share of goodwill was evaluated at ₹ 60,000 and the goodwill account is to be written off before admission. What will be the treatment for goodwill?
    (a) Write off the goodwill of ₹ 1,20,000 in old ratio.
    (b) Cash brought in by Daniel for goodwill will be distributed among old partners in sacrificing ratio.
    (c) Both (a) & (b)
    (d) None of the above
21. Which of the following asset is compulsory to revalue at the time of admission of a new partner:
    (a) Inventory.
    (b) Fixed Assets.
    (c) Investment.
    (d) Goodwill.
22. X and Y are partners sharing profits in the ratio of 3 : 1. They admit Z as a partner who pays ₹ 4,000 as Goodwill the new profit sharing ratio being 2 : 1 : 1 among X, Y and Z respectively. The amount of goodwill will be credited to :
    (a) X and Y as ₹ 3,000 and ₹ 1,000 respectively.
    (b) X only
    (c) Y only.
    (d) None of the above.

ANSWERS

1.	(b)	2.	(d)	3.	(b)	4.	(b)	5.	(c)
6.	(d)	7.	(a)	8.	(c)	9.	(b)	10.	(a)
11.	(a)	12.	(a)	13.	(a)	14.	(b)	15.	(a)
16.	(a)	17.	(b)	18.	(a)	19.	(a)	20.	(c)
21.	(d)	22.	(b)						

© The Institute of Chartered Accountants of India

PARTNERSHIP ACCOUNTS

Unit 4

Retirement of a Partner

© The Institute of Chartered Accountants of India

Learning Objectives

After studying this unit, you will be able to :

- Learn how to compute the gaining ratio and observe the use of such gaining ratio,
- Be familiar with the accounting treatment in relation to revaluation of assets and liabilities,
- Learn the accounting entries to be passed for transfer of reserves standing in the balance sheet to partners' capital accounts in a manner already discussed for admission of a partner in unit 3 of the chapter,
- Learn the technique of keeping records if the balance due to the retiring partner is transferred to loan account.
- Familiarize with the term Joint Life Policy.
- Learn how to keep records for payment of premium in relation to Joint Life Policy. Also observe the accounting treatment in relation to such Joint Life Policy in case of retirement of a partner.

1. INTRODUCTION

A partner may retire from the partnership firm because of old age, illness, etc. Generally, the business of the partnership firm may not come to an end when one of the partners retires. Other partners may continue to run the business of the firm. Readjustment takes place in case of retirement of a partner likewise the case of admission of a partner. Whenever a partner retires, the continuing partners make gain in terms of profit sharing ratio. Therefore, the remaining partners arrange for the amount to be paid to discharge the claims of the retiring partners. Assets and liabilities are revalued, value of goodwill is raised and surrender value of joint life policy, if any, is taken into account. Revaluation profit and reserves are transferred to capital or current accounts of partners. Lastly, final amount due to the retiring partner is determined and discharged.

2. CALCULATION OF GAINING RATIO

On retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. For example, if A, B and C were sharing profits and losses in the ratio of 5 : 3 : 2 and B retires, then A and C have to decide at which ratio they will share profits and losses in future. If it is decided that the continuing partners will share profits and losses in future at the ratio of 3:2, then A gains 1/10th [(3/5)-(5/10)] and C gains 2/10 [(2/5)-(2/10)]. So the gaining ratio between A and C is 1:2. If A and C decide to continue at the ratio 5:2, this indicates that they are dividing the gained share in the previous profit sharing ratio.

Example: Amir, Jamir and Samir are in partnership sharing profits and losses at the ratio of 3:2:1. Now Amir wants to retire and Jamir and Samir want to continue at the ratio of 3:2. In this case, Jamir gains 8/30th of share of partnership (3/5 less 2/6) whereas Samir gains 7/30th (2/5 less 1/6) share of the partnership. So gaining ratio between Jamir and Samir is 8:7. On the other hand, if Jamir and Samir would decide to continue sharing profits and losses at the ratio of 2:1, then Jamir would gain 2/6th share of partnership i.e. [(2/3)–(2/6)], and Samir would

© The Institute of Chartered Accountants of India

gain 1/6th share of partnership i.e. [(1/3)–(1/6)]. So it appears that in such a case gaining ratio of Jamir and Samir would be 2:1. i.e., the existing profit sharing ratio between them.

3. REVALUATION OF ASSETS AND LIABILITIES ON RETIREMENT OF A PARTNER

On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner. If there is revaluation profit, then such profit should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio. On the other hand, if there is loss on revaluation that is also to be distributed to all the partners including the retiring partner at the existing profit sharing ratio. To arrive at, profit or loss on revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is opened. Revaluation Account or Profit and Loss Adjustment Account is closed automatically by transfer of profit or loss balance to the Partners' Capital Accounts.

If it is decided that revalued figures of assets and liabilities will not appear in the balance sheet of the continuing partners, then a journal entry should be passed with the amount payable or chargeable to the retiring partner which the continuing partners will share at the ratio of gain. In the first instance, the journal entry for distribution of profit or loss on revaluation which will appear in the balance sheet also is as follows :

Revaluation A/c	Dr.
To Partners' Capital A/cs	
(For profit on revaluation)	
Or	
Partners' Capital A/cs	Dr.
To Revaluation A/c	
(For loss on revaluation)	

Now see how to deal with a situation where revalued figures will not appear in the Balance Sheet.

If A, B & C share profits and losses equally and there is a revaluation profit of ₹ 30,000 calculated on A's retirement, then ₹ 10,000 becomes due to A which is to be borne by B and C equally. So the journal entry will be as follows :

		₹	₹
B's Capital A/c	Dr.	5,000	
C's Capital A/c	Dr.	5,000	
To A's Capital A/c			10,000

Alternatively it is possible to account for the increase in the value of assets or decrease in the

© The Institute of Chartered Accountants of India

value of liabilities by debiting the appropriate asset account or liability account and crediting partners' capital account at the existing profit sharing ratio. Simultaneously the partners capital accounts are to be debited for such gain at the new profit sharing ratio and the respective assets and liabilities account is to be credited again. So the following journal entries are necessary for ₹ 10,000 increase in sundry fixed assets and ₹ 2,000 decrease in trade payables:

1)	Sundry Fixed Assets A/c	Dr.	10,000	
	Trade payables A/c	Dr.	2,000	
	To A's Capital A/c			4,000
	To B's Capital A/c			4,000
	To C's Capital A/c			4,000

(Distribution of Revaluation Profit amongst the existing partners at the old profit sharing ratio)

2)	B's Capital A/c	Dr.	6,000	
	C's Capital A/c	Dr.	6,000	
	To Sundry Fixed Assets A/c			10,000
	To Trade payables A/c			2,000

(Being revalued assets and liabilities are not required to be shown in the Balance Sheet)

In this case it is not necessary to open a separate Revaluation Account. However, the above effect can also be given through Memorandum Revaluation Account as discussed in the case of admission of a partner in para 2 of unit 3.

4. RESERVE

On the retirement of a partner any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio. Alternatively, only the retiring partner's share may be transferred to his Capital Account if the others continue at the same profit sharing ratio.

For example, A, B and C were in partnership sharing profits and losses at the ratio 5 : 3 : 2. A retired and B and C agreed to share profits and losses at the ratio of 3:2. Reserve balance was ₹ 10,000. In this case either of the following journal entries can be passed :

			₹	₹
(1)	Reserve A/c	Dr.	10,000	
	To A's Capital A/c			5,000
	To B's Capital A/c			3,000
	To C's Capital A/c			2,000
	(Transfer of reserve to Partners' Capital A/cs in 5 : 3 : 2 on A's retirement)			

or

© The Institute of Chartered Accountants of India

(2)	Reserve A/c	Dr.	5,000	
	To A's Capital A/c			5,000
	(Transfer of A's share of Reserve to the Capital Account on his retirement)			

Note that alternative (2) has the same implications because B and C continued at the same ratio 3 : 2 as they did before A's retirement.

Take another example : X, Y and Z were equal partners. Z decided to retire. X and Y decided to continue at the ratio of 3 : 2. Reserve standing at the date of retirement of Z was ₹ 9,000. In this case adjustment of Z's share was not sufficient since the relationship between X and Y was also changed.

X's gain : $\frac{3}{5}-\frac{1}{3}=\frac{9-5}{15}=\frac{4}{15}$

Y's gain : $\frac{2}{5}-\frac{1}{3}=\frac{6-5}{15}=\frac{1}{15}$

Gaining Ratio : X : Y

4 : 1

This is different from 1 : 1. So alternative (1) is to be followed in this case.

		₹	₹
Reserve A/c	Dr.	9,000	
To X's Capital A/c			3,000
To Y's Capital A/c			3,000
To Z's Capital A/c			3,000
(Transfer of Reserve on Z's retirement)			

If the continuing partners want to show reserve in the Balance Sheet, the journal entry will be:

		₹	₹
X's Capital A/c	Dr.	2,400	
Y's Capital A/c	Dr.	600	
To Z's Capital A/c			3,000
(Adjustment entry for Z's share in reserve)			

5. FINAL PAYMENT TO A RETIRING PARTNER

The following adjustments are necessary in the Capital A/c :

(i) Transfer of reserve,

(ii) Transfer of goodwill,

(iii) Transfer of profit/loss on revaluation.

After adjustment of the above mentioned items, the Capital Account balance standing to the

© The Institute of Chartered Accountants of India

credit of the retiring partner represents amount to be paid to him.

The continuing partners may discharge the whole claim at the time of retirement. Then the journal entry will appear as follows :

Retiring Partner's Capital A/c Dr.

