II B.COM - THIRD SEMESTER

SUBJECT: HIGHER FINANCIAL ACCOUNTING

SUB.CODE:18UCO4

Definition of Partnership

The Indian Partnership Act, 1932 governs partnership forms of business in India. Section 4 of this Act defines a partnership as the relationship between partners who have agreed to share the firm's profits carried on by all or any one of them acting for all.

A bare reading of this definition shows that a partnership requires partners who share their firm's profits amongst each other. Further, the firm's business must be carried on either by all of them together or by one of them acting on behalf of others. The members of such a business are individually called partners and collectively, a firm.

Considering the definition of partnership we just learned, let us now take a look at some features of partnerships.

Features of Partnerships

A typical partnership form of business will always have the following basic features.

1. Agreement

The definition of the partnership itself makes it clear that there must exist an agreement between partners to work together and share profits amongst them. Partners may make such an agreement either orally or in writing. If it exists in written form, we refer to such an agreement as a partnership deed.

Such written or oral agreement between partners must ensure that they are clear on their status as partners of their firm. This includes details pertaining to their work as partners, the firm's businesses, their profit and loss sharing ratio, etc.

TYPES OF PARTNERSHIP

According to the nature of agreement among partners, the different types of partnership are discussed below:
(A) According to Objectives:

1. Partnership at Will:
Such partnership exists on the will of the partners, i.e., it can be brought to an end whenever any of the partners gives notice of his intention to do so. This kind of partnership is formed to conduct the lawful business for an indefinite period.
2. Particular Partnership:
A particular partnership is formed for undertaking a particular venture. It comes to an end automatically with the completion of the venture.
(B) According to Tenure:

1. Partnership for Fixed Term:

Such a partnership is for a fixed period of time say 2 years, 5 years or any other duration. The partnership comes to an end automatically at the expiry of the period.

2. Flexible Partnership:

Partnerships which are formed neither for a fixed period nor for any particular venture are called flexible partnerships.

(C) According to Nature:

1. General Partnership:

In the absence of agreement, the provisions of the Indian Partnership Act 1932 are applicable for general partnerships in which the liability of each partner is unlimited.

2. Limited Partnership:

In limited partnership some or all except one partner have a limited liability to the extent of capital contributed by them. All the partners in partnership cannot have limited liability.

Features of Limited Partnership:

(i) A limited partnership consists of two partners, namely, general partners with unlimited liability and special or limited partners with their liability limited to their capital contribution. It must have one or more general partners and also one or more special partners.

(ii) A limited or special partner simply invests his money in the firm. He is not entitled to take part in the management of the business. His acts do not bind the firm but he is allowed to inspect the books of the firm for his information and may advise the general partners.

(iii) The bankruptcy, death or lunacy of a special partner does not dissolve the firm. It is thus, more stable than an ordinary partnership firm.

(iv) A special partner cannot assign his share to an outsider without the consent of the general partners.

(v) A special partner cannot withdraw any part of capital contributed by him. If he does so, his liability on the portion so withdrawn becomes unlimited. He will have to undertake separate liability for such an amount.

(vi) A limited partnership must be registered under the law. This is necessary to provide information to the public about the capital contribution of the limited partners and the extent of their liability. Non-registration makes the firm liable to be treated as a general partnership.

Merits of Limited Partnership:

(i) It is more stable than an ordinary partnership firm, because the bankruptcy, death or lunacy of a special partner does not dissolve the firm.

(ii) It enables mobilisation of capital from persons who don’t want to take unlimited risks.

(iii) It facilitates independent control over the business, by the general partner.

Demerits of Limited Partnership:

(i) Special partners have no role in the management of the firm.

(ii) Limited liability of special partners reduces the credit worthiness of the firm.

(iii) The general partner may take undue advantage of his position.

Distinction between Limited and General Partnership:

Limited Partnership:

1. Only the general partner has unlimited liability.
2. Special partner cannot take active part in the management of firm.
3. More stable.
4. Not allowed in India.

General Partnership:

1. All partners have unlimited liability.
2. Each partner can take part.
3. Less stable.
4. Allowed in India.

(D) According to Legality:

1. Legal Partnership- When the partnership is formed in accordance with the Partnership Act of 1932 and the Indian Contract Act, it is known as Legal Partnership.
2. Illegal Partnership- Partnership becomes illegal when it violates the provisions of any law of the country or when the requisite number of partners goes below the minimum limit or beyond the maximum limit.
A. Classification on the Basis of Duration:

i. Partnership at Will:
1. This type of partnership exists at the will of the partners.
2. It can continue as long as the partners' want. It is terminated when any partner give a notice of dissolution.
ii. Particular Partnership:
1. This type of partnership is formed for a specified time period to accomplish a particular project (e.g., construction of a building).
2. It dissolves automatically when the purpose for which it was formed is fulfilled or when the time duration expires.
B. Classification on the Basis of Liability:

i. General Partnership:
1. In general partnership, the liability of partners is limited and oint.
2. The partner enjoys the right to participate in the management of the firm.
3. Their acts are binding on each other as well as on the firm.
4. Registration of the firm is optional.
5. The existence of the firm is affected by the death, lunacy, insolvency or retirement of the partners.
ii. Limited Partnership:
1. In limited partnership, the liability of at least one partner is unlimited whereas the other partners may have limited liability.
2. The limited partners do not enjoy the right to participate in the management of the firm.
3. Their acts do not bind the firm or the other parties.
4. Registration of firm is compulsory.
5. Such partnership does not get terminated with the death, lunacy or insolvency of any partner with limited liability.
iii. Limited Liability Partnership:
A Limited Liability Partnership (LLP) is a partnership in which some or all partners have limited liabilities.
Limited Liability Partnership is a business organization that allows the limited partners to enjoy limited personal liability while general partners have unlimited personal liability.
It is similar to a general partnership except that it has two classes of partners. The general partner(s) have full management control over the business and also accept full management control for partnership liabilities. Limited partners have no personal liability beyond their investment in the partnership interest. Limited partners cannot participate in the general management and daily operations of the partnership business.

Partnership Deed

As explained above, partners are free to define the terms of their relationships, even if they go contrary to the Act in certain cases. They can either decide on such terms with an oral agreement or a written one.

Partnership deeds, in very simple words, are an agreement between partners of a firm. This agreement defines details like the nature of the firm, duties, and rights of partners, their liabilities and the ratio in which they will divide profits or losses of the firm.

Although the drafting of partnership deeds is not compulsory, it is always advised to do so. This helps in ensuring that all terms agreed by partners exist in written form on paper. Doing so can reduce disputes between partners and govern their functioning better.

Unlike similar documents like articles of association of companies, partnership deeds need not be registered mandatorily. However, registration can ensure the prevention of legal challenges to its validity when disputes arise. An ideal partnership deed is comprehensive and clear about all details pertaining to the functioning of a firm. It should not contain any ambiguities.

Contents of Partnership Deeds

Although there is no specific format prescribed for drafting a partnership deed, a typical deed contains the below mentioned clauses.

1. The name of the firm
2. Name and details of all partners
3. Date of commencement of business
4. Duration of the firm's existence
5. Capital contributed by each partner
6. Profit/loss sharing ratio
7. Interest on capital payable to partners
8. The extent of borrowings each partner can draw
9. Salary payable to partners, if any
10. The procedure of admission or retirement of a partner
11. The method used for calculating goodwill
12. Preparation of accounts of the firm
13. Mode of settlement of dues with a deceased partner's executors
14. The procedure followed in case disputes arise between partners

Absence of a Partnership Deed

In case partners do not adopt a partnership deed, the following rules will apply:

a. The partners will share profits and losses equally.

b. Partners will not get a salary.

c. Interest on capital will not be payable.

d. Drawings will not be chargeable with interest.

e. Partners will get 6% p.a. interest on loans to the firm if they mutually agree.

Limited Liability Partnerships (LLP)

Partners of typical partnership firms have unlimited liability towards their collective debts and legal consequences. This means that their own assets are liable for attachment for meeting the firm's debts and liabilities. And limited liability partnerships (LLP) solves this problem.

An LLP has all basic features of a regular partnership firm, except that of same legal entity status and unlimited liability of partners. Consequently, limited liability partnerships have legal existence and identity separate from that of its partners. Furthermore, its partners have limited liabilities.

Definition of LLP

The Parliament of India passed the Limited Liability Partnership Act in 2008 to govern LLP businesses in India. According to Section 2 of this law, an LLP is a partnership registered under the Act. Further, an LLP agreement means a written agreement either between an LLP's partners or between the LLP itself and its partners. This agreement defines the rights, liabilities, duties, and powers of the partners.

Since the Limited Liability Partnership Act, 2008 specifically governs limited liability partnerships in India, the provisions of the Indian Partnership Act, 1932 are not applicable to LLPs. They only apply to traditional partnership firms.

Capital Accounts: Fixed and Fluctuating

A Capital Account is a general ledger account which shows some of the special transactions like proprietor's investment in his own business, the aggregate amount of earning, expenses of companies, etc. There are many more transactions which affect the Capital. Like: Interest on Capital, Interest on Drawings, Salaries to the Partners, Commission for the Partners, etc. These values are put in Profit and Loss Appropriation Account and at the same time credited or debited to their respective Capital Accounts.

Methods of Capital Account Creation

- Fluctuating Capital Account Method
- Fixed Capital Account Method

Fluctuating Capital Account Method

Firstly, fluctuate means anything having unpredictable ups and downs. Hence, under this method, the Capital of each Partner keeps on changing from time to time.

In a firm, there is a single account under the name “Capital” which shows all the necessary information about the different transactions related to the capital. It mostly starts with a credit amount of the capital invested by the partner in the initial time of the business.

All the adjustments leading to a decrease in the Capital are shown on the Debit side of the Capital Account. For example, Drawings by Partners and interest comes on the debit side of the Capital account. All the adjustments leading to an increase in the Capital are shown on the Credit side.

Format of Fluctuating Capital Account Method

Capital A/c

Date	Particulars	A	B	Date	Particulars	A	B
	Drawings and interest on Drawings				Opening Balance or Initial Investment		
	Loss transferred from Profit and Loss A/c				Addition of capital, Interest on Capital, Salary, Commission or any other remuneration		
	Closing Balance				Profit transferred from Profit and Loss Appropriation A/c		

Fixed Capital Account Method

Under this method, the firm prepares 2 accounts which show different transactions related to the capitals of the partners.

These two accounts are as follows:

(a) Fixed Capital Account

A firm prepares Fixed Account with very basic capital related transactions. Unlike the Capital account, under these repetitive capital related transactions does not affect the Capital balance. Like, Salary of employees, commission for employees, interest on capital, interest on drawings, etc.

The firm opens the account in the name of "Fixed Capital Account". Initial Investment will appear on the credit side as the starting entry. Only 2 kinds of Capital related transactions can affect its balance :

(1) Addition of Capital

(2) Permanent Withdrawal of Capital

[Note: Sometimes even the Non-Permanent Withdrawals or Drawings are also included on the debit side of this account.]

Format of Fixed Capital Account

Capital Account

Date	Particulars	A	B	Date	Particulars	A	B
	Permanent withdrawal of capital				Opening Balance		
	Closing Balance				Addition of Capital		

(b) Current Account

It includes all the capital related transactions other than the initial investment of capital, addition of capital and withdrawal of capital. Hence, It mainly includes items such as :

1. Interest on Capital

2. Interest on Drawings

3. Salaries and other remuneration to employees

4. Commission to employees and even more.

Hence, by preparing this account, we can let the main capital of the business “fixed”. As a result of which there is no fluctuation at all. Hence, the firm will be able to find out the exact reasons behind the change.

Format of Current Account

Date	Particulars	A	B	Date	Particulars	A	B
	Drawings and interest on drawings				Opening Balance		
	Loss transferred from P&L A/c				Interest on Capital, Salary, Commission or any other remuneration.		
	Closing Balance				Profit transferred from P&L Appropriation A/c		

Difference Between Fixed and Fluctuating Capital Methods

Fixed Capital Method	Fluctuating Capital Method
Two accounts are prepared: Capital Account and Current Account	Only a single account is prepared: Capital Account
The capital balance remains unchanged	Capital balance fluctuates
Both Capital and Current Accounts appears in the Balance sheet.	Only Capital Account appears in the Balance Sheet.
If this method is used then it must be specified in the Partnership Deed.	If this method is used then it is not necessary to specify the method under the Partnership Deed
Fixed Capital Account will always show a Credit Balance	Fluctuating Capital account may show debit balance as well.

Calculation of interest on capital

Interest on capital is to be calculated on the capitals at the beginning for the relevant period. If there is any additional capital introduced or capital withdrawn during the year, it will cause change in the capitals and interest is to be calculated proportionately on the changed capitals for the relevant period.

Interest on capital = Amount of capital x Rate of interest per annum x Period of interest

Tutorial note: If capital at the beginning is not given, then it can be calculated as below:

Particulars	₹	₹
Capital at the end		xxx
Add: Drawings during the year (if fluctuating capital)	xxx	
Capital withdrawn during the year	xxx	xxx
		xxx
Less: Profit credited during the year (if fluctuating capital)	xxx	
Additional capital introduced during the year	xxx	xxx
Capital at the beginning		xxx

Illustration 1.1

Mannan and Ramesh share profits and losses in the ratio of 3:1. The capital on 1st April 2017 was ₹ 80,000 for Mannan and ₹ 60,000 for Ramesh and their current accounts show a credit balance of ₹ 10,000 and ₹ 5,000 respectively. Calculate interest on capital at 5% p.a. for the year ending 31st March 2018 and show the journal entries.

Solution

Calculation of interest on capital:

Interest on capital = Amount of capital x Rate of interest

Interest on Mannan's capital = 80,000 x 5/100 = ₹ 4,000

Interest on Ramesh's capital = 60,000 x 5/100 = ₹ 3,000

Note: Balance of current account will not be considered for calculation of interest on capital.

Date	Particulars	L.F.	Debit ₹	Credit ₹
2018 March 31	Interest on capital A/c Dr.		7,000	
	To Mannan's current A/c			4,000
	To Ramesh's current A/c			3,000
	(Interest on capital provided)			
,,	Profit and loss appropriation A/c Dr.		7,000	
	To Interest on capital A/c			7,000
	(Interest on capital closed)			

Illustration 1.2

Antony and Akbar were partners who share profits and losses in the ratio of 3:2. Balance in their capital account on 1st January 2018 was Antony ₹ 60,000 and Akbar ₹ 40,000. On 1st April 2018 Antony introduced additional capital of ₹ 10,000. Akbar introduced additional capital of ₹ 5,000 during the year. Calculate interest on capital at 6% p.a. for the year ending 31st December 2018.

Solution

Calculation of interest on capital:

Interest on Antony's capital:

On opening capital for 1 year	$= 60{,}000 \times \frac{6}{100}$	= ₹ 3,600
On additional capital for 9 months	$= 10{,}000 \times \frac{6}{100} \times \frac{9}{12}$	= ₹ 450
Interest on capital		₹ 4,050

Interest on Akbar's capital:

On opening capital for 1 year	$= 40{,}000 \times \frac{6}{100}$	= ₹ 2,400
On additional capital for 6 months	$= 5{,}000 \times \frac{6}{100} \times \frac{6}{12}$	= ₹ 150
Interest on capital		₹ 2,550

Note: Since the date of additional capital introduced by Akbar is not given, interest on additional capital is calculated for an average period of 6 months.

Illustration 1.3

The capital account of Arivazhagan and Srinivasan on 1st January 2017 showed a balance of 15,000 and ₹ 10,000 respectively. On 1st July 2017, Arivazhagan introduced an additional capital of ₹ 5,000 and on 1st September 2017 Srinivasan introduced an additional capital of ₹ 10,000.

Calculate interest on capital at 6% p.a. for the year ending 31st December 2017.

Solution

Calculation of interest on capital:

Arivazhagan:

On opening capital for 1 year $= 15,000 \times \frac{6}{100} = ₹\ 900$

On additional capital for 6 months $= 5,000 \times \frac{6}{100} \times \frac{6}{12} = ₹\ 150$

Interest on capital ₹ 1,050

Srinivasan:

On opening capital for 1 year $= 10,000 \times \frac{6}{100} = ₹\ 600$

On additional capital for 4 months $= 10,000 \times \frac{6}{100} \times \frac{4}{12} = ₹\ 200$

Total interest on capital ₹ 800

Calculation of interest on drawings

Interest on drawings can be computed by following either direct method or product method. Also if the partners withdraw fixed amount at fixed time interval, interest on drawings may be calculated on the basis of the average period method. Based on the dates of drawings and the amount of drawings, different methods can be followed for calculating interest on drawings.

(i) Direct method

Interest is calculated on drawings for the period from the date of drawings to the date of closing date of the accounting year. The following formula is used to compute the interest on drawings:

Interest on drawings = Amount of drawings x Rate of interest x Period of interest

Period of interest refers to the period from the date of drawings to the closing date of the accounting year. This method is suitable when different amounts are withdrawn at different time intervals.

Illustration 1.4

Velan is a partner who withdrew ₹ 20,000 on 1st April 2018. Interest on drawings is charged at 10% per annum. Calculate interest on drawings on 31st December 2018 and pass journal entries by assuming fluctuating capital method.

Solution

Interest on drawings = Amount of drawings x Rate of interest x Period of interest

$$= ₹\ 20,000 \times \frac{10}{100} \times \frac{9}{12} = ₹\ 1,500$$

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018	Velan's capital A/c	Dr.		1,500	
Dec. 31	To Interest on drawings A/c				1,500
	(Interest on drawings charged)				
,,	Interest on drawings A/c	Dr.		1,500	
	To Profit and loss appropriation A/c				1,500
	(Interest on drawings account closed)				

Illustration 1.5

Arun is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 12% p.a. During the year ended 31st December 2018 he drew as follows:

Date	₹
March 1	6,000
June 1	4,000
September 1	5,000
December 1	2,000

Calculate the amount of interest on drawings.

Solution

Interest on drawings = Amount of drawings x Rate of interest x Period of interest

Withdrawal on March 1 $= ₹\ 6,000 \times \frac{12}{100} \times \frac{10}{12} = ₹\ 600$

Withdrawal on June 1 $= ₹\ 4,000 \times \frac{12}{100} \times \frac{7}{12} = ₹\ 280$

Withdrawal on September 1 $= ₹\ 5,000 \times \frac{12}{100} \times \frac{4}{12} = ₹\ 200$

Withdrawal on December1 $= ₹\ 2,000 \times \frac{12}{100} \times \frac{1}{12} = ₹\ 20$

Total interest on drawings $= ₹\ 1,100$

Illustration 1.6

Arul is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 12% p.a. During the year ended 31st December 2018 he drew as follows:

Date	₹
March 1	3,000
June 1	3,000
September 1	3,000
December 1	3,000

Calculate the amount of interest on drawings.

Solution

Interest on drawings = Amount of drawings × Rate of interest × Period of interest

$$\text{Withdrawal on March 1} = ₹\ 3{,}000 \times \frac{12}{100} \times \frac{10}{12} = ₹\ 300$$

$$\text{Withdrawal on June 1} = ₹\ 3{,}000 \times \frac{12}{100} \times \frac{7}{12} = ₹\ 210$$

$$\text{Withdrawal on September 1} = ₹\ 3{,}000 \times \frac{12}{100} \times \frac{4}{12} = ₹\ 120$$

$$\text{Withdrawal on December 1} = ₹\ 3{,}000 \times \frac{12}{100} \times \frac{1}{12} = ₹\ 30$$

$$\text{Total interest on drawings} = ₹\ 660$$

Illustration 1.7

Rajan is a partner who withdrew ₹ 30,000 during the year 2018. Interest on drawings is charged at 10% per annum. Calculate interest on drawings on 31st December, 2018.

