Course: **Financial Accounting-II**	
Course Code: **BC 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **1**	

BRANCH ACCOUNTING

STRUCTURE:

1.0 OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning and types of Branches.

- To know the need and nature of Branch Accounting.
- To understand the different systems of Branch Accounting.

1.1 INTRODUCTION

Every business organization aims to increase its sales volume and profits for which a business organization takes different steps/actions. One of the actions is to open the branches. The branches are controlled by the head office and branches may locate in the home country or outside the country. A branch means any subordinate subdivision of a business. As per Companies Act, a branch is any establishment carrying on either the same or substantially the same activity as that is carried on by the head office of the company. For example Tata has its branches all over the country. Each branch is treated as a separate profit centre and hence the profit or loss of each branch is computed separately. It must also be noted that the concept of a branch means existence of head office which controls all the branches.

1.2 NATURE OF BRANCH ACCOUNTING

- It is a system where separate books of accounts are maintained for each branch.
- In this system Head office and each branch is treated as a separate entity.
- It helps to ascertain the performance of each branch separately which helps to take the necessary action.
- It Increases the expenses of the company because of manpower, Infrastructure or operational expenses.
- It ascertains the profit or loss of each branch.

1.3 TYPES OF BRANCHES

The branches can be divided into following categories:

- Dependent Branches
- Independent Branches
- Foreign Branches

Dependent Branches:

Dependent branches are those branches which are not keeping the full system of accounting. The following are the key features of branch accounting:

- The dependent branches are not allowed to make any purchases and they sell goods received from the head office only.
- Goods are supplied by the head office to such branches either at cost price or at invoice price.
- All the major expenses are paid by the head office.
- Normally the goods are sold for both the cash and credit.

Independent Branches:

Independent branches are those branches which are keeping the full system of accounting. They are allowed to purchase goods from the open market and also supply to the head office, if necessary. They can pay their expenses from the cash realized and can have the bank account on their own name.

Foreign Branches:

When a branch is located out of the home country, it is called foreign branch. Foreign branches keep their accounts in the foreign currency.

1.4 DIFFERENCE BETWEEN BRANCH ACCOUNTING AND DEPARTEMENTAL ACCOUNTING

BASIS OF DIFFERENCE	DEPARTMENTAL ACCOUNTING	BRANCH ACCOUNTING
Linkage	Departments are attached with the main organization under a single roof.	Branches are separate from the main organization.
Results of	Departments are the results of fast human life.	Branches are the outcomes of the tough competition and expansion of the business.

Geograpgical location	Departments are not geographically separated.	Branches are geographically separated.
Types	There is no classification of departments.	The branches may be dependent or independent.
Allocation of expenses	Allocation of departmental common expenses is a tough job.	There is no need of allocation of branch expenses.
Reconciliation	In departmental accounts, no reconciliation is required because there is no central account division.	To find out the net result of organization the reconciliation of different branch is a main job.
Trading	Departmental trading with their head office is conducted under the same roof although each department deals with separate line of activity.	Branch trading is conducted in different parts of the country under the head office dealing with usually the same line of activity.
Prfoitability	The profitability position of department is seen within the larger picture of a parent organizational profits.	The profitability of each branch is equally important and seen separately.
Methods of preparation of accounts	There are only two methods: Separate set of books are maintained Separate set of books are not maintained.	There are various methods of preparation of accounts like Stock and debtors system Debtors system Final accounts system Wholesale price system

Accounts maintained	The accounts maintained are; Departmental trading and profit and loss account General profit and loss account	The accounts maintained are: Branch stock account Branch adjustment account Branch debtors account Branch expenses account
Functional division	Functional division is possible in case of departmental concerns.	It is not possible in case of branch.
Control	The chief executive who is to keep a constant watch over the department supervisor closely and supervises effectively.	Control is impracticable in case of a far off branch since it is not possible for the head office to keep instant watch.
Reconciliation of results	Departmental accounting presents the trading results of each individual department.	Branch accounts present the trading results of each individual branches.
Nature	Departmental accounting is practically a segment of accounts.	Branch accounts are a condensation of accounts.
Expensive	These are comparatively less costly as a small team of accountants can be appointed to maintain the accounts.	Branch accounts are costly to maintain as it involves a big team of accountants to maintain accounts for each branch.

