Reconstitution- Retirement/Death of a Partner

Retirement/Death of a Partner

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Retirement/Death of a Partner
- Ways of Retirement
- Ascertainment of Amount Due to the Retiring/Deceased Partner
- Adjustments Required at the time of Retirement

Retirement of a Partner

Retirement of a partner implies a situation when a partner leaves a partnership firm for any reason and the remaining partners of the firm decide to continue with the business. There may be various reasons due to which a partner may seek retirement from a partnership firm. Some of these reasons are old age, illness, change in interests, etc. As on the event of retirement of a partner, there exists a change in the existing partnership agreement and relationship between the partners, so it can be said that retirement of partner leads to reconstitution of partnership firm. That is, to put in different words, in case of retirement of a partner, the old partnership deed gets terminated and is replaced by a new partnership deed, which defines new relationship among the remaining/continuing partners.

Retiring Partner's Liability

A general rule that applies while determining the liability of the retiring partner is that he cannot and should not be held responsible for a debt or liability once he has left the firm. For example: Rohan, Rahul and Raj are partners in a firm. Rahul retires from the firm on 5st January, 2019. Raj took a loan on behalf of the firm on 25th March, 2019 and failed to pay the interest on the debt when due. Then in this case, only Rohan and Raj will be held liable for the default in payment.

However, this general rule may not apply in the following cases:

Case 1: Holding Out
This occurs when the retiring partner has held himself as a member of the Partnership firm and has acted in that capacity, thereby giving an impression that he is still a partner to the firm. In such a case, the oral or written representation thus made in personal capacity or by knowledge of such representation through someone acting on his behalf, the retiring partner will be held liable. In the above example if Rahul takes a loan in the name of the firm even after the retirement then he shall be held liable for the same.

Case 2: Failure in Reporting about the Retirement through appropriate notice
This is a case of mistaken identity whereby, a person may be assumed as a Partner to the firm if he has not given a proper notice of his retirement to the concerned parties. He might as well be held responsible for a firm's debt or liability in such a case. To avoid confusion or doubt regarding his status, it is thus, advisable that he informs all the concerned parties about his retirement and give a public notice of

the same.

Case 3: Novation
It is a kind of agreement in which three parties are involved, namely:

1. The creditor of the Partnership firm
2. The Partner representing the firm at the time of contract with the creditor, and
3. The new or incoming partner

With the help of this agreement, the creditor may agree that the liability of the outgoing or retiring partner will no longer exist and instead the new partner will be taking it up. For example: Rohan, Rahul and Raj are partners in a firm. On 20th October, 2018 he took a debt from a creditor on firm's behalf. On 1st December, 2018 he decided to retire from the firm and Sohan agrees to join the firm as a partner. The creditor agrees to relieve Rohan of his liabilities and instead agrees to Sohan taking up the liability. Then this is the case of a novation agreement.

Ways of Retirement

A partner may retire from a partnership firm in any of the following ways.

(i) *With the Consent of all the Partners-* In this way, it becomes compulsory for the retiring partner to obtain the consent of all other partners of the firm before seeking retirement. This implies that the partner can get retirement if and only if all the partners agree on the decision of his/her retirement.

***Example*:** A, B and C are the partners in a partnership firm sharing profits and losses in the ratio of 4 : 3 : 1. On April 01, 2011, B wants to retire from the firm. To this, both A and C agreed. Thus, as B has obtained consent of all the partners so, now he can take retirement from the firm.

(ii) *With Express Agreement by All the Partners-* In case of written agreement among the partners, a partner may retire from the firm by expressing his/her intention of leaving the firm through a notice to the other partners of the firm. In other words, if a partner wants to leave the firm, he/she can do so by giving a notice to the other co-partners

***Example*:** A, B and C are the partners in a partnership firm sharing profits and losses in the ratio of 4 : 3 : 1. It was provided in their partnership deed that any partner may retire from the firm by giving a notice. On April 01, 2011, B wants to retire from the firm. So, he expresses his intention of retirement to A and C. In this case, B can retire from the firm even without obtaining the consent of all the partners.

(iii) *By Giving a Written Notice-* If partnership among the partners is at will then a partner may retire by giving notice in writing to all the other partners informing them about his/her intention to retire.

***Example*:** A, B and C are the partners in a partnership firm sharing profits and losses in the ratio of 4 : 3 : 1. The partnership between the partners is at will. B wants to retire from the firm. He can retire by giving a written notice to A and C expressing his intention to retire.

Ascertaining the Amount Due to the Retiring Partner

At the time of retirement of a partner, he/she is entitled to receive the following amounts.

i. Credit Balance of his Capital / Current Account
ii. Share of Goodwill
iii. Share of Accumulated Profits (Reserves)
iv. Share in the Gain of Revaluation of Assets and Liabilities.
v. Share of Profits upto the Date of Retirement.
vi. Interest on Capital (if any) upto the Date of Retirement
vii. Salary or Commission (if any) upto the Date of Retirement.

All these amount are posted on the ***credit side*** of the Retiring Partner's Capital Account.

Deductions

The following are some deductions (if any) which are to be made from his/her amount due (mentioned above).

i. Debit Balance of his/her Current Account
ii. Share of Accumulated Losses
iii. Share of Loss on Revaluation of Assets and Liabilities
iv. Share of Loss upto the Date of Retirement
v. Drawings upto the Date of Retirement
vi. Interest on Drawings (if any) upto the Date of Retirement.

All these amount are posted on the ***debit side*** of the Retiring Partner's Capital Account.

Example**:** A, B and C were partners sharing profits and losses equally. C decided to retire from the firm. Before taking into consideration the below-mentioned items, the capital of A, B and C were Rs 1,00,000, Rs 1,30,000 and Rs 90,000, respectively.

a. Interest on Capital at 5% p.a.
b. Drawings by C of Rs 12,000 and interest thereon amounted to Rs 600
c. Profit on revaluation of assets and liabilities Rs 30,000
d. Undistributed Profit and Loss (debit balance) Rs 6,000
e. Joint Life Policy Rs 50,000 and its surrender value Rs 36,000.

Prepare C's Capital Account at the time of his retirement.

Solution

C's Capital Account

Dr. **Cr.**

Particulars	Amount Rs	Particulars	Amount Rs
Drawings	12,000	Balance b/d	90,000

Interest on Drawings	600	Interest on Capital	4,500
Profit and Loss (Loss)	2,000	Revaluation (Profit)	10,000
C's Loan	1,01,900	Joint Life Policy	12,000
	1,16,500		1,16,500

Adjustments Required at the time of Retirement

Following are some of the accounting matters that are to be adjusted at the time of retirement of a partner.

i. Calculation of New-Profit Sharing Ratio
ii. Calculation of Gaining Ratio
iii. Treatment of Goodwill
iv. Revaluation of Assets and Liabilities
v. Distribution of Accumulated Profits and Losses
vi. Settlement of Amount due to the Retiring Partner
vii. Treatment of Joint Life Policy (JLP)
viii. Adjustment of Capital Accounts (if required)

New Profit Sharing Ratio

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Calculation of New Profit Sharing Ratio in case of Retirement/Death of a Partner
- Calculation of Gaining Ratio
- Difference between Gaining Ratio and Sacrificing Ratio

Introduction to New Profit Sharing Ratio

As learnt in the previous chapter that at the time of the retirement/death of any partner one of the existing partners discontinues his/her services to the partnership firm. The share of profit of the retiring/deceased partner is taken-over by the remaining/continuing partners. Consequently, there exists a change in the profit sharing ratio among the remaining/continuing partners of the reconstituted firm. Thus, there arises a need to calculate the new profit sharing ratio among the continuing partners.

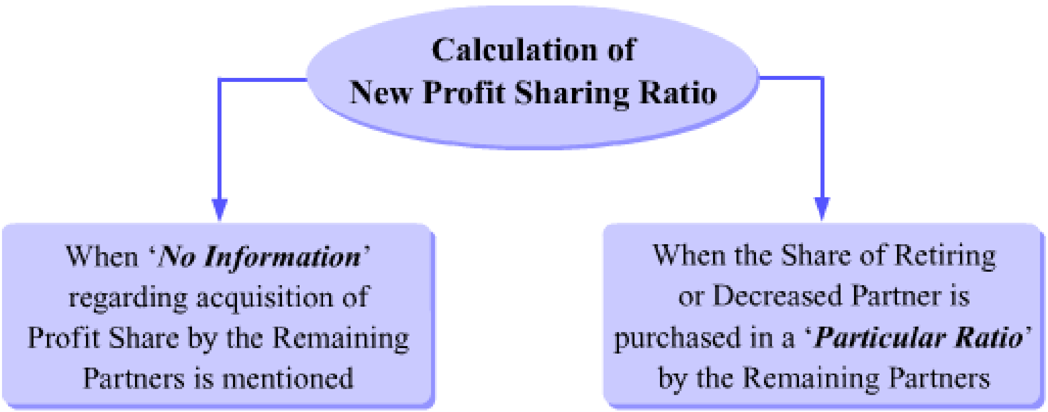
New profit sharing ratio (in case of retirement/death) is defined as a ratio in which the continuing partners agree to share their future profits and losses. In case of retirement/death of a partner, the new profit sharing ratio of the continuing/remaining partners can be described as a sum of their old profit share and portion of profit share acquired from the outgoing partner. Algebraically, New Profit Share of the Continuing Partners = Old Profit Share + Part of Profit Share acquired from the Outgoing Partner.

Calculation of New Profit Sharing Ratio in case of Retirement and Death of a Partner

Generally, in case of retirement and death of a partner, there arise two cases in which the remaining partners acquire the share of the outgoing or retiring partners. These are:

(i) ***No information*** regarding acquisition of profit share by the remaining partners is mentioned.

(ii) When the share of the retiring or deceased partner ***is purchased in a particular ratio*** by the remaining partners.



(i) No information regarding Acquisition of Profit Share by the Remaining Partners is mentioned.

In this case, no information regarding how the profit share of the outgoing partner is acquired by the remaining partners is mentioned in the question. In this case, the new profit sharing ratio of the remaining partners is computed just by crossing out the share of the outgoing partner.

Example:

P, Q and R are the three partners in the partnership firm sharing profits and losses in the ratio 4 : 3 : 1. On April 01, 2011, Q decided to take retirement from the firm.

Solution:

As we can see that in this case, no information is given as to how P and R are acquiring Q's profit share, so the new profit sharing ratio between P and R is calculated just by crossing out the Q's share. That is, the new ratio becomes 4 ~~: 3~~ : 1 i.e. 4 : 1.

Example: X, Y and Z are partners in a firm sharing profits and losses in the ratio of 5 : 3 : 2. On January 01, 2012, Y died.

Solution

Similar to the above example, no information is given as to how X and Z are acquiring Y's profit share, so the new profit sharing ratio between X and Z is calculated just by crossing out the Y's share. That is, the new ratio becomes 5 ~~: 3~~ : 2 i.e. 5 : 2.

(ii) When the share of the retiring or deceased partner is purchased in a particular ratio by the remaining partners.

It may happen that in case of retirement/death of a partner, the profit share of the outgoing partner is acquired by the remaining partners in an agreed/specified ratio. In this case, the new profit sharing ratio of the remaining partners is computed by adding the share of profit acquired from the outgoing partner to their old profit share.

***Example*:** P, Q and R are the three partners in a firm sharing profits and losses in the ratio of 4 : 3 : 2. On April 01, 2011, Q retires from the firm. On his retirement, P and R decided to acquire Q's profit share in the ratio of 3 : 2. Calculate new profit sharing ratio.

Solution

Q's share in profit = $\frac{3}{9}$

P and R decided to acquire his share in the ratio of 3 : 2

Share of Q acquired by P = $\frac{3}{9} \times \frac{3}{5} = \frac{9}{45}$

Share of Q acquired by R = $\frac{3}{9} \times \frac{2}{5} = \frac{6}{45}$

New Profit Share = Old Profit Share + Share Acquired from Q

P's new share = $\frac{4}{9} + \frac{9}{45} = \frac{29}{45}$

R's new share = $\frac{2}{9} + \frac{6}{45} = \frac{16}{45}$

∴ New Profit Sharing Ratio = 29 : 16

Important Note:

Sometimes, the new profit sharing ratio of the continuing partners is specifically mentioned in the question. So, in such cases, there is no need to calculate the new profit sharing ratio.

Gaining Ratio

On the eve of retirement/death of a partner, the continuing partners acquire the profit share of the retiring partner. The ratio in which the outgoing partner's profit share is gained or acquired by the remaining partners is known as Gaining ratio. This ratio is calculated by taking the difference between the new ratio and the old ratio of the partners.

Algebraically,

Gaining Ratio = New Profit Sharing Ratio – Old Profit Sharing Ratio

Example: P, Q and R are three partners in a firm sharing profits and losses in the ratio of 4 : 3 : 2. On April 01, 2011, Q retires from the firm. Calculate the gaining ratio.

Solution

This is the first case, in which no information regarding the acquisition of outgoing partners' profit share by the continuing partners is mentioned, so the new ratio of P and R is 4 : 2 or 2 : 1.

Gaining Ratio of P = New Profit Share of P – Old Profit Share of P

$$= \frac{2}{3} - \frac{4}{9} = \frac{2}{9}$$

Gaining Ratio of R = New Profit Share of R – Old Profit Share of R

$$= \frac{1}{3} - \frac{2}{9} = \frac{1}{9}$$

So, the Gaining Ratio is 2 : 1.

Example: K, M and N are the three partners in a firm sharing profits and losses in the ratio of 4 : 3 : 2. On March 31, 2012, M retires from the firm. After his retirement, K and N decided to acquire his share in the ratio of 3 : 2. Find out the gaining ratio.