Solution

$$= 30{,}000 \times \frac{10}{100} \times \frac{6}{12} = ₹\ 1{,}500$$

Note: Since, date of drawings is not given, interest is calculated for an average period of six months.

(ii) Product method

Under product method, interest is calculated on the total of the products, that is, the product of amount of drawings and the period for which the amount remained withdrawn. If the product is calculated in terms of months, then interest is calculated on the total of products at the rate per month. If the product is calculated in terms of days, then interest is calculated on the total of products at the rate per day. This method can be used in all situations as an alternative to direct method.

The procedure for calculating interest on drawings under product method is as follows:

a) Multiply each amount withdrawn by the relevant period (in months) to find out the individual product.

b) Find out the sum of all the individual products.

c) Calculate interest at the prescribed rate for one month by using the following formula.

Interest on drawings = Sum of products x Rate of interest p.a. × 1/12

Tutorial note

If the period of interest is taken in days, each amount withdrawn is to be multiplied by the relevant period (in days) to find out the individual product and the following formula is to be used to find out the interest on drawings.

Interest on drawings = Sum of products x Rate of interest p.a. ×1/365

Illustration1.8

Anbu is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 12% p.a. During the year ended 31st December 2018 he drew as follows:

Date	₹
March 1	6,000
June 1	4,000
September 1	5,000
December 1	2,000

Calculate the amount of interest on drawings by using product method.

Solution

Calculation of interest on drawings under product method

Date of drawings	Amount withdrawn ₹	Period up to December 31 (months)	Product ₹
March 1	6,000	10	60,000
June 1	4,000	7	28,000
September 1	5,000	4	20,000
December 1	2,000	1	2,000
Sum of product			1,10,000

Interest on drawings = Sum of product x Rate of interest × 1/12

= 1,10,000 × 12/100 × 1/12 = ₹ 1,100

(iii) Average period method

If the partners withdraw fixed amount at fixed time interval, interest on drawings may be calculated on the basis of the average period. Fixed time interval refers to withdrawal made monthly, quarterly, half-yearly, once in 2 months and once in 4 months. The following formula may be used to calculate interest on drawings:

$$\text{Interest on drawings} = \left[\begin{matrix}\text{Total amount of drawings}\\ \text{made during the year}\end{matrix}\right] \times \left[\begin{matrix}\text{Rate of interest}\\ \text{per annum}\end{matrix}\right] \times \left[\frac{\text{Average period}}{12}\right]$$

$$\text{Average period} = \frac{\left[\begin{matrix}\text{Number of months from}\\ \text{the date of first withdrawal}\\ \text{to the end of the year}\end{matrix}\right] + \left[\begin{matrix}\text{Number of months from}\\ \text{the date of last withdrawal}\\ \text{to the end of the year}\end{matrix}\right]}{12}$$

Average period is computed as follows:

The following table shows the average period in months for withdrawal made at the beginning, in the middle and at the end of every month, quarter and half-year of the year.

Frequency of withdrawal	Average period (in months)		
	Time of withdrawal		
	At the beginning	In the middle	At the end
Monthly	$\frac{(12+1)}{2} = 6.5$	$\frac{(11.5+0.5)}{2} = 6$	$\frac{(11+0)}{2} = 5.5$
Quarterly	$\frac{(12+3)}{2} = 7.5$	$\frac{(10.5+1.5)}{2} = 6$	$\frac{(9+0)}{2} = 4.5$
Half-yearly	$\frac{(12+6)}{2} = 9$	$\frac{(9+3)}{2} = 6$	$\frac{(6+0)}{2} = 3$

Illustration 1.9

John is a partner in a firm. He withdraws ₹ 1,000 p.m. regularly. Interest on drawings is charged @ 5% p.a. Calculate the interest on drawings using average period, if he draws

i. at the beginning of every month

ii. in the middle of every month

iii. at the end of every month

Solution

Total amount withdrawn = 1,000 × 12 = ₹ 12,000

(i) If drawings are made at the beginning of every month:

Average period = 6.5

Interest on drawings = Total amount of drawings × Rate of interest × Average period / 12

= ₹ 12,000 x 5/100 x 6.5/12 = ₹ 325

(ii) If drawings are made in the middle of every month:

Average period = 6

Interest on drawings = Total amount of drawings × Rate of interest × Average period/12

= ₹ 12,000 x 5/100 x 6/12

= ₹ 300

(iii) If drawings are made at the end of every month:

Average period = 5.5

Interest on drawings = Total amount of drawings × Rate of interest × Average period/12

= ₹ 12,000 x 5.5/100 x 6/12

= ₹ 275

Illustration 1.10

Priya and Kavitha are partners. Priya draws ₹ 4,000 at the end of each quarter. Interest on drawings is chargeable at 6% p.a. Calculate interest on drawings for the year ending 31st December 2018 using average period.

Solution

Calculation of interest on drawings of Priya (using average period)

Total amount of drawings = 4,000 x 4 = ₹ 16,000

If drawings are made at the end of every quarter, average period = 4.5

Interest on drawings = Total amount of drawings × Rate of interest × Average period / 12

= ₹ 16,000 6/100 x 4.5/12 = ₹ 360

Illustration 1.11

Vennila and Eswari are partners. Vennila draws ₹ 5,000 at the beginning of each half year. Interest on drawings is chargeable at 4% p.a. Calculate interest on drawings for the year ending 31st December 2018 using average period.

Solution

Calculation of interest on drawings of Vennila (using average period)

Total amount of drawings = 5,000 × 2 = ₹ 10,000

If drawings are made at the end of every half year, average period = 9

Interest on drawings = Total amount of drawings × Rate of interest × Average period/12

= ₹ 10,000 x 4/100 x9/12 = ₹ 300

Profit and Loss Appropriation Account

Profits are an important part of a business so as its allocation. That is why the Profit and Loss Appropriation Account is an important part of an organization. Profit and Loss Appropriation Account is necessary for businesses, especially partnerships because they help to allocate the net of expenditures and incomes among the various partners. Now let's discuss various facts about the Profit and Loss Appropriation A/c.

Meaning of Profit and Loss Appropriation Account

It is a special account that a firm prepares to show the distribution of profits/losses among the partners or partner's capital.

This account should not be confused with the typical Profit and Loss Account but rather seen as an extension of it as it is made after making the Profit and Loss Account.

Purpose

Overall, the firm uses it to show the allocation and distribution of Net Profit among the partners, reserves, and dividends.

Creators

A partnership form of business organizations creates such kind of special account. Moreover, the Partnership Deed plays a very important role in deciding the various rates and amounts.

Time of Creation

A firm prepares it after the preparation of profit and loss account at the end of every Financial Year, in short on 31st March every year. It is prepared just like many other ledger accounts.

Debit Items

It's Debit items include:

1. Net Loss transferred from P&L account,

2. Transfer of profit to Reserves,

3. Salary to Partners,

4. Interest on Capital,

5. Commission to Partners,

6. Payments designated for dividend payments.

Credit Items

It's Credit items include:

1. Net Profit Transferred to the account from the Profit and Loss Account,

2. Money was taken out from the general reserve,

3. Drawing by the partners and the interest thereupon.

Format of Profit and Loss Appropriation Account

Profit and Loss Appropriation A/c

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
	To Interest On CapitalA/c			By Profit And Loss A/c (Profit transferred from P&L A/c)	
	To Partner’s Salary A/c			By Interest on Drawings A/c	
	To Reserves A/c				
	To Partner’s Commission A/c				
	To Profit transferred to Partner’s Capital/Current Account				

Charge v/s Appropriation

Charge	Appropriation
Charge against profit means the deduction of any amount from the firm's revenue to reach Net Profit or Loss.	Appropriation of Profit is the distribution of Profit
Hence, the Profit and Loss Account is prepared.	Hence, the Profit and Loss Appropriation Account is prepared.

Balance of Profit and Loss Appropriation Account

The balance of the account (Credit – Debit) is transferred as the remaining profit either to the Capital accounts or to the Current accounts of the partners in their respective pre-decided profit distribution ratio or shares.

But in the case of deficiency of profits, adjust the allocation of profits to salary, commission, etc. keeping in view the availability of profit.

UNIT-II

ADMISSION OF A PARTNER

A business firm seeks new partners with business expansion being one of the driving motives. As per the Partnership Act, 1932, a new partner can be admitted into the firm with the consent of all the existing partners, unless otherwise agreed upon.

With the admission of a new partner, there is a reconstitution of the partnership firm and all the partners get into a new agreement for carrying out the business of the firm.

The following conditions led to the addition of a new partner:

1. When the firm is in an expansion mode and requires fresh capital.
2. When the new partners possess expertise, which can be beneficial for the business expansion of the firm.
3. When the partner in question is a person of reputation and adds goodwill to the firm.

The following adjustments need to be made at the time of admission of a new partner

1. Calculating the new profit-sharing ratio along with the sacrificing ratio.
2. Accounting for goodwill.
3. Revaluation of assets and liabilities.
4. Adjustment of capital as per new profit-sharing ratio.

With the admission of a new associate, the partnership enterprise is restructured and a new agreement is entered into; to carry on the trading concern of the enterprise. A newly added partner obtains 2 primary rights in the enterprise:

- Right to share the assets of the partnership firm
- Right to share the profits of the partnership firm

Treatment of Goodwill in the Admission of a Partner

A new partner is entitled to be a part of the future profits of the firm upon being added to the firm. The act of admitting new partner also leads to the reduction in the future profit-sharing ratio of the existing partners. For this reason, a new partner has to bring extra value apart from capital, this is known as Premium for Goodwill.

Treatment of goodwill on admission of a new partner will be based on the following conditions:

1. When the amount for goodwill is paid privately
2. When the amount necessary for paying the share of goodwill is brought as cash.
3. When share of goodwill is not brought as cash.

Adjustment of Capital and Change in Profit Sharing Ratio Among Existing Partners

Few significant points which require observation during the admission of a new partner are mentioned below:

- Sacrificing ratio
- New profit-sharing ratio

- Revaluation of assets and Reassessment of liabilities
- Valuation and adjustment of goodwill
- Adjustment of partners' capitals
- Distribution of accumulated profits (reserves)

New profit-sharing ratio and sacrificing ratio

1. New profit-sharing ratio

It is necessary to determine the new profit-sharing ratio at the time of admission of a partner because the new partner is entitled to share the future profits of the firm. New profit-sharing ratio is the agreed proportion in which future profit will be distributed to all the partners including the new partner. If the new profit-sharing ratio is not agreed, the partners will share the profits and losses equally.

2. Sacrificing ratio

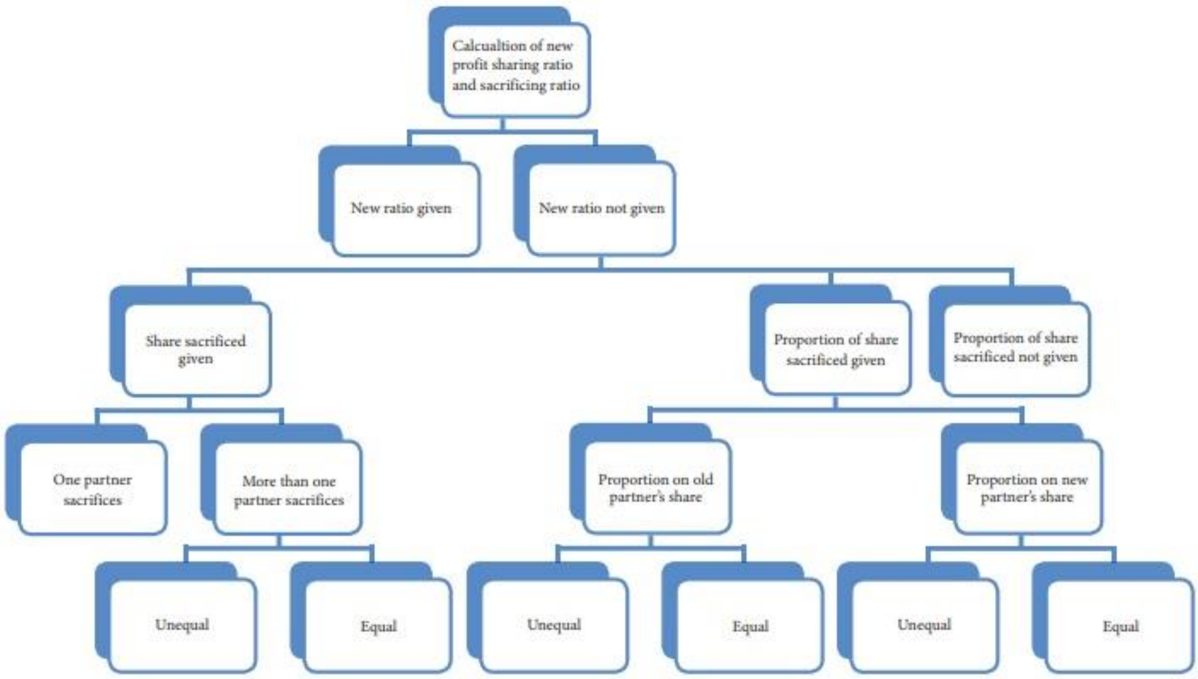
The old partners may sacrifice a portion of the share of profit to the new partner. The sacrifice may be made by all the partners or some of the partners. Sacrificing ratio is the proportion of the profit which is sacrificed or foregone by the old partners in favour of the new partner. The purpose of finding the sacrificing ratio is to share the goodwill brought in by the new partner. The share sacrificed is calculated by deducting the new share from the old share.

Share sacrificed = Old share - New share

Sacrificing ratio = Ratio of share sacrificed by the old partners

Share of the new partner is the sum of shares sacrificed by the old partners.

Tutorial note: When the new profit sharing ratio is not given in the problem, it is to be calculated based on the information given in the problem.



Calculation of sacrificing ratio and new profit-sharing ratio under different situations

1. When new profit-sharing ratio is given

When new profit-sharing ratio is given, sacrificing ratio has to be calculated as follows:

Sacrificing ratio = Ratio of share sacrificed by the old partners

Share sacrificed = Old share - New share

Illustration 2.1

Anbu and Raju are partners, sharing profits in the ratio of 3:2. Akshai is admitted as a partner. The new profit sharing ratio among Anbu, Raju and Akshai is 5:3:2. Find out the sacrificing ratio.

Solution

Old ratio of Anbu and Raju $= 3:2$ that is, $\frac{3}{5}:\frac{2}{5}$

New ratio of Anbu, Raju and Akshai $= 5:3:2$ that is, $\frac{5}{10}:\frac{3}{10}:\frac{2}{10}$

Share sacrificed = Old share - New share

Anbu $= \frac{3}{5} - \frac{5}{10} = \frac{6-5}{10} = \frac{1}{10}$

Raju $= \frac{2}{5} - \frac{3}{10} = \frac{4-3}{10} = \frac{1}{10}$

Sacrificing ratio of Anbu and Raju is $\frac{1}{10}:\frac{1}{10}$ that is 1:1

2. When new profit-sharing ratio is not given

(a) When share sacrificed is given

When new profit-sharing ratio is not given, but the share sacrificed by the old partner(s) is given, new profit-sharing ratio is calculated as follows:

New share of old partner	= Old share - Share sacrificed
Share of new partner	= Sum of shares sacrificed by old partners

Illustration 2.2

Hari and Saleem are partners sharing profits and losses in the ratio of 5:3. They admit Joel for 1/8 share, which he acquires entirely from Hari. Find out the new profit sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit sharing ratio

Share sacrificed by old partners

Hari $= \frac{1}{8}$

Saleem $= 0$

Sacrificing ratio $= 1:0$

Old ratio of Hari and Saleem is 5:3 that is $\frac{5}{8}:\frac{3}{8}$

New share of old partner = Old share - Share sacrificed

Hari $= \frac{5}{8} - \frac{1}{8} = \frac{5-1}{8} = \frac{4}{8}$

Saleem $= \frac{3}{8}$

Share of new partner

Joel $= \frac{1}{8}$

New profit sharing ratio of Hari, Saleem and Joel is $\frac{4}{8}:\frac{3}{8}:\frac{1}{8}$ that is, 4:3:1

Illustration 2.3

Ravi and Kumar share profits and losses in the ratio of 7:3. Christy is admitted as a new partner with 3/7 share which he acquires 2/7 from Ravi and 1/7 from Kumar. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit sharing ratio

Shares sacrificed $= \frac{2}{7}, \frac{1}{7}$

Sacrificing ratio of Ravi and Kumar is 2:1

Old profit sharing ratio $= 7:3$ or $\frac{7}{10} : \frac{3}{10}$

New share of old partners = Old share - Share sacrificed

Ravi $= \frac{7}{10} - \frac{2}{7} = \frac{49-20}{70} = \frac{29}{70}$

Kumar $= \frac{3}{10} - \frac{1}{7} = \frac{21-10}{70} = \frac{11}{70}$

Share of new partner

Christy $= \frac{3}{7}$

In order to equate the denominator of Christy's share, multiply and divide by 10

$$= \frac{3}{7} \times \frac{10}{10} = \frac{30}{70}$$

New profit sharing ratio of Ravi, Kumar and Christy $= \frac{29}{70} : \frac{11}{70} : \frac{30}{70} = 29:11:30$

Illustration 2.4

Hameed and Govind are partners sharing profits and losses in the ratio of 5:3. They admit John as a partner. John acquires his share 1/5 from Hameed and 1/5 from Govind. Find out the new profit sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit sharing ratio

Computation of sacrificing ratio and new profit sharing ratio

Share sacrificed = $\frac{1}{5}, \frac{1}{5}$

Sacrificing ratio of Hameed and Govind is 1:1

Old ratio is 5:3 that is $\frac{5}{8} : \frac{3}{8}$

New share of old partner = Old share - Share sacrificed

Hameed $= \frac{5}{8} - \frac{1}{5} = \frac{25-8}{40} = \frac{17}{40}$

Govind $= \frac{3}{8} - \frac{1}{5} = \frac{15-8}{40} = \frac{7}{40}$

Share of new partner

John = Sum of shares sacrificed by old partners

$= \frac{1}{5} + \frac{1}{5} = \frac{2}{5}$

In order to equalise the denominator of John's share, multiply and divide by 8

John's share = $\frac{2}{5} \times \frac{8}{8} = \frac{16}{40}$

New profit sharing ratio of Hameed, Govind and John is $\frac{17}{40} : \frac{7}{40} : \frac{16}{40}$ or 17:7:16

(b) When proportion of share sacrificed is given

(i) When share sacrificed is given as a proportion on old partners' share

When new profit-sharing ratio is not given, but the share sacrificed is given as a proportion on old partners' share, new profit-sharing ratio is calculated as follows:

Share sacrificed by old partner = Old share x Proportion of share sacrificed

New share of old partner = Old share - Share sacrificed

Share of new partner = Sum of shares sacrificed by old partners

Illustration 2.5

Suresh and Dinesh are partners sharing profits in the ratio of 3:2. They admit Ramesh as a new partner. Suresh surrenders 1/5 of his share in favour of Ramesh. Dinesh surrenders 2/5 of his share in favour of Ramesh. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit sharing ratio