1.5 SYSTEMS OF ACCOUNTING

As we discussed earlier dependent branches do not keep a complete set of books. The head office is responsible to keep the books of accounts for dependent branches. The following are the key methods which are adopted by head office to keep the branch accounts:

1.5.1 Debtors or Direct System:

This system of accounting is used for those branches which are small in size. Under this system, the head office simply opens a Branch Account for each branch in which it records all transactions relating to the branch. Branches are also not required to ascertain profit or loss as no information relating to the cost of sales is given to them.

Journal Entries under Debtors or Direct System:

Situation	Journal
To record Opening Balances of Branch Assets	Branch A/c Dr. To Branch Assets A/c
To record Opening Balances of Branch Liabilities	Branch Liabilities A/c Dr. To Branch A/c
When goods are supplied by the Head Office/ another Branch to Branch	Branch A/c Dr. To Goods sent to Branch A/c
When goods are returned by the Branch / Branch Customers directly to the Head Office	Goods Sent to Branch A/c Dr. To Branch A/c
When goods are supplied by the Branch to another Branch as per instructions of Head office	Goods Sent to Branch A/c Dr. To Branch A/c
When goods are supplied by the Head office but not received by the Branch head	Goods-in Transit A/c Dr. To Branch A/c
When the Head Office meets the branch expenses or sends cash to the Branch for meeting expenses	Branch A/c Dr. To Cash/Bank A/c
When remittances are received by the Head Office from the Branch/ Branch Customers	Cash/Bank A/c Dr. To Branch A/c
When remittances are sent by the Branch but not received by the Head office	Cash in-transit A/c Dr. To Branch A/c

When the balance in Goods sent to Branch Account is transferred	Goods sent to Branch A/c Dr. To Purchases A/c (in case of Trading concerns) or, To Trading A/c (in case of manufacturing concerns)
To record the closing balances of Branch Assets	Branch Assets A/c (Individually) Dr. To Branch A/c
To record the closing balances of Branch Liabilities	Branch A/c Dr. To Branch Liabilities (Individually)
To record Profit & Loss (a) If credit side exceeds the debit side (b) If debit side exceeds the credit side	Branch A/c Dr. To General Profit & Loss A/c General Profit & Loss A/c Dr. To Branch A/c

Performa of Branch Account:

Particulars	Amount	Particulars	Amount
To Opening Balance Stock Debtors Petty Cash Furniture Prepaid expenses To goods sent to branch A/c To Bank A/c (for expenses) To closing balances O. S. expenses Creditors		By opening balances O. S. expenses Creditors By bank A/c Cash sales Collections from debtors By goods sent to branch A/c (for goods returned by branch) By closing balances Stock Debtors	
To profit transferred to profit		Petty Cash	

and loss A/c		Furniture (less depreciation) Prepaid expenses By loss transferred to profit and loss A/c	

Example:

Godrej Ltd. has a branch at Delhi. Branch remits daily cash receipts to the Head Office and all expenses of the branch are paid by the Head Office directly. Pass journal entries and prepare Branch Account in the books of Head Office from the following particulars as on 31st March, 2019.

		`
Stock at Branch on 1st April, 2018		25,000
Goods Supplied to Branch during the year		2,40,000
Goods returned by Branch		14,000
Cash sent to branch for		
Rent		4,500
Salaries	12,000	
Advertisement	3,500	
Cash sent to Branch for petty expenses	1,800	
Cash received from the branch during the year	2,51,000	
Cash sent by branch on 28th March, 2019 still in transit	12,000	
Stock at branch on 31st March, 2019	32,000	
Balance of Petty Cash on 31st March, 2019	500	
Outstanding Rent on 31st March, 2019	1,500	
Outstanding Salaries on 31st March, 2019		3,000

Books of Head Office

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
	Delhi Branch A/c Dr. To Opening Stock at Branch A/c (Opening balance of branch stock)		25,000	25,000