Solution

M's share in profit = $\frac{3}{9}$

K and N decided to acquire his share in the ratio of 3 : 2

Share of M acquired by K = $\frac{3}{9} \times \frac{3}{5} = \frac{9}{45}$

Share of M acquired by N = $\frac{3}{9} \times \frac{2}{5} = \frac{6}{45}$

New Profit Share = Old Profit Share + Share Acquired from Q

K's new share = $\frac{4}{9} + \frac{9}{45} = \frac{29}{45}$

N's new share = $\frac{2}{9} + \frac{6}{45} = \frac{16}{45}$

∴ New Profit Sharing Ratio = 29 : 16

$$\text{Gaining Ratio of K} = \text{New Profit Sharing Ratio of K} - \text{Old Profit Sharing Ratio of K}$$
$$= \frac{29}{45} - \frac{4}{9} = \frac{29-20}{45} = \frac{9}{45}$$
$$\text{Gaining Ratio of N} = \text{New Profit Sharing Ratio of N} - \text{Old Profit Sharing Ratio of N}$$
$$= \frac{16}{45} - \frac{2}{9} = \frac{16-10}{45} = \frac{6}{45}$$

Example: X, Y and Z are the three partners in a firm sharing profits and losses in the ratio of 7 : 8 : 9. On December 31, 2012, Z retires from the firm. After his retirement, X and Y decided to share future profits and losses in the ratio of 3 : 2. Calculate the gaining ratio.

Solution

New Profit-Sharing (X and Y) = 3 : 2

Gaining Ratio = New Ratio – Old Ratio

X's gain = $\frac{3}{5} - \frac{7}{24} = \frac{72-35}{120} = \frac{37}{120}$

Y's gain = $\frac{2}{5} - \frac{8}{24} = \frac{48-40}{120} = \frac{8}{120}$

∴ Gaining Ratio = 37 : 8

Difference between Gaining Ratio and Sacrificing Ratio

The following are the major points of difference between the sacrificing ratio and gaining ratio.

Basis of Difference	Sacrificing Ratio	Gaining Ratio
Meaning	It is the ratio in which the old partners agree to sacrifice their share of profit in favour of new partner.	It is the ratio in which the continuing partners acquire the share of profit from outgoing partner.
Calculation	Sacrificing Ratio = Old Ratio – New Ratio	Gaining Ratio = New Ratio – Old Ratio
Time	It is calculated at the time of admission of new partner.	It is calculated at the time of retirement/death of old partner.
Objective	It is calculated to ascertain the share of profit and loss given up by the	It is calculated to ascertain the share of profit and loss acquired by the remaining

	existing partners in favour of new partner.	partners from the retiring or deceased partner.
Effect	It reduces the profit share of the existing partners.	It increases the profit share of the remaining partners.

Treatment of Goodwill in case of Retirement/Death

Objective

After going through this lesson, you shall be able to understand the following concepts

- Treatment of Goodwill in case of Retirement/Death of a Partner
- Different Cases of Treatment of Goodwill

Treatment of Goodwill

As learnt in the chapter of admission that goodwill is the value of a firm's reputation and its good brand name in the market. It is an intangible asset of a firm that is earned by the hardwork and the efforts of all the partners of the firm. As we know that *in case of admission of a new partner*, the new partner has to bring in an additional amount (besides capital) in the form of premium for goodwill to compensate the old partners. On the contrast, in case of retirement/death of a partner, the remaining/continuing partners need to compensate the outgoing (retiring/deceased) partner. This is because after the retirement/death of a partner, the fruits of the collective past performances and reputation will be shared only by the continuing partners. Hence, the remaining partners compensate the retiring or the deceased partner by entitling him/her a share of the firm's goodwill.

Accounting Standard 26- Treatment of Goodwill

As per the ***Accounting Standard 26* of ICAI**, goodwill is recorded in the books only when some consideration in money or money's worth has been paid for it. This practice is mandatory to follow. In the case of admission, retirement, death or change in profit sharing ratio among existing partners, Goodwill Account cannot be raised as no consideration is paid for it. This implies that the goodwill of a partnership firm is a self-generated goodwill, that is, the firm itself evaluates the value of the goodwill. The AS-26 standard specifies that goodwill should be immediately written off after it has been raised. That is, as per this accounting standard, goodwill has to be adjusted through Partners' Capital Account.

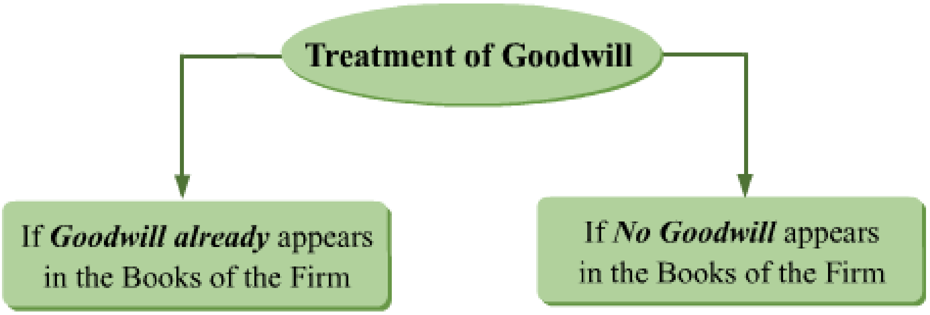
Important Note: It should be noted that the treatment of goodwill in the cases of retirement and death of a partner remains the same. There is no difference in the treatment of goodwill and its posting in the Partners' Capital Account in both the cases.

Different Cases of Treatment of Goodwill

The following are the two probable cases on which the treatment of goodwill rests.

Case-1 If *goodwill already* appears in the books of the firm.

Case-2 If _no goodwill_ appears in the books of the firm.



***Case 1:* If Goodwill Already appears in the Books of the Firm**

As in case of admission, if goodwill already appears in the Old Balance Sheet, then this goodwill is written-off among the old partners. Similarly, in case of retirement/death of a partner, if goodwill already appears in the Old Balance Sheet, then first of all this goodwill is written-off among _all the partners_ and after that the retiring/deceased partner's share of goodwill is adjusted through the continuing Partner's Capital Accounts in their _gaining ratio_.

Step 1: *Write-off the Existing Goodwill*

If goodwill already appears in the old balance sheet of the firm (if mentioned in the question), then first of all this goodwill is written-off and distributed among _all the partners_ (including the retiring/deceased partner) in their _old profit sharing ratio_. It is done by debiting the all Partners' Capital Accounts and crediting the Goodwill Account. This is done by passing the following Journal entry.

All Partner's Capital A/c Dr. {In Old Ratio}

To Goodwill A/c

(Goodwill written-off among all the partners in their old ratio)

Step 2: *Adjusting Goodwill through Partner's Capital Account*

After writing-off the old goodwill of the firm, the goodwill is adjusted through the continuing Partner's Capital Accounts with the share of the goodwill of the retiring or the deceased partner. It is done by debiting the remaining partners' capital accounts in their gaining ratio and crediting the retiring/deceased partner's capital account with the amount of retiring/deceased partner's goodwill. The Journal entry to record the adjusting of goodwill is:

Remaining Partner's Capital A/c Dr. {In Gaining Ratio}

To Retiring/Deceased Partner's Capital A/c

(Adjustment made for goodwill on retirement/death)

Note: In case, if any of the partner sacrifice his/her share on the retirement of a partner, then such sacrificing partner's capital account will be credited with the share of his sacrifice.

Example: X, Y and Z are the partners in a firm sharing profits and losses in the ratio of 2 : 2 : 1. On January 01, 2012, X retires from the firm. After his retirement, Y and Z decided to share future profits and losses in the ratio of 3 : 1. Goodwill of the firm appears in the books at Rs 75,000. Pass the necessary Journal entries.

Solution

(i)	X's Capital A/c	Dr.	30,000		
	Y's Capital A/c	Dr.	30,000		{In Old Ratio}
	Z's Capital A/c	Dr.	15,000		
	To Goodwill A/c			75,000	
	(Goodwill written-off among X, Y and Z in their old ratio, 2 : 2: 1)				
(ii)	Y's Capital A/c	Dr.	26,250		
	Z's Capital A/c	Dr.	3,750		
	To X's Capital A/c			30,000	
	(X's share of goodwill adjusted through the capital accounts of Y and Z in their gaining ratio of 7 : 1)				

Working Notes: *Calculation of Gaining Ratio*

Gaining Ratio = New Ratio – Old Ratio

Partners	Gaining Ratio
Y	$\frac{3}{4}-\frac{2}{5}=\frac{7}{20}$
Z	$\frac{1}{4}-\frac{1}{5}=\frac{1}{20}$

∴ Gaining Ratio = 7 : 1

Posting in the Partners' Capital Account

Partners' Capital Account

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Particulars	X	Y	Z	Particulars	X	Y	Z

Goodwill A/c (*JE1*)	30,000	30,000	15,000	Y's Capital A/c (*JE2*)	26,250		
X's Capital A/c (*JE2*)		26,250	3,750	Z's Capital A/c (*JE2*)	3,750		

***Example*:** P, Q and R were partners sharing profits and losses in the ratio 2 : 2 : 1. Q decided to retire from the firm and get the time of his retirement Goodwill was valued at Rs 60,000, while goodwill already appeared in the books Rs 20,000. Pass necessary Journal entries related to the treatment of goodwill.

Solution

Journal Entries

Date	Particulars		L.F.	Debit Amount Rs	Credit Amount Rs
	P's Capital A/c	Dr.		8,000	
	Q's Capital A/c	Dr.		8,000	
	R's Capital A/c	Dr.		4,000	
	To Goodwill A/c				20,000
	(Goodwill written-off)				
	P's Capital A/c	Dr.		16,000	
	R's Capital A/c	Dr.		8,000	
	To Q's Capital				24,000
	(Q's share of Capital adjusted)				

Goodwill written-off

$$\text{P's share} = 20{,}000 \times \frac{2}{5} = \text{Rs } 8{,}000$$

$$\text{Q's share} = 20{,}000 \times \frac{2}{5} = \text{Rs } 8{,}000$$

$$\text{R's share} = 20{,}000 \times \frac{1}{3} = \text{Rs } 4{,}000$$

Adjustment of Q's share of Goodwill

$$Q\text{'s share} = 60{,}000 \times \frac{2}{5} = \text{Rs } 24{,}000$$

$$P\text{'s gain} = 24{,}000 \times \frac{2}{3} = \text{Rs } 16{,}000$$

$$Q\text{'s gain} = 24{,}000 \times \frac{1}{3} = \text{Rs } 8{,}000$$

Example: X, Y and Z are the partners in a firm sharing profits and losses in the ratio of 2 : 2 : 1. On April 1, 2012, X retires from the firm. On that date, the goodwill of the firm appearing in the books is Rs 75,000. Y and Z decided to share future profits and losses in the ratio of 1 : 2. Pass the necessary Journal entries.

Solution

(i)	X's Capital A/c	Dr.	30,000	
	Y's Capital A/c	Dr.	30,000	
	Z's Capital A/c	Dr.	15,000	
	To Goodwill A/c			75,000

(Goodwill written-off among X, Y and Z in their old ratio)

(ii)	Z's Capital A/c $\left(\text{Rs } 75{,}000 \times \frac{7}{15}\right)$	Dr.	35,000	
	To X's Capital A/c $\left(\text{Rs } 75{,}000 \times \frac{2}{5}\right)$			30,000
	To Y's Capital A/c $\left(\text{Rs } 75{,}000 \times \frac{1}{15}\right)$			5,000

(Z compensates to X for his share of goodwill and also compensates to Y as Y is a sacrificing partner)

Working Notes: *Calculation of Gaining Ratio*

Gaining Ratio = New Ratio – Old Ratio

$$Y = \frac{1}{3} - \frac{2}{5} = \frac{-1}{15} \text{ (Sacrifice)}$$
$$Z = \frac{2}{3} - \frac{1}{5} = \frac{7}{15} \text{ (Gain)}$$

The negative sign implies that Y is a sacrificing partner. So, Z need to compensate Y besides X.

Posting in the Partners' Capital Account

Partners' Capital Account

Dr. **Cr.**

Particulars	X	Y	Z	Particulars	X	Y	Z
Goodwill A/c (***JE1***)	30,000	30,000	15,000				
X's Capital A/c (***JE2***)			30,000	Z's Capital A/c (***JE2***)	30,000	5,000	
Y's Capital A/c (***JE2***)			5,000				

Example: G, P, Q and R were partners sharing profits and losses in the ratio 4: 2: 3: 1. P decided to retire from the firm. On the date of P's retirement, goodwill appeared in the books at Rs 40,000. The new profit ratio as decided by the remaining partners is 2: 1: 2. Pass the necessary Journal entry.

Solution

Journal Entries

Date	Particulars		L.F.	Debit Amount Rs	Credit Amount Rs
	G's Capital A/c	Dr.		16,000	
	P's Capital A/c	Dr.		8,000	
	Q's Capital A/c	Dr.		12,000	
	R's Capital A/c	Dr.		4,000	
	To Goodwill A/c				40,000
	(Goodwill written-off)				
	R's Capital A/c $\left(40,000\times\frac{3}{10}\right)$	Dr.		12,000	
	To Q's Capital A/c $\left(40,000\times\frac{1}{10}\right)$				4,000
	To P's Capital A/c $\left(40,000\times\frac{2}{10}\right)$				8,000
	(R compensating P and Q as Q is gaining)				

Working Notes: *Calculation of Gaining Ratio*

$$G\text{'s Gain} = \frac{2}{5} - \frac{4}{10} = \frac{0}{10}$$

$$Q\text{'s Gain} = \frac{1}{5} - \frac{3}{10} = -\frac{1}{10} \textit{ (sacrificing)}$$

$$R\text{'s Gain} = \frac{2}{5} - \frac{1}{10} = \frac{3}{10} \textit{ (gaining)}$$

The negative sign for Q depicts that Q is sacrificing. Therefore, R need to compensate Q besides P. We can also see that G is neither gaining nor sacrificing.