Old share = 3:2 that is, Suresh $\frac{3}{5}$ and Dinesh $\frac{2}{5}$

Share sacrificed = Old share x Proportion of share sacrificed

Suresh $= \frac{3}{5} \times \frac{1}{5} = \frac{3}{25}$

Dinesh $= \frac{2}{5} \times \frac{2}{5} = \frac{4}{25}$

Sacrificing ratio of Suresh and Dinesh is $\frac{3}{25}$ and $\frac{4}{25}$, that is, 3:4

New share = Old share - Share sacrificed

Suresh $= \frac{3}{5} - \frac{3}{25} = \frac{15-3}{25} = \frac{12}{25}$

Dinesh $= \frac{2}{5} - \frac{4}{25} = \frac{10-4}{25} = \frac{6}{25}$

Share of new partner = Sum of shares sacrificed by Suresh and Dinesh

Ramesh $= \frac{3}{25} + \frac{4}{25} = \frac{3+4}{25} = \frac{7}{25}$

New profit sharing ratio of Suresh, Dinesh and Ramesh = $\frac{12}{25} : \frac{6}{25} : \frac{7}{25}$ that is, 12:6:7

Illustration 2.6

Prasanth and Nisha are partners sharing profits and losses in the ratio of 3:2. They admit Ramya as a new partner. Prasanth surrenders 2/5 of his share and Nisha surrenders 2/5 of her share in favour of Ramya. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit sharing ratio

Old share = 3:2 that is, Prasanth $\frac{3}{5}$ and Nisha $\frac{2}{5}$

Share sacrificed = Old share × Proportion of share sacrificed

Prasanth $= \frac{3}{5} \times \frac{2}{5} = \frac{6}{25}$

Nisha $= \frac{2}{5} \times \frac{2}{5} = \frac{4}{25}$

Sacrificing ratio of Prasanth and Nisha is $\frac{6}{25}$ and $\frac{4}{25}$, that is, 3:2

New share = Old share - Share sacrificed

Prasanth $= \frac{3}{5} - \frac{6}{25} = \frac{15-6}{25} = \frac{9}{25}$

Nisha $= \frac{2}{5} - \frac{4}{25} = \frac{10-4}{25} = \frac{6}{25}$

Share of new partner = Sum of shares sacrificed by Prasanth and Nisha

Ramya $= \frac{6}{25} + \frac{4}{25} = \frac{6+4}{25} = \frac{10}{25}$

New profit sharing ratio of Prasanth, Nisha and Ramya = $\frac{9}{25} : \frac{6}{25} : \frac{10}{25}$ that is, 9:6:10

(ii) When proportion of share sacrificed on new partner's share is given

When new profit sharing ratio is not given, but the proportion of share sacrificed on new partner's share is given, new profit sharing ratio is calculated as follows:

New share of old partner = Old share - Share sacrificed

Share sacrificed = New partner's share × Proportion of share sacrificed

Illustration 2.7

Ramesh and Raju are partners sharing profits in the ratio of 2:1. They admit Ranjan into partnership with 1/4 share of profit. Ranjan acquired the share from old partners in the ratio of 3:2. Calculate the new profit-sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit-sharing ratio

Ranjan's share $= \frac{1}{4}$

Old ratio $= 2:1$ that is, $\frac{2}{3}:\frac{1}{3}$

Proportion of share sacrificed $= 3:2$ that is, $\frac{3}{5}:\frac{2}{5}$

Share sacrificed = New partner's share × Proportion of share sacrificed

Ramesh $= \frac{1}{4}\times\frac{3}{5}=\frac{3}{20}$

Raju $= \frac{1}{4}\times\frac{2}{5}=\frac{2}{20}$

Sacrificing ratio of Ramesh and Raju is $\frac{3}{20}$ and $\frac{2}{20}$, that is, 3:2

New share of old partner = Old share - Share sacrificed

Ramesh $= \frac{2}{3}-\frac{3}{20}=\frac{40-9}{60}=\frac{31}{60}$

Raju $= \frac{1}{3}-\frac{2}{20}=\frac{20-6}{60}=\frac{14}{60}$

Share of new partner

Ranjan $= \frac{1}{4}$

In order to equate the denominator, multiply and divide Ranjan's share by 15

$$= \frac{1}{4}\times\frac{15}{15}=\frac{15}{60}$$

Thus, the new profit sharing ratio $= \frac{31}{60}:\frac{14}{60}:\frac{15}{60} = 31:14:15$

Illustration 2.8

Mahesh and Dhanush are partners sharing profits and losses in the ratio of 2:1. Arun is admitted for 1/4 share which he acquired equally from both Mahesh and Dhanush. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit sharing ratio

Arun's share $= \frac{1}{4}$

Proportion of share sacrificed $= 1:1$(equally) i.e. $\frac{1}{2}:\frac{1}{2}$

Share sacrificed = New partner's share × Proportion of share sacrificed

Mahesh $= \frac{1}{4} \times \frac{1}{2} = \frac{1}{8}$

Dhanush $= \frac{1}{4} \times \frac{1}{2} = \frac{1}{8}$

Sacrificing ratio of Mahesh and Dhanush is $\frac{1}{8}:\frac{1}{8}$ that is, 1:1

New share of old partner = Old share - Share sacrificed

Mahesh $= \frac{2}{3} - \frac{1}{8} = \frac{16-3}{24} = \frac{13}{24}$

Dhanush $= \frac{1}{3} - \frac{1}{8} = \frac{8-3}{24} = \frac{5}{24}$

Share of new partner

Arun $= \frac{1}{4}$

In order to equate, multiply and divide Arun's share by 6

$= \frac{1}{4} \times \frac{6}{6} = \frac{6}{24}$

New profit sharing ratio of Mahesh, Dhanush and Arun $= \frac{13}{24}:\frac{5}{24}:\frac{6}{24}$ that is, 13:5:6.

(c) When share sacrificed and proportion of share sacrificed is not given

When new profit-sharing ratio, share sacrificed and the proportion of share sacrificed is not given, but only the share of new partner is given, new profit sharing ratio is calculated by assuming that the share sacrificed is the proportion of old share. New profit sharing ratio is calculated as follows:

Share sacrificed = New partner's share x Old share

New share of old partner = Old share - Share sacrificed

Illustration 2.9

Vimal and Athi are partners sharing profits in the ratio of 2:1. Jeyam is admitted for 1/4 share in the profits. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit sharing ratio

Since share sacrificed, proportion of share sacrificed and new profit sharing ratio are not given, it is assumed that the existing partners sacrifice in their old profit sharing ratio, that is, 2:1.

Sacrificing ratio of Vimal and Athi is 2:1

Let the total share be 1

Jeyam's share $= \frac{1}{4}$

Remaining share $= 1 - \frac{1}{4} = \frac{4-1}{4}$

$= \frac{3}{4}$

New share of old partners = Remaining share × Old share

Vimal $= \frac{3}{4} \times \frac{2}{3} = \frac{6}{12}$

Athi $= \frac{3}{4} \times \frac{1}{3} = \frac{3}{12}$

Share of new partner

Jeyam $= \frac{1}{4}$

In order to equalise the denominator, multiply and divide by 3

Jeyam's share $= \frac{1}{4} \times \frac{3}{3} = \frac{3}{12}$

New profit sharing ratio of Vimal, Athi and Jeyam $= \frac{6}{12} : \frac{3}{12} : \frac{3}{12}$ that is, 2:1:1

Illustration 2.10

Anil, Sunil and Hari are partners in a firm sharing profits in the ratio of 4:3:3. They admit Raja for 20% profit. Calculate the new profit sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit sharing ratio

Old ratio of Anil, Sunil and Hari = 4:3:3 or $\frac{4}{10}:\frac{3}{10}:\frac{3}{10}$

Raja's share of profit = 20% or 20/100 or 1/5

Let the total share be 1

Remaining share $= 1-\frac{1}{5}=\frac{5-1}{5}$

$= \frac{4}{5}$

New share of old partners = Remaining share × Old share

Anil $= \frac{4}{5}\times\frac{4}{10}=\frac{16}{50}$

Sunil $= \frac{4}{5}\times\frac{3}{10}=\frac{12}{50}$

Hari $= \frac{4}{5}\times\frac{3}{10}=\frac{12}{50}$

Share of new partner

Raja $= \frac{1}{5}$

In order to equalise the denominator, multiply and divide Raja's share by 10

Raja's share $= \frac{1}{5}\times\frac{10}{10}=\frac{10}{50}$

New profit sharing ratio of Anil, Sunil, Hari and Raja = $\frac{16}{50}:\frac{12}{50}:\frac{12}{50}:\frac{10}{50}$ that is, 8:6:6:5.

Goodwill:

Goodwill is also one of the special aspects of partnership accounts which requires adjustment (also valuation if not specified) at the time of reconstitution of a firm viz., a change in the profit sharing ratio, the admission of a partner or the retirement or death of a partner.

Meaning of Goodwill

Over a period of time, a well-established business develops an advantage of good name, reputation and wide business connections. This helps the business to earn more profits as compared to a newly set up business. In accounting, the monetary value of such advantage is known as "goodwill".

It is regarded as an intangible asset. In other words, goodwill is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits. It is generally observed that when a person pays for goodwill, he/she pays for something, which places him in the position of being able to earn super profits as compared to the profit earned by other firms in the same industry.

In simple words, goodwill can be defined as “the present value of a firm’s anticipated excess earnings” or as “the capitalised value attached to the differential profit capacity of a business”. Thus, goodwill exists only when the firm earns super profits. Any firm that earns normal profits or is incurring losses has no goodwill.

Factors Affecting the Value of Goodwill

The main factors affecting the value of goodwill are as follows

Nature of business: A firm that produces high value added products or having a stable demand is able to earn more profits and therefore has more goodwill.

Location: If the business is centrally located or is at a place having heavy customer traffic, the goodwill tends to be high.

Efficiency of management: A well-managed concern usually enjoys the advantage of high productivity and cost efficiency. This leads to higher profits and so the value of goodwill will also be high.

Market situation: The monopoly condition or limited competition enables the concern to earn high profits which leads to higher value of goodwill.

Special advantages: The firm that enjoys special advantages like import licences, low rate and assured supply of electricity, long-term contracts for supply of materials, well-known collaborators, patents, trademarks.

Methods of Valuation of Goodwill:

1. Average Profits Method

2. Supper Profits Method

3. Capitalisation Method.

Average Profits Method:

Under this method, the goodwill is valued at agreed number of ‘years’ purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill, therefore, should be calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue.

For example, if the past average profits of a business works out at Rs. 20,000 and it is expected that such profits are likely to continue for another three years, the value of goodwill will be Rs. 60,000 (Rs. 20,000 × 3),

Super Profits Method

The basic assumption in the average profits (simple or weighted) method of calculating goodwill is that if a new business is set up, it will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases an existing business has to pay in the form of goodwill a sum equal to the total profits he is likely to receive for the first ‘few years. But it is contended that the buyer’s real benefit does not lie in total profits; it is limited to such amounts of profits which are in excess of the normal return on capital employed in similar business. Therefore, it is desirable to value, goodwill on the basis of the excess profits and not the actual profits. The excess of actual profits over the normal profits is termed as super profits.

Normal Profit =

Capital Employed × Normal Rate of Return / 100

Suppose an existing firm earns Rs. 18,000 on the capital of Rs. 1,50,000 and the normal rate of return is 10%. The Normal profits will work out at Rs. 15,000 (1.50,000 × 10/100). The super profits in this case will be Rs. 3,000 (Rs. 18,000 – 15,000). The goodwill under the super profit method is ascertained by multiplying the super profits by certain number of years’ purchase. If, in the above example, it is expected that the benefit of super profits is likely to be available for 5 years in future, the goodwill will be valued at Rs. 15,000 (3,000 × 5). Thus, the steps involved under the method are:

1. Calculate the average profit,

2. Calculate the normal profit on the capital employed on the basis of the normal rate of return,

3. Calculate the super profits by deducting normal profit from the average profits, and

4. Calculate goodwill by multiplying the super profits by the given number of years’ purchase.

Capitalisation Methods

Under this method the goodwill can be calculated in two ways: (a) by capitalizing the average profits, or (b) by capitalizing the super profits

Capitalisation of Average Profits: Under this method, the value of goodwill is ascertained by deducting the actual capital employed (net assets) in the business from the capitalized value of the average profits on the basis of normal rate of return. This involves the following steps:

(i) Ascertain the average profits based on the past few years’ performance.

(ii) Capitalize the average profits on the basis of the normal rate of return to ascertain the capitalised value of average profits as follows:

Average Profits × 100/Normal Rate of Return

(iii) Ascertain the actual capital employed (net assets) by deducting outside liabilities from the total assets (excluding goodwill).

Capital Employed = Total Assets (excluding goodwill) – Outside Liabilities

(iv) Compute the value of goodwill by deducting net assets from the capitalised value of average profits, i.e. (ii) – (iii)

Treatment of goodwill

Reputation built up by a firm has an impact on the present profit and future profit to be earned by the firm. At the time of admission of a partner, the existing partners sacrifice part of their share of profit in favour of the new partner. Hence, to compensate the sacrifice made by the existing partners, goodwill of the firm has to be valued and adjusted. In addition to capital, the new partner may contribute towards goodwill. This goodwill is distributed in the sacrificing ratio to the old partners who sacrifice.

1. Accounting treatment for goodwill

Accounting treatment for goodwill on admission of a partner is disccussed below:

1. When new partner brings cash towards goodwill
2. When the new partner does not bring goodwill in cash or in kind
3. When the new partner brings only a part of the goodwill in cash or in kind
4. Existing goodwill

1. When new partner brings cash towards goodwill

When the new partner brings cash towards goodwill in addition to the amount of capital, it is distributed to the existing partners in the sacrificing ratio. The following journal entries are to be made:

(i) For the goodwill brought in cash credited to old partners' capital account

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Cash / Bank A/c	Dr.		xxx	
	To Old partners' capital / current A/c (in sacrificing ratio)				xxx

(ii) For the goodwill brought in kind (in the form of assets) credited to old partners' capital account

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Respective Asset A/c	Dr.		xxx	
	To Old partners' capital / current A/c (in sacrificing ratio)				xxx

(iii) For withdrawal of cash received for goodwill by the old partners

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Old partners' capital / current A/c Dr.		xxx	
	To Cash / Bank A/c			xxx

Illustration 2.11

Amudha and Bhuvana are partners who share profits and losses in the ratio of 5:3. Chithra joins the firm on 1st January, 2019 for 3/8 share of profits and brings in cash for her share of goodwill of ₹ 8,000. Pass necessary journal entry for adjusting goodwill on the assumption that the fluctuating capital method is followed and the partners withdraw the entire amount of their share of goodwill.

Solution

As the sacrifice made by the existing partners is not mentioned, it is assumed that they sacrifice in their old profit sharing ratio 5:3. Therefore, sacrificing ratio is 5:3.

Journal Entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2019	Bank A/c Dr.		8,000	
January 1	To Amudha's capital A/c (5/8)			5,000
	To Bhuvana's capital A/c (3/8)			3,000
	(Cash brought for goodwill credited to Amudha and Bhuvana in sacrificing ratio)			
,,	Amudha's capital A/c Dr.		5,000	
	Bhuvana's capital A/c Dr.		3,000	
	To Bank A/c			8,000
	(Amount withdrawn by the partners)			

Illustration 2.12

Arun, Babu and Charles are partners sharing profits and losses equally. They admit Durai into partnership for 1/4 share in future profits. The goodwill of the firm is valued at ₹ 36,000 and Durai brought cash for his share of goodwill. The existing partners withdraw half of the amount of their share of goodwill. Pass necessary journal entries on the assumption that the fluctuating capital method is followed.

Solution

Durai's share of goodwill = 36,000 × 1/4 = ₹ 9,000

As the sacrifice made by the existing partners is not mentioned, it is assumed that they sacrifice in their old profit sharing ratio 1:1:1. Therefore, sacrificing ratio is 1:1:1.

Journal Entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Bank A/c	Dr.		9,000	
	To Arun's capital A/c				3,000
	To Babu's capital A/c				3,000
	To Charles's capital A/c				3,000
	(Cash brought for goodwill credited to old partners' capital account in sacrificing ratio)				
	Arun's capital A/c	Dr.		1,500	
	Babu's capital A/c	Dr.		1,500	
	Charles's capital A/c	Dr.		1,500	
	To Bank A/c				4,500
	(Cash withdrawn by the partners)				

Illustration 2.13

Vasu and Devi are partners sharing profits and losses in the ratio of 3:2. They admit Nila into partnership for 1/4 share of profit. Nila pays cash ₹ 3,000 towards her share of goodwill. The new ratio is 3:3:2. Pass necessary journal entry on the assumption that the fixed capital system is followed.

Solution

Calculation of sacrificing ratio

Sacrificing ratio = Old share – New share

Vasu $= \frac{3}{5} - \frac{3}{8} = \frac{24-15}{40} = \frac{9}{40}$

Devi $= \frac{2}{5} - \frac{3}{8} = \frac{16-15}{40} = \frac{1}{40}$

Therefore, sacrificing ratio is 9:1

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Bank A/c Dr.		3,000	
	To Vasu's current A/c (9/10)			2,700
	To Devi's current A/c (1/10)			300
	(Cash brought for goodwill credited to old partners' capital account in sacrificing ratio)			

2. When the new partner does not bring goodwill in cash or in kind

If the new partner does not bring goodwill in cash or in kind, his share of goodwill must be adjusted through the capital accounts of the partners. The following journal entry is passed.

Date	Particulars	L.F.	Debit ₹	Credit ₹
	New partners' capital A/c Dr.		xxx	
	To Old partners' capital / current A/c (in sacrificing ratio)			xxx

Illustration 2.14

Ashok and Mumtaj were partners in a firm sharing profits and losses in the ratio of 5:1. They have decided to admit Tharun into the firm for 2/9 share of profits. The goodwill of the firm on the date of admission was valued at ₹ 27,000. Tharun is not able to bring in cash for his share of goodwill. Pass necessary journal entries for goodwill on the assumption that the fluctuating capital system is followed.

Solution

As the sacrifice made by the existing partners is not mentioned, it is assumed that they sacrifice in their old profit sharing ratio of 5:1. Therefore, sacrificing ratio is 5:1.

Tharun's share of goodwill = 27,000 x 2/9 = ₹ 6,000

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Tharun's capital A/c Dr.		6,000	
	To Ashok's capital A/c (5/6)			5,000
	To Mumtaj's capital A/c (1/6)			1,000
	(Tharun's share of goodwill credited to the old partners' capital account in the sacrificing ratio)			

3. When the new partner brings only a part of the goodwill in cash or in kind

Sometimes the new partner may bring only a part of the goodwill in cash or assets. In such a case, for the cash or the assets brought, the respective account is debited and for the amount not brought in cash or kind, the new partner's capital account is debited. The following journal entry is passed.

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Cash / Bank A/c Dr.		xxx	
	New partners' capital A/c Dr.		xxx	
	To Old partners' capital / current A/c (in sacrificing ratio)			xxx

Illustration 2.15

Aravind and Balaji are partners sharing profits and losses in 3:2 ratio. They admit Anirudh into partnership. The new profit sharing ratio is agreed at 1:1:1. Anirudh's share of goodwill is valued at ₹ 20,000 of which he pays ₹ 12,000 in cash. Pass necessary journal entries for goodwill on the assumption that the fluctuating capital method is followed.