	Delhi Branch A/c Dr. To Good Supplied to Branch A/c (Goods sent to branch)		2,40,000	2,40,000
	Good Supplied to Branch A/c Dr. To Delhi Branch A/c (Goods returned by branch)		14,000	14,000
	Delhi Branch A/c Dr. To Cash A/c (Amount sent to branch for expenses)		20,000	20,000
	Delhi Branch A/c Dr. To Cash A/c (Amount sent to branch for petty expenses)		1,800	1,800
	Cash A/c Dr. To Delhi Branch A/c (Cash received from branch)		2,51,000	2,51,000
	Cash in Transit A/c Dr. To Delhi Branch A/c (Cash sent by branch still in transit)		12,000	12,000
	Closing Stock A/c Dr. Petty Cash A/c Dr. To Delhi Branch A/c (Closing balances at branch)		32,000 5,00	32,500
	Delhi Branch A/c Dr. To Outstanding Rent A/c To Outstanding Salary A/c (Rent and salary outstanding at branch)		4,500	1,500 3,000`
	Delhi Branch A/c Dr. To General Profit & Loss A/c Profit transferred to General Profit & Loss A/c		18,200	18,200
	Goods Supplied to Branch A/c Dr. To Trading A/c (Balance of Goods supplied to branch transferred to Trading A/c)		2,26,000	2,26,000

Dr. **Delhi Branch Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Opening Stock A/c	25,000	By Goods Supplied to Branch A/c (Goods returned by branch)	14,000
To Goods Supplied to Branch A/c	2,40,000	By Cash A/c	2,51,000
To Cash A/c (Expenses)	20,000	By Cash in Transit A/c	12,000
To Cash A/c (Petty Cash)	1,800	By Closing Stock A/c	32,000
To Outstanding Rent A/c	1,500	By Petty Cash A/c	500
To Outstanding Salary A/c	3,000		
To General Profit & Loss A/c	18,200		
	3,09,500		3,09,500

Example: Vinod Limited has a branch at Goa. Goods are invoiced to Branch at cost plus 25%. The expenses of the Branch are paid by Head Office. Branch keeps a Sales Journal and the debtor's ledger only. From the information supplied by the Branch, prepare Trading and Profit & Loss Account of the Branch for the year ending 31st December, 2019 and show the account of the Branch as it would appear in the books of the Head Office.

	₹
Opening Stock at Cost Price	1,18,000
Closing Stock at Invoice Price	1,03,000
Credit Sales	2,35,000
Cash Sales	96,000
Receipts from Debtors	2,56,000
Debtors on 31st December, 2019	58,000
Goods received from Head Office	2,26,000
Goods in transit from Head Office on 31st December, 2019	22,000
Expenses paid by Head Office for the Branch	49,000

Solution:

Trading and Profit & Loss Account

For the year ending 31st December, 2019

Particulars	**Amount**	**Particulars**	**Amount**
	`		`
To Opening Stock	1,18,000	By Sales: `	
To Goods Supplied from `		Cash Sales 96,000	
H.O, 2,26,000		Credit Sales 2,35,000	3,31,000
Add: Goods in Transit 22,000		By Goods in Transit 22,000	
2,48,000		Less: 25/125 of ` 22,000 4,400	17,600
Less: 25/125 of ` 2,48,000 49,600	1,98,400	By Closing Stock 1,03,000	
To Gross Profit c/d	1,14,600	Less: 25/125 of 1,03,000 20,600	82,400
	4,31,000		4,31,000
To Expenses	49,000	By Gross Profit b/d	1,14,600
To Net Profit transferred to General Profit & Loss A/c	65,600		
	1,14,600		1,14,600

Dr. **Goa Branch Account** **Cr.**

Particulars		**Amount**	**Particulars**		**Amount**
To Balance b/d:	`	`			`
			By Goods sent to Branch A/c		
Stock	1,18,000				
Debtors	79,000		(25/125 of ` 2,48,000)		49,600
		1,97,000	By Cash A/c:		
To Goods sent to Branch A/c:				`	
Goods received by					
			Cash Sales	96,000	
Branch	2,26,000				3,52,000
Add: Goods in transit	22,000		From Debtors	2,56,000	
			By Balance c/d:		
To Cash A/c (Expenses)		2,48,000			
			Stock	1,03,000	
To Stock Reserve A/c:		49,000			
			Debtors	58,000	
25/125 of `1,03,000	20,600				1,83,000
			Goods in Transit	22,000	
Add: Adjustment for					
Goods in transit					
(25/125 of ` 22,000)	4,400				
		25,000			
To General Profit & Loss A/c		65,600			
		5,84,600			5,84,600

1.5.2 Stock and Debtor System:

When there is large number of transactions, this method is particularly maintained by the Head Office to make efficient control over the branches. Under this method, the number of accounts are opened which are mentioned below:

(a) Branch Stock Account (at invoice price);

(b) Branch Debtors Account;

(c) Branch Adjustment Account (for recording loading for goods and for ascertaining gross profit)

(d) Branch Profit and Loss Account (for ascertaining branch net profit)

(e) Goods Sent to Branch Account.