Posting in the Partners' Capital Account

Partners' Capital Account

Dr. | **Cr.**

Particulars	G	P	Q	R	Particulars	G	P	Q	R
Goodwill A/c (***JE1***)	16,000	8,000	12,000	4,000	R's Capital A/c (***JE2***)		8,000	4,000	
Q's Capital A/c (***JE2***)				4,000					
P's Capital A/c (***JE2***)				8,000					

Example: X, Y and Z are partners in a partnership firm sharing profits and losses in the ratio of 4 : 3 : 2. The value of goodwill already appearing in the books of account amounted to Rs 81,000. X died on April 01, 2012. On the date of his death, the goodwill of the firm valued at Rs 72,000. Pass the necessary Journal entries.

Solution

Journal Entries

X's Capital A/c	Dr.	36,000	{In Old Ratio}
Y's Capital A/c	Dr.	27,000	
Z's Capital A/c	Dr.	18,000	
To Goodwill A/c		81,000	
(The goodwill appearing the books written off in the old ratio)			
Y's Capital A/c	Dr.	19,200	{In Gaining Ratio}
Z's Capital A/c	Dr.	12,800	

To X's capital A/c		32,000	
(Goodwill of X adjusted through Y and Z capital accounts in their gaining ratio)			

Working Notes

Old Ratio = 4 : 3 : 2

New Ratio (after X's death) = 3 : 2

Gaining Ratio (Y and Z) = 3 : 2

$$\text{Value of Goodwill of the Firm} = \text{Rs } 72,000$$

$$\text{X's Share of Goodwill} = \text{Rs } 72,000 \times \frac{4}{9} = \text{Rs } 32,000$$

Case 2: **If no Goodwill appears in the Books of the Firm at the time of retirement/death of partner**

In this case, as no goodwill is appearing in the books of account, so there is no need to pass the Journal entry for writting-off goodwill. Here, only the retiring/deceased partner's share of goodwill is to be adjusted through the remaining partners' capital accounts in their gaining ratio. It is done by debiting the remaining partners' capital accounts in their gaining ratio and crediting the retiring/deceased partner's capital account with the share of his/her goodwill.

Journal Entry

Remaining Partners' Capital A/c Dr.

To Retiring/Deceased Partner's Capital A/c

(Adjustment made for goodwill on retirement/death)

***Example*:** A, B and C are the partners in a partnership firm sharing profits and losses in the ratio of 3 : 2 : 1. B retires from the firm. On the date of his retirement, goodwill of the firm is valued at Rs 45,000. Pass the necessary Journal entry.

Solution

(i) A's Capital A/c $\left(\frac{3}{4} \times 15,000\right)$ Dr. 11,250

C's Capital A/c $\left(\frac{1}{4} \times 15,000\right)$ Dr. 3,750

To B's Capital A/c 15,000

(B's share of goodwill adjusted to A and C in their gaining ratio)

<u>Working Notes</u>:

Goodwill of the Firm $= \text{Rs}\,45,000$

B's Share of Goodwill $= \text{Rs}\,45,000 \times \frac{2}{6} = \text{Rs}\,15,000$

New Ratio = 3: 1

A's Gain $= \frac{3}{4} - \frac{3}{6} = \frac{3}{12}$

C's Gain $= \frac{1}{4} - \frac{1}{6} = \frac{1}{12}$

Gaining Ratio of A and C = 3 : 1

Posting in the Partners' Capital Account

Partners' Capital Account

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
B's Capital A/c (*JE1*)	11,250	3,750		A's Capital A/c (*JE1*) C's Capital A/c (*JE1*)		11,250 3,750	

<u>Example</u>: A, B and C were partners sharing profits and losses in the ratio 5 : 3 : 2. C retired from the firm. At the time of his retirement, goodwill was valued at Rs 50,000. Pass the necessary Journal entry for the adjustment of goodwill.

Solution

Journal Entries

Date	Particulars	L.F.	Debit Amount Rs	Credit Amount Rs
	A's Capital A/c Dr. B's Capital A/c Dr. To C's Capital (C's share of goodwill adjusted)		6,250 3,750	 10,000

Working Notes:

Calculation of Gaining Ratio

$$\text{A's gain} = \frac{5}{8} - \frac{5}{10} = \frac{5}{40}$$

$$\text{B's gain} = \frac{3}{8} - \frac{3}{10} = \frac{3}{40}$$

Gaining Ratio of A and B = 5 : 3

Adjustment of Goodwill

$$\text{C's share of Goodwill} = 50{,}000 \times \frac{2}{10} = \text{Rs } 10{,}000$$

$$\text{A's gain in Goodwill} = 10{,}000 \times \frac{5}{8} = \text{Rs } 6{,}250$$

$$\text{B's gain in Goodwill} = 10{,}000 \times \frac{3}{8} = \text{Rs } 3{,}750$$

Hidden Goodwill

The retiring or deceased partner's account has to be settled because he is no longer a partner to the firm. This settlement can be paid in lump sum or installments. In case, he is paid in lump sum then there might be a possibility that the amount due is in excess of his capital and his share of reserves & surpluses, undistributed profits, etc. This shall be treated as his share of goodwill and is known as Hidden Goodwill. Let's understand this with the help of an example:

P, Q and R are partners. Their profit sharing ratio is 2:2:1. Q retires. His capital account after making all the adjustments regarding reserves, profits and revaluation stood at Rs. 2,00,000. P and R agreed to pay Rs. 2,30,000 in full settlement of his claim. It means that Rs. 30,000 (i.e. Rs. 2,30,000 – Rs. 2,00,000) is Q's share of goodwill and will be debited to P and R's Capital Account in their gaining ratio (being 2:1) and credited to Q's Capital Account.

Journal

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
	P's Capital A/c	Dr.		20,000	
	R's Capital A/c	Dr.		10,000	
	To Q's Capital A/c				30,000
	(Being Q's share of goodwill adjusted to the Capital Account of P				

	and R in the gaining ratio)			

Revaluation of Assets and Reassessment of Liabilities

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Adjustment of Accumulated Profits and Losses
- Revaluation of Assets and Reassessment of Liabilities
- Partners' Capital Account
- Format of Balance Sheet

Adjustment of Accumulated Profits and Losses

At the time of retirement, a partnership firm may have accumulated profits and losses (as reflected in the books of the firm) such as general reserve, reserve fund, workmen's compensation fund, investment fluctuation fund, credit and debit balance of profit and loss account, deferred revenue expenditure, etc. Such undistributed profits and losses should be distributed among all the partners of a firm including the retiring partner in their old profit sharing ratio. In other words, the retiring partner also has a right to share all accumulated profits and losses of a firm.

For Distributing Accumulated Profits

Reserve fund A/c Dr. {In Old Ratio}

General Reserve A/c Dr.

Profit and Loss A/c Dr.

Workmen's Compensation Fund A/c* Dr.

Investment Fluctuation Fund A/c* Dr.

Contingency Reserve A/c* Dr.

To All Partner's Capital A/c (individually)

(Reserves transferred to capital accounts of the partner in their old ratio)

For Distributing Accumulated Losses

All Partner's Capital A/c (individually) Dr {In Old Ratio}

To Profit and Loss A/c (debit balance)

(Accumulated losses transferred to capital accounts of the partners in their old ratio)

* Workmen's Compensation Fund, Contingency Reserve and Investment Fluctuation Reserve are distributed among ***all*** the partners only with the excess amount. It means, the difference of the two values, i.e. the value that appears in the Old Balance Sheet of the firm (before retirement/death) and the value that is given in the adjustments. If the value that is given in the adjustments is ***lesser than*** the value that is appearing in the Old Balance Sheet then the difference amount is transferred to the All Partners' Capital Account in their old ratio. Also, the value that is given in the adjustment is shown on the Liabilities side of the New Balance Sheet (after retirement/death).

On the other hand, if the value given in the adjustment is ***more than*** the value that is appearing in the Old Balance Sheet then the difference amount is debited to the Revaluation Account of the firm and is ***not transferred to the All Partners' Capital Account***. This is because, an increase in the value of such reserves/funds is considered a loss to the firm, hence, is debited to the Revaluation Account. In this situation, the value given in the adjustment is shown on the Liabilities side of the New Balance Sheet.

For example,

I. If WCF appears on the Liabilities side of the Old Balance Sheet at **Rs 25,000** and in the adjustments, a claim of workmen's compensation of **Rs 20,000** is given, then the excess amount of Rs 5,000 (i.e. Rs 25,000 – Rs 20,000) is distributed among all the partners in their old profit sharing ratio. The claim of workmen's compensation of Rs 20,000 is shown on the Liabilities side of the New Balance Sheet.

II. If WCF appears on the Liabilities side of the Old Balance Sheet at **Rs 30,000** and in the adjustments, a claim of workmen's compensation of **Rs 40,000** is given, then the difference amount of Rs 10,000 (i.e. Rs 40,000 – Rs 30,000) is debited to the Revaluation Account. This is because there an increase in the value of compensation, hence, it is a loss to the firm. The claim of workmen's compensation of Rs 40,000 is shown on the Liabilities side of the New Balance Sheet.

Note 1: If in the question, ***no adjustments*** related to Workmen's Compensation Fund, Contingency Reserve and Investment Fluctuation Reserve reserves ***are given***, then such reserves/funds ***are transferred to*** the All Partners' Capital Account with the whole amount.

Note 2: Often, there exists some reserves in the form Employees Provident Fund, Provision for Tax, Taxation Reserve, Joint Life Policy (JLP) Reserve and Depreciation Reserve (such as Machinery Replacement Reserve) in the Old Balance Sheet. It should not be noted that such items are ***not distributed among the partners*** and are shown on the Liabilities side of the New Balance Sheet of the new firm.

***Example*:** M, N and O are partners in a firm sharing profits and losses in the ratio of 3 : 1 : 1. On January 01, 2012, O retires from the firm. On the date of his retirement, the firm had a reserve fund of Rs 50,000 and a debit balance of profit and loss account of Rs 30,000. Pass the necessary Journal entries.

Solution

For Distributing Reserve Fund

Reserve Fund A/c	Dr.	50,000	
To M's Capital A/c			30,000

To N's Capital A/c 10,000

To O's Capital A/c 10,000

(Reserve fund transferred to all Partners' Capital Accounts)

For Distributing Profit and Loss Account (Debit Balance)

M's Capital A/c Dr. 18,000

N's Capital A/c Dr. 6,000

O's Capital A/c Dr. 6,000

To Profit and Loss A/c 30,000

(Accumulated loss transferred to all Partners' Capital Accounts)

***Example*:** X, Y and Z are the partners in a firm sharing profits and losses equally. B died on December 31, 2013. On that date, the firm had a general reserve and profit and loss A/c of Rs 39,000 and Rs 45,000 respectively. Pass the necessary journal entries.

Solution

Reserve Fund A/c Dr. 39,000

Profit and Loss A/c Dr. 45,000

To X's Capital A/c 28,000

To Y's Capital A/c 28,000

To Z's Capital A/c 28,000

(Reserve fund and profit and loss account transferred to the capital accounts of partners in their old ratio)

Revaluation of Assets and Reassessment of Liabilities

At the time of retirement or death of a partner, it becomes inevitable to revalue the assets and liabilities of the firm for ascertaining their true and fair values. The revaluation is necessary as the value of assets and liabilities may increase or decrease with the passage of time. Further, it may be possible that there are certain assets and liabilities that remained unrecorded in the books of accounts. The retiring or the deceased partner may be benefited or may bear loss due to change in the values of assets and liabilities. Therefore, the revaluation of the assets and liabilities is necessary in order to ascertain the true profit or loss that is to be divided among all the partners in their old profit sharing ratio. For this purpose an account in the name of revaluation account is prepared to ascertain the profits or losses of the firm.

Revaluation Account in case of retirement/death of a partner is prepared in the same way as it is prepared in case of admission of a new partner. Any increase in the value of assets and decrease in the value of liabilities is credited to the revaluation account. This is because, it is a profit or gain for a firm. On the other hand, any decrease in the value of assets and increase the value of liabilities are debited to this account. This is because, it is a loss to the firm. Also, any unrecorded assets of the firm will be credited and unrecorded liability of the firm will be debited to this account. If credit side of revaluation account is more than its debit side then it reveals the profit. On the other hand, if debit side is more than its credit side it will be considered as net loss. Any profit or loss from this account will be transferred to the all partner's capital in their old profit sharing ratio.
Important Note: It should be noted that in case of death of a partner, the treatment of accumulated profits and losses and the revaluation of assets and liabilities is done exactly in the same manner as it is done in the case of retirement.

Journal Entries to be recorded for Revaluation of Assets and Liabilities

*For **Increase** in the Value of **Assets***	*For **Decrease** in the Value of **Assets***
Assets A/c Dr. To Revaluation A/c {By increased value}	Revaluation A/c Dr. To Assets A/c {By decreased value}

*For **Increase** in the Value of **Liability***	*For **Decrease** in the Value of **Liability***
Revaluation A/c Dr. To Liability A/c {By increased value}	Liability A/c Dr. To Revaluation A/c {By decreased value}

*For recording **Unrecorded Assets***	*For recording **Unrecorded Liability***
Assets A/c Dr. To Revaluation A/c	Revaluation A/c Dr. To Assets A/c

For Transfer of Profit on Revaluation (*i.e. credit side > debit side*)	For Transfer of Loss on Revaluation *(i.e. debit side > credit side*)
Revaluation A/c Dr. To Old Partner's Capital A/c {Old Ratio}	Old Partner's Capital A/c Dr. To Revaluation A/c {Old Ratio}

Procedure to Prepare Revaluation Account

The following are the various steps involved in preparation of Revaluation Account.