Solution

Calculation of sacrificing ratio

Sacrificing ratio = Old share – New share

Aravind $= \frac{3}{5} - \frac{1}{3} = \frac{9-5}{15} = \frac{4}{15}$

Balaji $= \frac{2}{5} - \frac{1}{3} = \frac{6-5}{15} = \frac{1}{15}$

Therefore, sacrificing ratio is 4:1

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Cash A/c	Dr.		12,000	
	Anirudh's capital A/c	Dr.		8,000	
	To Aravind's capital A/c (4/5)				16,000
	To Balaji's capital A/c (1/5)				4,000
	(Share of goodwill of Anirudh credited to old partners' capital account)				

4. Existing goodwill

If goodwill already appears in the books of accounts, at the time of admission if the partners decide, it can be written off by transferring it to the existing partners' capital account / current account in the old profit sharing ratio. The following journal entry is to be passed:

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Old partners' capital / current A/c (in old ratio)	Dr.		xxx	
	To Goodwill A/c				xxx
	(Existing goodwill written off)				

Illustration 2.16

Sathish and Sudhan are partners in a firm sharing profits and losses in the ratio of 4:3. On 1st April 2018, they admitted Sasi as a partner. On the date of Sasi's admission, goodwill appeared in the books of the firm at ₹ 35,000. By assuming fluctuating capital account, pass the necessary journal entry if the partners decide to

(i) write off the entire amount of existing goodwill

(ii) write off ₹ 21,000 of the existing goodwill.

Solution

(i) To write off the entire amount of existing goodwill

Journal entry

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018	Sathish's capital A/c (4/7)	Dr.		20,000	
April 1	Sudhan's capital A/c (3/7)	Dr.		15,000	
	To Goodwill A/c				35,000
	(Existing goodwill written off)				

(ii) To write off ₹ 21,000 of the existing goodwill

Journal entry

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018	Sathish's capital A/c (21,000 x 4/7)	Dr.		12,000	
April 1	Sudhan's capital A/c (21,000 x 3/7)	Dr.		9,000	
	To Goodwill A/c				21,000
	(Existing goodwill written off to the extent of ₹ 21,000)				

Distribution of accumulated profits, reserves and losses

Profits and losses of previous years which are not distributed to the partners are called accumulated profits and losses. Any reserve and accumulated profits and losses belong to the old partners and hence these should be distributed to the old partners in the old profit sharing ratio. Reserves include general reserve, reserve fund, workmen compensation fund and investment fluctuation fund. Incase of workmen compensation fund, the excess amount after providing for anticipated claim is the accumulated profit to be transferred.

Following are the journal entries to be passed:

(a) For transferring accumulated profit and reserves

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Profit and loss appropriation A/c	Dr.		xxx	
	General reserve A/c	Dr.		xxx	
	Reserve fund A/c	Dr.		xxx	
	Workmen compensation fund A/c	Dr.		xxx	
	Investment fluctuation fund A/c	Dr.		xxx	
	To Old partners' capital / current A/c (in the old ratio)				xxx

(b) For transferring accumulated loss

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Old partner's capital / current A/c	Dr.		xxx	
	ToProfit and loss A/c (in old ratio)				xxx

Illustration 2.17

Mala and Vimala were partners sharing profits and losses in the ratio of 3:2. On 31.3.2017, Varshini was admitted as a partner. On the date of admission, the book of the firm showed a reserve fund of ₹ 50,000. Pass the journal entry to distribute the reserve fund.

Solution

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Reserve fund A/c	Dr.		50,000	
March 31	To Mala's capital A/c (50,000 x 3/5)				30,000
	To Vimala's capital A/c (50,000 x 2/5)				20,000
	(Reserve fund transferred to old partners' capital account in the old profit sharing ratio)				

Illustration 2.18

Kavitha and Radha are partners of a firm sharing profits and losses in the ratio of 4:3. They admit Deepa on 1.1.2019. On that date, their balance sheet showed debit balance of profit and loss account being accumulated loss of ₹ 70,000 on the asset side of the balance sheet. Give the journal entry to transfer the accumulated loss on admission.

Solution

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2019 January 1	Kavitha's capital A/c Dr.		40,000	
	Radha's capital A/c Dr.		30,000	
	To Profit and loss a/c			70,000
	(Accumulated loss transferred to old partners' capital account in the old profit sharing ratio)			

Illustration 2.19

Rathna Kumar and Arockia Das are partners in a firm sharing profits and losses in the ratio of 3:2. Their balance sheet as on 31st March, 2017 is as follows:

Liabilities	₹	₹	Assets	₹
Capital accounts:			Buildings	30,000
Rathna Kumar	30,000		Plant	60,000
Arockia Das	50,000	80,000	Furniture	20,000
Profit and loss appropriation A/c		20,000	Debtors	10,000
General reserve		5,000	Stock	15,000
Workmen compensation fund		15,000	Cash at bank	15,000
Sundry creditors		30,000		
		1,50,000		1,50,000

David was admitted into the partnership on 1.4.2017. Pass journal entry to distribute the accumulated profits and reserve on admission.

Solution

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017 April 1	Profit and loss appropriation A/c Dr.		20,000	
	General reserve A/c Dr.		5,000	
	Workmen compensation fund A/c Dr.		15,000	
	To Rathna Kumar's capital A/c (40,000 x 3/5)			24,000
	To Arockia Das's capital A/c (40,000 x 2/5)			16,000
	(Accumulated profit and reserve transferred to old partners' capital account in the old profit sharing ratio)			

Adjustment of capital on the basis of new profit sharing ratio

Sometimes, it may be agreed by the partners that their capitals in the reconstituted firm be in the proportion of their new profit sharing ratio. There can be two situations.

The new partner may be required to bring proportionate capital for his share of profit. New partner's capital is calculated on the basis of the capital of the reconstituted firm or on the basis of combined capitals of the old partners for their share of profit.

The old partners may be required to make their capital in proportion to their new profit sharing ratio. Old partners' capital is calculated on the basis of the capital brought by the new partner for his share of profit. The deficiency or excess in the old partners' capital account may be adjusted through the current accounts or cash may be brought in or withdrawn by the partners.

Comprehensive problems

Illustration 2.20

Vetri and Ranjit are partners, sharing profits in the ratio of 3:2. Their balance sheet as on 31st December 2017 is as under:

Liabilities	₹	₹	Assets	₹
Capital accounts:			Furniture	25,000
Vetri	30,000		Stock	20,000
Ranjit	20,000	50,000	Debtors	10,000
Reserve fund		5,000	Cash in hand	35,000
Sundry creditors		45,000	Profit and loss A/c (loss)	10,000
		1,00,000		1,00,000

On 1.1.2018, they admit Suriya into their firm as a partner on the following arrangements.

(i) Suriya brings ₹ 10,000 as capital for 1/4 share of profit.

(ii) Stock to be depreciated by 10%

(iii) Debtors to be revalued at ₹ 7,500.

(iv) Furniture to be revalued at ₹ 40,000.

(v) There is an outstanding wages of ₹ 4,500 not yet recorded.

Prepare revaluation account, partners' capital account and the balance sheet of the firm after admission.

Solution

Dr	Revaluation Account			Cr.
Particulars	₹	₹	**Particulars**	₹
To Stock A/c		2,000	By Furniture A/c	15,000
To Debtors A/c		2,500		
To Outstanding wages A/c		4,500		
To Profit on revaluation transferred to capital A/c				
Vetri (3/5)	3,600			
Ranjit (2/5)	2,400	**6,000**		
		15,000		15,000

Dr.				Capital Account			Cr.
Particulars	**Vetri ₹**	**Ranjit ₹**	**Suriya ₹**	**Particulars**	**Vetri ₹**	**Ranjit ₹**	**Suriya ₹**
To Profit and loss A/c	6,000	4,000	-	By Balance b/d	30,000	20,000	-
To Balance c/d	**30,600**	**20,400**	**10,000**	By Reserve fund A/c	3,000	2,000	-
				By Revaluation A/c	3,600	2,400	-
				By Bank A/c	-	-	10,000
	36,600	24,400	10,000		36,600	24,400	10,000
				By Balance b/d	30,600	20,400	10,000

Balance Sheet as on 1st January 2018

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Furniture	25,000	
Vetri	30,600		Add: Appreciation	15,000	40,000
Ranjit	20,400		Stock	20,000	
Suriya	10,000	61,000	Less: Depreciation	2,000	18,000
Sundry creditors		45,000	Debtors	10,000	
Outstanding wages		4,500	Less: Decrease	2,500	7,500
			Cash in hand	35,000	
			Add: Suriya's capital	10,000	45,000
		1,10,500			1,10,500

Illustration 2.21

The balance sheet of Rekha and Mary on 31st March 2018 is as follows:

Liabilities	₹	₹	Assets	₹
Capital accounts:			Buildings	50,000
Rekha	50,000		Stock	8,000
Mary	30,000	80,000	Sundry debtors	60,000
General reserve		40,000	Cash at bank	32,000
Workmen compensation fund		10,000		
Sundry creditors		20,000		
		1,50,000		1,50,000

They share the profits and losses in the ratio of 3:1.They agreed to admit Kavitha into the partnership firm for 1/4 share of profit which she gets entirely from Rekha.

Following are the conditions:

i. Kavitha has to bring ₹ 20,000 as capital. Her share of goodwill is valued at 4,000. She could not bring cash towards goodwill.

ii. Depreciate buildings by 10%

iii. Stock to be revalued at ₹ 6,000

iv. Create provision for doubtful debts at 5% on debtors

Prepare necessary ledger accounts and the balance sheet after admission.

Solution

Dr. Revaluation Account Cr.

Particulars	₹	Particulars	₹	₹
To Buildings A/c	5,000	By Loss on revaluation transferred to		
To Stock A/c	2,000	Rekha's capital A/c (3/4)	7,500	
To Provision for bad debts A/c	3,000	Mary's capital A/c (1/4)	2,500	10,000
	10,000			10,000

Dr. Capital Account Cr.

Particulars	Rekha ₹	Mary ₹	Kavitha ₹	Particulars	Rekha ₹	Mary ₹	Kavitha ₹
To Revaluation A/c	7,500	2,500	-	By Balance b/d	50,000	30,000	-
To Rekha's capital A/c (share of goodwill)	-	-	4,000	By Bank A/c	-	-	20,000
				By General reserve A/c	30,000	10,000	-
				By Workmen compensation fund A/c	7,500	2,500	-
To Balance c/d	**84,000**	**40,000**	**16,000**	By Kavitha's capital A/c (share of goodwill)	4,000	-	-
	91,500	42,500	20,000		91,500	42,500	20,000
				By Balance b/d	84,000	40,000	16,000

Balance Sheet as on 1st April 2018

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Buildings	50,000	
Rekha	84,000		Less: Depreciation	5,000	45,000
Mary	40,000		Stock	8,000	
Kavitha	16,000	1,40,000	Less: Decrease	2,000	6,000
Sundry creditors		20,000	Sundry debtors	60,000	
			Less: Provision for		
			doubtful debts	3,000	57,000
			Bank (32,000+20,000)		52,000
		1,60,000			1,60,000

Illustration 2.22

Ameer and Raja are partners sharing profits in the ratio of 3:2. Their balance sheet is shown as under on 31.12.2018.

Liabilities	₹	₹	Assets	₹
Capital accounts:			Machinery	60,000
Ameer	80,000		Furniture	40,000
Raja	70,000	1,50,000	Debtors	30,000
Reserve fund		15,000	Stock	10,000
Creditors		35,000	Prepaid insurance	40,000
			Cash at bank	20,000
		2,00,000		2,00,000

Rohit is admitted as a new partner who introduces a capital of ₹ 30,000 for his 1/5 share in future profits. He brings ₹ 10,000 for his share of goodwill.

Following revaluations are made:

i. Stock is to be appreciated to ₹ 14,000

ii. Furniture is to be depreciated by 5%

iii. Machinery is to be revalued at ₹ 80,000

Prepare the necessary ledger accounts and the balance sheet after the admission.

Solution

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

Particulars	₹	₹	Particulars	₹
To Furniture A/c		2,000	By Stock A/c	4,000
To Profit on revaluation transferred to			By Machinery A/c	20,000
Ameer's capital A/c (3/5)	13,200			
Raja's capital A/c (2/5)	8,800	**22,000**		
		24,000		24,000

Dr. **Capital Account** **Cr.**

Particulars	Ameer ₹	Raja ₹	Rohit ₹	Particulars	Ameer ₹	Raja ₹	Rohit ₹
To Balance c/d	**1,08,200**	**88,800**	**30,000**	By Balance b/d	80,000	70,000	-
				By Bank A/c	-	-	30,000
				By Reserve fund A/c	9,000	6,000	-
				By Revaluation A/c	13,200	8,800	-
				By Bank A/c* (share of goodwill)	6,000	4,000	-
	1,08,200	88,800	30,000		1,08,200	88,800	30,000
				By Balance b/d	1,08,200	88,800	30,000

*__Note:__ Since the sacrificing ratio is not given and the new partner's share is given, it is assumed that the old profit sharing ratio (3:2) is the sacrificing ratio and the new partner's share of goodwill is distributed to the old partners accordingly.

Dr. **Cash at bank Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance b/d	20,000		By Balance c/d	**60,000**
	To Rohit's capital A/c	30,000			
	To Ameer's capital A/c	6,000			
	To Raja's capital A/c	4,000			
		60,000			60,000

Balance Sheet as on 1st January 2019

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Machinery	60,000	
Ameer	1,08,200		Add: Appreciation	20,000	80,000
Raja	88,800		Furniture	40,000	
Rohit	30,000	2,27,000	Less: Depreciation	2,000	38,000
Creditors		35,000	Debtors		30,000
			Stock	10,000	
			Add: Appreciation	4,000	14,000
			Prepaid insurance		40,000
			Cash at bank		60,000
		2,62,000			2,62,000

Illustration 2.23

Veena and Pearl are partners in a firm sharing profits and losses in the ratio of 2:1. Their balance sheet as on 31st March, 2018 is as follows:

Liabilities	₹	₹	Assets	₹
Capital accounts			Buildings	60,000
Veena	60,000		Machinery	30,000
Pearl	40,000	1,00,000	Debtors	20,000
General reserve		30,000	Stock	10,000
Workmen compensation fund		10,000	Cash at bank	30,000
Sundry creditors		10,000		
		1,50,000		1,50,000

Deri is admitted on 1.4.2018 subject to the following conditions:

a) The new profit sharing ratio among Veena, Pearl and Deri is 5:3:2.

b) Deri has to bring a capital of ₹ 30,000

c) Stock to be depreciated by 20%

d) Anticipated claim on workmen compensation fund is ₹ 1,000

e) Unrecorded investment of ₹ 11,000 has to be brought into books

f) The goodwill of the firm is valued at ₹ 30,000 and Deri brought cash for his share of goodwill. The existing partners withdraw the entire amount brought by Deri towards goodwill.

Prepare the necessary ledger accounts and balance sheet after admission.

Solution

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

Particulars	₹	₹	Particulars	₹
To Stock A/c		2,000	By Investments A/c	11,000
To Profit on revaluation transferred to				
Veena's capital A/c (2/3)	6,000			
Pearl's capital A/c (1/3)	3,000	9,000		
		11,000		11,000

Old ratio of Veena and Pearl $= 2:1$ that is, $\frac{2}{3}:\frac{1}{3}$

New ratio of Veena, Pearl and Deri $= 5:3:2$ i.e. $\frac{5}{10}:\frac{3}{10}:\frac{2}{10}$

Share sacrificed = Old share - New share

Veena $= \frac{2}{3}-\frac{5}{10}=\frac{20-15}{30}=\frac{5}{30}$

Pearl $= \frac{1}{3}-\frac{3}{10}=\frac{10-9}{30}=\frac{1}{30}$

Sacrificing ratio of Veena and Pearl = 5:1

Dr. **Capital Account** Cr.

Particulars	Veena ₹	Pearl ₹	Deri ₹	Particulars	Veena ₹	Pearl ₹	Deri ₹
To Bank A/c	5,000	1,000	-	By Balance b/d	60,000	40,000	-
To Balance c/d	**92,000**	**56,000**	**30,000**	By Bank A/c	-	-	30,000
				By General reserve A/c	20,000	10,000	-
				By Workmen compensation fund A/c (10,000- 1,000)	6,000	3,000	-
				By Revaluation A/c	6,000	3,000	-
				By Bank A/c* (share of goodwill)	5,000	1,000	-
	97,000	57,000	30,000		97,000	57,000	30,000
				By Balance b/d	92,000	56,000	30,000

* Goodwill of the firm is ₹ 30,000

Deri's share of goodwill = 30,000 × 2/10 = ₹ 6,000

It is to be distributed to Veena and Pearl in their sacrificing ratio of 5:1

Dr. **Cash at bank Account** **Cr.**

Particulars	₹	Particulars	₹
To Balance b/d	30,000	By Veena's capital A/c	5,000
To Deri's capital A/c	30,000	By Pearl's capital A/c	1,000
To Veena's capital A/c	5,000	By Balance c/d	60,000
To Pearl's capital A/c	1,000		
	66,000		66,000

Balance Sheet as on 1st April 2018

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Buildings		60,000
Veena	92,000		Machinery		30,000
Pearl	56,000		Investments		11,000
Deri	30,000	1,78,000	Debtors		20,000
Workmen's compensation			Stock	10,000	
fund (10,000-9,000)		1,000	Less: Decrease	2,000	8,000
Sundry creditors		10,000	Cash at bank		60,000
		1,89,000			1,89,000

Revaluation of assets and liabilities

When a partner is admitted into the partnership, the assets and liabilities are revalued as the current value may differ from the book value. Determination of current values of assets and liabilities is called revaluation of assets and liabilities. The reasons for revaluation of assets and liabilities are as follows:

i. To give a true and fair view of the state of affairs of the firm and

ii. To share the gain arising from the revaluation of assets and liabilities as it is due to the old partners.

There are two ways in which the revaluation of assets and liabilities may be dealt with in the accounts.

a) Revised value of assets and liabilities are shown in the books

b) Revised value of assets and liabilities are not shown in the books

1. When revised value of assets and liabilities are shown in the books

Under this method, the assets and liabilities are shown at their revised values in the books and in the balance sheet which is prepared immediately after the admission of a partner. A Revaluation account is opened to record the increase or decrease in assets and liabilities. Revaluation account is also called Profit and loss adjustment account. It is a nominal account. Revaluation account is credited with increase in value of assets and decrease in the value of liabilities. It is debited with decrease in value of assets and increase in the value of liabilities. Unrecorded assets if any are credited and unrecorded liabilities if any are debited to the revaluation account. The profit or loss arising therefrom is transferred to the capital accounts of the old partners in the old profit sharing ratio. If the total of the credit side of the revaluation account exceeds the total of the debit side, the difference is profit on revaluation. If the total of the debit side of the revaluation account exceeds the total of the credit side, the difference is loss on revaluation.

Following are the journal entries to be passed to record the revaluation of assets and liabilities:

Date	Particulars		L.F.	Debit ₹	Credit ₹
	1. For increase in the value of asset				
	Concerned asset A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	2. For decrease in the value of asset				
	Revaluation A/c	Dr.		xxx	
	To Concerned asset A/c				xxx
	3. For increase in the amount of liabilities				
	Revaluation A/c	Dr.		xxx	
	To Concerned liability A/c				xxx
	4. For decrease in the amount of liability				
	Concerned liability A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	5. For recording an unrecorded asset				
	Concerned asset A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	6. For recording an unrecorded liability				
	Revaluation A/c	Dr.		xxx	
	To Concerned liability A/c				xxx
	7. For transferring the balance in revaluation A/c				
	(a) If there is profit on revaluation				
	Revaluation A/c	Dr.		xxx	
	To Old partners' capital A/c (individually in old ratio)				xxx
	(b) If there is loss on revaluation				
	Old partners' capital A/c (individually in old ratio)	Dr.		xxx	
	To Revaluation A/c				xxx

Format of Revaluation Account:

Dr. **Revaluation Account** Cr.