To Bank A/c

Sometimes the retiring partner agrees to retain some portion of his claim in the partnership as loan. The journal entry will be as follows :

Retiring partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

To Bank A/c

Illustration 1

A and B are partners in a business sharing profit and losses as A-3/5th and B-2/5th. Their balance sheet as on 1st January, 2011 is given below :

Liabilities		₹	*Assets*	₹
Capital Accounts			Plant and Machinery	20,000
A	20,000		Inventories	16,000
B	15,000	35,000	Trade receivables	15,000
Reserve Account		15,000	Balance at Bank	6,000
Trade payables		7,500	Cash in hand	500
		57,500		57,500

B retires from the business owing to illness and A takes it over. The following revaluation was made:

(1) The goodwill of the firm is valued at ₹ 25,000.

(2) Depreciate Plant & Machinery by 7.5% and Inventories by 15%.

(3) Doubtful debts provision is raised against trade receivables at 5% and a discount reserve against trade payables at 2%.

You are asked to journalise the above transactions in the books of the firm and close the Partners' Accounts as on 1st January 2011. Give also the opening Balance Sheet of A.

Solution

Journal

2011			*Dr.* ₹	*Cr.* ₹
Jan 1.	A's Capital Account	Dr.	10,000	
	To B's Capital Account			10,000
	(The amount of share of goodwill adjusted on B's retirement)			

© The Institute of Chartered Accountants of India

	Reserve Account	Dr.	15,000	
	To A's Capital Account			9,000
	To B's Capital Account			6,000
	(Transfer of reserve to A's Capital Account and B's Capital Account in the profit sharing ratio)			
	Profit and Loss Adjustment Account	Dr.	4,650	
	To Plant and Machinery Account			1,500
	To Inventory Account			2,400
	To Provision for Doubtful Debts Account			750
	(Reduction in the values, assets and creation of provision for doubtful debts as per agreement with B)			
	Reserve for Discount on Trade payables A/c	Dr.	150	
	To Profit and Loss Adjustment Account			150
	(Creation of reserve for discount on trade payables at 2%)			
	A's Capital Account	Dr.	2,700	
	B's Capital Account	Dr.	1,800	
	To Profit and Loss Adjustment Account			4,500
	(Transfer of loss on revaluation of assets and liabilities to Capital Accounts of A and B in the profit sharing ratio)			
	B's Capital Account	Dr.	29,200	
	To B's Loan Account			29,200
	(Transfer of B's Capital Account to his Loan A/c)			

Balance Sheet of A as on 1st January, 2011

Liabilities	₹	₹	*Assets*	₹	₹
A's Capital Account		16,300	Plant and Machinery		18,500
B's Loan Account		29,200	Inventories		13,600
Trade payables	7,500		Trade receivables	15,000	
Less : Reserve for Discount	(150)	7,350	*Less* : Prov for Bad Debts	(750)	14,250
			Balance at Bank		6,000
			Cash		500
		52,850			52,850

© The Institute of Chartered Accountants of India

Illustration 2

F, G and K were partners sharing profits and losses at the 2 : 2 : 1. K wants to retire on 31.12.2011. Given below is the Balance Sheet of the partnership as well as other information :

Balance Sheet as on 31.12.2011

Liabilities	₹	*Assets*	₹
Capital A/cs	1,20,000	Sundry Fixed Assets	1,50,000
F	80,000	Inventories	50,000
G	60,000	Trade receivables	70,000
K	10,000	(Including Bills Receivable 20,000)	
Reserve	50,000	Bank	50,000
Trade payables	3,20,000		3,20,000

F and G agree to share profits and losses at the ratio of 3 : 2 in future. Value of Goodwill is taken to be ₹ 50,000. Sundry Fixed Assets are revalued upward by ₹ 30,000 and Inventories by ₹ 10,000. Bills Receivable dishonoured ₹ 5,000 on 31.12.2011 but not recorded in the books. Dishonour of bill was due to insolvency of the customer. F and G agree to bring sufficient cash to discharge claim of K and to make their capital proportionate. Also they wanted to maintain ₹ 75,000 bank balance for working capital. Pass necessary journal entries and draft the Balance Sheet of M/s F & G.

Solution

Journal Entries

			₹	₹
(1)	F's Capital A/c	Dr.	10,000	
	To K's Capital A/c			10,000
	(Being the adjustment for goodwill on K's retirement) - Refer W.N.			
(2)	Reserve A/c	Dr.	10,000	
	To F's Capital A/c			4,000
	To G's Capital A/c			4,000
	To K's Capital A/c			2,000
	(Transfer of Reserve to Partners' Capital A/cs on K's retirement)			
(3)	Sundry Fixed Assets A/c	Dr.	30,000	
	Inventory A/c	Dr.	10,000	
	To Profit and Loss Adjustment A/c			40,000
	(Increase in the value of Sundry Fixed Assets and Inventory recorded)			

© The Institute of Chartered Accountants of India

(4)	Profit and Loss Adjustment A/c	Dr.	5,000	
	To Trade Receivable A/c			5,000
	(Loss arising out of dishonoured bill recorded)			
(5)	Profit and Loss Adjustment A/c	Dr.	35,000	
	To F's Capital A/c			14,000
	To G's Capital A/c			14,000
	To K's Capital A/c			7,000
	(Profit on revaluation transferred to Partners' Capital A/cs on K's retirement)			
(6)	Bank A/c	Dr.	1,04,000	
	To F's Capital A/c			70,000
	To G's Capital A/c			34,000
	(Cash brought in by F and G as per agreement)			
(7)	K's Capital A/c	Dr.	79,000	
	To Bank A/c			79,000
	(Payment made to K on retirement)			

Working Note:

Adjusting entry for goodwill

Partner	*Old Share*	*New Share*	*Gain*	*Sacrifice*
F	$\frac{2}{5}$	$\frac{3}{5}$	$\frac{1}{5}$	–
G	$\frac{2}{5}$	$\frac{2}{5}$	–	–
K	$\frac{1}{5}$	–	–	$\frac{1}{5}$

Adjusting entry:

F's Capital A/c (50,000 X 1/5)	Dr.	₹ 10,000	
To K's Capital A/c			₹ 10,000

© The Institute of Chartered Accountants of India

Illustration 3

With the illustration 2, prepare capital accounts of partners and draft the Balance Sheet of Ms/ F & G after K's retirement.

Solution

Balance Sheet
(after K's retirement)

Liabilities	₹	*Assets*	₹
Capital A/cs		Sundry Fixed Assets	1,80,000
F	1,98,000	Inventories	60,000
G	1,32,000	Trade receivables	65,000
Trade payables	50,000		
		Bank	75,000
	3,80,000		3,80,000

Partners' Capital Accounts

	F ₹	*G* ₹	*K* ₹		*F* ₹	*G* ₹	*K* ₹
To K's Capital A/c	10,000	–	–	By Balance b/d	1,20,000	80,000	60,000
To Balance c/d	1,28,000	98,000	79,000	By F's Capital A/c			10,000
				By P & L Adj. A/c	14,000	14,000	7,000
				By Reserve	4,000	4,000	2,000
	1,38,000	98,000	79,000		1,38,000	98,000	79,000
To Bank	–	–	79,000	By Balance b/d	1,28,000	98,000	79,000
To Balance c/d	1,98,000	1,32,000	–	By Bank	70,000	34,000	–
	1,98,000	1,32,000	79,000		1,98,000	1,32,000	79,000

Working Notes :

1. Total Capital

	₹
Sundry Fixed Assets (₹ 1,50,000 + 30,000)	1,80,000
Inventory (₹ 50,000 + ₹ 10,000)	60,000
Trade receivables	65,000
(Including Bill Receivable of 15,000)	
Bank	75,000
	3,80,000
Less: Sundry Ceditors	(50,000)
	3,30,000
F's share (3,30,000 × 3/5)	1,98,000
G's share (3,30,000 × 2/5)	1,32,000

© The Institute of Chartered Accountants of India

2. **Bank Account**

	₹		₹
To Balance b/d	50,000	By K's Capital A/c	79,000
To F's Capital A/c	70,000	By Balance c/d	75,000
To G's Capital A/c	34,000		
	1,54,000		1,54,000

Illustration 4

A, B & C were in partnership sharing profits in the proportions of 5:4:3. The balance sheet of the firm as on 31st March, 2011 was as under :

Liabilities	₹	*Assets*	₹
Capital accounts:		Goodwill	40,000
A	1,35,930	Fixtures	8,200
B	95,120	Inventories	1,57,300
C	61,170	Trade receivables	93,500
Trade payables	41,690	Cash	34,910
	3,33,910		3,33,910

A had been suffering from ill-health and gave notice that he wished to retire. An agreement was, therefore, entered into as on 31st March, 2011, the terms of which were as follows:

(i) The profit and loss account for the year ended 31st March, 2011 which showed a net profit of ₹ 48,000 was to be re-opened. B was to be credited with ₹ 4,000 as bonus, in consideration of the extra work which had devolved upon him during the year. The profit sharing was to be revised as from 1st April, 2010, to 3:4:4.

(ii) Goodwill was to be valued at two years' purchase of the average profits of the preceding five years. The fixtures were to be valued by an independent valuer. A provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book values.

The valuations arising out of the above agreement were goodwill ₹ 56,800 and fixtures ₹ 10,980.

B and C agreed, as between themselves, to continue the business, sharing profits in the ratio of 3:2 and decided to eliminate goodwill from the balance sheet, to retain the fixtures on the books at the revised value, and to increase the provision for doubtful debts to 6%.

You are required to submit the journal entries necessary to give effect to the above arrangements and to draw up the capital account of the partners after carrying out all adjusting entries as stated above.