1. First of all, any decrease in the value of assets and increase in the value of liabilities are recorded on the ***Debit side*** of Revaluation Account.

2. Secondly, any increase in the value of assets and decrease in the value of liabilities is recorded on the ***Credit side*** of the account.
3. If there is any Unrecorded Asset of the firm then it is shown on the ***Credit side*** of the account.
4. Similarly, any Unrecorded Liabilities are shown on the ***Debit side*** of the Revaluation Account.
5. Then, Outstanding expenses of the firm are recorded on the ***Debit side*** and Prepaid expenses are recorded on the Credit side of the Revaluation Account.
6. Similarly, any income that is received in advance is given, then it is shown on the ***Debit side*** and Prepaid expenses (i.e. expenses paid in advance) are recorded on the ***Credit side*** of the Revaluation Account.
7. Lastly, if the total of the debit side exceeds the total of the credit side, then it is regarded as *Revaluation Loss* and is transferred to the Debit Side of the Partners' Capital Account in their profit sharing ratio. On the other hand, if the total of the debit side is short of the total of the credit side, then it is regarded as *Revaluation Profit* and is transferred to the Credit Side of Partners' Capital Account in their profit sharing ratio.

Format of Revaluation Account

Revaluation Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Decrease in Value of Assets	×××	Increase in Value of Assets	×××
Increase in Value of Liabilities	×××	Decrease in Value of Liabilities	×××
Unrecorded Liabilities	×××	Unrecorded Assets	×××
Outstanding Expenses (e.g. Salaries)	×××	Prepaid Expenses (Salaries in advance)	×××
Income received in advance	×××	Income Earned but not yet received	×××
Revaluation Profit* A's Capital A/c B's Capital A/c (Transferred to the Credit side of All Partners' Capital A/c in Old Ratio)	×××	Revaluation Loss # A's Capital A/c B's Capital A/c (Transferred to the Debit side of All Partners' Capital A/c in Old Ratio)	×××

* If Credit side > Debit Side

If Credit side < Debit Side

Note : A special care is need to be taken while going through the adjustments, especially for '***to***' and '***by***'.

Example

The value of Machinery in the Old Balance Sheet of a firm is given as Rs 20,000. Treat the following adjustments.
a) Machinery depreciated by Rs 5,000.
b) Machinery depreciated to Rs 12,000.
c) Machinery appreciated by Rs 3,000.
d) Machinery appreciated to Rs 25,000.

Solution

Case (a)- In this case, machinery is depreciated by Rs 5,000, therefore, in the Revaluation Account, the decrease in the value of machinery is to be shown on the debit side with Rs 5,000 and on the Assets side of the New Balance Sheet, machinery is to be shown at Rs 15,000 (i.e. Rs 20,000 – Rs 5,000).

Case (b)- In this case, machinery is depreciated to Rs 12,000. It means there is a fall in the value of machinery by Rs 8,000 (i.e. Rs 20,000 – Rs 12,000). So, in the Revaluation Account, the fall in the value of machinery is to be shown on the debit side with Rs 8,000 and the machinery is to be shown on the Assets side of the New Balance Sheet at its final value of Rs 12,000.

Case (c)- In this case, machinery is appreciated by Rs 3,000, therefore, in the Revaluation Account, the increase in the value of machinery is to be shown on the credit side with Rs 3,000 and on the Assets side of the New Balance Sheet, machinery is to be shown at Rs 23,000 (i.e. Rs 20,000 + Rs 3,000).

Case (d)- In this case, machinery is appreciated to Rs 25,000. It means there is an increase in the value of machinery by Rs 5,000 (i.e. Rs 25,000 – Rs 20,000). So, in the Revaluation Account, the increase in the value of machinery is to be shown on the credit side with Rs 5,000 and on the Assets side of the New Balance Sheet, machinery is to be shown at its final value of Rs 25,000.

Posting in Revaluation Account and Balance Sheet

Revaluation Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
(Case-a) Machinery **(Case-b)** Machinery	5,000 8,000	**(Case-c)** Machinery **(Case-d)** Machinery	3,000 5,000

Balance Sheet

Liabilities	**Amount Rs**	**Assets**	**Amount Rs**
		(Case-a) Machinery 20,000	

		Less: Depreciation	5,000	15,000
		(Case-b) Machinery	20,000	
		Less: Depreciation	8,000	12,000
		(Case-c) Machinery	20,000	
		Add: Appreciation	3,000	23,000
		(Case-d) Machinery	20,000	
		Add: Appreciation	5,000	25,000

Adjustments related to Provision for Doubtful Debts- It is one of the most common adjustment, where the students often make mistakes. However; it should always be remember that any adjustment related to provision for doubtful debts such as Provision on debtors should be brought up to 10%, Provision on debtors to be increased by Rs 2,200, etc. is to be provided on the amount of debtors and not on the provision. Also, it should be remember that any increase (or decrease) in amount of provisions implies a fall (or rise) in the amount of debtors and accordingly, is shown on the debit (or credit) side of the Revaluation Account.

Partners' Capital Account- Continuing and Retiring (or Deceased) Partner's Capital Account

Partners' Capital Account is prepared to ascertain the closing capital balances of the partners of a firm. These capital balances are shown on the Liabilities side of the New Balance Sheet. The below given is a procedure to prepare and comprehensive format of the Partners' Capital Account.

Procedure to Prepare Partners' Capital Account

The following are the various steps involved in the preparing Partners' Capital Account.

1. First of all, the opening balance of capital is shown on the credit side of the Partners' Capital Account as 'Balance b/d'. In case, if the capital balance of any of the partners appears on the Assets side of the Balance Sheet (in the question), then it is shown on the debit side of the Capital Account as 'Balance b/d'.

2. Then, Revaluation Profit is transferred to the Credit side and in case of Loss, it is transferred to the Debit side of the capital account.

3. Thirdly, we need to transfer reserves such as, General Reserve, Reserve Fund, Investment Fluctuation Fund*, Workmen Compensation Fund and Contingency Reserve* (see NOTE), Credit Balance of P & L Account etc. are transferred to the credit side of the capital account in the old profit sharing ratio of old partners.

4. Similarly, on the debit side, losses such as Debit Balance of P & L, Deferred Revenue Expenditure, Advertisement Suspense Account, etc. are transferred to the debit side of the capital account in the old profit sharing ratio of old partners.

5. Goodwill already appearing in the old balance sheet is also transferred to the debit side of the Partners' Capital Account in the old profit sharing ratio of old partners.

6. If any of the partners has taken-over any of the assets, then it is shown on the Debit side and if any liability is paid-off by any partner, then it is shown on the credit side of the capital account.

7. On the credit side Retiring/Deceased Partner's up to date Profit is recorded and on the Debit Side Retiring/Deceased Partner's up to date Loss is recorded.

8. The final payment/due to the Retiring/Deceased Partner is shown on the debit side of the Partners' Capital Account.

9. Finally, if the total of the credit side exceeds the total of the debit side, then the final capital balance of the remaining partners is shown 'Balance c/d' on the Debit side. On the contrast, if the total of the debit side exceeds the total of the credit side, then the final capital balance of the remaining partners is shown as 'Balance c/d' on the Credit side.

10. If the Partners' Capital Account shows a credit balance (Cr. Side > Dr. Side), then it is also shown on the Liabilities side of the Balance Sheet. On the other hand, if the Partners' Capital Account shows a debit balance (Dr. Side > Cr. Side), then it is shown on the Assets side of the Balance Sheet.

11. Also, often, there exists some reserves in the form Employees Provident Fund, Provision for Tax, Taxation Reserve, Joint Life Policy (JLP) Reserve and Depreciation Reserve (such as Machinery Replacement Reserve) in the Old Balance Sheet. It should be noted that such items are **not distributed among the partners** and are shown on the Liabilities side of the New Balance Sheet of the new firm.

Partners' Capital A/c

Dr. **Cr.**

Particulars	**A**	**B**	**C**	**Particulars**	**A**	**B**	**C**
Deferred Revenue Expenditure (Advertisement Expenditure)	_	_	_	Balance b/d	_	_	_
				General Reserve	_	_	_
				Reserve Fund	_	_	_
Profit and Loss (Debit Balance)	_	_	_	Profit and Loss (Credit Balance)	_	_	_

Goodwill A/c ♣ (For writting-off the existing goodwill)	–	–	–	Workmen's Compensation Fund*	–	–	–
				Investment Fluctuation Fund*	–	–	–
				Contingency Reserve*	–	–	–
Revaluation Loss	–	–	–	Revaluation Profit	–	–	–
Assets (Taken over by Partners')	–	–	–	Liabilities (If taken over by Partners')	–	–	–
Profit and Loss Suspense Account (up to date loss of retired/deceased partner, in case of retirement & death during the year)				Profit and Loss Suspense Account (up to date profit of retired/deceased partner, in case of retirement & death during the year)			
Cash/Bank/Partner's Loan (For amount paid to the retiring/deceased partner)	–	–	–		–	–	–
Balance c/d (If Cr. Side > Dr. side)				Balance c/d (If Dr. side > Cr. Side)			

* Workmen's Compensation Fund, Investment Fluctuation Fund and Contingency Reserve are transferred to the Partner's Capital A/c (Credit side) only with the excess amount.

♣ This represents the amount of existing Goodwill that is already appearing on the Assets side of the Old Balance sheet and written-off among the all partners in their old profit sharing ratio.

New Balance Sheet

After the preparation of Revaluation Account and Partners' Capital Account, the last step is to prepare New Balance Sheet of the newly reconstituted firm (i.e. after the retirement/death of a partner). The below mentioned is a procedure and a comprehensive format of Balance Sheet.

Procedure to Prepare New Balance Sheet

The following are the various steps involved in the preparing New Balance Sheet.

1. First of all, all the assets are recorded on the Right Hand Side of the Balance Sheet and all the Liabilities are recorded on the Left Hand Side on their net value i.e. after all adjustments in their values.

2. There can be two probable cases of adjustments namely, to or by. In case the assets are increased or decreased to, then the final value itself is shown in the New Balance Sheet. For Example, value of machinery increased to Rs 18,000. In the New Balance Sheet machinery will be shown at Rs 18,000. On the other hand, if the assets are increased or decreased by, then the value of asset is shown at its net value (i.e. after adding or subtracting the value as the case may be). For example, Machinery of Rs 20,000 is increased by Rs 4,000. In the New Balance Sheet, machinery will be shown at Rs 24,000 (20,000 + 4,000).

3. Similarly, Liabilities are also shown at their final value after considering the above adjustments.

4. The funds such as Workmen's Compensation Fund, Investment Fluctuation Fund and Contingency Reserve are shown in the New Balance Sheet at the value given in the adjustment. Eg..... In case no adjustment regarding these funds is given, then these are not shown in the New Balance Sheet. Rather these are distributed among the old partners.

5. Then, the Unrecorded Assets and Unrecorded Liabilities found at the time of revaluation are also shown in the New Balance Sheet.

6. Capital Balances of the partners revealed through Partners Capital Account after all adjustment are recorded on the Liabilities side of the Balance Sheet. In case the Partners' Capital Account shows a debit balance (i.e. balance c/d on credit side) then it is shown on the Assets side of the Balance Sheet.
7. Similarly, if the final payment to the Retiring/Deceased Partner is made through loan then the Loan is shown on the Liabilities Side of the New Balance Sheet.

Format of Balance Sheet

New Balance Sheet
after the retirement or death of an existing partner

Liabilities	Amount Rs	Assets	Amount Rs
Bank Overdraft		Cash in Hand	
Creditors		Cash at Bank	
General Reserve		Debtors	
Contingency Reserve		Less: Provision for Doubtful Debts	
Depreciation Reserve		Bills Receivable	
Workmen's Compensation Fund		Stock	
Investment Fluctuation Fund		Land and Building	
Machinery Replacement Reserve		Plant and Machinery	
Employee Provident Fund		JLP	
Provision for Tax			

JLP Reserve Bills Payable Executors' Loan Account (or Retiring Partner's Loan Account) Unrecorded Liabilities (if given in adjustments) Capitals: A: B:		Profit and Loss Suspense Account (up to date profit of retired/deceased partner) Unrecorded Assets (if given in adjustments) Capitals*: A: B:	
	**		○○

Note: The equality of ** and ○○ ensures the arithmetical accuracy of the solution.

**** If the closing balance of the Partners' Capital Account (i.e. Balance c/d) happens to appear on the credit side of the Partners' Capital Account, then it is shown on the Assets side of the New Balance Sheet.***

Disposal of Amount Due to Retiring Partner

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Ascertainment of Amount due to the Retiring Partner
- Mode of Payments/Settlement of Payment to the Retiring Partner
- Retiring Partner's Loan Account

Ascertainment of Amount Due to the Retiring Partner

The retiring partner of a firm is entitled to share all the profits and losses of the firm which has been earned/incurred during the period for which he/she was a partner of the firm. The amount due to the retiring partner is computed by preparing his/her Capital Account. The following are some items that should be considered before ascertaining the amount due the retiring partner.

i. Opening Balance of Capital/Current Account of Retiring Partner
ii. Share of Profit or Losses of Revaluation Account
iii. Share of Accumulated Profits or Losses
iv. Share of Goodwill of a Firm
v. Salary or Commission (*if any*)
vi. Interest on Capital (*if any*)

vii. Amount of his/her Drawings
viii. Interest on Drawings (*if any*), etc.