Particulars	₹	Particulars	₹
To Concerned asset A/c (net decrease)	xxx	By Concerned asset A/c (net increase)	xxx
To Concerned liability A/c (net increase)	xxx	By Concerned liability A/c (net decrease)	xxx
To Old partners' capital A/c (profit on revaluation shared in old ratio)*	xxx	By Old partners' capital A/c (loss on revaluation shared in old ratio)*	xxx
	xxx		xxx

*There will be either profit or loss on revaluation.

*There will be either profit or loss on revaluation.

Illustration 2.24

Rajesh and Ramesh are partners sharing profits in the ratio 3:2. Raman is admitted as a new partner and the new profit sharing ratio is decided as 5:3:2. The following revaluations are made. Pass journal entries and prepare revaluation account.

a) The value of building is increased by ₹ 15,000.

b) The value of the machinery is decreased by ₹ 4,000.

c) Provision for doubtful debt is made for ₹ 1,000.

Solution

Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Buildings A/c Dr.		15,000	
	To Revaluation A/c			15,000
	(Appreciation in value of buildings recorded)			
	Revaluation A/c Dr.		5, 000	
	To Machinery A/c			4,000
	To Provision for doubtful debts A/c			1,000
	(Decrease in assets recorded and provision made)			
	Revaluation A/c Dr.		10,000	
	To Rajesh's capital A/c			6,000
	To Ramesh's capital A/c			4,000
	(Profit on revaluation transferred)			

Dr. Revaluation Account Cr.

Particulars	₹	₹	Particulars	₹
To Machinery A/c		4,000	By Buildings A/c	15,000
To Provision for doubtful debts A/c		1,000		
To Profit on revaluation transferred to				
Rajesh's capital A/c (3/5)	6,000			
Ramesh's capital A/c (2/5)	4,000	**10,000**		
		15,000		15,000

Illustration 2.25

Sriram and Raj are partners sharing profits and losses in the ratio of 2:1. Nelson joins as a partner on 1st April 2017. The following adjustments are to be made:

i. Increase the value of stock by ₹ 5,000

ii. Bring into record investment of ₹ 7,000 which had not been recorded in the books of the firm.

iii. Reduce the value of office equipment by ₹ 10,000

iv. A provision would also be made for outstanding wages for ₹ 9,500.

Give journal entries and prepare revaluation account.

Solution

Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Stock A/c	Dr.		5,000	
April 1	Investment A/c	Dr.		7,000	
	To Revaluation A/c				12,000
	(Increase in the value of stock and unrecorded investment accounted)				
,,	Revaluation A/c	Dr.		19,500	
	To Office equipment A/c				10,000
	To Outstanding wages A/c				9,500
	(Reduction in the value of office equipment and provision of outstanding wages recorded)				
,,	Sriram's capital A/c	Dr.		5,000	
	Raj's capital A/c	Dr.		2,500	
	To Revaluation A/c				7,500
	(Loss on revaluation transferred)				

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

Particulars	₹	Particulars	₹	₹
To Office equipment A/c	10,000	By Stock A/c		5,000
To Outstanding wages A/c	9,500	By Investment A/c		7,000
		By Loss on revaluation transferred to		
		Sriram's capital A/c (2/3)	5,000	
		Raj's capital A/c (1/3)	2,500	**7,500**
	19,500			19,500

Illustration 2.26

Raghu and Sam are partners in a firm sharing profits and losses in the ratio of 3:2. Their balance sheet as on 31st March, 2017 is as follows:

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Machinery		30,000
Raghu	40,000		Furniture		10,000
Sam	30,000	70,000	Stock		10,000
Sundry creditors		30,000	Debtors	21,000	
			Less: Provision for		
			doubtful debts	1,000	20,000
			Bank		30,000
		1,00,000			1,00,000

Prakash is admitted on 1.4.2017 subject to the following conditions:

a) He has to bring a capital of ₹ 10,000

b) Machinery is valued at ₹ 24,000

c) Furniture to be depreciated by ₹ 3,000

d) Provision for doubtful debts should be increased to ₹ 3,000

e) Unrecorded trade receivables of ₹ 1,000 would be brought into books now

Pass necessary journal entries and prepare revaluation account and capital account of partners after admission.

Solution

Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017 April 1	Bank A/c	Dr.		10,000	
	To Prakash's capital A.c				10,000
	(Capital brought by Prakash)				
,,	Revaluation A/c	Dr.		11,000	
	To Machinery A/c				6,000
	To Furniture A/c				3,000
	To Provision for doubtful debts A/c				2,000
	(Depreciation on machinery and furniture and provision made for doubtful debts adjusted)				
,,	Trade receivables A/c			1,000	
	To Revaluation A/c				1,000
	(Unrecorded trade receivables recorded)				
,,	Raghu's capital A/c			6,000	
	Sam's capital A/c	Dr.		4,000	
	To Revaluation A/c				10,000
	(Loss on revaluation transferred to capital accounts)				

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

Particulars	₹	Particulars	₹	₹
To Machinery	6,000	By Trade receivables A/c		1,000
To Furniture	3,000	By Loss on revaluation transferred to		
To Provision for bad debts	2,000	Raghu's capital A/c (3/5)	6,000	
		Sam's capital A/c (2/5)	4,000	**10,000**
	11,000			11,000

Dr. **Capital Account** **Cr.**

Date	Particulars	Ragu ₹	Sam ₹	Prakash ₹	Date	Particulars	Ragu ₹	Sam ₹	Prakash ₹
	To Revaluation A/c	6,000	4,000	-		By Balance b/d	40,000	30,000	-
	To Balance c/d	**34,000**	**26,000**	**10,000**		By Bank	-	-	10,000
		40,000	30,000	10,000			40,000	30,000	10,000
						By Balance b/d	34,000	26,000	10,000

Illustration 2.27

Anand and Balu are partners in a firm sharing profits and losses in the ratio of 7:3. Their balance sheet as on 31st March, 2018 is as follows:

Liabilities	₹	₹	Assets	₹
Capital accounts:			Land	60,000
Anand	50,000		Stock	40,000
Balu	30,000	80,000	Debtors	20,000
Sundry creditors		20,000	Cash in hand	10,000
Profit and loss A/c		30,000		
		1,30,000		1,30,000

Chandru is admitted as a new partner on 1.4.2018 by introducing a capital of ₹ 20,000 for 1/4 share in the future profit subject to the following adjustments:

a) Stock to be depreciated by ₹ 3,000

b) Provision for doubtful debts to be created for ₹ 2,000.

c) Land was to be appreciated by ₹ 10,000

Prepare revaluation account and capital account of partners after admission.

Solution

Dr. **Revaluation Account** Cr.

Particulars	**₹**	**₹**	**Particulars**	**₹**
To Stock		3,000	By Land A/c	10,000
To Provision for doubtful debts		2,000		
To Profit on revaluation transferred to				
Anand's capital A/c (7/10)	3,500			
Balu's capital A/c (3/10)	1,500	**5,000**		
		10,000		10,000

Dr. **Capital Account** Cr.

Particulars	**Anand ₹**	**Balu ₹**	**Chandru ₹**	**Particulars**	**Anand ₹**	**Balu ₹**	**Chandru ₹**
To Balance c/d	**74,500**	**40,500**	**20,000**	By Balance b/d	50,000	30,000	-
				By Bank A/c	-	-	20,000
				By Revaluation A/c	3,500	1,500	-
				By Profit and loss A/c	21,000	9,000	-
	74,500	40,500	20,000		74,500	40,500	20,000
				By Balance b/d	74,500	40,500	20,000

2. When revised values of assets and liabilities are not shown in the books

Under this method, the assets and liabilities are shown at their original values and not at the revised values in the books and in the balance sheet which is prepared immediately after the admission of a partner. The net result of revaluation is adjusted through the capital accounts of the partners. A Memorandum revaluation account which is a temporary account is opened when the revised values are not to be shown in the books of accounts.

Adjustment of capital on the basis of new profit sharing ratio

Sometimes, it may be agreed by the partners that their capitals in the reconstituted firm be in the proportion of their new profit sharing ratio. There can be two situations.

The new partner may be required to bring proportionate capital for his share of profit. New partner's capital is calculated on the basis of the capital of the reconstituted firm or on the basis of combined capitals of the old partners for their share of profit.

The old partners may be required to make their capital in proportion to their new profit sharing ratio. Old partners' capital is calculated on the basis of the capital brought by the new partner for his share of profit. The deficiency or excess in the old partners' capital account may be adjusted through the current accounts or cash may be brought in or withdrawn by the partners.

Comprehensive problems

Illustration 2.28

Vetri and Ranjit are partners, sharing profits in the ratio of 3:2. Their balance sheet as on 31st December 2017 is as under:

Liabilities	₹	₹	Assets	₹
Capital accounts:			Furniture	25,000
Vetri	30,000		Stock	20,000
Ranjit	20,000	50,000	Debtors	10,000
Reserve fund		5,000	Cash in hand	35,000
Sundry creditors		45,000	Profit and loss A/c (loss)	10,000
		1,00,000		1,00,000

On 1.1.2018, they admit Suriya into their firm as a partner on the following arrangements.

(i) Suriya brings ₹ 10,000 as capital for 1/4 share of profit.

(ii) Stock to be depreciated by 10%

(iii) Debtors to be revalued at ₹ 7,500.

(iv) Furniture to be revalued at ₹ 40,000.

(v) There is an outstanding wages of ₹ 4,500 not yet recorded.

Prepare revaluation account, partners' capital account and the balance sheet of the firm after admission.

Solution

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

Particulars	₹	₹	Particulars	₹
To Stock A/c		2,000	By Furniture A/c	15,000
To Debtors A/c		2,500		
To Outstanding wages A/c		4,500		
To Profit on revaluation transferred to capital A/c				
Vetri (3/5)	3,600			
Ranjit (2/5)	2,400	**6,000**		
		15,000		15,000

Dr. **Capital Account** **Cr.**

Particulars	Vetri ₹	Ranjit ₹	Suriya ₹	Particulars	Vetri ₹	Ranjit ₹	Suriya ₹
To Profit and loss A/c	6,000	4,000	-	By Balance b/d	30,000	20,000	-
To Balance c/d	**30,600**	**20,400**	**10,000**	By Reserve fund A/c	3,000	2,000	-
				By Revaluation A/c	3,600	2,400	-
				By Bank A/c	-	-	10,000
	36,600	24,400	10,000		36,600	24,400	10,000
				By Balance b/d	30,600	20,400	10,000

Balance Sheet as on 1st January 2018

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Furniture	25,000	
Vetri	30,600		Add: Appreciation	15,000	40,000
Ranjit	20,400		Stock	20,000	
Suriya	10,000	61,000	Less: Depreciation	2,000	18,000
Sundry creditors		45,000	Debtors	10,000	
Outstanding wages		4,500	Less: Decrease	2,500	7,500
			Cash in hand	35,000	
			Add: Suriya's capital	10,000	45,000
		1,10,500			1,10,500

Illustration 2.29

The balance sheet of Rekha and Mary on 31st March 2018 is as follows:

Liabilities	₹	₹	Assets	₹
Capital accounts:			Buildings	50,000
Rekha	50,000		Stock	8,000
Mary	30,000	80,000	Sundry debtors	60,000
General reserve		40,000	Cash at bank	32,000
Workmen compensation fund		10,000		
Sundry creditors		20,000		
		1,50,000		1,50,000

They share the profits and losses in the ratio of 3:1.They agreed to admit Kavitha into the partnership firm for 1/4 share of profit which she gets entirely from Rekha.

Following are the conditions:

i. Kavitha has to bring ₹ 20,000 as capital. Her share of goodwill is valued at 4,000. She could not bring cash towards goodwill.

ii. Depreciate buildings by 10%

iii. Stock to be revalued at ₹ 6,000

iv. Create provision for doubtful debts at 5% on debtors

Prepare necessary ledger accounts and the balance sheet after admission.

Solution

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

Particulars	₹	Particulars	₹	₹
To Buildings A/c	5,000	By Loss on revaluation transferred to		
To Stock A/c	2,000	Rekha's capital A/c (3/4)	7,500	
To Provision for bad debts A/c	3,000	Mary's capital A/c (1/4)	2,500	10,000
	10,000			10,000

Dr. **Capital Account** **Cr.**

Particulars	Rekha ₹	Mary ₹	Kavitha ₹	Particulars	Rekha ₹	Mary ₹	Kavitha ₹
To Revaluation A/c	7,500	2,500	-	By Balance b/d	50,000	30,000	-
To Rekha's capital A/c (share of goodwill)	-	-	4,000	By Bank A/c	-	-	20,000
				By General reserve A/c	30,000	10,000	-
				By Workmen compensation fund A/c	7,500	2,500	-
To Balance c/d	**84,000**	**40,000**	**16,000**	By Kavitha's capital A/c (share of goodwill)	4,000	-	-
	91,500	42,500	20,000		91,500	42,500	20,000
				By Balance b/d	84,000	40,000	16,000

Balance Sheet as on 1st April 2018

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Buildings	50,000	
Rekha	84,000		Less: Depreciation	5,000	45,000
Mary	40,000		Stock	8,000	
Kavitha	16,000	1,40,000	Less: Decrease	2,000	6,000
Sundry creditors		20,000	Sundry debtors	60,000	
			Less: Provision for		
			doubtful debts	3,000	57,000
			Bank (32,000+20,000)		52,000
		1,60,000			1,60,000

Illustration 2.30

Ameer and Raja are partners sharing profits in the ratio of 3:2. Their balance sheet is shown as under on 31.12.2018.

Liabilities	₹	₹	Assets	₹
Capital accounts:			Machinery	60,000
Ameer	80,000		Furniture	40,000
Raja	70,000	1,50,000	Debtors	30,000
Reserve fund		15,000	Stock	10,000
Creditors		35,000	Prepaid insurance	40,000
			Cash at bank	20,000
		2,00,000		2,00,000

Rohit is admitted as a new partner who introduces a capital of ₹ 30,000 for his 1/5 share in future profits. He brings ₹ 10,000 for his share of goodwill.

Following revaluations are made:

i. Stock is to be appreciated to ₹ 14,000

ii. Furniture is to be depreciated by 5%

iii. Machinery is to be revalued at ₹ 80,000

Prepare the necessary ledger accounts and the balance sheet after the admission.

Solution

Dr. **Revaluation Account** Cr.

Particulars	₹	₹	Particulars	₹
To Furniture A/c		2,000	By Stock A/c	4,000
To Profit on revaluation transferred to			By Machinery A/c	20,000
Ameer's capital A/c (3/5)	13,200			
Raja's capital A/c (2/5)	8,800	**22,000**		
		24,000		24,000

Dr. **Capital Account** Cr.

Particulars	Ameer ₹	Raja ₹	Rohit ₹	Particulars	Ameer ₹	Raja ₹	Rohit ₹
To Balance c/d	**1,08,200**	**88,800**	**30,000**	By Balance b/d	80,000	70,000	-
				By Bank A/c	-	-	30,000
				By Reserve fund A/c	9,000	6,000	-
				By Revaluation A/c	13,200	8,800	-
				By Bank A/c* (share of goodwill)	6,000	4,000	-
	1,08,200	88,800	30,000		1,08,200	88,800	30,000
				By Balance b/d	1,08,200	88,800	30,000

***Note:** Since the sacrificing ratio is not given and the new partner's share is given, it is assumed that the old profit sharing ratio (3:2) is the sacrificing ratio and the new partner's share of goodwill is distributed to the old partners accordingly.

Dr. **Cash at bank Account** **Cr.**

Date	Particulars	₹	Date	Particulars	₹
	To Balance b/d	20,000		By Balance c/d	**60,000**
	To Rohit's capital A/c	30,000			
	To Ameer's capital A/c	6,000			
	To Raja's capital A/c	4,000			
		60,000			60,000

Balance Sheet as on 1st January 2019

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Machinery	60,000	
Ameer	1,08,200		Add: Appreciation	20,000	80,000
Raja	88,800		Furniture	40,000	
Rohit	30,000	2,27,000	Less: Depreciation	2,000	38,000
Creditors		35,000	Debtors		30,000
			Stock	10,000	
			Add: Appreciation	4,000	14,000
			Prepaid insurance		40,000
			Cash at bank		60,000
		2,62,000			2,62,000

Dr. **Capital Account** Cr.

Particulars	Veena ₹	Pearl ₹	Deri ₹	Particulars	Veena ₹	Pearl ₹	Deri ₹
To Bank A/c	5,000	1,000	-	By Balance b/d	60,000	40,000	-
To Balance c/d	**92,000**	**56,000**	**30,000**	By Bank A/c	-	-	30,000
				By General reserve A/c	20,000	10,000	-
				By Workmen compensation fund A/c (10,000- 1,000)	6,000	3,000	-
				By Revaluation A/c	6,000	3,000	-
				By Bank A/c* (share of goodwill)	5,000	1,000	-
	97,000	57,000	30,000		97,000	57,000	30,000
				By Balance b/d	92,000	56,000	30,000

* Goodwill of the firm is ₹ 30,000

Deri's share of goodwill = 30,000 × 2/10 = ₹ 6,000

It is to be distributed to Veena and Pearl in their sacrificing ratio of 5:1

Dr. **Cash at bank Account** Cr.

Particulars	₹	Particulars	₹
To Balance b/d	30,000	By Veena's capital A/c	5,000
To Deri's capital A/c	30,000	By Pearl's capital A/c	1,000
To Veena's capital A/c	5,000	By Balance c/d	60,000
To Pearl's capital A/c	1,000		
	66,000		66,000

Balance Sheet as on 1st April 2018

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Buildings		60,000
Veena	92,000		Machinery		30,000
Pearl	56,000		Investments		11,000
Deri	30,000	1,78,000	Debtors		20,000
Workmen's compensation			Stock	10,000	
fund (10,000-9,000)		1,000	Less: Decrease	2,000	8,000
Sundry creditors		10,000	Cash at bank		60,000
		1,89,000			1,89,000

UNIT-III

RETIREMENT AND DEATH OF A PARTNER

Introduction

When a partner leaves from a partnership firm, it is known as retirement. The reasons for the retirement of a partner may be illness, old age, better opportunity elsewhere, disagreement with other partners, etc. On retirement of a partner, existing agreement comes to an end. The firm is reconstituted and other partners continue the partnership firm with a new agreement. A partner who retires from the firm is called an outgoing partner or a retiring partner.

Section 32(1) of The Indian Partnership Act, 1932 states that a partner may retire from the firm

a) with the consent of all the other partners,

b) in accordance with an express agreement by the partners, or

c) where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

The retiring partner is liable for all the acts of the firm up to the date of his retirement. It is necessary for the retiring partner to give a public notice of his retirement from the firm to get relieved from the liabilities to the third parties for the acts of the firm after the retirement. The remaining partners must settle the amount due to the retiring partner.

Like admission and changes in profit sharing ratio in case of retirement or death also the existing partnership deep comes to end and the new once comes into exist- tense among the remaining partner. There is not much difference in the accounting treatment at the time of retirement or in the event of death.