In addition to above, there are certain accounts which may also be opened; viz (a) Branch Expense Account; (b) Branch Cash Account; (c) Branch Fixed Asset Account (d) Abnormal Loss / Lost-in-Transit Account etc. Under this method, the most important account is the Branch Adjustment Account which helps to ascertain Gross Profit. It takes only the loading on Opening Stock, Closing Stock, and Goods Sent to Branch, Goods Returned by Branch, any abnormal loss, Surplus of stock etc.

Apparent Profit and Apparent Loss

An unusual increase or decrease in the value of stock arises at Branch Stock Account due to inaccurate prediction of the expected selling price of the goods which are invoiced by the H.O. Usually H.O. sent goods after charging certain percentage of profit. But in reality, the said goods are sold either at a higher or at a lower price rather than the price fixed by the H.O. for which Branch Stock Account shows either a surplus of stock which is known here as Apparent Profit or a Shortage of stock which is known as Apparent Loss. The said apparent profit or loss should be recorded as under.

(a) For Apparent Profit

Branch Stock A/c …………………….. Dr.

To Apparent Profit A/c

Apparent Profit A/c ……………………... Dr.

To Branch (Stock) Adjustment A/c

(b) In case of Apparent Loss, the entry will be reversed

Journal Entries under Stock and Debtor System:

No.	Transactions	Journal Entry
1	Goods sent to Branch by HO	Branch Stock Account (total Value of goods) Dr. To Goods sent to Branch (at Cost) To Branch Adjustment A/c (loading, if any)
2	Goods returned by Branch to HO	Goods sent to Branch Account (at Cost) Dr.

		Branch Adjustment A/c (loading, if any) Dr. To Branch Stock A/c (total value of goods)
3	Assets provided by HO to Branch either by way of fresh purchase or by way of transfer from HO	Branch Assets Account Dr. To (Main) Cash Account/Vendor Account [or] To (HO) Assets Account (in case of transfer)
4	Cash sent to Branch for expenses	Branch Cash Account Dr. To (Main) Cash Account
5	Cash Sales at the Branch	Branch Cash Account Dr. To Branch Stock Account
6	Credit Sales at the Branch	Branch Debtors Account Dr. To Branch Stock Account
7	Collection from Branch Debtors	Branch Cash Account Dr. To Branch Debtors Account
8	Sales Returns at the Branch	Branch Stock Account Dr. To Branch Debtors Account
9	Discounts / Bad Debts etc.	Branch Expenses Account Dr. To Branch Debtors Account
10	Various expenses incurred at Branch	Branch Expenses Account Dr. To Branch Cash Account
11	Branch Expenses directly met by HO	Branch Expenses Account Dr. To (Main) Cash Account
12	Remittances made by Branch to Head Office	(Main) Cash Account Dr. To Branch Cash Account
13	Goods Lost in Transit/Stolen etc.	Goods Lost in Transit A/c (at cost) Dr. Branch Adjustment (loading if any) Dr. To Branch Stock Account (total value of goods)
	At the End of the Year : Closing Entries	
14	Recording Closing Stock at Branch Excess of Sale Price over Invoice Price	Closing Stock at Branch Account (incl. Loading) Dr. To Branch Stock Account Branch Stock Account Dr. To Branch Adjustment Account
15	Recording Unrealised Profit on Closing Stock i.e. Stock Reserve (after this entry,	Branch Adjustment Account Dr. To Stock Reserve (closing)

	the Branch Adjustment Account will show Gross Profit)	**Note :** Stock Reserve on Opening Stock is credited to Branch Adjustment A/c.
16	Recording Gross Profit at Branch	Branch Adjustment Account Dr. To Branch P & L Account
17	Depreciation on Branch Assets, (if any)	Branch Expenses Account Dr. To Branch Assets Account
18	Transfer of Branch Expenses	Branch P & L Account Dr. To Branch Expenses Account
19	Recording Net Profit at Branch	Branch P & L Account Dr. To General P & L Account