The above items are posted in the debit side and the credit side of the retiring Partner's Capital Account. After, recording all the related adjustments to the retiring Partner's Capital Account, the final balance (to be payable to the retiring partner) is calculated by summing up the items on the debit side and summing up the items on the credit side of capital account. The amount so calculated can be either a positive balance (when total of debit side < total of credit side) or a negative balance (when total of debit side > total of credit side). While, the positive final capital balance of the retiring partner implies that the firm has to pay this amount to the retiring partner, on the other hand, a negative final capital balance implies that the partner is liable to pay this amount to the firm (this case is very rare). The below mentioned is an extract of the Retiring Partner's Capital Account showing all the important adjustments and items to be posted in his/her capital account before ascertaining the amount of final capital balance payable to him.

Retiring Partner's Capital Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Drawings		Balance b/d	
Deferred Revenue Expenditure - (Advertisement Expenditure)		General Reserve	
		Reserve Fund	
Profit and Loss (Debit balance)		Profit and Loss (Credit balance)	
Revaluation Loss		Revaluation Profit	
Interest on Drawings		Interest on Capital	
Goodwill (existing goodwill, if any written-off)		Workmen Compensation Fund*	
		Investment Fluctuation Fund*	
Assets (if taken over by partner)		Contingency Reserve*	
		Salary, Commission	
Cash/Bank/Partner's Loan ♣ *(final amount payable to the retiring partner)*		Liabilities (if taken over by partner)	

* *only with the excess amount*

♣ *It represents the final amount to be payable to the retiring partner. It is calculated as the difference between the total of credit side and the total of debit side, after recording all the related adjustments in the retiring partner's capital account.*

♣ *If nothing is mentioned in the question regarding the mode of the payment to the retiring or the deceased partner, then it is assumed to be payment through loan. The capital account of the retiring or the deceased partner is closed by transferring the balancing figure to the credit side of the Retiring/Deceased Partner's Loan A/c. The Retiring/Deceased Partner's Loan A/c will be shown on the Liabilities side of the New Balance Sheet*

Modes of Payment to the Retiring Partner

The final payment can be made to the retiring partner either in cash/bank or through loan (in instalment). The following are the three ways in which the amount due to the retiring partner can be settled.

i. Payment through Cash/Bank
ii. Payment through Loan
iii. Payment Partly in Cash/Bank and Partly through Loan

(i) Payment through Cash

When the whole payment to the retiring partner is to be made in cash, then the Retiring Partner's Capital Account is debited with the amount due to him/her and Cash/ Bank Account is credited.

Journal Entry

Retiring Partner's Capital A/c	Dr.
To Cash/Bank A/c	

(ii) Payment through Loan

Sometimes, it might happen that firm is not in a situation to make the payment of amount due to the retiring partner in cash. In such a case, the payment to the retiring partner can made through loan by transferring the amount due to him/her to his/her loan account. *The loan account of retiring partner is shown in the New Balance Sheet as a liability on the Liabilities side.* Also, the firm is liable to pay interest on the outstanding amount due to the retiring partner @ 6% p.a.(unless the question explicitly specifies the rate of interest on loan). This interest is payable for a period from the due date of loan (date of retirement) till the date of the actual payment.

In case, the firm has invested the amount (loan amount) due to the retiring partner in any project and has earned profit, then the retiring partner has the option of either taking the interest on the outstanding loan amount or to take the share in the profits so earned.

Journal Entry

For Transferring the Due Amount to Retiring Partner's Loan Account	
Retiring Partner's Capital A/c To Retiring Partner's Loan A/c	Dr.
For Amount of Interest Due	
Interest on Loan A/c To Retiring Partner's Loan A/c (Interest on retiring partner's loan provided)	Dr.
For Payment of Instalment	

Retiring Partner's Loan A/c	Dr.
To Bank A/c	

(iii) <u>Payment Partly in Cash and Partly through Loan</u>

Sometimes, the firm may opt to discharge the amount due to the retiring partner by partly paying in cash and partly paying through loan. In this case, Cash/Bank account is credited with the amount that is paid in cash (usually paid immediately) and the balance amount is credited to the Retiring Partner's Loan Account.

Retiring Partner's Capital A/c	Dr.
To Cash/Bank A/c	
To Retiring Partner's Loan A/c	

<u>Note</u>: Sometimes, the firm does not have sufficient balance to dispense the final amount due to the retiring partner immediately. In such cases, the settlement is made through a Bank Overdraft. That is, Retiring Partner's Capital A/c is debited and Bank Overdraft A/c is credited. In the New Balance Sheet (i.e. post reconstitution), the total balance in Bank Overdraft A/c is shown (i.e. Existing Bank Overdraft appearing in the Old Balance Sheet ***plus*** Amount required to settle Retiring Partner's Capital Account). This case is an extension to Case 1 (Payment through Cash/Bank Overdraft).

Retiring Partner's Loan Account

Loan account of retiring partner is prepared when the firm is unable to pay the amount due to the him/her immediately. In such a situation, the amount due to the retiring partner is transferred to his/her loan account. Based on the conditions mentioned in the question, Retiring Partner's Loan Account can either be prepared for one year or for more than one year. If the outstanding amount is settled in just one instalment, then the Retiring Partner's Loan Account is prepared for just one year, however; if the outstanding amount is paid-off in more than one instalment, then the Retiring Partner's Loan Account is prepared for more than one year. Unless the question explicitly specifies the rate of interest on loan, the firm is liable to pay interest on the outstanding amount due to the retiring partner @ 6% p.a. The amount of interest is calculated on the outstanding balance and is paid at the end of the financial period (December, 31 or March 31).

Retiring Partner's Loan Account (For One Year)

Dr. **Cr.**

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
			Date of Retirement/Death	Retiring Partner's Capital A/c	–
End of the first year	Cash/Bank A/c	–	End of the first year	Interest A/c	–

Retiring Partner's Loan Account (For More than One Year)

Dr. **Cr.**

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
End of the first year	Cash A/c (Interest + First year instalment)	–	Date of Retirement/ Death	Retiring Partners' Capital A/c	–
End of the first year	Balance c/d	–	End of the first year	Interest A/c	–
End of the second year	Cash A/c (Interest + Second year instalment)		Beginning of the second year	Balance b/d	–
End of the second year	Balance c/d		End of the second year	Interest A/c	–
End of the third year	Cash A/c (Interest + Third year instalment)		Beginning of the third year	Balance b/d	–
			End of the third year	Interest A/c	–

***Example*:** A, B and C are three partners sharing profits and losses equally. On January 01, 2011, C retires from the firm. The total amount to be paid by the firm to C amounted to Rs 75,000. Pass the necessary Journal entries to record the payment to C in the following cases.

(i) whole amount is paid immediately in cash

(ii) paid through loan

(iii) paid immediately Rs 25,000 in cash and the balance amount in loan.

Solution

(i) Whole Payment in Cash

C's Capital A/c Dr. 75,000

To Cash A/c 75,000

(Amount paid to C in cash)

Posting in the Partner's Capital Account

Partners' Capital A/c

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
Cash/Bank A/c			75,000				

(ii) <u>Payment made through Loan</u>

C's Capital A/c Dr. 75,000

To C's loan A/c 75,000

(Amount due to C transferred to his loan account)

Posting in the Partner's Capital Account

Partners' Capital A/c

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
C's Loan A/c			75,000				

(iii) <u>Rs 25,000 in Cash and Balance through Loan</u>

C's Capital A/c Dr. 75,000

To Cash A/c 25,000

To C's loan A/c 50,000

(Rs 25,000 paid in cash and balance of Rs 50,000 transferred to C's loan account)

Posting in the Partner's Capital Account

Partners' Capital A/c

Dr. Particulars	A	B	C	Particulars	A	B	Cr. C
Cash/Bank A/c			25,000				
C's Loan A/c			50,000				

Example: Ajay, Vijay and Sanjay are partners in a firm sharing profits and losses in the ratio of 2 : 2 : 1. Vijay retires from the firm on April 01, 2011. The amount to be paid to Vijay on his retirement amounted to Rs 84,000. The firm decided to pay Rs 10,000 immediately and the balance amount in four equal instalments together with the interest at 8% p.a. Prepare the Vijay's Loan Account.

Solution

Partners' Capital A/c

Dr. Particulars	Ajay	Vijay	Sanjay	Particulars	Ajay	Vijay	Cr. Sanjay
Cash/Bank A/c		10,000					
Vijay's Loan A/c		74,000					

Vijay's Loan Account

Dr. Date	Particulars	Amount Rs	Date	Particulars	Cr. Amount Rs
March 31, 2012	Cash A/c (Rs 18,500 + 5,920)	24,420	April 01, 2011	Vijay's Capital A/c	74,000
March 31, 2012	Balance c/d	55,500	March 31, 2012	Interest A/c (74,000 × 8%)	5,920
		79,920			79,920
March 31, 2013	Cash A/c (18,500 + 4,440)	22,940	April 1, 2012	Balance b/d	55,500
March 31,	Balance c/d	37,000	March	Interest A/c (55,500 × 8%)	4,440

2013			31, 2013		
		59,940			59,940
March 31, 2014	Cash A/c (18,500 + 2,960)	21,460	April 1, 2013	Balance b/d	37,000
March 31, 2014	Balance c/d	18,500	March 31, 2014	Interest A/c (37,000 × 8%)	2,960
		39,960			39,960
March 31, 2015	Cash A/c (18,500 + 1,480)	19,980	April 1, 2014	Balance b/d	18,500
			March 31, 2015	Interest A/c (18,500 × 8%)	1,480
		19,980			19,980

Adjustment of Partner's Capital Account

Objective

After going through this lesson, you shall be able to understand the following cases of Adjustments of Partners' Capital in case of retirement and death of a partner.

- When the Total Capital of the New Firm is Mentioned.
- When the Total Capital of the New Firm is not Mentioned.
- When the Amount Payable to the Retiring Partner is to be Contributed by Remaining Partners
- When Capitals of Partners are adjustment by Maintaining a Minimum Cash/Bank Balance

Important Note: It should be noted that in case of death of a partner, the treatment of accumulated profits and losses and the revaluation of assets and liabilities is done exactly in the same manner as it is done in the case of retirement.

Adjustment of Partners' Capital Account in case of Retirement/Death of a Partner

After the retirement/death of a partner, the remaining partners may decide that their capital should be adjusted in such a manner that the new capital becomes in proportion to their new profit sharing ratio. The method through which the capitals of the continuing partners is made proportionate to the new profit sharing ratio is known as Adjustment of Capital. After adjusting the capital of the partners proportionate to their new profit share, there could be a difference in the two capital balances i.e. new capital balance and old capital balance. If the new capital balance is less than the old capital balance then it will be considered as *surplus* and the partner can withdraw that excess capital. On the other hand, if the new capital balance is more than the old capital balance then it is regarded as Deficit and the partner is required to bring the additional capital.

Journal Entry for Surplus or Deficit

For Surplus in Capital	For Deficiency in Capital
Partner's Capital A/c Dr. To Cash/Bank A/c (Excess capital withdrawn by the partner)	Cash/Bank A/c Dr. To Partner's Capital A/c (Deficiency made good by bringing additional amount by the partner)

Let us discuss some cases of adjustments of partners's capital accounts after the retirement of a partner.

Case 1 *When Capital of the New Firm is Specified*

If in the question, the total capital of the new firm after the retirement or death of a partner is mentioned, then the new capital of the continuing partners is calculated on the basis of the given total capital (mentioned in the question). The following are the steps involved in the adjustments of the capital in this case.

***Step1*:** Calculate Cr. – Dr. Balances (Adjusted Old capital) of the remaining partners, after all adjustments.

***Step 2*:** Calculate the individual new capital of the continuing partners by the following formula.

$$\text{New Capital of one of the Remaining Partners} = \text{Total Capital of the Firm After Retirement / Death} \times \text{New Profit Share of Remaining Partners}$$

***Step 3*:** If the amount calculated in the Step 1 (adjusted old capital after all adjustments) exceeds the amount calculated in the Step 2 (new capital), then the difference amount (surplus) is paid to the partner in cash or through bank, i.e. debited to the Partners' Capital Account. On the other hand, if the amount calculated in the Step 2 exceeds the amount calculated in the Step 1, then the difference amount (shortage) is to be brought in by the partner, i.e. credited to the Partners' Capital Account.

Step 4: The retiring (or deceased) partner's balance (i.e. Cr. – Dr.) is transferred to his loan Account or paid in cash (or transferred to the Executors' Account in case of death of a partner).

***Example*:** Tarun, Varun, and Arjun are the partners in a firm sharing profits and losses in the ratio of 3 : 2 : 1. On April 1, 2011, Arjun retires from the firm. The capital balances of the partners *after all the adjustments* stood at Rs 75,000 , Rs 70,000 and Rs 60,000, respectively. The total capital of the new firm after the retirement of Arjun is decided at Rs 1,50,000. Calculate the actual amount to be paid off or to be brought in by the remaining partners. Also, pass the necessary Journal entries.

Solution

Old Ratio = 3 : 2 : 1

New Ratio (after Arjun's retirement) = 3 : 2

***Step1*:** Calculate Cr. – Dr. Balances (Adjusted Old capital) of the remaining partners, after all adjustments.

It is being given in the question that the capital balances of all the partners after all the required adjustments are Rs 75,000 , Rs 70,000 and Rs 60,000, respectively. Therefore, no need to calculate them separately.