Amount due to Retiring/Deceased Partner (To be credited to his capital account)
1. Credit Balance of his capital.
2. Credit Balance of his current account (if any).
3. Share of Goodwill. (By gaining partners)
4. Share of Reserves of Undistributed profits.
5. His share in the profit on revaluation of assets and liabilities.
6. Share in profits up to the date of Retirement/Death. (By p & L suspense A/c)
7. Interest on capital if involved.
8. Salary if any
Deduction from the above sum (to be debited to capital account)
1. Debit balance of his current account (if any)
2. Share of existing Goodwill to be written off.
3. share of accumulated loss.
4. Drawing and interest on drawings (if any)
5. Share of loss on account of Revaluation of assets and liabilities.
6. His share of business loss up to the date of Retirement/Death (To p & L) suspense A/C)
Accounting Treatment
1. Calculation of new profit sharing ratio and gaining ratio
2. Treatment of goodwill.
3. Evaluation a/c preparation with the adjustment in the respect of unrecorded assets /liabilities.
4. Distribution of reserves and accumulated profits/loss.
5. Ascertainment of share of profit/loss till the date of retirement. death.
6. Adjustment of capital if required.

7. Settlement of the Accounts due to Retired/Deceased partner.

New profit Sharing Ratio & Gaining Ratio

New profit Sharing Ratio: it is the ratio in which the remaining partners share future profits after retirement/death.

Gaining ratio: it is the ratio in which the continuing partners have acquired the share from the outgoing partner. Gaining Ratio = New Ratio -Old Ratio.

Calculation of the two ratios.

Following situations may arise

1. When no information about new ratio or gaining ratio is given in question

In this case it considered that the share of the retraining partner is acquired the remaining partners in the old ratio. Then no need to calculate the new paining ratio as it will be the same as before.

2. Gaining ratio is given which is different than the old ratio in this New share of continuing partner = has old share + gained from outgoing partner.

3. if the new ratio is given the Gaining ratio = New Ratio -Old Ratio

TREATMENT OF GOODWILL

According to accounting standards – 10, Good will account can't be raised as only purchased goodwill is recorded in books. Therefore only adjustment entry is done for goodwill

Steps to be followed

1. When old good will appears in the books then first of all this is writer in the old ratio**. Remember Old Goodwill old Ratio**

All Partner's capital A/C Dr.

To Good Will A/c

2. After written off of goodwill adjustment of retiring partner's share goodwill will be made through the following journal entry.

Remaining Partner's Capital, A/C Dr. (in gaining

To Retiring/Deceased Partner's Capital A/c

Hidden Goodwill

Sometimes goodwill is not given in the question directly, But if a firm agrees to pay a sum which is more than retiring partner's balance in capital also after making all adjustment with respect to resaves, revaluation of assets and liabilities etc. then cases amount is treated as his share of goodwill (known as hidden goodwill).

3. Revaluation of Assets and Reassessment of Liabilities

Revaluation A/c is prepared in the same way as in the case of admission of a new partner. Profit and loss on revaluation is transferred among all the partners in old ratio.

4. Adjustment of Reservation and Surplus (Profits)

(Appearing in the Balance Sheet – Liability Side)

(a) General Reserve A/cDr.

Reserve Fund A/cDr.

Profit & Loss A/c (Credit Balance)Dr.

To all partners Capital/Current A/c (in old ratio)

(b) Specific Funds – If the specific funds such as workmen's compensation funds or investment fluctuation fund are in excess of actual requirement, the excess will be transferred to the Capital A/c in old ratio.
Workmen Compensation Fund A/cDr.

Investment Fluctuation Funds A/cDr.

To All Partner's Capital A/cs

(c) For distributing accumulated losses
(i.e. P & L A/c debit balance shown on the Asset side of Balance Sheet)

All partner's Capital/Current A/cDr. (in old ratio)

To P & L A/c

Disposal of the Amount Due to the Retiring Partner
This outgoing partners A/c is settled as per the terms of partnership deed. Three cases may be there as given below –

1. When the retiring partner is paid full amount either in cash or by coeque.
Retiring Partner's Capital A/cDr.

To Cash Bank A/c

2. When the retiring partner is paid nothing in cash then the whole amount due is transferred to his loan A/c
Retiring Partner's Capital A/cDr.

To retiring partner's Loon A/c

3. When Retiring Partner is partly paid in cash and the remaining amount in treated Loan.
Retiring Partner's Capital A/cDr. (Total Amount due)

To Cash Bank A/c (Amount Paid)

To Retiring Partner's Loan A/c (Amount of Loan)

Settlement of loan of the Retiring Partner
Loan of the retiring partner is disposed off accordingly of the pre decided term and conditions among the partners. Normally the Principal amount is paid in **few equal installments.** In such cases **interest is credited to the Loan A/c on the basic of the amount outstanding at the beginning of each year** and the amount paid it debited to loan A/c. The following Journal entries are done
a. For interest on Loan.
Interest A/cDr.

To Retiring partner's Loan A/c

b. For the payment of installment.

Retiring Partner's Loan A/cDr.

To Cash/Bank A/c (including interest)

Adjustment of Capitals
At the time of retirement/death, the remaining partners may decide to adjust their capitals in their new profit sharing Ratio. Then

· The sum of their capitals will be treated as the total capital of the new firm which will be divided in their New Profit Sharing Ratio.

· Excess of Deficiency of capital in the individual capital A/c is calculated.

· Such excess or shortage is adjusted by withdrawal or contribution in case or transferring to their current A/cs.

Journal Entries
(a) For excess Capital withdrawn by the Partners
Partner's capital A/cDr.

To Cash/Bank A/c

(b) For deficiency, cash will be brought in by the partner
Cash/Bank A/cDr.

To Partner's capital A/c

DEATH OF A PARTNER
Accounting treatment in the case of death is same as in the case of return except the following:

1. The deceased partners claim is transferred to his executer's account.
2. Normally the retirement takes place at the end of the Accounting pried but the death may occur at any time. Hence the claim of deceased part shall also include his share .Normally the retirement takes place at the end of the Accounting period but the death may occur at any time. Hence the claim of deceased part shall also include his share or profit or loss, interest on capital drawings if any from the date of the last balance sheet to the date his death. profit or loss, interest on capital drawings if any from the date of the last balance sheet to the date his death.
1. Calculation of profit/Loss for the intervening Period.
It is calculated by any one of the two methods given below:

a. On Time Basis : In this method **proportionally profit** for the time period is calculated either on the **basis of last year's profit or on basis of average profits of last few years** and then deceased profit share is calculated based on his share of profits.
b. On Turnover or Sales Basis : In this method the profits upto the date of death for the current year are calculated on the **basis of current year's sales upto the date of death by using the formula.**
Profits for the current year upto the date of death =

(Sales of the current year upto the date of death/total sales of last year) × Profit for the last year.

On this basis, the deceased partner's share of profit is calculated.

Illustration 3.1

Raja and /Rani are partners in a firm sharing profits and losses in the ratio 3:2. The balance sheet on 31.12.2008 was as follows:

Liabilities	Rs.	Assets	Rs.
Capital Account		Machinery	25000
Raja	60000	Furniture	20000
Rani	40000	Stock	25000
General Reserve	50000	Debtors	50000
Creditors	30000	Cash in hand	60000
	180000		180000

Rani retires from the firm on 1.1.2010 & Raja is to run the business on the following revaluation

(i) Depreciate Furniture at 5%

(ii) Depreciate Stock by 10%

(iii) Provision for Bad debts on Debtors at 5%

(iv) Rani is to be paid in cash on the date.

Prepare Revaluation A/c, Capital A/c and Balance Sheet

Solution

Dr. **Revaluation Account** Cr.

Particulars	Rs.	Particulars	Rs.
To Furniture(5%@Rs.20,000) To Stock(10%@Rs 25,000) To Provision on Debtors (5%@Rs.50,000)	1000 2500 2500	By Revaluation Loss: Raja 3600 Rani 2400 (3:2)	 6000
	6000		6000

Dr. **Capital Account** Cr.

Particulars	Raja	Rani	Particulars	Raja	Rani
To Revaluation (loss) A/c	3600	2400	By Balance c/d	60000	40000
To Cash A/c (?)	-	57600	By General reserve	30000	20000
To Balance c/d	86400	-	(3:2)		
	90000	60000		90000	60000

Balance Sheet of Rajas as on 1.1.2010

Liabilities	Rs.	Assets	Rs.
Capital A/c		Machinery	25000
Raja	86400	Furniture (20000-1000)	19000
Creditors	30000	Stock (25000 – 2500)	22500
		Debters	47500
		Cash 60000	
		(-)Rani's Capital 67600	2400
	116400		116400

Illustration 3.2

Ram and Shyam are partners sharing profits and losses in the ratio of 3:2. Their Balance sheet is as follows:

Liabilities	Rs.	Assets	Rs.
Capital Accounts:		Machinery	30000
Ram	30000	Stock	24000
Shyam	22500	Debtors	22500
Reserve	22500	Bank	9000
Sundry Creditors	11250	Cash	750
	86250		86250

Shyam retires and the following revaluation are made:

(i) Depreciate Machinery by 7.5% and stock by 15%

(ii) A Bad debts provision is raised against debtors at 5% and a discount reserve against creditors at 2%

(iii) The goodwill of the firm is valued at Rs.37500

Prepare Revaluation A/c, Partner's Capital A/c and Balance sheet after Shyam's retirement.

Solution

Dr. **Revaluation Account** Cr.

Particulars	Rs.	Particulars	Rs.
To Machinery (7.5% @ Rs.30,000)	2250	By Reserve for creditors (2% @ Rs. 11,250)	225
To Stock (15% @ Rs.24000)	3600	By Revaluation Loss:	
To Provision for Bad debts (5% @ Rs.22,500)	1125	Ram 4050 Shyam 2700	6750
	6975		6975

Journal Entry (adjustment for Goodwill)

For Goodwill adjusted only to the extent of the retiring partner's share

Ram's Capital A/c	Dr.	15,000	
To Shyam's Capital A/c			15,000

Dr. **Capital Account** Cr.

Particulars	Ram Rs.	Shyam Rs.	Particulars	Ram Rs.	Shyam Rs.
To Shyam's Capital A/c	15,000		By Balance b/d	30,000	22,500
To Revaluation (loss)			By Reserve	13,500	9,000
To S's loan	4,050	2,700	By Ram's Capital		15,000
To Balance c/d	-	43,800			
	24,450				
		46,500		43,500	46,500

Balance of Ram as on (after Shyam's retirement)………

Liabilities	Rs.	Assets		Rs.
Capital Account Ram	24,450	Machinery	30,000	
		(-)Deperclation	2,250	27,750
Shyam's Loan A/c	43,800			
Sundry Creditors 11250		Stock	24,000	
(-)Reserves@2% 225	11,025	(-)Depreciation	3,600	20,400
		Debtors	22,500	
		(-) Provision	1,125	21,375
		Bank		9,000
		Cash		750
	79,275			79,275

Death of a Partner

Death of a partner dissolves the partnership but the surviving partners usually carry on the business by purchasing the deceased partner's share. Under these circumstance, similar situation arises as at the time of retirement of a partner, but the difference is retirement may be planned one, death is a permanent retirement. Generally, the date of retirement coincides with the last date of accounting year, but death may occur during any day of the accounting year.

In short, in case of a retirement of a partner, his share to transferred to this loan account (if not paid in cash immediately) after his retirement. But in case of a death of a partner, the deceased partner's share including a share of profit and goodwill is transferred to his executor's account.

Joint Life Policy

In the event of death of a partner, the partnership firm will have to pay a heavy sum of money to his/her legal representative. The firm may not have adequate working capital and hence it unable to pay the representative of the deceased partner. To overcome this situation, the partners would take out a "joint life policy" on the lives of all the partner. Every year premium is payable and in case of death of the partner(s), the Insurance company would pay the sum insured. This would help the firm to pay the representative of the deceased partner. It should be noted that the "amount of Insurance" received is an asset and any profit or loss on such assets should be shared by all the partners including the deceased partner is their profit sharing ratio.

Accounting Treatment of Joint Life Policy

The firm pays Joint Life Policy premium in the name of partners when a partner dies, the firm gets the policy amount from the insurance company and the same has to be paid to the representatives of the deceased partner, this has to be treated by the firm in their books. There are three methods of accounting treatment of Joint Life Policy.

Accounting Treatment of Joint Life policy

Method 1	**Method 2**	**Method 3**
Premium paid is treated As an 'expense'	Premium paid is treated as an asset	When Premium paid is treated as an asset and reserve is maintained
[Joint Life policy Account is not maintained]	[Joint Life policy is treated is maintained at its surrender value]	

Solution

Method 1

In this case the premium is charged to profit & loss account every year. However, in 2009, the Joint Life Policy would appear as follows:

Joint Life Policy

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2009 Apr 15	To Partner's Capital A/c A 80000 B 80000 C 40000	2,00,000	2009 Apr 15	ByBank A/c (Money received)	2,00,000
		2,00,000			2,00,000

Method 2

Premium paid is treated as an asset

Joint Life Policy Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2008 Jan 1	To Bank A/c (premium)	20,000	2006 Dec 31	By Profit & Loss A/c (Trf.)	20,000
		20,000			20,000
2007 Jan 11	To Bank A/c (premium)	20,000	2007 Dec 31	By Profit & Loss A/c (Bal fig) By Balance c/d	16,000 4,000
		20,000			20,000
2008 Jan 1	To Balance b/d To Bank A/c (premium)	4,000 20,000	2008 Dec 31	By Profit & loss A/c (Bal fig) By Balance c/d	15,000 9,000
		24,000			24,000
2009 Jan 1 Apr 15	To Balance b/d To Bank A/c(premium) To partner capital A/c A(2/5) 68400 B(2/5) 68400 C(1/5) 34200	9,000 20,000 1,71,000	2009 Apr 15	By Bank A/c (Money received)	2,00,000
		2,00,000			2,00,000

Method 3

Premium paid is treated as an asset and a reserve is created

Joint Life Policy Account

Date	Particulars	Rs.	Date	Particulars	Rs.
2008 Jan 1	To Bank A/c (premium)	20,000	2006 Dec 31	By Joint life policy Reserve A/c	20,000
		20,000			20,000
2007 Jan 11	To Bank A/c (premium)	20,000	2007 Dec 31	By Joint life policy Reserve A/c By Balance c/d	16,000 4,000
		20,000			20,000
2008 Jan 1	To Balance b/d To Bank A/c (premium)	4,000 20,000	2008 Dec 31	By Joint life policy Reserve A/c By Balance c/d	15,000 9,000
		24,000			24,000
2009 Jan 1 Apr 15	To Balance b/d To Bank A/c(premium) To partner capital A/c A(2/5) B(2/5) C(1/5)	9,000 20,000 72,000 72,000 72,000	2009 Apr 15	By Bank A/c (Money received) By Joint life policy Reserve A/c	2,00,000 9,000
		2,00,000			2,00,000

Joint Life Policy Reserve Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
2006 Dec 31	To Joint Life Policy (Trf)	20,000	2006 Dec 31	By Profit & Loss Appropriation A/c	20,000
		20,000			20,000
Dec 31	To Joint life policy A/c (Rs.20,000 – Rs. 4,000)	16,000	2007 Dec 31	By Profit & Loss Appropriation A/c	20,000
	By Balance c/d	4,000			
		20,000			20,000
2008 Dec 31	To Joint life policy A/c (Rs. 24,000 – Rs. 9,000)	15,000	2008 Jan 1	By Balance b/d	4,000
	To Balance c/d	9,000	Dec 31	By Profit & loss Appropriation A/c	20,000
		24,000			24,000
2009 Apr 15	To Joint Life policy (Trf)	9000	2009 Jan 1	By Balance c/d	9,000
		9000			9,000

UNIT-IV

Amalgamation of Partnership

Introduction:

These final accounts are similar to the final accounts of sole trader, with certain changes regarding the distribution of profit/loss in the partners in their profit-sharing ratio. But there are different transactions in partnership regarding admission, retirement, death of a partner, amalgamation, dissolution, conversion of partnership firm etc. which affect on the accounting of partnership firm. In this unit you have to learn accounting for amalgamation of partnership firms.

Amalgamation of Partnership Firms:

The unit amalgamation of partnership firms covers meaning of amalgamation of partnership firms, objectives of amalgamation of partnership firms, the accounting procedure for amalgamation, the journal entries and ledger posting for amalgamation of partnership firms and the problems solved.

Meaning of Amalgamation of Partnership Firms:

Amalgamation means to merge or to combine two or more business units carrying on same type of business and form a new busines unit.

Amalgamation of partnership firms means merger of two or more partnership firms with e another and form a new partnership firm. When two or more existing partnership firms, carrying on same type of business, come together end their separate entity and form a new firm it is called as amalgamation of partnership firms.

Amalgamation may be formed with any one of the following ways :

i) Merging of two or more existing sole proprietors into each another and form a new partnership firm.

ii) Merging one existing partnership firm with one existing sole proprietor and form a new partnership firm.

iii) Absorbing one existing partnership firm by another existing partnership firm.

iv) Merging two or more existing partnership firms with one another and form a new partnership firm.

Objectives of Amalgamation of Partnership firms:

Amalgamation of partnership firm is done to achieve the following objectives:

- To avoid the cut-throat competition.
- To minimize the common expenses of business.

- To get advantage of large scale business.
- To strengthen the capital position.
- To get advantage of expertise of different people, etc.

Accounting Procedure for Amalgamation of Partnership Firms :

Accounting for amalgamation of partnership firms includes closing the books of accounts of amalgamating / old firms and opening the books of accounts of amalgamated / new firm. There are two methods used for closing the books of accounts

1. Revaluation Method, and 2. Realisation Method.

In Revaluation Method, a Revaluation or Profit & Loss Adjustment A/c is prepared to record the effect of increase or decrease in the value of assets and liabilities. In Realisation Method, the purchase price is calculated and all assets and outsider liabilities are transferred to Realisation A/c at book values. In this unit the Revaluation Method is followed. As per this method, for closing the books of accounts of old firms journal entries are to be passed taking into consideration the following points :

i) Revaluation of Assets and liabilities.

ii) Creation of Goodwill.

iii) Close Reserves and other Profit Accounts.

iv) Close Loss Account.

v) Close Assets and Liabilities Accounts which are not taken over by the new firm.

vi) Transfer / close Assets and Liabilities Accounts which are taken over by the new firm.

vii) Close Capital Accounts of the partners.

To open the books of accounts of the New Firm the journal entries are to be passed taking into consideration the following points :

i) Assets of the old firm taken over by the new firm.

ii) Liabilities of the old firm taken over by the new firm.

iii) Capitals of the partners of the old firm taken over by the new firm.

iv) Adjustment of Goodwill.

v) Adjustment of Capitals of the Partners.

Journal Entries and Ledger Accounts for Amalgamation of Partnership Firms :

In the amalgamation of partnership firms closing entries and opening entries are to be passed. The closing entries are to be passed to close the books of accounts of amalgamating /old firms and the opening entries are to be passed to open the books of accounts of amalgamated/new firm.

Journal Entries in the Books of Old Firms (Closing Entries) :

For Revaluation of Assets and Liabilities: Assets and Liabilities of the old firms may be revalued at the time of amalgamation. There may be increase or decrease in the values of assets and liabilities which shows profit or loss. To record this profit or loss a Profit & Loss Adjustment A/c or Revaluation A/c is to be opened. The net profit or loss on this account is to be transferred to Partner's Capital A/c in the old profit-sharing ratio. For this purpose following journal entries are to be passed.

a) For increase in the value of asset and decrease in the value of Liability, which shows revaluation profit.