© The Institute of Chartered Accountants of India

Solution

Journal Entries

Particulars		*Dr.* ₹	*Cr.* ₹
A's Capital Account	Dr.	20,000	
B's Capital Account	Dr.	16,000	
C's Capital Account	Dr.	12,000	
To Profit and Loss Adjustment Account			48,000
(Profit written back for making adjustments)			
Profit and Loss Adjustment Account	Dr.	4,000	
To B's Capital account			4,000
(Bonus Credited to B's Capital Account)			
Profit and Loss Adjustment Account	Dr.	44,000	
To A's Capital Account			12,000
To B's Capital Account			16,000
To C's Capital Account			16,000
(Distribution of profits in the new ratio)			
Fixtures Account	Dr.	2,780	
To Provision for Doubtful debts Account @ 2%			1,870
To A's Capital Account			248
To B's Capital Account			331
To C's Capital Account			331
(Revaluation of assets on A's retirement)			
A's Capital Account	Dr.	10,909	
B's Capital Account	Dr.	14,545	
C's Capital Account	Dr.	14,546	
To Goodwill			40,000
(Old goodwill shown in the balance sheet has been written off)			
A's Capital Account	Dr.	1,32,760	
To A's Loan Account			1,32,760
(Transfer of A's Capital Account to his Loan Account)			
B's Capital Account	Dr.	2,244	
C's Capital Account	Dr.	1,496	
To Provision for Doubtful Debts Account			3,740
(Raising provision for bad debts)			

© The Institute of Chartered Accountants of India

B's Capital Account	Dr.	13,425	
C's Capital Account	Dr.	2,066	
To A's Capital Account			15,491
(Adjusting entry of goodwill passed through partners' capital accounts in gaining/sacrificing ratio)			

Partners' Capital Accounts

Dr. Cr.

	A ₹	B ₹	C ₹		A ₹	B ₹	C ₹
To Profit and Loss Adjustment A/c	20,000	16,000	12,000	By Balance b/d	1,35,930	95,120	61,170
To Goodwill	10,909	14,545	14,546	By Profit and Loss Adjustment A/c	–	4,000	–
To A's Loan A/c	1,32,760	–	–				
To Provision for Doubtful Debts A/c	–	2,244	1,496	By Profit and loss Adjustment A/c	12,000	16,000	16,000
To A	–	13,425	2,066	By Fixtures Less provision for DD A/c	248	331	331
To Balance c/d	–	69,237	47,393	By B	13,425		
				By C	2,066		
	1,63,669	1,15,451	77,501		1,63,669	1,15,451	77,501

Note : The balance of A's Capital Account has been transferred to A's Loan Account.

Working Note:

Calculation for adjustment of Amount of Goodwill

Partner	*Old Share*	*New Share*	*Gain*	*Sacrifice*
A	$\frac{3}{11}$	–	–	$\frac{3}{11}$
B	$\frac{4}{11}$	$\frac{3}{5}$	$\frac{13}{55}$	–
C	$\frac{4}{11}$	$\frac{2}{5}$	$\frac{2}{55}$	–

Illustration 5

K, L & M are partners sharing profits and losses in the ratio 5:3:2. Due to illness, L wanted to retire from the firm on 31.3.2011 and admit his son N in his place.

© The Institute of Chartered Accountants of India

Balance Sheet of K, L and M as on 31.3.2011

Liabilities	₹	₹	*Assets*	₹
Capital:			Goodwill	30,000
K	40,000		Furniture	20,000
L	60,000		Trade receivables	50,000
M	30,000	1,30,000	Inventory in Trade	50,000
Reserve		50,000	Cash and Bank balances	50,000
Trade payables		20,000		
		2,00,000		2,00,000

On retirement of L assets were revalued : Goodwill ₹ 50,000, furniture ₹ 10,000 and Inventory in trade ₹ 30,000. 50% of the amount due to L was paid off in cash and the balance was retained in the firm as capital of N. On admission of the new partner, goodwill has been written off. M is paid off his extra balance to make capital proportionate.

Pass necessary journal entries. Prepare balance sheet of M/s K, M and N as on 1.4.2011. Show necessary workings.

Solution

Journal Entries

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
31.3.2011	K's Capital A/c	Dr.	15,000	
	L's Capital A/c	Dr.	9,000	
	M's Capital A/c	Dr.	6,000	
	To Goodwill A/c			30,000
	(Being old goodwill of balance sheet written off)			
	Profit and Loss Adjustment A/c	Dr.	30,000	
	To Furniture A/c			10,000
	To Inventory in Trade A/c			20,000
	(Being revaluation of furniture and Inventory in trade recorded)			
	K's Capital A/c	Dr.	15,000	
	L's Capital A/c	Dr.	9,000	
	M's Capital A/c	Dr.	6,000	
	To Profit and Loss Adjustment A/c			30,000
	(Being net revaluation loss debited to capital accounts of K, L and M in the ratio 5:3:2)			

© The Institute of Chartered Accountants of India

	Reserve A/c	Dr.	50,000	
	To K's Capital A/c			25,000
	To L's Capital A/c			15,000
	To M's Capital A/c			10,000
	(Being reserve transferred to capital accounts, K, L and M)			
	L's Capital A/c	Dr.	72,000	
	To Cash A/c			36,000
	To N's Capital A/c			36,000
	(Being 50% of the amount due to L was paid off in cash and balance was retained in the firm as capital of N)			
	N's Capital A/c	Dr.	15,000	
	To L's Capital A/c			15,000
	(Being adjusting entry for goodwill passed in gaining/sacrificing ratio)			
	M's Capital A/c	Dr.	14,000	
	To Bank A/c			14,000
	(Being amount paid to M to make his capital proportionate)			

Working Note:

1. Calculation for adjustment of Amount of Goodwill

Partner	*Old Share*	*New Share*	*Gain*	*Sacrifice*
K	$\frac{5}{10}$	$\frac{5}{10}$	–	–
L	$\frac{3}{10}$	–	–	$\frac{3}{10}$
M	$\frac{2}{10}$	$\frac{2}{10}$	–	–
N	–	$\frac{3}{10}$	$\frac{3}{10}$	–

2. Calculation of excess capital paid off to M to make capital proportionate.

Partner	*Capital Balance*	*Capital Ratio (After all Adjustments)*	*P/L Ratio*	*Excess Capital Paid Off*
K	35,000	5	5	–
N	21,000	3	3	–
M	28,000	4	2	$\frac{28,000}{4} \times 2 = 14,000$

© The Institute of Chartered Accountants of India

Illustration 6

With the information given in illustration 5, prepare capital accounts of partners and prepare balance sheet of M/s K, M and N as on 1.4.2011. Show necessary workings.

Solution

Partners' Capital Accounts

Dr. *Cr.*

	K ₹	L ₹	M ₹	N ₹		K ₹	L ₹	M ₹	N ₹
To Goodwill	15,000	9,000	6,000	-	By Balance b/d	40,000	60,000	30,000	-
To Profit and					By Reserve	25,000	15,000	10,000	-
Loss adjustment					By L's Capital A/c	-	-	-	36,000
A/c	15,000	9,000	6,000	-	By N's Capital A/c	-	15,000	-	-
To Cash A/c	-	36,000	-	-					
To N's capital A/c	-	36,000	-	-					
To L's Capital A/c	-	-	-	15,000					
To Bank A/c									
(Balancing figure)	-	-	14,000	-					
To Balance c/d	35,000	-	14,000	21,000					
	65,000	90,000	40,000	36,000		65,000	90,000	40,000	36,000
					By Balance b/d	35,000	–	14,000	21,000

Balance Sheet of M/s K, M & N

as on 1st April, 2011

Liabilities	₹	₹	*Assets*	₹
Capital Accounts:			Furniture	10,000
K	35,000		Trade receivables	50,000
M	14,000		Inventory in Trade	30,000
N	21,000	70,000		
Trade payables		20,000		
		90,000		90,000

© The Institute of Chartered Accountants of India

Illustration 7

Dowell & Co. is a partnership firm with partners Mr. A, Mr. B and Mr., C, sharing profits and losses in the ratio of 10:6:4. The balance sheet of the firm as at 31st March, 2011 is as under:

Liabilities		₹	Assets	₹
Capital :			Land	10,000
Mr. A	80,000		Buildings	2,00,000
Mr. B	20,000		Plant and machinery	1,30,000
Mr. C	30,000	1,30,000	Furniture	43,000
Reserves			Investments	12,000
(unappropriated profit)		20,000	Inventories	1,30,000
Long Term Debt		3,00,000	Trade receivables	1,39,000
Bank Overdraft		44,000		
Trade payables		1,70,000		
		6,64,000		6,64,000

It was mutually agreed that Mr. B will retire from partnership and in his place Mr. D will be admitted as a partner with effect from 1st April, 2011. For this purpose, the following adjustments are to be made:

(a) Goodwill is to be valued at ₹ 1 lakh but the same will not appear as an asset in the books of the reconstituted firm.

(b) Buildings and plant and machinery are to be depreciated by 5% and 20% respectively. Investments are to be taken over by the retiring partner at ₹ 15,000. Provision of 20% is to be made on Trade receivables to cover doubtful debts.

(c) In the reconstituted firm, the total capital will be ₹ 2 lakhs which will be contributed by Mr. A, Mr. C and Mr. D in their new profit sharing ratio, which is 2:2:1.

  (a) The surplus funds, if any, will be used for repaying bank overdraft.

  (b) The amount due to retiring partner shall be transferred to his loan account.

Prepare

(a) Revaluation account;

(b) Partners' capital accounts;

(c) Bank account; and

(d) Balance sheet of the reconstituted firm as on 1st April, 2011.