Step 2**:** Calculate the individual new capital of the Tarun and Varun as:

$$\text{New Capital of one of the Remaining Partners} = \text{Total Capital of the Firm After Retirement / Death} \times \text{New Profit Share of Remaining Partners}$$

$$\text{New Capital of Tarun} = 1{,}50{,}000 \times \frac{3}{5} = \text{Rs } 90{,}000$$

$$\text{New Capital of Varun} = 1{,}50{,}000 \times \frac{2}{5} = \text{Rs } 60{,}000$$

These capital balances are shown on the Debit Side of the Partners' Capital Accounts as 'Balance c/d'.

Step 3**:** New capital of Tarun is Rs 90,000 and the Adjusted Old Capital (after all adjustment- as per the Step 1) is Rs 75,000. That is, New Capital exceeds his Adjusted Old Capital, so the difference amount of Rs 15,000 (90,000 - 75,000) is *deficit and is to be brought in by Tarun*.

Similarly, New capital of Varun is Rs 60,000 and the Adjusted Old Capital (after all adjustment- as per the Step 1) is Rs 70,000. That is, New Capital falls short of his Adjusted Old Capital, so the difference amount of Rs 10,000 (70,000 - 60,000) is *surplus and is paid to Varun*.

<u>Posting in the Partner's Capital Account</u>

Partners' Capital Account

Dr. Particulars	Tarun	Varun	Arjun	Particulars	Tarun	Varun	**Cr.** Arjun
Arjun's Loan A/c/ or Executor's A/c			60,000				
Cash/Bank A/c		10,000		Cash/Bank A/c	15,000		
Balance c/d	90,000	60,000					

<u>Journal Entries</u>

(i) Bank A/c Dr. 15,000

To Tarun's Capital A/c 15,000

(Additional capital brought in by Tarun)

(ii) Varun's Capital A/c Dr. 10,000

To Bank A/c 10,000

(Excess amount withdrawn by Varun)

Example: Gaurav, Rahul and Saurav were carrying on a business in partnership sharing profits and losses in the ratio of 3 : 2 : 1. Their Balance Sheet as at March 31, 2012 was as follows:

Balance Sheet
as on March 31, 2012

Liabilities		Amount (Rs)	Assets		Amount (Rs)
Capital A/cs:			Land and Building		40,000
Gaurav	56,500		Goodwill		12,000
Rahul	29,000		Plant and Machinery		30,000
Saurav	22,500	1,08,000	Stock		10,000
Investment Fluctuation Fund		18,000	Debtors	30,000	
Sundry Creditors		25,000	*Less*: Provision for Doubtful Debts	(2,000)	28,000
			Investments (Market Value Rs 18,000)		21,000
			Cash		10,000
		1,51,000			1,51,000

Saurav desired to retire from the firm. Remaining partners decided to continue the business on following terms:

1. Goodwill of firm valued at Rs 30,000.
2. Stock is overvalued by Rs 4,000 and all debtors were considered to be good.
3. Land and Building appreciated by 5% and Plant and Machinery depreciated by 20%.
4. Capital of the new firm was fixed at Rs 80,000. It is decided to adjust capital of the remaining partners as per their new profit-sharing ratio.

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

Solution

Revaluation Account

Dr. **Cr.**

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Stock	4,000	Land and Building	2,000
Plant and Machinery	6,000	Provision for Doubtful Debts	2,000
		Loss on revaluation transferred to:	

		Gaurav's Capital A/c	3,000	
		Rahul's Capital A/c	2,000	
		Saurav's Capital A/c	1,000	6,000
	10,000			10,000

Partners' Capital Account

Dr. **Cr.**

Particulars	Gaurav	Rahul	Saurav	Particulars	Gaurav	Rahul	Saurav
Goodwill	6,000	4,000	2,000	Balance b/d	56,500	29,000	22,500
Revaluation A/c (Loss)	3,000	2,000	1,000	Gaurav's Capital A/c			3,000
Saurav's Capital A/c	3,000	2,000		Rahul's Capital A/c			2,000
Saurav's Loan A/c			27,000	Investment Fluctuation Fund	7,500	5,000	2,500
Cash A/c (*Balancing Figure*) ***** See Video***	4,000			Cash A/c (*Balancing Figure*) ***** See Video***		6,000	
Balance c/d ***** See Video***	48,000	32,000					
	64,000	40,000	30,000		64,000	40,000	30,000

Note: As the Market Value of Investment (i.e. Rs 18,000) is less than its Book Value (i.e. Rs 21,000), so this loss of Rs 3,000 (21,000 –18,000) is first adjusted from available Investment Fluctuation Fund. Thereafter, the remaining balance of Investment Fluctuation Fund i.e. Rs 15,000 (Rs 18,000 – Rs 3,000) is distributed among all the partners.

Cash Account

Dr. **Cr.**

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Balance b/d	10,000	Gaurav's Capital A/c	4,000
Rahul's Capital A/c	6,000	Balance c/d	12,000
	16,000		16,000

Balance Sheet

as on March 31, 2012 (after Saurav's retirement)

Liabilities	Amount	Assets	Amount

	(Rs)		(Rs)
Capital A/cs:		Land and Building	42,000
Gaurav 48,000		Plant and Machinery	24,000
Rahul 32,000	80,000	Stock	6,000
Saurav's Loan	27,000	Debtors	30,000
Sundry Creditors	25,000	Investments	18,000
		Cash	12,000
	1,32,000		1,32,000

***Working Notes*:**

WN1 *Calculation of Gaining Ratio*

Old Ratio (Gaurav, Rahul and Saurav) = 3 : 2 : 1
Saurav retires from firm.
New Ratio (Gaurav and Rahul) = 3 : 2
∴Gaining Ratio = 3 : 2

WN2 *Adjustment of Capital*

Total Capital of New Firm (after Saurav's retirement) =Rs 80,000

New Ratio = 3 : 2

$$\text{Gaurav's New Capital} = 80{,}000 \times \frac{3}{5} = \text{Rs } 48{,}000$$

$$\text{Rahul's New Capital} = 80{,}000 \times \frac{2}{5} = \text{Rs } 32{,}000$$

Particulars	Gaurav	Rahul
New Capital Balance	48,000	32,000
Adjusted Old Capital Balance	(52,000)	(26,000)
Cash brought in by/paid to the partner	**4,000 (Dr.)**	**6,000 (Cr.)**

Case 2 *When the Total capital of the New Firm is Not specified*

In case, the total capital of the new firm after the retirement of a partner is ***not specified,*** then the sum total of the capital balances of the remaining partners (after all the required adjustments) is considered as the total capital of the new firm. The new capital of the continuing partners is calculated on the basis of the total capital and new profit sharing ratio. The following are the steps involved in the adjustment of capital in this case.

***Step1*:** Calculate Cr. – Dr. Balances (Adjusted Old capital) of the remaining partners, after all adjustments.

***Step 2*:** Add the adjusted old capitals after all adjustments of the continuing partners. This is the total capital of the newly reconstituted firm.

***Step 3*:** Calculate the individual new capital of the continuing partners by the following formula.

$$\text{New Capital of one of the Remaining Partners} = \text{Total Capital of the Firm After Retirement / Death} \times \text{New Profit Share of Remaining Partners}$$

***Step 4*:** If the amount calculated in the Step 1 (Adjusted Old Capital after all adjustments) exceeds the amount calculated in the Step 3 (new capital), then the difference amount (surplus) is paid to the partner in cash or through bank, i.e. debited to the Partners' Capital Account. On the other hand, if the amount calculated in the Step 3 exceeds the amount calculated in the Step 1, then the difference amount (shortage) is to be brought in by the partner, i.e. credited to the Partners' Capital Account.

Step 5: The retiring (or deceased) partner's balance (i.e. Cr. – Dr.) is transferred to his loan Account or paid in cash (or transferred to the Executors' Account in case of death of a partner).

***Example*:** Mahima, Priyanka and Deepika are three partners in a firm sharing profits and losses equally. On April 1, 2011, Mahima retires from the firm. On that date, the capital balances of Mahima, Priyanka and Deepika after all the necessary adjustments were Rs 90,000, Rs 1,20,000 and Rs 1,10,000 respectively. The remaining partners of the firm decided to adjust their capital account in their new profit sharing ratio. Calculate the amount of cash to be paid off or to be brought in by the continuing partners. Also pass the necessary journal entries.

Solution

Old Ratio = 1 : 1 : 1

New Ratio (after Mahima's retirement) = 1 : 1

***Step1*:** Calculate Cr. – Dr. Balances (Old capital) of the remaining partners, after all adjustments.

It is being given in the question that the capital balances of all the partners after all the required adjustments are Rs 90,000 , Rs 1,20,000 and Rs 1,10,000, respectively. Therefore, no need to calculate them separately. However; in the long practical problems you need to calculate them.

***Step 2*:** Add the adjusted old capitals of the continuing partners. This is the total capital of the newly reconstituted firm.

Total Capital of the New Firm = Rs 1,20,000 + Rs 1,10,000 = Rs 2,30,000

***Step 3*: Calculate the individual new capital of the continuing partners by the following formula.

$$\text{New Capital of one of the Remaining Partners} = \text{Total Capital of the Firm After Retirement / Death} \times \text{New Profit Share of Remaining Partners}$$

$$\text{New Capital of Priyanka} = 2,30,000 \times \frac{1}{2} = \text{Rs } 1,15,000$$

$$\text{New Capital of Deepika} = 2,30,000 \times \frac{1}{2} = \text{Rs } 1,15,000$$

These capital balances are shown on the Debit Side of the Partners' Capital Accounts as 'Balance c/d'.

***Step 4*: New capital of Priyanka is Rs 1,15,000 and the Adjusted Old Capital (after all adjustment- as per the Step 1) is Rs 1,20,000. That is, New Capital falls short of her Adjusted Old Capital, so the difference amount of Rs 5,000 (1,20,000 - 1,15,000) is *surplus and is paid back to Priyanka*.

Similarly, New capital of Deepika is Rs 1,15,000 and the Adjusted Old Capital (after all adjustment- as per the Step 1) is Rs 1,10,000. That is, New Capital exceeds her Adjusted Old Capital, so the difference amount of Rs 5,000 (1,15,000 - 1,10,000) is *deficit and is to be brought in by Deepika.*

Posting in the Partner's Capital Account

Partners' Capital A/c

Dr.							Cr.
Particulars	**Mahima**	**Priyanka**	**Deepika**	**Particulars**	**Mahima**	**Priyanka**	**Deepika**
Mahima's Loan A/c/ or Executor's A/c	90,000						
Cash/Bank A/c		5,000		Cash/Bank A/c			5,000
Balance c/d		1,15,000	1,15,000				

Journal Entries

(i) Priyanka's Capital A/c Dr. 5,000

To Bank A/c 5,000

(Excess amount withdrawn by Priyanka)

(ii) Bank A/c Dr. 5,000

To Deepika's Capital A/c 5,000

(Deficit amount brought in by Deepika)

<u>Example</u>: The following is the Balance Sheet of the partnership firm of Akku, Makku and Takku who are sharing profits and losses in the ratio of 2 : 1 : 1.

Balance Sheet

as on March 31, 2012

Liabilities		Amount (Rs)	Assets		Amount (Rs)
Capital A/cs:			Land and Building		25,000
Akku	29,000		Furniture		15,000
Makku	31,000		Patents		10,000
Takku	18,000	78,000	Stock		18,000
Profit and Loss A/c		16,000	Debtors	15,000	
Sundry Creditors		20,000	*Less*: Provision for Doubtful Debts	(700)	14,300
			Cash		31,700
		1,14,000			1,14,000

Takku retired from the firm on the above date. Akku and Makku decided to continue the business on the following terms-

1. Goodwill of the firm is valued at 2.5 years' purchase of average profits of past 3 years.
2. Stock is overvalued by Rs 2,400 and sundry creditors to be reduced by Rs 1,000.
3. Depreciate Furniture by 20% and appreciate the value of land and building by Rs 12,000.
4. Debtors are to be revalued at its book value *less* 2% as provision for dooubtful debts.
5. The profits of the firm for the year 2010 and 2011 were Rs 8,600 and Rs 4,200 respectively.
6. Remaining Partners decided to adjust their capital balances as per their new profit sharing ratio.
7. Takku's final balance is to settled in cash.