Example: Alpha Limited Delhi invoices goods to their Branch at Patna at 20% above cost. Head Office pays all branch expenses except petty expenses which are met by the Branch. From the following particulars, prepare necessary accounts under the Stock and Debtors system in the Head Office books:

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Stock at Invoice Price on 1st April, 2016	2,91,000
Branch's Debtors on 1st April, 2016	1,02,000
Petty Cash on 1st April, 2016	9,000
Goods Sent to Branch at Invoice Price	11,40,000
Cash Sales	4,76,000
Credit Sales	7,77,000
Goods returned by Branch	66,000
Allowances to Customers	8,000
Discount Allowed	11,000
Goods returned by Customers	35,000
Bad debts	13,500
Salaries and Wages	83,000
Rent & Rates	22,000

Selling & Advertisement Expenses	41,000
Cash received from Debtors	6,23,000
Stock at Invoice Price on 31st March, 2017	1,41,000
Petty Cash Balance on 31st March, 2017	6,500

Also verify the profit by preparing a Branch Account under direct method.

Dr. **Delhi Branch Account** **Cr.**

Particulars	**Amount**	**Particulars**	**Amount**
	`		`
To Balance b/d (Opening Stock)	2,91,000	By Cash A/c (Cash Sales)	4,76,000
To Goods sent to Branch A/c	11,40,000	By Branch Debtors A/c (Credit Sales)	7,77,000
To Branch Debtors A/c (Sales Return)	35,000	By Goods sent to Branch A/c (Returned by Branch)	66,000
		By Shortage A/c (Balancing figure)	6,000
		By Balance c/d (Closing Stock)	1,41,000
	14,66,000		14,66,000

Dr. **Branch Adjustment Account** **Cr.**

Particulars	**Amount**	**Particulars**	**Amount**
	`		`
To Stock Reserve A/c (20/120 of ` 1,41,000)	23,500	By Stock Reserve A/c (20/120 of ` 2,91,000)	48,500
To Shortage A/c (20/120 of ` 6,000)	1,000	By Goods sent to Branch A/c [20/120 of ` 10,74,000 (11,40,000 – 66,000)] (Return)	1,79,000
To Branch Profit & Loss A/c (Gross Profit transferred)	2,03,000		
	2,27,500		2,27,500

Dr. **Branch Expenses Account** **Cr.**

Particulars	**Amount**	**Particulars**	**Amount**
	`		`
To Petty Expenses		By profit & Loss A/c	

To Allowances to Customers To Discount Allowed To Bad Debts To Salaries & Wages To Rent & Rates To Selling & Advertisement Expenses	2,500 8,000 11,000 13,500 83,000 22,000 41,000		1,81,000
	1,81,000		1,81000

Dr. **Branch Profit & Loss Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Branch Expenses A/c	1,81,000	By Branch Adjustment A/c (Gross Profit)	2,03,000
To Shortage in Stock (` 6,000 – ` 1,000)	5,000		
To Net Profit	17,000		
	2,03,000		2,03,000

Dr. **Branch Debtors Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Balance b/d To Credit Sales	1,02,000 7,77,000	By Allowances A/c By Discount A/c By Sales Return A/c By Bad Debts A/c By Cash A/c (Received from debtors) By Balance c/d (balancing figure)	8,000 11,000 35,000 13,500 6,23,000 1,88,500
	8,79,000		8,79,000

Dr. **Branch Petty Cash Account** **Cr.**

Particulars	Amount	Particulars	Amount

	`		`
To Balance b/d	9,000	By Petty Expenses A/c	
		(Balancing figure)	2,500
		By Balance c/d	6,500
	9,000		9,000

Dr. **Branch Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Balance b/d (1st April, 2016):		By Stock Reserve A/c	
Stock 2,91,000		(20/120 of ` 2,91,000)	48,500
Debtors 1,02,000		By Goods sent to Branch A/c	
Petty Cash 9,000	4,02,000	(Returned by Branch)	66,000
To Goods sent to Branch A/c	11,40,000	By Goods sent to Branch A/c	
To Cash A/c:		[20/120 of `10,74,000	1,79,000
		(11,40, 000 – 66,000)]	
Salaries and Wages 83,000		By Cash A/c: `	
Rent & Rates 22,000		Cash Sales 4,76,000	
Selling & Advertisement		Cash Received	
Expenses 41,000	1,46,000	From Debtors 6,23,000	10,99,000
To Stock Reserve A/c		By Balance c/d (31st March, 2007):	
(201/20 of `1,41,000)	23,500	Stock 1,41,000	
To General Profit & Loss A/c	17,000	Debtors 1,88,500	3,36,000
	17,28,500	Petty Cash 6,500	17,28,500