© The Institute of Chartered Accountants of India

Solution

Revaluation Account

Dr.	₹		Cr. ₹
To Buildings A/c	10,000	By Investments A/c	3,000
To Plant and Machinery A/c	26,000	By Loss to Partners:	
To Provision for Doubtful Debts A/c	27,800	A 30,400	
		B 18,240	
		C 12,160	60,800
	63,800		63,800

A's Capital Account

Dr.	₹		Cr. ₹
To Revaluation A/c	30,400	By Balance b/d	80,000
To Balance c/d	80,000	By Reserves A/c	10,000
		By C and D's Capital A/c	10,000
		By Bank A/c (balancing figure)	10,400
	1,10,400		1,10,400

B's Capital Account

Dr.	₹		Cr. ₹
To Revaluation A/c	18,240	By Balance b/d	20,000
To Investments A/c	15,000	By Reserves A/c	6,000
To B's Loan A/c	22,760	By C and D's Capital A/c	30,000
	56,000		56,000

C's Capital Account

Dr.	₹		Cr. ₹
To Revaluation A/c	12,160	By Balance b/d	30,000
To A and B's Capital A/c	20,000	By Reserves A/c	4,000
To Balance c/d	80,000	By Bank A/c (balancing figure)	78,160
	1,12,160		1,12,160

© The Institute of Chartered Accountants of India

D's Capital Account

Dr.	₹		Cr. ₹
To A and B's Capital A/cs	20,000	By Bank A/c	60,000
To Balance c/d	40,000		
	60,000		60,000

Illustration 8

After preparing revaluation account and partners' capital accounts, let us prepare Bank account and Balance Sheet of the reconstituted firm as on 1st April, 2011 from the information given in illustration 7.

Solution

Bank Account

Dr.	₹		*Cr.* ₹
To A's capital A/c	10,400	By Bank Overdraft A/c	44,000
To C's capital A/c	78,160	By Balance c/d	1,04,560
To D's capital A/c	60,000		
	1,48,560		1,48,560

Balance Sheet of Dowell Co.
as at 1st April, 2011

Liabilities		₹	*Assets*		₹
Capital Accounts:			Land		10,000
A	80,000		Buildings		1,90,000
B	80,000		Plant and Machinery		1,04,000
C	40,000	2,00,000	Furniture		43,000
Long Term Debts		3,00,000	Inventories		1,30,000
Trade payables		1,70,000	Trade receivables	1,39,000	
B's Loan Account		22,760	Less: Provision for		
			Doubtful Debts	(27,800)	1,11,200
			Balance at Bank		1,04,560
		6,92,760			6,92,760

© The Institute of Chartered Accountants of India

6. PAYING A PARTNER'S LOAN IN INSTALMENT

Strictly speaking, paying a partner's loan is only a matter of arranging finance. However, sometimes it is stated that the loan is to be paid off in so many equal instalments and that the balance is to carry interest. In such case what should be done is that the loan should be divided into equal parts. The interest for the period should be calculated and the payment should consist of the instalment on account of the loan plus interest for the period. Suppose a partner's loan stands at ₹ 30,000 and that it has to be paid in four annual equal instalments and that the loan is to carry interest at 6% per annum. The annual instalment on account of loan comes to ₹ 7,500. For the first year the first interest is ₹ 1,800 i.e. 6% on ₹ 30,000. In the first year the amount to be paid will be ₹ 9,300. Balance of ₹ 22,500 will now be left. Next year the interest will be ₹ 1,350. The amount to be paid therefore will be ₹ 7,500 plust interest viz., ₹ 8,850. The loan account will appear in the books as under.

Retiring Partner's loan Account

Dr.		₹			*Cr.* ₹
I Year	To Cash (7,500 + 1,800)	9,300	I year	By Capital Account	30,000
	To Balance c/d	22,500		By Interest Account	1,800
		31,800			31,800
II Year	To Cash (7,500 + 1,350)	8,850	II Year	By Balance b/d	22,500
	To Balance c/d	15,000		By Interest A/c	1,350
				(6% on ₹ 22,500)	
		23,850			23,850
III Year	To Cash	8,400	III Year	By Balance b/d	15,000
	To Balance c/d	7,500		By Interest Account	900
		15,900			15,900
IV Year	To Cash	7,950	IV Year	By Balance b/d	7,500
					450
		7,950			7,950

© The Institute of Chartered Accountants of India

Illustration 9

M/s X and Co. is a partnership firm with the partners A, B and C sharing profits and losses in the ratio of 3:2:5. The balance sheet of the firm as on 30th June 2011, was as under :

Balance Sheet of X and Co.

as on 30.06.2011

Liabilities	₹	*Assets*	₹
A's Capital A/c	1,04,000	Land	1,00,000
B's Capital A/c	76,000	Building	2,00,000
C's Capital A/c	1,40,000	Plant and Machinery	3,80,000
Long Term Loan	4,00,000	Investments	22,000
Bank Overdraft	44,000	Inventories	1,16,000
Trade payables	1,93,000	Trade receivables	1,39,000
	9,57,000		9,57,000

It was mutually agreed that B will retire from partnership and in his place D will be admitted as a partner with effect from 1st July, 2011. For this purpose, the following adjustments are to be made:

(a) Goodwill of the firm is to be valued at ₹ 2 lakhs due to the firm's locational advantage but the same will not appear as an asset in the books of the reconstituted firm.

(b) Buildings and plant and machinery are to be valued at 90% and 85% of the respective balance sheet values. Investments are to be taken over by the retiring partner at ₹ 25,000. Trade receivables are considered good only upto 90% of balance sheet figure. Balance be considered bad.

(c) In the reconstituted firm, the total capital will be ₹ 3 lakhs, which will be contributed by A, C and D in their new profit sharing ratio, which is 3:4:3.

(d) The amount due to retiring partner shall be transferred to his loan account.

You are required to prepare Revaluation Account and Partners' Capital Accounts.

© The Institute of Chartered Accountants of India

Solution

Revaluation Account

Dr. 2011		₹	2011		Cr. ₹
July 1	To Building	20,000	July 1	By Investments	3,000
	To Plant and Machinery	57,000		(25,000-22,000)	
	To Bad Debts	13,900		By Partners' Capital A/cs	
				(loss on revaluation)	
				A (3/10) 26,370	
				B (2/10) 17,580	
				C (5/10) 43,950	87,900
		90,900			90,900

Partners' Capital Accounts

Dr. *Cr.*

	A ₹	B ₹	C ₹	D ₹		A ₹	B ₹	C ₹	D ₹
To Revaluation A/c	26,370	17,580	43,950	–	By Balance b/d	1,04,000	76,000	1,40,000	–
To B's and C's capital A/cs	–	–	–	60,000	By D's Capital A/c (W.N.1)	–	40,000	20,000	–
To Investments A/c	–	25,000	–	–	By Bank A/c	12,370	–	3,950	1,50,000
To B's loan A/c	–	73,420	–	–					
To Balance c/d (W.N. 2)	90,000	-	1,20,000	90,000					
	1,16,370	1,16,000	1,63,950	1,50,000		1,16,370	1,16,000	1,63,950	1,50,000

Working Notes :

1. **Adjustment of goodwill**

   Goodwill of the firm is valued at ₹ 2 lakhs

   Sacrificing ratio:

   A 3/10-3/10 = 0

   B 2/10-0 = 2/10

   C 5/10-4/10 = 1/10

   Hence, sacrificing ratio of B and C is 2:1. A has not sacrificed any share in profits after retirement of B and admission of D in his place.

© The Institute of Chartered Accountants of India

Adjustment of D's share of goodwill through existing partners' capital accounts in the profit sacrificing ratio:

			₹
B :	₹ 60,000 x 2/3	= 40,000	
C :	₹ 60,000 x 1/3	= 20,000	60,000

2. Capital of partners in the reconstituted firm :

	₹
Total capital of the reconstituted firm (given)	3,00,000
A (3/10)	90,000
B (4/10)	1,20,000
C (3/10)	90,000

7. JOINT LIFE POLICY

A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners. The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. The objective of taking such a policy is to minimise the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

The accounting treatment for the premium paid and the Joint Life Policy may be on any of the following ways:

1. When premium paid is treated as an expense: When premium is treated as an expense then it is closed every year by transferring to profit and loss account. In this case complete amount received from the insurance company either on a surrender of policy or on the death of the partner becomes a gain.

Accounting entries are:

(a) On payment of premium

Joint Life Policy Insurance Premium A/c Dr.

To Bank A/c

(b) On charging to Profit and Loss Account

Profit and Loss Account Dr.

To Joint Life Policy Insurance Premium A/c

(c) On maturity of the Policy

Insurance Company/ Bank Account Dr.

To Partners' Capital A/cs (individually)

(Including the account of the representative of a deceased partner)

© The Institute of Chartered Accountants of India

2. When premium paid is treated as an asset: In this case insurance premium paid is first debited to life policy account and credited to bank account. At the end of the year the amount in excess of surrender value is treated as a loss and is transferred to Profit and Loss Account. In this case the amount received from the insurance company in excess of the surrender value results in a gain at the time of receipt of such amount which is transferred to Capital Accounts of the partners in the profit sharing ratio.

3. Creation of Joint Policy Reserve Account: Under this method, premium paid is debited to policy account and credited to bank account. At the end of the year, amount equal to premium is transferred from Profit and Loss Appropriation Account to Policy Reserve Account. After this, policy account is brought down to its surrender value by debiting the life policy reserve account with amount which exceeds the surrender value of the policy. Thus, in this method, policy account appears on the assets side and policy reserve account appears on the liabilities side of the Balance Sheet until it is realised. Both these accounts appear in the Balance Sheet at the surrender value of the policy. This method is different from the method discussed in (2) above only in respect of reserve account.

On the death of a partner Joint Life Policy Reserve Account is transferred to Joint Life Policy Account and then the balance is transferred to Partners' Capital Accounts.