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

Solution

Revaluation Account

Dr. **Cr.**

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Furniture	3,000	Sundry Creditors	1,000
Stock	2,400	Land and Building	12,000
Profit on revaluation transferred to:		Provision for Doubtful Debts (700 – 300)	400

Akku's Capital A/c	4,000			
Makku's Capital A/c	2,000			
Takku's Capital A/c	2,000	8,000		
		13,400		13,400

Partner's Capital Account

Dr. **Cr.**

Particulars	Akku	Makku	Takku	Particulars	Akku	Makku	Takku
Takku's Capital A/c	4,000	2,000		Balance b/d	29,000	31,000	18,000
Cash A/c			30,000	Profit and Loss A/c	8,000	4,000	4,000
				Revaluation A/c (Profit)	4,000	2,000	2,000
Cash A/c (*Balancing Figure*) ***** See Video***		11,000		Akku's Capital A/c			4,000
				Makku's Capital A/c			2,000
Balance c/d	48,000	24,000		Cash A/c (*Balancing Figure*) ***** See Video***	11,000		
	52,000	37,000	30,000		52,000	37,000	30,000

Cash Account

Dr. **Cr.**

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Balance b/d	31,700	Makku's Capital A/c	11,000
Akku's Capital A/c	11,000	Takku's Capital A/c	30,000
		Balance c/d	1,700
	42,700		42,700

Balance Sheet

as on March 31, 2012 (after Takku's retirement)

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Capital A/cs:			Land and Building	37,000
Akku	48,000		Furniture	12,000
Makku	24,000	72,000	Patents	10,000

Sundry Creditors	19,000	Stock		15,600
		Debtors	15,000	
		Less: Provision for Doubtful Debts	(300)	14,700
		Cash		1,700
	91,000			91,000

Working Notes:

WN1 *Calculation of Goodwill of the Firm*

$$\text{Average Profits} = \frac{\text{Total Profit of Last 3 Years'}}{\text{Number of Years}} = \frac{8,600 + 4,200 + 16,000}{3} = \text{Rs } 9,600$$

Goodwill of firm = Average Profit × Number of Years' Purchase
= 9,600 × 2.5 = Rs 24,000

$$\text{Takku's Share in Firm's Goodwill} = 24,000 \times \frac{1}{4} = \text{Rs } 6,000$$

WN2 *Calculation of Gaining Ratio*
Old Ratio (Akku, Makku and Takku) = 2 : 1 : 1

Takku retires from firm.
New Ratio (Akku and Makku) = 2 : 1
∴Gaining Ratio = 2 : 1

WN3 *Adjustment of Capital*

Adjusted Old Capital of Akku = 41,000 – 4,000 = 37,000
Adjusted Old Capital of Makku = 37,000 – 2,000 = 35,000
Combined Capital of Akku and Makku (after all adjustments) = 37,000 + 35,000 = Rs 72,000

New Ratio = 2 : 1

$$\text{Akku's New Capital} = 72,000 \times \frac{2}{3} = \text{Rs } 48,000$$

$$\text{Makku's New Capital} = 72,000 \times \frac{1}{3} = \text{Rs } 24,000$$

Particulars	Akku	Makku
New Capital Balance	48,000	24,000

Adjusted Old Capital Balance	(37,000)	(35,000)
Cash brought in by/paid to the partner	**11,000 (Cr.)**	**11,000 (Dr.)**

Case 3 *When the Amount Payable to the Retiring Partner is to be Contributed by Remaining Partners*

On the retirement of a partner, it might be possible that the firm does not have enough amount to discharge the payment due to the retiring partner. In such a case, the remaining partners are required to bring in sufficient cash from their personal property. This amount is to be brought in by them in such a way so as to make their new capital balances proportionate to their new profit sharing ratio. In this situation, the total of the capital balances of the remaining partners plus the extra amount required to discharge the payment due to the retiring partner is taken as the total new capital of the (new) firm. That is,

Total New Capital of the Firm = Total of Capital Balances of Remaining Partners + Amount Required to Settle Retiring Partners' Account

Let us understand various steps involved in this case with the help of the following example.

Example: Disha, Rahul and Monica are the partners in a firm sharing profits and losses in the ratio of 2 : 1 : 1. Capital balances of Disha, Rahul and Monica after all adjustments were Rs 1,05,000, Rs 1,20,000 and Rs 1,35,000 respectively. Rahul retires from the firm. The remaining partners decided that the amount payable to Rahul will be brought in by them in such a way as to make their capitals proportionate to their new profit sharing ratio. Calculate the amount of cash to be paid off or to be brought in by the remaining partners and also pass the necessary journal entries.

Solution

Old Ratio = 2 : 1 : 1

New Ratio (after Rahul's retirement) = 2 : 1

Step1: Calculate Cr. – Dr. Balances (Adjusted Old Capital) of the remaining partners, after all adjustments.

The adjusted capital balances of the partners are given in the question as Rs 1,05,000, Rs 1,20,000 and Rs 1,35,000 respectively.

Step 2: Add the adjusted old capitals after all adjustments of the continuing partners and also the amount payable to the retiring/deceased partner. This is the total capital of the newly reconstituted firm.

Total New Capital of the New Firm = Adjusted Capital Balances of the Continuing Partners + Amount Payable to Rahul

Total New Capital of the New Firm = (Rs 1,05,000 + Rs 1,35,000) + Rs 1,20,000 = Rs 3,60,000

Step 3: Calculate the individual new capital of the continuing partners by the following formula.

$$\text{New Capital of one of the Remaining Partners} = \text{Total Capital of the Firm After Retirement / Death} \times \text{New Profit Share of Remaining Partners}$$

$$\text{New Capital of Disha} = 3,60,000 \times \frac{2}{3} = \text{Rs } 2,40,000$$

$$\text{New Capital of Monica} = 3,60,000 \times \frac{1}{3} = \text{Rs } 1,20,000$$

***Step 4*:** Calculation of Amount to be Paid off / Brought in by the Remaining Partners

Particulars	Disha	Monica
New Capital Balance	2,40,000	1,20,000
Less: Adjusted Old Capital	1,05,000	1,35,000
	$1,35,000$ $(Deficit)$	$15,000$ $(Surplus)$

Step 5: The retiring (or deceased) partner's balance (i.e. Cr. – Dr.) is transferred to his loan Account or paid in cash (or transferred to the Executors' Account in case of death of a partner).

Journal Entry

(i) Bank A/c Dr. 1,35,000

To Disha's Capital A/c 1,35,000

(Additional capital brought in by Disha)

(ii) Monica's Capital A/c Dr. 15,000

To Bank A/c 15,000

(Excess amount withdrawn by Monica)

Example: The following is the Balance Sheet of the partnership firm of D, E and F who are sharing profits and losses equally.

Balance Sheet

as on March 31, 2012

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Capital A/cs:			Fixed Assets	2,00,000
D	65,000		Stock	45,000
E	85,000		Debtors	40,000
F	95,000	2,45,000	Cash	15,000
Sundry Creditors		1,00,000	Deferred Revenue Expenditure	45,000

	3,45,000		3,45,000

D retired on March 31, 2012. Remaining partners E and F decided to continue the business on following terms:

1. Stock is revalued at Rs 35,000 and fixed assets are to be appreciated by 10%.
2. Salary for the month of March 2012 amounting Rs 3,000 remains unpaid.
3. There is sale of old typewriter of Rs 9,000.
4. 50% of debtors were considered good and on the remaining debtors provision is to be made @ 5%.
5. Goodwill is valued at Rs 60,000 on D's retirement.
6. D was to be paid through cash brought in by E and F in such a way as to make their capitals proportionate to their new profit sharing ratio.

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

Solution

Revaluation Account

Dr. **Cr.**

Particulars		Amount (Rs)	Particulars	Amount (Rs)
Stock		10,000	Cash A/c (sale of old typewriter)	9,000
Salary Outstanding		3,000	Fixed Assets	20,000
Provision for Bad Debts (20,000 × 5%)		1,000		
Profit on revaluation transferred to:				
D's Capital A/c	5,000			
E's Capital A/c	5,000			
F's Capital A/c	5,000	15,000		
		29,000		29,000

Partners' Capital Accounts

Dr. **Cr.**

Particulars	D	E	F	Particulars	D	E	F
Deferred Revenue Expenditure	15,000	15,000	15,000	Balance b/d	65,000	85,000	95,000
D's Capital A/c		10,000	10,000	Revaluation A/c (Profit)	5,000	5,000	5,000
				E's Capital A/c	10,000		
				F's Capital A/c	10,000		
Cash A/c	75,000			Cash A/c (*Balancing Figure*) ***** See Video***		42,500	32,500
Balance c/d		1,07,500	1,07,500				

	90,000	1,32,500	1,32,500		90,000	1,32,500	1,32,500

Cash Account

Dr. Particulars	Amount (Rs)	Particulars	Cr. Amount (Rs)
Balance b/d	15,000	D's Capital A/c	75,000
E's Capital A/c	42,500	Balance c/d	24,000
F's Capital A/c	32,500		
Revaluation A/c (Old Typewriter)	9,000		
	99,000		99,000

Balance Sheet

as on March 31, 2012 (*after D's retirement*)

Liabilities		Amount (Rs)	Assets		Amount (Rs)
Capital A/cs:			Fixed Assets		2,20,000
E	1,07,500		Stock		35,000
F	1,07,500	2,15,000	Cash		24,000
Sundry Creditors		1,00,000	Debtors	40,000	
Salary Outstanding		3,000	*Less*: Provision	(1,000)	39,000
		3,18,000			3,18,000

***Working Notes*:**

WN1 *Calculation of Gaining Ratio*

Old Ratio (D, E and F) = 1 : 1 : 1
D retires from firm.
New Ratio (E and F) = 1 : 1
∴Gaining Ratio = 1 : 1

WN2 *Adjustment of Capital*

Adjusted Old Capital of E = 90,000 – 25,000 = 65,000
Adjusted Old Capital of F = 1,00,000 – 25,000 = 75,000

Combined Capital of E and F (after all adjustments) = 65,000 + 75,000 = Rs 1,40,000
Amount to be brought in by E and F = Cash to be paid to D = Rs 75,000

Therefore, Total Capital of firm = Combined Capital of E and F + Amount to be brought in by E and F
= 75,000 + 1,40,000 = Rs 2,15,000

New Ratio = 1 : 1

$$\text{E's New Capital} = 2{,}15{,}000 \times \frac{1}{2} = \text{Rs } 1{,}07{,}500$$

$$\text{F's New Capital} = 2{,}15{,}000 \times \frac{1}{2} = \text{Rs } 1{,}07{,}500$$

Particulars	E	F
New Capital Balance	1,07,500	1,07,500
Adjusted Old Capital Balance	(65,000)	(75,000)
Cash brought in by the partners	**42,500 (Cr.)**	**32,500 (Cr.)**

Case 4 *Adjustment of Capital by Maintaining Minimum Cash / Bank Balance*

On the retirement of a partner, sometimes, the firm may decide to maintain a minimum cash or bank balance after making payment to him/her. In such a case, the capital accounts of the remaining partners is adjusted in their new profit sharing ratio in such a way, that after making payment to the retiring partner, the desired cash/bank is maintained.

In other words, the remaining partners are required to bring in sufficient amount so that after paying the retiring partner the firm is left with the desired amount of cash/bank balance. In this case, the capital of the new firm is calculated after considering the minimum cash/bank balance.In this situation, the total of the capital balances of the remaining partners ***plus*** the extra amount required to discharge the payment due to the retiring partner ***plus*** desired cash balance ***minus*** existing cash balance is taken as the total new capital of the newly reconstituted firm. That is,

Total New Capital of Firm = Total of Capital of Remaining Partners + Amount Payable to Retiring/Deceased Partner + Desired Cash Balance – Old Cash Balance

Let us understand various steps involved in this case with the help of the following example.

Example**:** Mohit, Saurav and Pankaj are the partners in a firm sharing profits and losses in the ratio of 5 : 2 : 3. On March 31, 2012, Saurav retires from the firm. The capital balances of Mohit, Saurav and Pankaj after all the necessary adjustments are Rs 60,000, Rs 45,000 and Rs 35,000 respectively. The firm had a cash balance of Rs 8,000. Mohit and Pankaj decided to adjust their capital account in their new profit sharing ratio. Also the firm wants to maintain a minimum cash balance of Rs 10,000. Calculate the amount of cash to be paid off or to be brought in by the remaining partners and pass the necessary Journal entries.

Solution

Old Ratio = 5 : 2 : 3

New Ratio (after Saurav's retirement) = 5 : 3

Step 1: Calculate adjusted old capital balances of all the partners, after all adjustments (including the retiring or the deceased partner).

These are being in the question as Rs 60,000, Rs 45,000 and Rs 35,000.

Step 2**:** Calculate the total amount of cash required by the following formula.

Total New Capital of Firm = Total of Capital of Mohit and Pankaj + Amount Payable to Saurav + Desired Cash Balance - Old Cash Balance (given in the old balance sheet)

Total New Capital of Firm = (Rs 60,000 + Rs 35,000) + Rs 45,000 + Rs 10,000 - Rs 8,000

= Rs 1,42,000

Step 3**:** Calculate the new capital for each of the continuing partners by the following formula.

$$\text{New Capital of one of the Remaining Partners} = \text{Total Capital of the Firm After Retirement / Death} \times \text{New Profit Share of Remaining Partners}$$

$$\text{New Capital of Mohit} = 1,42,000 \times \frac{5}{8} = \text{Rs } 88,750$$

$$\text{New Capital of Pankaj} = 1,42,000 \times \frac{3}{8} = \text{Rs } 53,250$$

Step 4: Calculation of Amount to be Paid off / Brought in by the Remaining Partners

	Mohit (Rs)	**Pankaj (Rs)**
New Capital Balance	88,750	53,250
Existing Capital Balance	60,000	35,000
	$\underline{\underline{28,750}}$ (*Deficit*)	$\underline{\underline{18,250}}$ (*Deficit*)

Step 5: The retiring (or the deceased) partner's balance (i.e. Cr. – Dr.) is transferred to his loan Account or paid in cash (or Executors' Account in case of death of a partner).

Partners' Capital A/c

Dr. **Cr.**

Particulars	**Mohit**	**Saurav**	**Pankaj**	**Particulars**	**Mohit**	**Saurav**	**Pankaj**

Saurav's Loan A/c/ or Executor's A/c		45,000		Cash/Bank A/c	28,750		18,250
Balance c/d	88,750		53,250				

Journal Entry

Bank A/c Dr. 47,000

To Mohit's Capital A/c 28,750

To Pankaj's Capital A/c 18,250

(Additional capital brought in by Mohit and Pankaj)

Note: It should be noted that the closing balance of the Cash/Bank Account (i.e. Balance c/d) will automatically reveal the same amount (in this case Rs 10,000) as required to be the minimum amount of Cash as stated in the question. This ensures the accuracy of the calculation involved in the adjustment of capital. In the New Balance Sheet, Cash Account will be shown at the new balance of Rs 10,000.