1.5.3 Final Accounts System:

The profit or loss of a dependent branch can also be worked out by preparing a Memorandum Branch Trading and Profit & Loss Account. This account is prepared on the basis of cost of goods sent to the branch (not the invoice price). Apart from the Branch Trading and Profit & Loss Account, the head office also maintains the Branch Account. But, under this system, the Branch Account is in the nature of a personal account which shows only the mutual transactions between the head office and the branch, the balance of Branch Account, therefore, represents the net assets of the branch. Under this method, the profit or loss of the branch is ascertained by preparing the Branch Trading and Profit and Loss Account in place of Branch Account.

a) At cost price

Branch Trading and Profit & Loss account

Particulars	**Amount**	**Particulars**	**Amount**
To opening stock at branch(at cost)	Xxx	By sales made at branch	Xxx
To goods sent from head office xxx		(net of returns)	
Less: Goods returned to H.o. xxx	Xxx	-cash	Xxx
To Purchase (made directly by branch if any)	Xxx	-credit	Xxx
To direct expense at branch (if any)		By closing stock at branch	Xxx
To Gross Profit c/d	Xxx	(at cost)	
	Xxx		Xxx
To various expenses incurred at branch	Xxx		
(including bad debts if any)		By gross profit b/d	Xxx
To general profit & loss acc.	Xxx		
(net profit transferred)			
	Xxx		
	xxx		xxx

(b) At Invoice Price

If goods are invoiced above cost, the loading (i.e., profit element) on Opening Stock, Goods Sent from Head office (net of returns) and Closing Stock are reversed, to ascertain the true profits.

1.5.4 Wholesale Price System:

Sometimes the manufacturing organizations (head office) sell their products through wholesalers as well as through own branches. In case the head office decides two prices (i) Wholesale price; and (ii) retail price. Goods are supplied to the whole-seller and branches at wholesale price, that is, cost plus profit. The branches are supposed to sell these goods at retail price which is greater than the wholesale price. It means the branches earn more profit than the head office. But the total profit (Retail price-cost) cannot be considered as branch profit. The real profit of the branch shall be the difference between the wholesale price and retail price.

The wholesale price means cost plus profit. Therefore in the books of head office Branch Stock Account shall be maintained at wholesale price. At the end of the accounting period, the problem arises only when the goods received from head office remains unsold at branch, because it includes a part of profit which has been charged by the head office. To calculate the proportion of profit, the value of unsold goods shall be reduced from wholesale price to cost price. For instance, the cost price of a product is `100, the retail price is `160, and the wholesale price is `150. Now, under retail profit basis there will be a profit of `60 (i.e., `160 - `100) earned by the branch. But if it is sold under wholesale basis, the amount of profit will be `50. Usually, it is the usual practice to debit branch with wholesale profit basis to know the usual profit made by a branch. For this purpose, H.O. Trading account will be credited with goods sent to branch at wholesale price. At the same time, closing stock at branch should be valued as per wholesale price basis. For this, H.O. should make proper reserve on closing stock at branch. The journal entry will be

Profit & Loss A/c ……………… Dr. (Wholesale price - Cost price.)

To Stock Reserve A/c

Example: A head office fixes selling price for its goods at 200% of the cost. Goods are sent to the branch at 25% less than the selling price and to other dealers at 20% less than the selling price. Calculate the profit at the head office and at branch separately from the following information:

	`	`

Opening Stock	36,000	7,200
Purchases	2,40,000	–
Goods sent to Branch	67,500	–
Goods sent to Other Dealers	72,000	–
Sales to Customers	1,80,000	92,000
Expenses	40,000	4,000

Solution:

Cost Price, Say = ` 100

Selling Price = ` 200

Branch Price = ` 150 (200 – 200 x 25%)

Dealer's Price = ` 160 (200 – 200 x 20%)

Trading & Profit & Less Account

For the year ended ……..