Illustration 10

Red, White and Black shared profits and losses in the ratio of 5:3:2. They took out a joint life Policy in 2007 for ₹ 50,000, a premium of ₹ 3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2007 nil; 2008 ₹ 900; 2009 ₹ 2,000; 2010 ₹ 3,600.

Black retires on 15th April, 2011. Prepare ledger accounts assuming no Joint Life Policy Account is maintained.

Solution

Joint Life Policy Premium Account

		₹			₹
10th June, 2007	To Bank Account	3,000	31st Dec., 2007	By Profit and Loss A/c	3,000
10th June, 2008	To Bank Account	3,000	31st Dec., 2008	By Profit and Loss A/c	3,000
10th June, 2009	To Bank Account	3,000	31st Dec., 2009	By Profit and Loss A/c	3,000
10th June, 2010	To Bank Account	3,000	31st Dec., 2010	By Profit and Loss A/c	3,000

© The Institute of Chartered Accountants of India

Profit and Loss Account

		₹		₹
31st Dec., 2007	To Joint Life Policy Premium Account	3,000		
31st Dec., 2008	To Joint Life Policy Premium Account	3,000		
31st Dec., 2009	To Joint Life Policy Premium Account	3,000		
31st Dec., 2010	To Joint Life Policy Premium Account	3,000		

Joint Life Policy Account

		₹			₹
15th April, 2011	To Capital A/cs: (Transfer)		15th April, 2011	By Bank Account	3,600
	Red 5/ 10	1,800			
	White 3/ 10	1,080			
	Black 2/10	720			
		3,600			3,600

Illustration 11

Red, White and Black shared profits and losses in the ratio of 5: 3: 2. They took out a Joint Life Policy in 2007 for ₹ 50,000, a premium of ₹ 3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2007 nil; 2008 ₹ 900: 2009 ₹ 2,000; 2010 ₹ 3,600.

Black retires on 15th April, 2011. Prepare ledger accounts assuming Joint Life Policy Account is maintained on surrender value basis.

© The Institute of Chartered Accountants of India

Joint Life Policy Account

		₹			₹
10th June, 2007	To Bank Account	3,000	31st Dec., 2007	By Profit and Loss A/c	3,000
10th June, 2008	To Bank Account	3,000	31st Dec., 2008	By Profit and Loss A/c	2,100
				By Balance c/d	900
		3,000			3,000
1st January, 2009	To Balance b/d	900	31st Dec., 2009	By Profit and Loss A/c	1,900
10th June, 2009	To Bank Account	3,000		By Balance c/d	2,000
		3,900			3,900
1st January, 2010	To Balance b/d	2,000	31st Dec., 2010	By Profit and Loss A/c	1,400
10th June, 2010	To Bank Account	3,000		By Balance c/d	3,600
		5,000			5,000
1st January, 2011	To Balance b/d	3,600	15th April, 2011	By Bank	3,600
		3,600			3,600

Profit and Loss Account

		₹			₹
31st Dec., 2007	To Joint Life Policy Account	3,000			
31st Dec., 2008	To Joint Life Policy Account	2,100			
31st Dec., 2009	To Joint Life Policy Account	1,900			
31st Dec., 2010	To Joint Life Policy Account	1,400			

© The Institute of Chartered Accountants of India

Illustration 12

A, B and C are in partnership sharing profits and losses at the ratio of 5 : 3 : 2. The balance sheet of the firm on 31.12.2011 was as follows :

Balance Sheet

Liabilities	₹	*Assets*	₹
Capital A/cs		Sundry Fixed Assets	80,000
A	50,000	Inventories	50,000
B	40,000	Trade receivables	30,000
C	30,000	Joint Life Policy	20,000
Bank Loan	40,000	Bank	10,000
Trade payables	30,000		
	1,90,000		1,90,000

On 1.1.2012, A wants to retire, B and C agreed to continue at 2:1. Joint Life Policy was taken on 1.1.2006 for ₹ 1,00,000 and its surrender value as on 31.12.2011 was ₹ 25,000. For the purpose of A's retirement goodwill was raised for ₹ 1,00,000. Sundry Fixed Assets was revalued for ₹ 1,10,000. But B and C did not prefer to show such increase in assets in the Balance Sheet. Also they agreed to bring necessary cash to discharge 50% of the A's claim, to make the bank balance ₹ 25,000 and to make their capital proportionate.

Prepare necessary journal entries.

Solution

Journal Entries

			₹	₹
1.	B's Capital A/c	Dr.	49,500	
	C's Capital A/c	Dr.	18,000	
	To A's Capital A/c			67,500
	(Share of revaluation profit ₹ 67,500 including good will due to A borne by B and C at the gaining ratio 11 : 4)			
2.	A's Capital A/c	Dr.	1,17,500	
	To A's Loan A/c			58,750
	To Bank A/c			58,750
	(Settlement of A's claim on his retirement by payment of 50% in case and transferring the balance to his Loan A/c).			
3.	Bank A/c	Dr.	73,750	
	To A's Capital A/c			60,333
	To A's Capital A/c			13,417
	(Cash brought in by the continuing partners).			

© The Institute of Chartered Accountants of India

Working Notes :

1. Revaluation Profit

	₹
Goodwill	1,00,000
Sundry Fixed Assets	30,000
Joint Life Policy	5,000
	1,35,000

A's Share ₹ 1,35,000 × 5/10 = ₹ 67,500.

2. Gaining Ratio

B : 2/3 - 3/10 = 11/30

C : 1/3 - 2/10 = 4/30

Gaining Ratio : B : C

11 : 4

3. Total Capital

		₹
Assets as per Balance Sheet		1,90,000
Additional Bank Balance		15,000
		2,05,000
Less : Bank Loan	40,000	
Sundry Crs.	30,000	
A's Loan	58,750	(1,28,750)
		76,250
B's Share		50,833
C's Share		25,417

8. SEPARATE LIFE POLICY

Instead of life policy taken jointly on the name of all the partners, all the partners may take individual life policies for each of them by paying the premium from the firm. In the event of retirement, the retired partner is entitled for the surrender value of the life policies of all the partners.

© The Institute of Chartered Accountants of India

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices :

1. Retiring or outgoing partner:

   (a) Is liable for firm's liabilities. (b) Not liable for any liabilities of the firm.

   (c) Is liable for obligations incurred before his retirement.

   (d) Is liable for obligations incurred before and after his retirement.

2. A, B and C are partners with profits sharing ratio 4:3:2. B retires. If A & C shares profits of B in 5:3, then find the new profit sharing ratio.

   (a) 47:25. (b) 17:11. (c) 31:11. (d) 14:21.

3. C, D and E are partners sharing profits and losses in the proportion of ½, 1/3 and 1/6. D retired and the new profit sharing ratio between C and E is 3:2 and the Reserve of ₹ 12,000 is divided among the partners in the ratio:

   (a) ₹ 2,000: ₹ 4,000: ₹ 6,000. (b) ₹ 5,000: ₹ 5,000: ₹ 2,000.

   (c) ₹ 4,000: ₹ 6,000: ₹ 2,000. (d) ₹ 6,000: ₹ 4,000: ₹ 2,000.

4. Outgoing partner is compensated for parting with firm's future profits in favour of remaining partners. In what ratio do the remaining partners contribute to such compensation amount?

   (a) Gaining Ratio. (b) Capital Ratio. (c) Sacrificing Ratio. (d) Profit Sharing Ratio.

5. Joint Life Policy is taken by the firm on the life(s) of ....

   (a) All the partners jointly. (b) All the partners severely.

   (c) On the life of all the partners and employees of the firm. (d) Both 'a' and 'b'.

6. At the time of retirement of a partner, firm gets .... from the insurance company against the Joint Life Policy taken jointly for all the partners.

   (a) Policy Amount. (b) Surrender Value.

   (c) Policy Value for the retiring partner and Surrender Value for the rest.

   (d) Surrender Value for all the partners.

7. A, B and C takes a Joint Life Policy, after five years B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy premium is fully charged to revenue as and when paid?

   (a) ₹ 50,000 credited to all the partners in old ratio.

   (b) ₹ 2,50,000 credited to all the partners in old ratio.

   (c) ₹ 2,00,000 credited to all the partners in old ratio.

© The Institute of Chartered Accountants of India

(d) No treatment is required.

8. A, B and C takes a Joint Life Policy, after five years, B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy is maintained at the surrender value?

   (a) ₹ 50,000 credited to all the partners in old ratio.

   (b) ₹ 2,50,000 credited to all the partners in old ratio.

   (c) ₹ 2,00,000 credited to all the partners in old ratio.

   (d) No treatment is required.

9. A, B and C takes a Joint Life Policy, after five years B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy is maintained at surrender value along with the reserve?

   (a) ₹ 50,000 credited to all the partners in old ratio.

   (b) ₹ 2,50,000 credited to all the partners in old ratio.

   (c) ₹ 2,00,000 credited to all the partners in old ratio.

   (d) Distribute JLP Reserve Account in old profit sharing ratio.

10. A, B and C are partners sharing profits in the ratio 2:2:1. On retirement of B, goodwill was valued as ₹ 30,000. Find the contribution of A and C to compensate B.

   (a) ₹ 20,000 and ₹ 10,000.
   (b) ₹ 8,000 and ₹ 4,000.

   (c) They will not contribute any thing.

   (d) Information is insufficient for any comment.

11. Claim of the retiring partner is payable in the following form.

   (a) Fully in cash.

   (b) Fully transferred to loan account to be paid later with some interest on it.

   (c) Partly in cash and partly as loan repayable later with agreed interest.

   (d) Any of the above method.

12. A, B and C were partners in a firm sharing profits and losses in the ratio of 2:2:1 respectively with the capital balance of ₹ 50,000 for A and B, for C ₹ 25,000. B declared to retire from the firm and balance in reserve on the date was ₹ 15,000. If goodwill of the firm was valued as

© The Institute of Chartered Accountants of India

₹ 30,000 and profit on revaluation was ₹ 7,050 then what amount will be transferred to the loan account of B.