Particular Asset / Liability A/c .... Dr.

To Profit & Loss Adjustment A/c / Revaluation A/c

b) For decrease in the value of asset and increase in the value of liability which shows revaluation loss.

Profit & Loss Adjustment A/c / Revaluation A/c. . Dr.

Particular Asset / Liability A/c

c) For closing the Profit & Loss Adjustment A/c / Revaluation A/c and transferring profit. Profit & Loss Adjustment A/c / Revaluation A/c. Dr.

To Partner's Capital A/cs

(If there is a loss, a reverse entry will be passed)

v) For Creation of Goodwill : If there is no goodwill account in the books of the old firm and if it is to be created the following entry will be passed,

Goodwill A/c.................... Dr.

To Partner's Capital A/cs

(Goodwill is to be transferred in the old profit-sharing ratio)

vi) For closing Reserves and Profit Accounts: The balance on these accounts is to be transferred to Partner’s Capital A/cs in the old profit sharing ratio.

Reserves A/c .... Dr.

Profit & Loss A/c (Cr. Balance)........Dr.

To Partner's Capital A/cs

vii) For closing Loss Account: The Profit & Loss A/c showing Dr. balance is a loss account It appears on the asset side of the Balance sheet. The balance on this account also transferred to Partner's Capital A/cs in the old profit-sharing ratio.

Partner's Capital A/cs .... Dr.

To Profit & Loss A/cs

viii) For closing Assets and Liabilities A/cs which are not taken over by the New Firm : Those assets and Liabilities which are not taken over by the new firm will be either sold away / paid off by the old firm or transferred to Partner / Partner's Capital A/cs in the capital ratio. The profit or loss on such transaction will be transferred to P & L Adjustment A/c or directly to Partner's Capital A/cs in the old profit-sharing ratio. For this purpose, following journal entries are to be passed.

a) If an asset is sold away for cash

Cash / Bank A/c..................Dr.

To Particular Asset A/c

b) If an asset is taken over by the partner / partners Partner/s Capital A/c .. Dr.

To Particular Asset A/c

c) If a liability is paid off

Particular Liability A/c .... Dr.

To Cash / Bank A/c

d) If a liability is taken over by the partner/ partners Particular Liability A/c .... Dr.

To Partner/s Capital A/c

ix) For closing Assets and Liabilities which are taken over by the New Firm : The accounts of assets and liabilities which are taken over by the new firm will be closed by transferring them to the New Firm A/c at agreed values.

a) For closing Assets

New Firm A/c .... Dr

To Assets A/c

b) For closing Liabilities

Liabilities A/c .... Dr

To New Firm A/c

x) For closing Partner's Capital A/cs : Partner's Capital A/cs of the old firm are to be closed with the net balance by transferring them to the New Firm A/c

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

To New Firm A/c

Ledger Accounts if the Books of the Old Firms:

Form the above journal entries the following important ledger accounts will be prepared in the books of old firms.

i) Profit & Loss Adjustment A/c / Revaluation A/c

ii) Partner's Capital A/cs

iii) New Firm A/c

iv) Good will A/c

v) Partner's Current A/c, etc.

Journal Entries in the Books of the New Firm (Opening Entries):

i) For Assets, Liabilities and Capitals of the Partners of the old firm taken over by the New Firm:

Assets A/c .... Dr. (at agreed values) To Labilities A/c (at agreed values)

To Partner's Capital A/cs (at transferred balance)

ii) For Adjustment of Goodwill: The good will transferred from the old firm to the new firm may be maintained as it is or may be written off or may be reduced by the New Firm. If the goodwill is written off or reduced the entry will be as follows:

All Partner's Capital A/cs ....Dr.

To Goodwill A/c

(All partner's capital A/c are debited in the new profit-sharing ratio)

iii) For Adjustment of Capitals: If the capitals of the partners in the nw firm are changed as per the new profit-sharing ratio or as per the agreement, there is a need to pass journal entries for the adjustment of capitals. The adjustments of capital may be made in cash or through current A/cs.

a) For cash brought in or through current A/c for adjustment of shortage of capital Cash / Bank A/c....Dr.

Particular Partner Current A/c. ....Dr.

To Particular Partner Capital A/c

b) For cash paid or through current a/c for adjustment of excess capital Particular Partner Capital A/c. Dr.

To Cash / Bank A/c

To Particular Partner Current A/c

Ledger Accounts in the Books of New Firm: From the above journal entries the Opening Balance Sheet of the new firm is to be prepared. Also, the Partner's Capital A/s, Cash/Bank A/c may be prepared.

Illustration 4.1 : The following were the Balance Sheets of two firms M/s P and Q and M/s R and S.

Balance Sheets as at 31/03/2012

Liabilities	P & Q Rs.	R & S Rs.	Assets	P & Q Rs.	R & S Rs.
Sundry Creditors	20000	25000	Cash at Bank	5600	6700
Mrs. P's Loan	5000	-	Stock	20400	18300
Capitals - P	40000	-	Debtors	15000	20000
Q	20000	-	Furniture	4000	5000
R	-	24000	Premises	40000	-
S	-	16000	Investment	-	15000
	85000	65000		85000	65000

The two firms decided to amalgamate their business as from 1st January, 2013 under the name Bharat Traders. For this purpose, it was agreed that Mrs. P's Loan should be repaid and the Investment of M/s. R & S be not taken over by the new firm.

Goodwill of P & Q was fixed at Rs. 8000 and that of R & S at Rs. 10000. Premises were revalued at Rs. 50000, but the stock of P & Q was found overvalued by Rs. 4000. The stock of R & S was undervalued by Rs. 2000. A reserve for bad debts was created at 5% of both firms.

The total capital of Bharat Traders was to be 80000 and it was shared by the P, Q, R & S in their new profit sharing ratio which was 3 : 2 : 3 : 2 respectively.

Pass necessary journal entries to close the books of M/s P & Q and M/s R & S also pass opening entries in the books of Bharat Traders. Prepare necessary accounts in the books of all the firms.

Solution :

Journal Entries in the Books of M/s P & Q (old Firm) (Closing Entries)

Date	Particulars	L.F. No.	Dr. Rs.	Cr. Rs.
1-1-2013	Premises A/c Dr.		10000	-
	To Profit & Loss Adjustment A/c		-	10000
	or			
	To Revaluation A/c			
	(Being increase in value of premises) Profit & Loss Adjustment A/c Dr.		4750	
	or			
	Revaluation A/c Dr.			4000
	To Stock A/c			750
	To Provision for Bad Debts A/c		8000	
	(Being decrease in value of stock & debtors) Goodwill A/c Dr.			4000

	To P's Capital A/c		4000
	To Q's Capital A/c		
	(Being creation of goodwill)	5000	
	Mrs. P's Loan A/c Dr.		5000
	To Bank A/c		
	(Being Mrs. P's Loan A/c paid)	5250	
	Profit & Loss Adjustment A/c Dr.		
	or		2625
	Revaluation A/c Dr.		2625
	To P's Capital A/c To Q's Capital A/c		
	(Being revaluation profit transferred) Bharat Traders A/c Dr.	94000	600
	To Cash at bank A/c		
	To stock A/c		16400
	To Debtors A/c		15000
	To Furniture A/c		4000
	To Premises A/c		50000
	To Goodwill A/c		8000
	(Being assets transferred to new firm) Sundry Creditors A/c Dr.	20000	
	Provision for Bad Debts A/c Dr.	750	20750
	To Bharat Traders A/c		
	(Being Liabilities transferred to new firm) P's Capital A/c Dr.	46625 26625	

	Q's Capital A/c Dr. To Bharat Traders A/c (Being partners capital a/cs closed)		73250

Ledger Accounts in the Books of M/s P & Q (old firm)

(Closing Accounts)

Profit & Loss Adjustment A/c or

Dr. Revaluation A/c Cr.

Date	Particulars J.F. No.	Rs.	Date	Particulars J.F. No.	Rs.
	To Stock A/c	4000		By Premises A/c	10,000
	To Provision for Bad Debts A/c	750			
	To P's Capital A/c	2625			
	To Q's Capital A/c	2625			
		10,000			10,000

Dr. Partner's Capital A/c Cr.

Particulars	P Rs.	Q Rs.	Particulars	P Rs.	Q Rs.
To Bharat Traders A/c	46625	26625	By Balance b/d	40000	20000
			By P & L Adjustment A/c	2625	2625
			By Goodwill A/c	4000	4000
	46625	26625		46625	26625

Dr. Bharat Traders A/c (New Firm) Cr.

Particulars	Rs.	Particulars	Rs.
To Cash at Bank A/c	600	By Sundry Creditors A/c	20000
To stock A/c	16400	By Provision for Bad Debts A/c	750
To Debtors A/c	15000	By P's Capital A/c 46625	
To Furniture A/c	4000	By Q's Capital A/c 26625	73250
To Premises A/c	50000		
To Goodwill A/c	8000		
	94000		94000

Dr. Cash at Bank A/c Cr.

Particulars	Rs.	Particulars	Rs.
To Balance bid	5600	By Mrs P's Loan A/c By Bharat Traders A/c	5000 600
	5600		5600

Dr. Mrs P's Loan A/c Cr.

Particulars	Rs.	Particulars	Rs.
To Cash at Bank A/c	5000	By Balance bld	5000
	5000		5000

Dr. Goodwill A/c Cr.

Particulars	Rs.	Particulars	Rs.
To P's Capital A/c To Q's Capital A/c	4000 4000	By Bharat Traders A/c	8000
	8000		8000

Journal Entries in the Books of M/s R & S (old firm) (Closing Entries)

Date	Particulars	L.F. No.	Dr. Rs.	Cr. Rs.
	Stock A/c Dr.		2000	
	To Profit & Loss Adjustment A/c (Being increase in value of stock)			2000
	Profit & Loss Adjustment A/c Dr.		1000	
	To Provision for Bad Debts A/c (Being decrease in value of debtors)			1000
	Profit & Loss Adjustment A/c Dr.		1000	
	To R's Capital A/c			500
	To S's Capital A/c			500

	(Being profit transferred)		
	Goodwill A/c Dr.	10000	
	To R's Capital A/c		5000
	To S's Capital A/c		5000
	(Being goodwill created)		
	Bank A/c Dr.	15000	
	To Investment A/c		15000
	(Being investment sold)		
	Bharat Traders A/c Dr.	77000	
	To Cash at Bank A/c		21700
	To Stock A/c		20300
	To Debtors A/c		20000
	To Furniture A/c		5000
	To Goodwill A/c		10000
	(Being assets transferred)		
	Sundry Creditors A/c Dr.	25000	
	Provision for Bad Debts A/c Dr.	1000	
	To Bharat Traders A/c		26000
	(Being Liabilities transferred)		
	R's Capital A/c Dr.	29500	
	S's Capital A/c Dr.	21500	
	To Bharat Traders A/c		51000
	(Being Partners Capital A/cs closed)		

Ledger Accounts in the Books of M/s R & S (old firm) (Closing Accounts)

Dr. Profit & Loss Adjustment A/c Cr.

Particulars	Rs.	Particulars	Rs.
To Provision for Bad Debts A/c	1000	By Stock A/c	2000
To R's Capital A/c	500		
To S's Capital A/c	500		
	2000		2000

Dr. Partner's Capital A/c Cr.

Particulars	R Rs.	S Rs.	Particulars	R Rs.	S Rs.
To Bharat Traders A/c	29500	21500	By Balance bld	24000	16000
			By Profit & Loss Adjustment A/c	500	500
			By Goodwill A/c	5000	5000
	29500	21500		29500	21500

Dr. Bharat Traders A/c (New Firm) Cr.

Particulars	Rs.	Particulars	Rs.
To Cash at Bank A/c	21700	By Sundry Creditors A/c	25000
To Stock A/c	20300	By Provision for Bad Debts A/c	1000
To Debtors A/c	20000	By R's Capital A/c 29500	
To Furniture A/c	5000	By S's Capital A/c 21500	51000
To Goodwill A/c	10000		
	77000		77000

Dr. Cash at Bank A/c Cr.

Particulars	Rs.	Particulars	Rs.
To Balance bld	6700	By Bharat Traders A/c	21700
To Investment A/c	15000		
	21700		21700

Dr. Investment A/c Cr.

Particulars	Rs.	Particulars	Rs.
To Balance bld	15000	By Bank A/c	15000
	15000		15000

Dr. Goodwill A/c Cr.

Particulars	Rs.	Particulars	Rs.
To R's Capital A/c To S's Capital A/c	5000 5000	By Bharat Traders A/c	10000
	10000		10000

Note : Investment of M/s R & S is not taken over by the new firm. It is treated as sold by the old firm at book value.

Journal Entries in the Books of Bharat Traders (New Firm) (Opening Entries)

Date	Particulars		L.F. No.	Dr. Rs.	Cr. Rs.
	Cash at Bank A/c	Dr.		600	
	Stock A/c	Dr.		16400	
	Debtors A/c	Dr.		15000	
	Furniture A/c	Dr.		4000	
	Premises A/c	Dr.		50000	
	Goodwill A/c	Dr.		8000	
	To Sundry Creditors A/c				20000
	To Provision for Bad Debts A/c				750
	To P's Capital A/c				46625
	To Q's Capital A/c				26625
	(Being assets, Liabilities & Partners Capitals of M/s P & Q taken over)				
	Cash at Bank A/c	Dr.			
	Stock A/c	Dr.		21700	
	Debtors A/c	Dr.		20300	
	Furniture A/c	Dr.		20000	
	Goodwill A/c	Dr.		5000	
	To Sundry Creditors A/c			10000	
	To Provision for Bad Debts A/c				25000
	To R's Capital A/c				1000
	To S's Capital A/c				29500
					21500

	(Being assets, Liabilities & partners capitals of M/s R & S taken over)		
	P's Capital A/c Dr.	22625	
	Q's Capital A/c Dr.	10625	
	R's Capital A/c Dr.	5500	
	S's Capital A/c Dr.	5500	
	To cash at Bank A/c		44250
	(Being extra capital amount paid in cash)		

Note : The total capital of Bharat Traders (New Firm) is fixed at Rs. 80000 and shared by all partners in the ratio 3 : 2 : 3 : 2 . It is treated as the extra capital is paid in cash.

Ledger Posting in the Books of Bharat Traders (New Firm)

Balance Sheet of Bharat traders as on 1st January, 2013 (Opening Balance Sheet)

Liabilities	Rs.	Assets	Rs.
Capital A/cs		Stock A/c	36700
P	24000	Debtors A/c 35000	
		Less - Provision for Bad Debts 1750	33250
Q	16000	Furniture A/c	9000
R	24000	Premises A/c	50000
S	16000	Goodwill A/c	18000
Sundry Creditors A/c	45000		
Bank Loan A/c	21950		
(44250 - 600 + 21700)			
	146950		146950

Dr. Partner's Capital A/c Cr.

Particulars	P Rs.	Q Rs.	R Rs.	S Rs.	Particulars	P Rs.	Q Rs.	R Rs.	S Rs.
To Cash at Bank A/c (Bank Loan)	22625	10625	5500	5500	By M/s P & Q	46625	26625	-	-
					By M/s R & S	-	-	29500	21500
To Balance cld (New Capital)	24000	16000	24000	16000					
	44625	26625	29500	21500		46625	26625	29500	21500
					By Balance bld	24000	16000	24000	16000

OR

Capital Adjustment through working note :

Partners	Capital Transferred Rs.	Capital Required Rs.	Amount Paid Rs.
P	46625	24000	22625
Q	26625	16000	10625
R	29500	24000	5500
S	21500	16000	5500
	124250	80000	44250

UNIT-V

Dissolution.

Dissolution means discontinuance, Dissolution may be of two types.

Dissolution

Dissolution of a partnership [Admission/Retirement/Death Of a Partner]	Dissolution of Firm [Cessation of discontinuation of Partnership among all Partners]

After dissolution of a firm, the partnership firm ceases to exist and no business would be carried on by the partners. But in the case of dissolution of partnership, only the partners change and the firm is reconstituted to carry on the business. Gajal and Arora in their ‘Accounting Book’ bring out the main grounds for dissolution as

D - Death [Death of a Partner]
I - Incapacity
S - Transfer of ‘share’ [Partnership share] to some other person
S - ‘Serious misconduct’ of partnership
O - Completion of ‘Object’ of the firm, for which it was formed.
L - ‘Lunacy’ of a partner
U - ‘Unexpected Losses’ of a firm
T - Expiry of the ‘Term’ of partnership
I - ‘Insolvency’ of one/all of the partners
O - Unlawful ‘object’ of the firm
N - ‘Notice’ given by all partners.

In this chapter we would be dealing with ‘Dissolution of firms’ as the dissolution of partnership has been explained in previous chapters.

Modes of Dissolution of a firm:

According to sec.40 to 44 of Partnership Act, 1932. The following are the modes of dissolution of a firm:

Compulsory Dissolution (sec.41)

(i) By the adjudication of all the partners or one of the partner as insolvent.

(ii) By the happening of an event which makes it unlawful for the firm to be carried on the business.

Dissolution of agreement: (Sec.42)

A firm may be dissolved with the consent of all the partners or in accordance with a contract among them.

Dissolution by notice: (Sec.43)

Any partner can dissolve the partnership by giving notice in writing to all other partners if the partnership is at will.

Dissolution by court: (Sec.44)

A court may dissolve a firm on any one of following:

(i) Where a partner has become unsound mind, [i.e. of in same mind]

(ii) Where a partner becomes permanently incapable of doing his duties

(iii) Where a partner is found guilty of misconduct while carrying on the business.

(iv) Where a partner willfully or persistently commits breach of agreement.

(v) Where a partner transfers all his shares to a third party

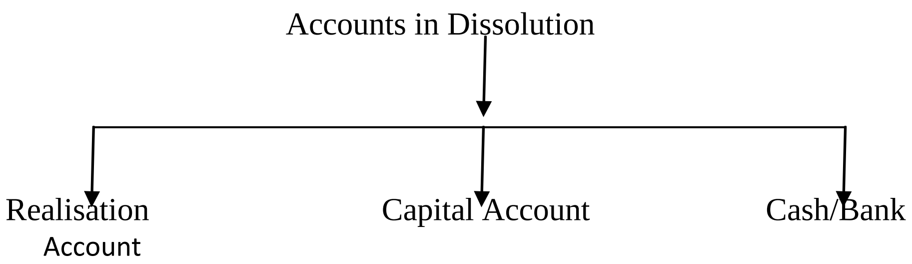
(vi) Where the court of law finds that the business cannot be carried without loss.

(vii) On any other grounds which the court of law thinks just and equitable to wind up the business.

Accounting Treatment

Normal Dissolution

The following accounts are usually opened n case of dissolution of a firm:



Realisation Account

All assets and Liabilities are transferred to this account. When assets are realized they are credited to this account and when liabilities are paid they are debited to this account. The difference would represent either profit or loss on realization, which would be transferred to partner’s capital account in their profit-sharing ratio.

Capital Account

After incorporating all the adjustments (including transfer of current accounts to capital accounts), the balance would represent either amount due to or due from partners. This capital Account would be closed either by payment of cash or by bringing in cash.

Cash/Bank Accounts

After incorporating all the adjustments relating to cash or Bank, the balance of this account must be equal to the amounts due to or due from partners. Technically, the cash and bank account would close, when payment is made/received from partners.