Death of a Partner

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Introduction to Death of a Partner
- Ascertainment of Share of Profits of Deceased Partner till the Date of his/her Death- Time Basis and Sales Basis
- Disposal of Amount Due to the Deceased Partner

Death of a Partner

Similar to the admission and retirement of a partner, death of any of the partners of a partnership also results in the reconstitution of a partnership. This is because with the death of a partner, the old partnership deed comes to an end and is replaced by a newly formed partnership agreement. This new partnership agreement defines the new relationship among the remaining or continuing partners of the firm. Death of a partner also changes the profit sharing ratio, so we need to calculate the new profit sharing ratio among the continuing partners. In addition to this, the need for revaluing assets and liabilities also becomes necessary. Thus, it can be said that there is not much difference in the accounting treatment of retirement of a partner and death of a partner. In case of retirement of a partner, the amount due to the retiring partner is paid to him/her or transferred to his/her loan account. But in case of death of a partner, the amount due to the deceased partner is paid to his/her legal representative or transferred to his/her Executor's Account.

The mentioned below are some accounting matters that are required to be deal in case of death of a partner

i. Calculation of New Profit Sharing Ratio
ii. Treatment of Goodwill
iii. Adjustment for Revaluation of Asset and Liabilities
iv. Adjustment of Accumulated Profits and Losses
v. Adjustment of Partners' Capital Account
vi. Ascertaining the Share of Profits of the Deceased Partner till the Date of Death
vii. Treatment of Joint Life Policy
viii. Disposal of Amount Due to the Deceased Partner

From the above list of adjustments made at the time of death, we can say that first five points i.e. (i) to (v) remains the same. However; the treatment of the following three items in case of death of a partner differs from that of in case of retirement.

i. Ascertaining the Share of Profits of the Deceased Partner till the Date of Death
ii. Treatment of Joint Life Policy
iii. Disposal of Amount Due to the Deceased Partner

Ascertainment of Share of Profits of Deceased Partner till the Date of His/Her Death

In case of death of a partner, the deceased partner is entitled to receive his/her share in all the profits and losses that the firm have earned/incurred till his/her date of death. Practically, it is not possible for any firm to close its books of accounts at any time (during an accounting period) with respect to death of a partner. Therefore, in such a situation, the share of profits of the deceased partner is ascertained either on *Time Basis* or on *Turnover/Sales Basis*. The amount of profit or loss so ascertained is dispensed to the deceased partner through the *Profit and Loss Suspense Account*. The following are the Journal entries to record profit and loss up-to-date of the death.

Journal Entries

In case of *Profit*		In case of *Loss*	
Profit and Loss Suspense A/c	Dr.	Deceased Partner's Capital A/c	Dr.
To Deceased Partner's Capital A/c		To Profit and Loss Suspense A/c	

(A) TIME BASIS

Death of a partner may take place at any time during an accounting period. In such a situation, we need to calculate the profits/losses for the period for which the partner remained in the business during the year. Therefore, one of the way in which such profits/losses can be calculated is the basis of time. According to this approach, the up-to-date profit of the deceased partner is calculated by the given below formula.

$$\text{Up to Date Profit of Deceased Partner} = \text{Average Profits} \times \frac{\text{No. of Months Partner Remained}}{12} \times \text{Share of Deceased Partner}$$

where,

$$\text{Average Profits} = \frac{\text{Sum of Profits of Last Years} - \text{Loss } (\textit{if any})}{\text{Total Number of Years}}$$

***Example*:** Ravi, Ajay and Rakesh are three partners in a firm sharing profits and losses in the ratio of 3 : 2 : 1. Ravi died on August 30, 2012. His share of profits from the beginning of the accounting period till the date of his death is decided to be calculated on the basis of the average profits of last four years. Profits for the year 2008, 2009, 2010 and 2011 were Rs 22,000, Rs 18,000, Rs 14,000 and Rs 24,000 respectively. The firm closes its books every year on March 31.Calculate amount of Ravi's profits till the date of his death. Also, pass the necessary Journal entries.

Solution

Calculation of Average Profit

$$\text{Average Profit} = \frac{\text{Total Profit for Last Four Years}}{4}$$

$$\text{Average Profit (of last 4 years)} = \frac{22{,}000 + 18{,}000 + 14{,}000 + 24{,}000}{4}$$

$$= \text{Rs } 19{,}500$$

$$\text{Ravi's share of Profit till the date of his death} = \text{Rs } 19{,}500 \times \frac{5}{12} \times \frac{3}{6}$$

$$\text{(from April 01, 2011 to August 30, 2011)} \quad = \text{Rs } 4{,}062.50$$

Journal Entry

Profit and Loss Suspense A/c	Dr.	4,062.50	
To Ravi's Capital A/c			4,062.50

***Example*:** Amit, Sumit and Rachit are the partners in a firm sharing profits and losses equally. Sumit dies on June 03, 2011. The profit of the firm for the year ending March 31, 2011 was Rs 90,000. Calculate the Sumit's share of profits on the basis of last year profit. Also pass the necessary Journal entry.

Solution

Profit for the Last Year = Rs 90,000

$$\text{Sumit's share of Profit till the date of his death} = \text{Rs } 90{,}000 \times \frac{2}{12} \times \frac{1}{3}$$

$$\text{(from April 01, 2011 to June 03, 2011)} \quad = \text{Rs } 5{,}000$$

Journal Entry

Profit and Loss Suspense A/c	Dr.	5,000	
To Sumit's Capital A/c			5,000

(B) SALES BASIS

In case of death of a partner, the share of profit of the deceased partner for the period for which he/she remained in the business can also be computed on the basis of previous sales of the firm. According to this concept, the up-to-date profit share of the deceased partner is calculated by the given below formula.

$$\text{Up to Date Profit of Deceased Partner} = \frac{\text{Previous Year's Profit}}{\text{Previous Year's Sales}} \times \text{Sales till the Date of Death of Partner} \times \text{Share of Deceased Partner}$$

***Example*:** P, Q and R are the partners in a firm sharing profits and losses in ratio of 2 : 1 : 3. R died on July 29, 2011. Sales of the firm for the year ending March 31, 2011 was Rs 1,50,000 and profits were Rs 22,500. Sales for the period between April 01, 2011 and July 31, 2011 amounted to Rs 65,000. Calculate the R's share of profits on the basis of sales and also pass the Journal entry.

Solution

Sales for Last Year (Previous Year Sales) = Rs 1,50,000

Profit for Last Year (Previous Year Profit) = Rs 22,500

Sales from April 01 to July 29, 2011 = Rs 65,000

$$\text{Up to Date Profit of Deceased Partner} = \frac{\text{Previous Year's Profit}}{\text{Previous Year's Sales}} \times \text{Sales till the Date of Death of Partner} \times \text{Share of Deceased Partner}$$

$$\therefore \text{ R's Profit till his death } = \frac{22{,}500}{1{,}50{,}000} \times 65{,}000 \times \frac{3}{6} = \text{Rs } 4{,}875$$

Journal Entry

Profit and Loss Suspense A/c	Dr.	4,875	
To R's Capital A/c			4,875

Disposal of Amount Due to the Deceased Partner

In case of death of a partner, the amount due to the deceased partner is paid to his/her executor. The amount due to the deceased partner is calculated in the same way as calculated in the case of retirement of a partner. The deceased partner is entitled to share all the profits/losses which have been earned/incurred during the period for which he remained in the partnership business i.e. till the date of his/her death.

Difference between Disposal of Amount to Retiring Partner and to Deceased Partner

In accounting terms, there is not much difference in the calculation procedure of the amount payable to the retiring partner and to the deceased partner. In case of retirement of a partner, the amount due to the retiring partner is paid to him/her in cash or transferred to his/her loan account. But in case of death of a partner, the amount due to the deceased partner is paid to his/her legal representative or transferred to his/her executor's account. Therefore, in case of death, executor's loan account is prepared to discharge the amount due to him/her. The executor can be paid in any of the following ways:

1. Payment in cash/bank (immediately paid-off)
2. Payment in instalments (through loan)
3. Partly in cash/bank and partly in instalments

Note: Sometimes, the firm does not have sufficient balance to dispense the final amount due to the deceased partner immediately. In such cases, the settlement is made through a Bank Overdraft. That is, Deceased Partner's Executor's A/c is debited and Bank Overdraft A/c is credited. In the New Balance Sheet (i.e. post reconstitution), the total balance in Bank Overdraft A/c is shown (i.e. Existing Bank Overdraft appearing in the Old Balance Sheet ***plus*** Amount required to settle Deceased Partner's Capital Account). This case is an extension to Case 1 (Payment through Cash/Bank Overdraft).

Important Note-It should be noted in all the three above mentioned ways, the final amount payable to the deceased partner will be transferred to his/her Executor's Account. This implies that the deceased partner's Capital Account is closed by transferring its balance to the Executor's Account.

This executor's loan account is prepared either for one year or for more than one year. Generally, if the firm desires to pay off the loan in instalments, then the executor's account is prepared for more than one year. It should also be noted that similar to the case of retirement, in case of death, the executor is entitled to receive interest on the outstanding amount at 6% p.a. (unless and until it is specified in the question).

Executor's Account (for one year)

Dr. | | | | | **Cr.**

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
			Date of Death	Deceased Partners' Capital A/c	–
End of First Year	Cash/Bank A/c	–	End of First Year	Interest A/c	–

If the amount of loan is payable in instalments, then the Executor's Account is prepared for more than one year.

Executor's Account (for more than one year)

Dr. **Cr.**

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
	Cash A/c / Bank A/c (1st instalment + Interest)	–		Deceased Partner's Capital A/c	–
	Balance c/d	–		Interest A/c	–
	Cash/Bank A/c (2nd instalment + Interest)			Balance b/d	–
	Balance c/d			Interest A/c	–
	Cash/Bank A/c (3rd instalment + Interest)			Balance b/d	–
	Balance c/d			Interest A/c	–

Example: A, B and C are three partners sharing profits and losses equally. On January 01, 2011, C died. The total amount to be paid by the firm to C amounted to Rs 85,000. Pass the necessary Journal entries to record the payment to C in the following cases.

i. whole amount is paid immediately in cash
ii. paid through loan
iii. paid immediately Rs 35,000 in cash and the balance amount in loan.

Solution

(i) Whole Payment in Cash

C's Capital A/c Dr. 85,000

To C's Executor's A/c 85,000

(Balance of C's Capital Account transferred to C's Executor's Account)

C's Executor's A/c Dr. 85,000

To Cash/Bank A/c 85,000

(Amount paid to C's Executor in cash)

Posting in the Partner's Capital Account

Partners' Capital A/c

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
C's Executor's A/c			85,000				

C's Executors' Account

Dr. **Cr.**

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
Jan. 01, 2011	Cash/Bank A/c	85,000	Jan. 01, 2011	C's Capital A/c	85,000
		85,000			85,000

(ii) *<u>Payment made through Loan</u>*

C's Capital A/c Dr. 85,000

To C's Executor's A/c 85,000

(Amount due to C transferred to his executor's account)

Posting in the Partner's Capital Account

Partners' Capital A/c

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
C’s Executor's A/c			85,000				

C’s Executors’ Account

Dr. Cr.

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
Jan. 01, 2011	C's Executor's Loan A/c	85,000	Jan. 01, 2011	C’s Capital A/c	85,000
		85,000			85,000

(iii) Rs 35,000 in Cash and Balance through Loan

C's Capital A/c Dr. 85,000

To Cash A/c 35,000

To C's Executor's Loan A/c 50,000

(Rs 35,000 paid in cash and balance of Rs 50,000 transferred to C's loan account)

Posting in the Partner's Capital Account

Partners’ Capital A/c

Dr. Cr.

Particulars	A	B	C	Particulars	A	B	C
C's Executor's A/c			85,000				

C’s Executors’ Account

Dr. | **Cr.**

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
Jan. 01, 2011	Cash/Bank A/c	35,000	Jan. 01, 2011	C’s Capital A/c	85,000
	C's Executor's Loan A/c	50,000			
		85,000			85,000

Section 37 of the Indian Partnership Act, 1932

The premise of this section is to ensure that after the retirement or death of a partner, the remaining partners settle his dues as quickly as possible. Even if there is a delay then the outgoing partner is given certain extra incentive as has been mutually agreed or as per this section. The details of this benefit are given as follows:

i. He will be entitled to interest or share in profits or nothing as has been mutually decided among the partners.
ii. If nothing is agreed among the partners, then the outgoing partner or his representative can choose to get either of the following till the final settlement
iii. Interest on the balance amount @6% per annum.
iv. Share in the profits earned to his amount outstanding to total capital.

$$\textbf{Share in Profit} = \frac{\text{Outstanding Amount of Outgoing Partner}}{\text{Capital of all Partners + Balance of Outgoing Partner}} \times \textbf{Profit from the date of death/retirement till the date of next balance sheet}$$

Example: X, Y and Z were partners in a firm sharing profits in the ratio of 2:2:1. Z retired on 1^{st} August, 2018 on which date the capitals of X, Y and Z after all necessary adjustment stood at Rs. 70,000; Rs. 60,000 and Rs. 55,000 respectively. X and Y carried on the business for another 5 months without settling the account of Z. During the period of 5 months ended 31^{st} December, 2018, a profit of Rs. 45,000 was earned by the firm. State which of the two options available as per Section 37 of the Indian Partnership Act, 1932 will be exercised by Z?

Answer: Z has the following two options:

i. Interest @ 6% on his balance amount = Rs. 55,000 x 6/100 x 5/12 = Rs. 1375
ii. Share in the subsequent profits attributable to the use of his balance

= (55,000/1, 85,000* x 45,000) = Rs. 13,378.40 (Approx.)

*: Capitals of X and Y + Balance of Z = Rs. (70,000 + 60,000 + 55,000) = Rs. 1,85,000

Hence, Z will be exercising option (ii) because it pays him more as compared to the other option.