(a) ₹ 70,820. (b) ₹ 50,820. (c) ₹ 25,820. (d) ₹ 58,820.

13. A, B and C are partners sharing profits and losses in the ratio of 3:2:1. C retires on a decided date and Goodwill of the firm is to be valued at ₹ 60,000. Find the amount payable to retiring partner on account of goodwill.

    (a) ₹ 30,000. (b) ₹ 20,000. (c) ₹ 10,000. (d) ₹ 60,000.

14. A, B and C were partners sharing profits and losses in the ratio of 3:2:1. A retired and Goodwill of the firm is to be valued at ₹ 24,000. What will be the treatment for goodwill?

    (a) Credited to Revaluation Account at ₹ 24,000.

    (b) Adjusted through partners' capital accounts in gaining/sacrificing ratio.

    (c) Only A's capital account credited with ₹ 12,000.

    (d) Only A's capital account credited with ₹ 24,000.

15. A, B and C were partners sharing profits and losses in the ratio of 3:2:1. A retired and firm received the joint life policy as ₹ 7,500 appearing in the balance sheet at ₹ 10,000. JLP is credited and cash debited with ₹ 7,500, what will be the treatment for the balance in Joint Life Policy?

    (a) Credited to partner's current account in profit sharing ratio.

    (b) Debited to revaluation account.

    (c) Debited to partner's capital account in profit sharing ratio.

    (d) Either (b) or (c).

16. Balances of M/s. Ram, Rahul and Rohit sharing profits and losses in proportion to their capitals, stood as Ram - ₹ 3,00,000; Rahul - ₹ 2,00,000 and Rohit - ₹ 1,00,000. Ram desired to retire from the firm and the remaining partners decided to carry on, Joint life policy of the partners surrendered and cash obtained ₹ 60,000. What will be the treatment for Joint Life Policy Account?

    (a) ₹ 60,000 credited to Revaluation Account.

    (b) ₹ 60,000 credited to Joint Life Policy Account.

    c. ₹ 30,000 debited to Ram's Capital Account.

    d. Either (a) or (b).

17. Balances of A, B and C sharing profits and losses in proportion to their capitals, stood as A - ₹ 2,00,000; B - ₹ 3,00,000 and C - ₹ 2,00,000; Joint Life Policy Reserve A/c ₹ 80,000 and Joint Life Policy A/c is shown in the Balance Sheet ₹ 80,000. A desired to retire from the firm and the remaining partners decided to carry on in equal ratio, Joint life policy of the

© The Institute of Chartered Accountants of India

partners surrendered and cash obtained ₹ 80,000. What will be the treatment for Joint Life Policy Reserve A/c?

(a) Cash received credited to Revaluation Account.

(b) JLP Reserve balance credited to Partner's Capital Account in old profit sharing ratio.

(c) JLP Reserve balance credited to Partner's Capital Account in new profit sharing ratio.

(d) Cash received credited to Partners' Capital Accounts in old profit sharing ratio.

18. Balances of A, B and C sharing profits and losses in proportionate to their capitals, stood as A - ₹ 2,00,000; B - ₹ 3,00,000 and C - ₹ 2,00,000. A desired to retire from the firm, B and C share the future profits equally, Goodwill of the entire firm be valued at ₹ 1,40,000 and no Goodwill account being raised.

(a) Credit Partner's Capital Account with old profit sharing ratio for ₹ 1,40,000.

(b) Credit Partner's Capital Account with new profit sharing ratio for ₹ 1,40,000.

(c) Credit A's Account with ₹ 40,000 and debit B's Capital Account with ₹ 10,000 and C's Capital Account with ₹ 30,000.

(d) Credit Partner's Capital Account with gaining ratio for ₹ 1,40,000.

19. Balances of Ram, Hari & Mohan sharing profits and losses in the ratio 2:3:2 stood as Ram - ₹ 10,00,000; Hari - ₹ 15,00,000; Mohan - ₹ 10,00,000; Joint Life Policy ₹ 3,50,000. Hari desired to retire from the firm and the remaining partners decided to carry on with the future profit sharing ratio of 3:2. Joint Life Policy of the partners surrendered and cash obtained ₹ 3,50,000. What would be the treatment for JLP A/c?

(a) ₹ 3,50,000 credited to partner's capital account in new ratio.

(b) ₹ 3,50,000 credited to partner's capital account in old ratio.

(c) ₹ 3,50,000 credited to partner's capital account in capital ratio.

(d) ₹ 3,50,000 credited to JLP account.

ANSWERS

1.	(c)	2.	(a)	3.	(d)	4.	(a)	5.	(d)
6.	(b)	7.	(a)	8.	(d)	9.	(d)	10.	(b)
11.	(d)	12.	(a)	13.	(c)	14.	(b)	15.	(d)
16.	(b)	17.	(b)	18.	(c)	19.	(d)		

© The Institute of Chartered Accountants of India

PARTNERSHIP ACCOUNTS

Unit 5

Death of a Partner

© The Institute of Chartered Accountants of India

Learning Objectives

After studying this unit you will be able to:

- Understand the implication of the excess money received on death of a partner from a joint life policy from the insurance company in the accounts of the partnership. Learn the journal entries required to record this transaction.
- Understand the accounting implications if death of a partner takes place at any date during the accounting period. Learn to record this transaction and how to record payment of profit to the Executor of the deceased partner for part of the accounting year.
- Be familiar with other accounting treatments in case of death of partner which are similar to the explained in case of retirement of a partner.

1. INTRODUCTION

Business of a partnership firm may not come to an end due to death of a partner. Other partners shall continue to run the business of the firm. The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the capital accounts of all partners including the deceased partner. Goodwill is dealt with exactly in the way already discussed in the case of retirement in the earlier unit. Treatment of joint life policy will also be same as in the case of retirement. However, in case of death of a partner, the firm would get the joint policy value. The only additional point is that as death may occur on any day, the representatives of the deceased partner will be entitled to the partner's share of profit from the beginning of the year to the date of death. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

The amount due to the deceased partner carries interest at the mutually agreed upon rate. In the absence of agreement, the representatives of the deceased partner can receive, at their option, interest at the rate of 6% per annum or the share of profits earned for the amount due to the deceased partner.

2. SPECIAL TRANSACTIONS IN CASE OF DEATH: JOINT LIFE POLICY

If Joint Life Policy appears in the Balance Sheet at surrender value, then the firm will gain on the death of a partner. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000 which is appearing in the Balance Sheet at the surrender value of ₹ 10,000,. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

© The Institute of Chartered Accountants of India

The journal entries will appear as follows:

			₹	₹
(i)	Bank A/c	Dr.	1,00,000	
	To Joint Life Policy A/c			1,00,000
	(Policy value received from the insurance company on A's death)			
(ii)	Joint Life Policy A/c	Dr.	90,000	
	To A's Capital A/c			45,000
	To B's Capital A/c			27,000
	To C's Capital A/c			18,000

However, if joint life policy does not appear in the Balance Sheet, then entry (ii) is to be passed for ₹ 1,00,000 and it would appear as follows :

Joint Life Policy A/cs	Dr.	1,00,000	
To A's Capital A/c			50,000
To B's Capital A/c			30,000
To C's Capital A/c			20,000

3. SPECIAL TRANSACTIONS IN CASE OF DEATH: SEPARATE LIFE POLICY

In the event of death of a partner, the policy of the deceased partner will get mature and the firm will receive the assured value of the policy. In this case, the legal representative of the deceased partner is entitled to get the proportionate share of (a) assured value of the matured policy of the deceased partner (b) surrender values of other life policies of the remaining partners taken by the firm.

Bank A/c Dr. (Assured value)

To Separate Life Policy of Deceased partner A/c

(Policy value received on death of a partner)

Separate Life Policy of Deceased Partner A/c Dr. (Assured value)

Separate Life Policy of Remaining Partners A/c Dr (Surrender value)

To Executor's A/c (Total value distributed in profit sharing ratio)

To Remaining partners A/c (Total value distributed in profit sharing ratio)

(Being the total of assured value of deceased partner's life policy and surrender value of other partners' life policy(s) distributed in the profit and loss sharing ratio)

© The Institute of Chartered Accountants of India

4. SPECIAL TRANSACTIONS IN CASE OF DEATH : PAYMENT OF DECEASED PARTNER'S SHARE

The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although, revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death.

For example, A, B and C are in partnership sharing profits and losses at the ratio of 2:2:1. A died on 15th April, 2011. The firm closes its books of account as on 31st December every year. So the executor of A is entitled for 3½ months profit. If A's share is immediately paid off then profit for 2011 can be taken as base for calculating 3½ months profits in the year, 2011. If M/s. A, B & C earned ₹ 96,000 in year 2010, then 3½ months profit is ₹ 28,000. A's share comes to ₹ 28,000 × 2/5 i.e. ₹ 11,200.

Journal entry is :

Profit and Loss Suspense A/c *	Dr.	₹11,200	
To A's Capital A/c			₹ 11,200
(Share of A 3½ months profit in 2011 is transferred to his Capital Account on death)			

* At the end of the year 2011, the Profit & Loss Suspense A/c will be transferred to Profit and Loss A/c.

Illustration 1

The Balance Sheet of Seed, Plant and Flower as at 31st December, 2011 was as under :

Liabilities		₹	*Assets*	₹
Trade payables		20,000	Fixed Assets	40,000
General Reserve		5,000	Debtors	10,000
Capital :			Bills Receivable	4,000
Seed	25,000		Inventories	16,000
Plant	15,000		Cash at Bank	10,000
Flower	15,000	55,000		
		80,000		80,000

The profit sharing ratio was: Seed 5/10, Plant 3/10 and Flower 2/10. On 1st May, 2009 Plant died. It was agreed that:

(a) Goodwill should be valued at 3 years purchase of the average profits for 4 years. The profits were :

2007	₹ 10,000	2009	₹ 12,000
2008	₹ 13,000	2010	₹ 15,000

© The Institute of Chartered Accountants of India

(b) The deceased partner to be given share of profits upto the date of death on the basis of the previous year.