Journal Entries to close books of accounts: For closing Assets Accounts:

Realisation A/c	Dr.	xxx	
To Plant & Machinery A/c			xxx
To Furniture & fixtures A/c			xxx
To Stock A/c			xxx
To Debtors A/c			xxx
To Investments A/c			xxx
To Goodwill A/c			xxx
[Being assets transferred to Realisation Account]			

The following points are to be noted while transferring the assets:-

(a) All assets [except cash & bank] are to be transferred at "Book Value" only.

(b) Assets against which provision or reserve are created. These asses should be transferred at gross figure. [i.e without deducting the amount of provision / reserve]. Separate entry has to be passed to transfer the provisions: ie

Provision for Bad & doubtful doubtful debts A/c	Dr.	xxx	
Provision for Depreciation A/c	Dr.	xxx	
To Realisation A/c			xxx

(c) Cash and bank balance would be transferred to Realisation Account if the firm is dissolved due to sale of business, unless specifically mentioned.

(d) When an of the assets is being taken over by a partner

Partner's Capital A/c	Dr.	xxx	
To realization A/c			xxx
[Being asset taken by a partner]			

(e) Treatment of Goodwill.

(i) Good will treatment does not have much impact in cases of dissolution. If it appears in the balance Sheet and it is treated like any other asset and is transferred to realization account at the book value.

(ii) If the goodwill does not appear in the balance sheet, it is not calculated.

(iii) If same amount is realized for Goodwill, then it is credited to Realisation Account.

Cash A/c	Dr.	xxx	
To realization A/c			xxx
[Being cash realised for Goodwill]			

(iv) If any of the partner's agree to pay for goodwill then it is recorded by the following entry;

Partner's Capital (or) Current A/c Dr. xxx

To Realisation A/c xxx

[Being Goodwill taken by partner]

For closing liabilities :

All liabilities are to transferred to Realisation account at their book value.

Liabilities A/c Dr.

To Realisation A/c

[Being transfer of liabilities to realisation account]

Liabilities can be discharged by any of the following ways.

(i) When cash is paid for any liability

Realisation A/c Dr. xxx

To Cash / Bank A/c xxx

[Being cash paid for payment of liability]

(ii) When any of partner agrees to discharge the liabilities

Realisation A/c Dr. xxx

To Partner's Capital (or) Current A/c xxx

[Being Liability take over by partner]

Illustration 5.1

Ram, Rahim and Suresh share profit in the ratio 3 : 2 : 1. On 31st December, 2008 their Balance Sheet was as follows:

Liabilities	Rs.	Assets	Rs.
Creditors	12000	Machinery	25000
Genera Reserve	3000	Stock	11000
Capital :		Debtors	9500
Ram	20000	Goodwill	13000
Rahim	15000	Cash	1500
Suresh	10000		
	60000		60000

On the above date, the firm was dissolved. The assets, except cash, realized Rs. 60,000. The creditors were settled at Rs. 11,500. Dissolution expenses amounted to Rs. 800. Give necessary ledger A/c's

Solution

Realisation Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Machinery	25000	By Creditors	12000
To Stock	11000	By Cash [assets realized]	60000
To Debtors	9500		
To Goodwill	13000		
To Cash [Creditors paid]	11500		
To Cash [Realisation Exp]	800		
To Partner's capital A/c [Realisation of profit] Ram 600, Rahim 400, Suresh 200	1200		
	72000		72000

Capital Account

Dr. Cr.

Particulars	Ram Rs.	Rahim Rs.	Suresh Rs.	Particulars	Ram Rs.	Rahim Rs.	Suresh Rs.
To Cash A/c (cash paid to partners)	22100	16400	10700	By Balance b/d	20000	15000	10000
				By General Reserve (3 : 2 : 1)	1500	1000	500
				By Realisation A/c	600	400	200
	22100	16400	10700		22100	16400	10700

Cash Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	1500	By Realisation A/c (Creditors paid)	11500
To Realisation A/c (Assets realised)	60000	By Realisation A/c (Realisation Exp)	800
		By Partners Capital A/c Ram 22100, Rahim 16400, Suresh 10700	49200
	61500		61500

lllustration 5.2

S & W are partners in firm sharing profit and loss in the ratio of 4:3. They have decided to dissolve the partnership on 31.3.2009 on which date their Balance Sheet stood as under:

Liabilities	Rs.	Assets		Rs.
Capital : S	160000	Plant		120000
W	60000	Debtors	90000	
Bank Loan	20000	(-) Provision	4000	86000
Creditors	80000	Trade Marks		12000
		Furniture		4000
		Stock		60000
		Cash		28000
		Advertisement expenses		10000
	320000			320000

The realization showed the following results:

(i) Debtors realized 90% of book value

(ii) Trade mark Rs.8000

(iii)Goodwill was sold for Rs.10000

(iv) Plant and stock were taken over by S for Rs.144000 and Rs.36000 respectively

(v) An unrecorded asset estimated at Rs.6000 was sold for Rs.2000

Discounts amounting to Rs.800 were allowed b creditors while paying their claims. Expenses of realization amounted to Rs.4000. prepare Realisation A/c, Bank A/c and partners capital account assuming that settlement was made on 1.4.0

Solution

Realisation Account

Dr. Cr.

Particulars	Rs.	Particulars		Rs.
To Plant A/c	120000	By Provision for bad debts		4000
To Furniture A/c	4000	By Creditors A/c		80000
To Debtors A/c	90000	By Cash A/c (debtors Rs.90000 X 90%)		81000
To Trade Marks A/c	12000	By Cash A/c (Trademark)		8000
To Stock	60000	By Cash A/c (Goodwill)		10000
To Cash A/c (Creditors Rs.80000-Rs.800)	79200	To S's Capital A/c (Rs. 144000 + Rs.36000)		180000
To Cash A/c (Exp)	4000	By Cash A/c (Unrecorded asset)		2000
		By Loss transferred to		
		S's Capital (1/5)	3360	
		W's Capital (1/5)	840	4200
	369200			369200

Note: Bank loan should not be transferred to Realisation account. It has be paid off directly.

Partner’s Capital Account

Dr. Cr.

Particulars	S Rs.	W Rs.	Particulars	S Rs.	W Rs.
To Advertisement expense	8000	2000	By Balance b/d	160000	60000
(Rs.10000 in 4:1)		-	By Cash A/c (Bal.fig)	31360	-
To Realisation A/c	180000	840			
(Plant & Stock)		57160			
To Realisation A/c (loss)	3360				
To Cash A/c (Bal.fig)	-				
	191360	60000		191360	60000

CashAccount

Dr. Cr.

Particulars	Rs.	Rs	Particulars	Rs.	Rs.
To Balance b/d		28000	By Realisarion A/c		
To Realisation A/c			Creditors	79200	83200
Debtors	81000		Realisation Exp	4000	
Trademark	8000				
Goodwill	10000		By Bank loan A/c		20000
Unrecorded assets	2000		By W’s Capital A/c		57160
		101000			
To S’s capital A/c		31360			
		160360			160360

Insolvency of a Partner

Garner Vs Murray

If a partner capital account shows a debit balance on the date of dissolution of the firm, he has to pay the debit balance to the firm to settle his account. But, if such a partner is insolvent, i.e., unable to settle his debts to the firm his deficiency that he is not able to bear will be borne by the other solvent partners in accordance with the decision in Garner Vs. Murray. In this case, it was ruled that in the absence of any agreement to the contrary, the deficiency on account of the insolvent partner’s capital account should be borne by the other solvent partners in proportion to their capitals which settle in the books of the firm before the dissolution of the firm. The loss on account of the insolvency of a partner is a capital loss and hence borne by other solvent partners in proportion to their capitals. Prior to this decision, the share of deficiency was borne by the partners in their profit-sharing ratio. Another ruling in Garner Vs. Murray is that the solvent partners should bring in cash equal to their loss on realization.

Applicability of Garner Vs. Murray in India

In the absence of any specific provision in the Indian Partnership Act, 1932 and any decision of a court in India, it is a common practice to seek guidance from the English Law.

Therefore, it has became a practice in India to follow the decision of Garner Vs. Murray in the absence of any specific agreement between the partners with regard to sharing the deficiency of an insolvent partner.

Illustration 5.3

The following is the balance sheet of the firm as on 31.03.2010 as follows:

Liabilities		Rs.	Assets	Rs.
Creditors		204800	Bank	11000
Loan Account -	P	60000	Debtors	192120
	Q	24000	Stock	128000
Current Account -	P	42400	Plant and Machinery	57200
	Q	5000	Land and Buildings	16800
Capitals Account -	P	120000	Current Account - R	19880
	Q	80000		
	R	40000		
		576200		576200

It was decide to dissolve the firm on the date. The assets except bank balance realized Rs.453520. The firm had to pay Rs.3000 for an outstanding bill not recorded earlier in the books. R became insolvent and a sum of Rs.2000 was realized from his estate.

Prepare necessary ledger account. Close the books of the firm as per Garner Vs. Murray rule

Solution

Realisation Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Debtors	192120	By Creditors	204800
To Stock	128000	By Bank (assets)	453520
To Plant and Machinery	57200	By Loss transferred	
To Land and Buildings	168000	P's Current A/c 31600	
To Bank (Exp)	3000	Q's Current A/c 31600	
To Bank (Crs.)	204800	R's Current A/c 31600	94800
	753120		753120

R's Capital Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To R's current A/c (Transfer)	51480	By Balance b/d	40000
		By Bank	2000
		By Deficiency	
		P's Current A/c 5688	
		Q's Current A/c 3792	9480
	51480		51480

Current Accounts

Dr. Cr.

Particulars	P Rs.	Q Rs.	R Rs.	Particulars	P Rs.	Q Rs.	R Rs.
To Realisation A/c	-	-	19880	By balance b/d	42400	5000	-
To Realisation A/c	31600	31600	31600	By capital A/c	-	-	51480
To R's Capital [Deficiency	5688	3792	-	By Bank	31600	31600	
To Capital	37612	1208	-				
	74000	36600	51480		74000	36600	51480

Capital Account (Solvent Partners)

Dr. Cr.

Particulars	P	Q	Particulars	P	Q
To Bank A/c	156712	81208	By balance b/d	120000	80000
			By Current A/c	36712	1208
	156712	81208		156712	81208

Cash Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	11000	By realisation	3000
To Realisation A/c (Assets)	453520	By realisation A/c	204800
		By P's Loan A/c	60000
To P's Current A/c	31600	By Q's Loan A/c	24000
To Q's Current A/c	31600	By P's capital	156712
To R's Capital A/c	2000	By Q's capital	81208
	529720		529720

Insolvency of all Partners

Illustration 5.4

The balance sheet M, V, A as on 31.12.2009 is given below.

Liabilities	Rs.	Assets	Rs.
Capital M	10000	Debtors	40000
V	6000	Bank	2000
M's Loan	20000	Furniture	6000
Creditors	80000	A's Capital	2000
	116000		116000

Bank Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d	2000	By Realization A/c (Exp.)	6000
To Realization (Assets)	64000	By Creditors (Bal. Fig)	63000
To M's capital A/c (privater)	3000		
	69000		69000

Creditors Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Bank A/c	63000	By balance b/d	80000
To deficiency (Bal. fig)	17000		
	80000		80000

Deficiency Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To V's capital A/c	6000	By M's capital	21000
To A's capital A/c	32000	By Creditors A/c	17000
	38000		38000

Piecemeal Distribution

In Dissolution of a firm, it is assumed that all the amount due to the creditors and partners are settled on the date of dissolution itself; but this assumption is unrealistic and practically impossible because the process of realizing the assets and payment of liabilities takes some time.

In such a case, when there is a gradual realization of assets it is necessary to avoid the unpleasant consequences of a partner's account being overdrawn. Distributing cash of various realization of assets in such a way that the final unpaid balance of the capital of each partner is left in is profit-sharing ratio. The final profit or loss on realization can be determined only after all the assets are realized and all the liabilities are paid off. The partners get their capital gradually as and when the amount is received after settlement of third party liabilities. The Following order of payment is followed in gradual realization.

1) The debts of the firm to third parties have to be aid.
2) Amount due to partner as loan to be paid (if any)
3) Then, the capital of the partners to be paid out of the remaining amount.

The Payment are made by adopting any one of the following two methods

1) Proportionate Capital method
2) Maximum Loss method

1.Proportionate Capital Method

It is also known as "Highest Relative Capital Method". According to this method the partner who has the higher relative capital, that is whose capital is greater in proportion to his profit-sharing ratio, is first paid off. For determining the amount by which the capital of each partner is in excess of his relative capital, the least capital is taken as base and the capital of other partners are made to proportionate to their profit sharing ratio. This is called as their hypothetical capital. The amount of hypothetical capital of each partner is deducted from the amount of actual capital. The resultant amount will be the excess capital held by him. This excess amount is paid to these partners in the "Excess Capital Proportion Ratio". After this payment the partner's capital will be on their profit sharing ratio and further realization amount is distributed in the profit sharing ratio. When the final realization is distributed, the balance of unpaid capital is the "Loss on Realization".

Illustration 5.5

From the Balance Sheet of A, B and C who share the profits and losses in 2:2:1 ratio, prepare the statement distribution of cash.

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	30000	Cash	4000
Capital A	30000	Sundry Debtors	44000
B	24000	Stock	44000
C	8000		
	92000		92000

The firm was dissolved and the assets were realized gradually. Rs. 20000 was received first, Rs.30000 was received next and Rs.180000 finally.

Solution

Note: Proportionate capital method is adapted in this problem, so the partners A & B have a greater proportion in their capitals compared to partner C. C has the least capital of Rs.8000, so his capital is taken as the base for computing excess capitals of A & B.

Statement of distribution of cash

Particulars	Sundry Creditors	Capitals A	B	C
Capital as per Balance Sheet	30000	30000	24000	8000
Less: Cash in Hand	4000	-	-	-
Balance due	26000	30000	24000	8000
Less: I Realization (Rs.20000)	20000	-	-	-
Balance due	6000	30000	24000	8000
Less: II Realization (Rs.30000)				
Rs.6000 to Creditors	6000	-	-	-
Rs.22000 to A & B in 7:4	-	14000	8000	-
Rs.2000 to A, B & C in (2:2:1)	-	800	800	400
Balance due	-	15200	15200	7600
Less: III Realization	-			
(Rs.18000 in 2:2:1)		7200	7200	3600
Loss on Realization	-	8000	8000	4000
Profit sharing ratio		2	2	1

Working notes:

Capital of C is taken as the basic capital (since being the least capital of A , B & C) = Rs.8000

Capital of the Firm based on C's Capital = Rs. 40000

	A	B	C
Capital as per balance sheet	30000	24000	8000
Less: Capital based on C's Capital (Rs.40000 in 2:2:1)	16000	16000	8000
Surplus capital (Excess Capital)	14000	8000	-

Total surplus Rs.22000 (Rs. 14000+Rs.8000) will be shared in their excess capital proportion ratio i.e. 7:4

Illustration 5.6

The following is the balance sheet of A, B and C on 31.12.2009. On that date they decided to dissolve the partnership

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	2000	Sundry Asset	49000
A's Loan	5000		
Capital A	15000		
B	18000		
C	9000		
	49000		49000

The assets realized the following sums in instalments:

I – Rs.1000, II – Rs.3000, III – 3900, IV – Rs.6000 and finally V – Rs.20100. The Expenses of realization amounted to Rs.100 only. The partners share profit and losses in the ratio of 2:2:1. Show how the distribution of cash is made.

Solution

Calculation of Proportionate Capital

		A	B	C
Capital	(X)	15000	18000	9000
Profit Sharing Ratio		2	2	1
Capital (Divided by Profit sharing ratio)		7500	9000	9000
Taking Rs.7500 as base(Y) (Rs.7500 multiply in 2:2:1)		1500	15000	7500
Excess Capital/Surplus(X-Y)		Nil	3000	1500
Excess Capital Ratio(ECR)			2 :	1

Statement of distribution of cash

Particulars	Creditors	A's Loan	Particulars A (Rs.)	B(Rs.)	C(Rs.)
Balance as per balance sheet	2000	5000	15000	18000	9000
Less: I Reduction (Rs.1000)	1000	-	-	-	-
Balance due	1000	5000	15000	18000	9000
Less: II Realization(Rs.3000)					
Rs.1000 to Sundry Creditors,					
Rs.2000 to A's Loan	1000	2000	-	-	-
Balance due	-	3000	15000	18000	9000
Less: III Realization(Rs.3900)					
Rs.3000 to A's Loan	-	3000	-	-	-
Rs.9000 to B & C in 2:1 (ECR)	-	-	-	600	300
Balance due	-	-	15000	17400	8700
Less: IV Realization(Rs.6000)					
Rs.3600 to B & C in 2:1 (ECR)	-	-	-	2400	1200
Rs.2400 to A, B, C in 2:2:1	-	-	960	960	480
Balance due	-	-	14040	14040	7020
Less: V Realization	-				
(Rs.20100in 2:2:1)		-	8040	8040	4020
Loss on Realization	-	-	6000	6000	3000
Profit sharing ratio			2	2	1

Maximum Loss Method

In the process of gradual distribution of cash under the maximum loss method, it is assumed that each installment realized is considered to be final payment and there is no further realization. Outstanding assets and claims are considered to be worthless. So partner's account are adjusted on that basis. The maximum loss is the difference between the total amounts due to partners and the amount available. The maximum loss is ascertained at every stage of realization and the same is distributed among the partner's in their profit-sharing ratio. In this process there is a possibility of partner having debit balance which is presumed deficiency and the partner as insolvent and this deficiency is shared by solvent partners in their capital ratio. This process is applied in all stages of realization. The balance unpaid capital is the loss on realization, which will be I their profit-sharing ratio.

Illustration5.7

X, Y and Z are partners in a firm, who are sharing profits and losses in the proportions of 3:2:1 respectively. The following is the balance sheet as on 31.12.2009. On that date they decided to dissolve the partnership

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	10000	Cash	120000
X	45000	Sundry Debtors	10000
Y	45000		
Z	30000		
	130000		130000

The firm is dissolved and the realizations of assets were as follows:

Realization	*Amount Realised*
	Rs.
I	15000
II	22500
III	37500

Prepare a statement showing how the distribution of cash has been made under maximum loss method.

Solution

Statement of distribution of cash

Particulars	Sundry Creditors	X	Capitals Y	Z
Balance as per balance sheet Less: Cash in hand	10000 10000	45000 -	45000 -	30000 -
Balance due (A) I Realization (Rs.15000) Less: Maximum Loss: Rs.105000 In 3:2:1	- -	45000 52500	45000 35000	30000 17500
(Total of Capitals – Realization) (Rs. 120000 – Rs. 15000)	- -	(-) 7500 (+)7500	10000 4500	12500 3000
(+/-)Deficiency of X's		-	5500	9500
capital Between Y and Z in 3:2 (B) Balance due (C)=(A-	- -	45000 41250	39500 27500	20500 13750
B) II Realization	-	3750	12000	6750
(Rs.22500) Less: Maximum Loss (Rs. 105000-22500 = Rs.82500 in 3:2:1)	- -	41250 22500	27500 15000	13750 7500
(D) Balance due(E)=(C)-	-	18750	12500	6250
(D) III Realization (Rs. 37500) Maximum Loss (Rs.82500-Rs.37500 = Rs.45000 in 3:2:1 (F) Balance due/Loss on Realization (E-F) Profit sharing ratio		22500 3	15000 2	7500 1

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