Particulars	H.O.	Branch	Particulars	H.O.	Branch
	`	`		`	`
To Opening Stock	36,000	7,200	By Goods sent to Branch	67,500	–
To Purchases	2,40,000	–	By Goods Sent to other dealers	72,000	–
To Goods received from H.O.		67,500	By Sales	1,80,000	92,000
To Gross Profit c/d	1,39,500	23,000	By Closing Stock (Bal. figure)	96,000	5,700
	4,15,500	97,700		4,15,500	97,700
To Expenses	40,000	4,000	By Gross Profit b/d	1,39,500	23,000
To Stock Reserve	1,900	–	By Stock Reserve	2,400	
To Net Profit	1,00,000	19,000			
	1,41,900	23,000		1,41,900	23,000

Working Notes:

1. Calculation of Gross Profit:

	`	
H.O. Gross Profit on goods sent to Branch ` 67500 × $\frac{50}{150}$ =	22,500	
Gross Profit on goods sent to Other Dealers ` 72,000 × $\frac{60}{160}$ =	27,000	
Gross Profit on goods sold to Customers ` 1,80,000 × $\frac{100}{200}$ =	90,000	
Total Gross Profit		1,39,500

2. Branch : Gross Profit on goods sold by branch = ` 92,000 × $\frac{50}{200}$ = ` 23,000

3. Unrealised Profit against opening branch stock = ` 7,200 × $\frac{50}{150}$ = ` 2,400

4. Unrealised Profit against closing branch stock = ` 5,700 × $\frac{50}{150}$ = ` 1,900

1.6 INDEPENDENT BRANCH ES

When there are voluminous transactions in a Branch, they prepare the accounts independently. They purchase and sell goods independently and also sell the goods which are sent by H.O. As the branches are owned by H.O., the profit or loss so made by the branch is enjoyed by H.O. These branches prepare a Trial Balance, Trading and Profit and Loss Account and a Balance Sheet at the end of the year. As such, they maintain a Head Office Account and on contrary H.O. maintain a Branch Account. All sorts of transactions, e.g., remittance of cash, transfer of goods etc. are to be passed through these accounts.

Needless to say that where H.O. receives the accounts from the branches, it incorporates profit of the branches as –

Branch A/c……………………….. Dr.

To Profit & Loss A/c

Sometimes, the balance of branch account in H.O. books and H.O. accounts in branch books do not agree. If that be so, the same must be adjusted accordingly i.e., Goods-in-Transit or Cash-in-Transit etc. At last the Branch Balance Sheet is amalgamated with H.O. Balance Sheet by eliminating inter-branch/H.O. transaction as per the respective heads of assets and liabilities.

INDEPENDENT BRANCHES

Accounting Steps:

S No.	**Transaction**	**HO Books**	**Branch Books**
1.	Goods sent by H.O. to Branch	Branch A/c Dr. To Goods Sent to Branch A/c	Goods Recd. from H.O. A/c. Dr. To H.O. A/c
2.	Goods returned by Branch to H.O.	Goods Sent to Branch A/c Dr. To Branch A/c	HO A/c. Dr. To Goods Recd. From H. O. A/c
3.	Branch Expenses incurred at Branch Office	—	Expenses A/c Dr. To Cash / Bank A/c
4.	Branch expenses paid for by the Head Office	Branch A/c Dr. To Cash/Bank A/c	Expenses A/c. Dr. To H.O. A/c
5.	Purchases made from parties other than H.O. by Branch	—	Purchases A/c Dr. To Bank/ Creditors A/c
6 .	Sales effected by the Branch		Cash/Debtors A/c Dr. To Sales A/c
7.	Collection from Debtors received directly by the H.O.	Cash/Bank A/c Dr. To Branch A/c	H.O. A/c Dr. To Sundry Debtors A/c
8.	Payment by H.O. for Purchase made by the Branch	Branch A/c Dr. To Bank A/c	Purchases/Creditors A/c Dr. To H.O. A/c
9.	Purchase of Asset by Branch	—	Sundry Assets A/c Dr. To Bank/Liability
10.	Asset account maintained at H.O. and asset purchased by Branch	Branch Asset A/c Dr. To Branch A/c	H.O. A/c Dr. To Bank/Creditors A/c
11.	Depreciation when asset account is maintained by H.O.	Branch A/c Dr To Branch Asset A/c	Depreciation A/c Dr. To H.O. A/c
12.	Remittance of Funds by H.O. to Branch	Branch A/c Dr. To Bank A/c	Bank A/c Dr. To H.O. A/c
13.	Remittance of Funds to H.O. by Branch	Bank A/c Dr. To Branch A/c	Ho A/c Dr. To Bank A/c
14.	Transfer of Goods between different branches	Recipient Branch A/c Dr. To Supplying Branch A/c	(i) Supplying Branch A/c Dr. To Goods recd. from H.O. A/c (ii) Goods recd. from H.O. A/c Dr. To H.O. A/c