(c) Fixed Assets were to be depreciated by 10%. A bill for ₹ 1,000 was found to be worthless. These are not to affect goodwill.

(d) A sum of ₹ 7,750 was to be paid immediately, the balance was to remain as a loan with the firm at 9% p.a. as interest.

Seed and Flower agreed to share profits and losses in future in the ratio of 3 : 2.

Give necessary journal entries.

Solution

Journal Entries

2011			*Dr.* ₹	*Cr.* ₹
May 1	General Reserve Account	Dr.	5,000	
	To Seed's Capital Account			2,500
	To Plant's Capital Account			1,500
	To Flower's Capital Account			1,000
	(General Reserve transferred to Capital Account on the death of Plant)			
	Seed's Capital Account	Dr.	3,750	
	Flower's Capital Account	Dr.	7,500	
	To Plant's Capital Acco0unt			11,250
	(Adjustment for goodwill on the death of Plant on the basis of gaining ratio)			
	(Value = 3 × (10,000 + 13,000 + 12,000 + 15,000)/4)			
	Revaluation Account	Dr.	5,000	
	To Fixed Assets Account			4,000
	To Bills Receivable Account			1,000
	(Depreciation of fixed assets @ 10% and writing off of one bill for ₹ 1,000 on Plant's death)			
	Seed's Capital Account	Dr.	2,500	
	Plant's Capital Account	Dr.	1,500	
	Flower's Capital Account	Dr.	1,000	
	To Revaluation Account			5,000
	(Loss on Revaluation transferred to capital accounts)			

© The Institute of Chartered Accountants of India

	Particulars		Dr.	Cr.
	Profit and Loss Suspense Account	Dr.	1,500	
	To Plant's Capital Account			1,500
	(Plant's share of four month's profit based on the year 2010)			
	Plant's Capital Account	Dr.	27,750	
	To Plant's Executor's Account			27,750
	(Amount standing to the credit of Plant's Capital Account transferred to the credit of his Executor's Account)			
	Plant's Executor's Account	Dr.	7,750	
	To Bank Account			7,750
	(Amount paid to Plant's Executors)			

Illustration 2

The following was the Balance Sheet of Om & Co. in which X, Y, Z were partners sharing profits and losses in the ratio of 1:2:2 as on 31.3.2011. Mr. Z died on 31st December, 2011. His account has to be settled under the following terms.

Balance Sheet of Om & Co. as on 31.3.2011

Liabilities	₹	₹	*Assets*	₹
Trade payables		20,000	Goodwill	30,000
Bank loan		50,000	Building	1,20,000
General reserve		30,000	Computers	80,000
Capital accounts:			Inventories	20,000
X	40,000		Trade receivables	20,000
Y	80,000		Cash at bank	20,000
Z	80,000	2,00,000	Investments	10,000
		3,00,000		3,00,000

Goodwill is to be calculated at the rate of two years purchase on the basis of average of three years' profits and losses. The profits and losses for the three years were detailed as below:

Year ending on	profit/loss
31.3.2011	30,000
31.3.2010	20,000
31.3.2009	(10,000) Loss

Profit for the period from 1.4.2011 to 31.12.2011 shall be ascertained proportionately on the basis of average profits and losses of the preceding three years.

During the year ending on 31.3.2011 a car costing ₹ 40,000 was purchased on 1.4.2010 and debited to traveling expenses account on which depreciation is to be calculated at 20% p.a. This asset is to be brought into account at the depreciated value.

© The Institute of Chartered Accountants of India

Other values of assets were agreed as follows:

Inventory at ₹ 16,000, building at ₹ 1,40,000, computers at ₹ 50,000; investments at ₹ 6,000. Trade receivables were considered good.

You are required to:

(i) Calculate goodwill and Z's share in the profits of the firm for the period 1.4.2011 to 31.12.2011.

(ii) Prepare revaluation account assuming that other items of assets and liabilities remained the same.

Solution

(i) Calculation of goodwill and Z's share of profit:

		₹	₹
(a)	*Adjusted profit for the year ended 31.3.2011:*		
	Profit (Given)		30,000
	Add: Cost of car wrongly written off	40,000	
	Less: Depreciation for the year 2010-11 (20% on ₹ 40,000)	(8,000)	32,000
			62,000

(b) *Average of last three year's profits and losses*

Year ended on	*Profit/(loss)* ₹
31.3.2009	(10,000)
31.3.2010	20,000
31.3.2011	62,000
	72,000
Average profit (72,000/3)	24,000

(c) Goodwill at 2 years' purchase

₹ 24,000 x 2 = ₹ 48,000

(d) Z's share of profits from the period 1.4.2011 to 31.12.2011

₹ 24,000 x 9/12 x 2/5 = ₹ 7,200

© The Institute of Chartered Accountants of India

(ii) **Revaluation Account**

Dr.	₹			Cr. ₹
To Inventory account	4,000	By Building account		20,000
To Computers account	30,000	By Loss transferred to		
To Investments account	4,000	X	3,600	
		Y	7,200	
		Z	7,200	18,000
	38,000			38,000

Illustration 3

On the basis of illustration 2, prepare partners' capital accounts and balance sheet of the firm Om & Co. as on 31.12.2011.

Solution

Partners' Capital Accounts

Dr.	X ₹	Y ₹	Z ₹		X ₹	Y ₹	Cr. Z ₹
To Revaluation A/c	3,600	7,200	7,200	By Balance b/d	40,000	80,000	80,000
To Z's Executor's A/c			1,12,000	By General reserve	6,000	12,000	12,000
To Goodwill A/c	6,000	12,000	12,000	By X and Y	–	–	19,200
To Z	6,400	12,800	–	By Car A/c	6,400	12,800	12,800
To Balance c/d	36,400	72,800		By Profit and Loss suspense A/c	–	–	7,200
	52,400	1,04,800	1,31,200		52,400	1,04,800	1,31,200

Balance Sheet of Om & Co. as 31.12.2011

Liabilities	₹	Assets	₹
Trade payables	20,000	Building	1,40,000
Bank loan	50,000	Car	32,000
Capital accounts:		Inventories	16,000
X	36,400	Computers	50,000
Y	72,800	Investments	6,000
Z's Executor's account	1,12,000	Trade receivables	20,000
		Cash at bank	20,000
		Profit and Loss suspense Account	7,200
	2,91,200		2,91,200

© The Institute of Chartered Accountants of India

Goodwill calculated at the time of death of partner Z (See W.N.c of solution 2) ₹ 48,000

Partner	*Old Share*	*New Share*	*Gain*	*Sacrifice*
X	$\frac{1}{5}$	$\frac{1}{3}$	$\frac{2}{15}$	–
Y	$\frac{2}{5}$	$\frac{2}{3}$	$\frac{2}{15}$	–
Z	$\frac{2}{5}$	–		$\frac{2}{5}$

Adjusting entry :

X's Capital Account	Dr.	6,400	
Y's Capital Account	Dr.	12,800	
To Z's Capital Account			19,200
(Adjustment for goodwill on the death of Z on the basis of gaining ratio)			

Illustration 4

The partnership agreement of a firm consisting of three partners - A, B and C (who share profits in proportion of ½, ¼ and ¼ and whose fixed capitals are ₹ 10,000; ₹ 6,000 and ₹ 4,000 respectively) provides as follows:

(a) That partners be allowed interest at 10 per cent per annum on their fixed capitals, but no interest be allowed on undrawn profits or charged on drawings.

(b) That upon the death of a partner, the goodwill of the firm be valued at two years' purchase of the average net profits (after charging interest on capital) for the three years to 31st December preceding the death of a partner.

(c) That an insurance policy of ₹ 10,000 each to be taken in individual names of each partner, the premium is to be charged against the profit of the firm.

(d) Upon the death of a partner, he is to be credited with his share of the profits, interest on capitals etc. calculated upon 31st December following his death.

(e) That the share of the partnership policy and goodwill be credited to a deceased partner as on 31st December following his death.

(f) That the partnership books be closed annually on 31st December.

A died on 30th September 2011, the amount standing to the credit of his current account on 31st December, 2010 was ₹ 450 and from that date to the date of death he had withdrawn ₹ 3,000 from the business.

An unrecorded liability of ₹ 2,000 was discovered on 30th September, 2011. It was decided to record it and be immediately paid off.

© The Institute of Chartered Accountants of India

The trading result of the firm (before charging interest on capital) had been as follows: 2008 Profit ₹ 9,640; 2009 Profit ₹ 6,720; 2010 Loss ₹ 640; 2011 Profit ₹ 3,670.

Assuming the surrender value of the policy to be 20 percent of the sum assured, you are required to prepare an account showing the amount due to A's legal representative as on 31st December, 2011.

Solution

A's Capital Account

2011		₹	2011		₹
Sep. 30	To Current A/c (3,000 - 450)	2,550	Jan. 1	By Balance b/d	10,000
			Dec. 31	By Profit and Loss A/c :	
Dec. 31	To Profit and Loss Adjt. (Unrecorded Liability)	1,000		Interest on Capital	1,000
				Share of Profit	835
	To Balance Transferred to			B & C (Goodwill)	3,240
	A's Executor's A/c	18,525		Insurance Policies A/c	7,000
		22,075			22,075

Working Notes :

(i) Valuation of Goodwill

Year	Profit before Interest on fixed capital	Interest	Profit after interest
	₹	₹	₹
2008	9,640	2,000	7,640
2009	6,720	2,000	4,720
2010	(-) 640	2,000	(-) 2,640
	15,720	6,000	9,720

	₹
Average	3,240
Goodwill at two years purchase of average net profits	6,480
Share of A in the goodwill	3,240

(ii) Profit on Separate Life Policy :

A's policy	10,000
B and C's policy @ 20%	4,000
	14,000
Share of A (1/2)	7,000

(iii) Share in profit for 2011 :

Profit for the year	3,670
Less : Interest on capitals	(2,000)
	1,670
A's share in profit (1/2)	835

© The Institute of Chartered Accountants of India

(iv) As unrecorded liability of ₹ 2,000 has been charged to Capital Accounts through Profit and Loss Adjustment Account, no further adjustment in current year's profit is required.

(v) Profits for 2008, 2009 and 2010 have not been adjusted (for valuing goodwill) for unrecorded liability for want of precise information.

Illustration 5

The following is the Balance Sheet of M/s. ABC Bros as at 31st December, 2010.

Balance Sheet as at 31st December, 2010

Liabilities		₹	*Assets*		₹
Capital	A	4,100	Machinery		5,000
	B	4,100	Furniture		2,800
	C	4,500	Fixture		
General Reserve		1,500	Cash		2,100
Trade payables		2,350	Inventories		1,500
			Trade receivables	4,500	
			Less: Provision for DD	300	950
					4,200
		16,550			16,550

C died on 3rd January, 2011 and the following agreement was to be put into effect.

(a) Assets were to be revalued : Machinery to ₹ 5,850; Furniture to ₹ 2,300; Inventory to ₹ 750.

(b) Goodwill was valued at ₹ 3,000 and was to be credited with his share, without using a Goodwill Account

(c) ₹ 1,000 was to be paid away to the executors of the dead partner on 5th January, 2011.

You are required to show:

(i) The Journal Entry for Goodwill adjustment.

(ii) The Revaluation Account and Capital Accounts of the partners.

(iii) Which account would be debited and which account credited if the provision for doubtful debts in the Balance Sheet was to be found unnecessary to maintain at the death of C.

Solution

(i) Journal Entry in the books of the firm

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
Jan 3	A's Capital A/c	Dr.	500	
2011	B's Capital A/c	Dr.	500	
	To C's Capital A/c			1,000
	(Being the required adjustment for goodwill through the partner's capital accounts)			

© The Institute of Chartered Accountants of India

(ii) **Revaluation Account**

Dr. *Particulars*	₹	*Particulars*	*Cr.* ₹
To Furniture A/c (₹ 2,800 - 2,300)	500	By Machinery A/c (₹ 5,850 - 5,000)	850
To Inventory A/c (₹ 950 - 750)	200		
To Partners' Capital A/cs (A - ₹ 50, B - ₹ 50, C - ₹ 50)	150		
	850		850

Partners Capital Accounts

Particulars	*A* ₹	*B* ₹	*C* ₹	*Particulars*	*A* ₹	*B* ₹	*C* ₹
To C (Goodwill)	500	500	–	By Balance b/d	4,100	4,100	4,500
To Cash A/c	–	–	1,000	By General Reserve A/c	500	500	500
To Executors A/c	–	–	5,050	By Revaluation A/c (Profit)	50	50	50
To Balance C/d	4,150	4,150	–	By A (Goodwill)	–	–	500
				By B (Goodwill)	–	–	500
	4,650	4,650	6,050		4,650	4,650	6,050

(iii) Provision for Doubtful Debts Account is a credit balance. To close, this account is to be debited. It becomes a gain for the partners. Therefore, either Partners' Capital Accounts (including C) or Revaluation Account is to be credited.

Working Note :

Statement showing the Required Adjustment for Goodwill

Particulars	*A*	*B*	*C*
Right of goodwill before death	1/3	1/3	1/3
Right of goodwill after death	1/2	1/2	–
Gain / (Sacrifice)	(+) 1/6	(+) 1/6	(-) 1/3

Profit sharing ratio is equal before or after the death of C because nothing has been mentioned in respect of profit-sharing ratio.

Illustration 6

B and N were partners. The partnership deed provides inter alia:

(i) That the accounts be balanced on 31st December each year.

(ii) That the profits be divided as follows:

B : One-half; N : One-third; and carried to Reserve Account : One-sixth

(iii) That in the event of death of a partner, his executor will be entitled to the following:

(a) the capital to his credit at the date of death; (b) his proportion of profit to date of death based on the average profits of the last three completed years; (c) his share of goodwill based on three years' purchases of the average profits for the three preceding completed years.

© The Institute of Chartered Accountants of India

Trial Balance on 31st December, 2010

Particulars	*Dr. ₹*	*Cr. ₹*
B's Capital		90,000
N's Capital		60,000
Reserve		30,000
Bills receivable	50,000	
Investments	40,000	
Cash	1,10,000	
Trade payables		20,000
Total	2,00,000	2,00,000

The profits for the three years were 2008 : ₹ 42,000; 2009 : ₹ 39,000 and 2010 : ₹ 45,000. N died on 1st May, 2011. Show the calculation of N (i) Share of Profits; (ii) Share of Goodwill; (iii) Draw up N's Executors Account as would appear in the firms' ledger transferring the amount to the Loan Account.

Solution

(i)	**Ascertainment of N's Share of Profit**		**(ii)**	**Ascertainment of Value of Goodwill**	
	2008	42,000		2008	42,000
	2009	39,000		2009	39,000
	2010	45,000		2010	45,000
	Total Profit	1,26,000		Total Profit for 3 years	1,26,000
	Average Profit	42,000		Average Profit	42,000
	4 months' Profit	14,000		Goodwill - 3 years	
				Purchase of Average Profit	1,26,000
	N's Share in Profit				
	(2/5th* of ₹14,000)	5,600		N's Share of goodwill	
				(2/5 of ₹ 1,26,000)	50,400

* Profit sharing ratio between B and N = 1/2; 1/3; = 3 : 2, Therefore N's share of Profit = 2/5

N's Executors Account

Date 2011	*Particulars*	₹	*Date* 2011	*Particulars*	₹
May 1, -	To N's Loan A/c	1,28,000	Jan. 1	By Capital A/c	60,000
			May 1	By Reserves (2/5th of ₹ 30,000)	12,000
			May 1	By B's Capital A/c (Share of goodwill)	50,400
			May 1	By P/L Suspense A/c (Share of Profit)	5,600
		1,28,000			1,28,000

SELF EXAMINATION QUESTIONS

Pick up the correct answer from the given choices:

1. On the death of a partner, his executor is paid the share of profits of the dying partner for the relevant period. This payment is recorded in Profit & Loss ……… Account.
   (a) Adjustment. (b) Appropriation. (c) Suspense. (d) Reserve.

© The Institute of Chartered Accountants of India

2. Revaluation account is prepared at the time of
   (a) Admission of a partner
   (b) Retirement of a partner
   (c) Death of a partner
   (d) All of the above
3. In the absence of proper agreement, representative of the deceased partner is entitled to the Dead partner's share in
   (a) Profits till date, goodwill, joint life policy, share in revalued assets and liabilities.
   (b) Capital, goodwill, joint life policy, interest on capital, share in revalued assets and liabilities.
   (c) Capital, profits till date, goodwill, interest on capital, share in revalued assets and liabilities.
   (d) Capital, profits till date, goodwill, joint life policy, share in revalued assets and liabilities.
4. As per Section 37 of the Indian Partnership Act, 1932, the executors would be entitled at their choice to the interest calculated from the date of death till the date of payment on the final amount due to the dead partner at …… percent per annum.
   (a) 7. (b) 4. (c) 6. (d) 12.
5. A, B and C are the partners sharing profits and losses in the ratio 2:1:1. Firm has a joint life policy of ₹ 1,20,000 and in the balance sheet it is appearing at the surrender value i.e. ₹ 20,000. On the death of A, how this JLP will be shared among the partners.
   (a) ₹ 50,000: ₹ 25,000: ₹ 25,000.
   (b) ₹ 60,000: ₹ 30,000: ₹ 30,000.
   (c) ₹ 40,000: ₹ 35,000: ₹ 25,000.
   (d) Whole of ₹ 1,20,000 will be paid to A.
6. R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2011. It was decided to value the goodwill on the basis of three year's purchase of last five years average profits. If the profits are ₹ 29,600; ₹ 28,700; ₹ 28,900; ₹ 24,000 and ₹ 26,800. What will be D's share of goodwill?
   (a) ₹ 20,700. (b) ₹ 27,600. (c) ₹ 82,800. (d) ₹ 27,000.
7. R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2011 and profits for the accounting year 2010-2011 were ₹ 24,000. How much share in profits for the period 1st April 2011 to 30th June 2011 will be credited to D's Account.
   (a) ₹ 6,000. (b) ₹ 1,500. (c) Nil. (d) ₹ 2,000.
8. If three partners A, B & C are sharing profits as 5:3:2, then on the death of a partner A, how much B & C will pay to A's executer on account of goodwill. Goodwill is to be calculated on the basis of 2 years purchase of last 3 years average profits. Profits for last three years are: ₹ 3,29,000; ₹ 3,46,000 and ₹ 4,05,000.
   (a) ₹ 2,16,000 & ₹ 1,42,000.
   (b) ₹ 2,44,000 & ₹ 2,16,000.
   (c) ₹ 3,60,000 & ₹ 3,60,000.
   (d) ₹ 2,16,000 & ₹ 1,44,000.

ANSWERS

1.	(c)	2.	(d)	3.	(d)	4.	(c)	5.	(a)
6.	(a)	7.	(b)	8.	(d)				

© The Institute of Chartered Accountants of India