15.	Charging the Branch service charges by H.O.	Branch (Expenses) A/c Dr. To Service Charges A/c	Expense A/c Dr. To H.O. A/c
16.	Cash-in-transit	Cash-in-transit A/c. Dr. To Branch A/c.	Cash-in-transit A/c. Dr. To H.O. A/c.
17.	Goods-in-transit	Goods-in-transit A/c. Dr. To Branch A/c.	Goods-in-transit A/c. Dr. To H.O. A/c.

1.7 FOREIGN BRANCH

Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate. Since the accounts are maintained in Foreign Currency they have to be translated into Reporting Currency i.e. the currency in which the Head Office transacts. Exchange rate of Reporting Currency in not stable in relation to foreign currencies due to international demand and supply effects on various currencies. Therefore, different rates are assigned to different transactions and balances upon translation**.**

Profit / Loss on Translation: Profit or Loss arising out of change in Exchange rate should be Credited/ Debited to the Profit and Loss Account for the current period.

Entries:

(a) For loss in Exchange :

Branch Profit & Loss A/c. Dr.

To, Difference in Exchange A/c.

(b) For Profit in Exchange :

Difference in Exchange A/c. Dr.

To, Branch Profit & Loss A/c

1.8 SUMMARY

Every business organization aims to grow in sales volume and profits for which a business organization takes different steps/actions. One of the actions is to open the different branches. The branches are controlled by the head office and branches may locate in the home country or outside the country. A branch means any subordinate subdivision of a business and may be dependent branches, independent branches and foreign branches. Dependent branches do not keep a complete set of books. The head office is responsible to keep the books of accounts for dependent branches. The following are the methods to keep the branch accounts:

1. Debtors or Direct System
2. Stock and Debtor System
3. Final Accounts System
4. Wholesale Price System

1.9 KEYWORDS

Dependent Branches: Branches which do not keep the complete record of accounts. Their complete accounts are maintained by Head Office.

Goods in Transit: The goods sent by the head office which do not reach the branch till closing of accounts.

Inter-Branch Transactions: Transactions which took place between all the branches.

Foreign-Branch: If head office opens a branch in foreign country, then it is called Foreign Branch.

Branch Adjustment Account: A account which is prepared for making the adjustment of Profit Margin included in different items of goods.

1.10 SELF ASSESSMENT QUESTIONS

Q1**)** What do you mean by Branch? Why there is need of Branches? Discuss the types of Branches?

Q2) Explain the objectives of maintaining the accounts of branches in detail.

Q3) Elaborate the different methods of keeping the accounts of dependent branches by the head office.

Q4) What do you mean by foreign branch? Explain the rules for the conversion of foreign branch currency to home currency?

Q5) What journal entries are made in the books of head office under Stock and Debtors System?

1.11 SUGGESTED/FURTHER READINGS

1. S.N. Maheshwari: Advanced Accountancy, Vikas Publishing House Pvt. Ltd.
2. J.R. Monga: Basic Financial Accounting, MKM Publishers Pvt. Ltd.
3. D.K. Goyal: Accountancy, Arya Publications.
4. R.K.Mittal: Financial Accounting, V.K. Publications Ltd.

Course: **Financial Accounting-II**	
Course Code: **BC 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **3**	

PARTNERSHIP ACCOUNTS: DEED, ACCOUNTS, GOODWILL, JOINT LIFE POLICY AND CHANGE IN PROFIT SHARING RATIO

STRUCTURE:

3.0 OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning of Partnership and Characteristics of Partnership.
- To know the meaning and contents of Partnership Deed.
- Know the types of Partnership Accounts.
- Understand the meaning and methods of valuation of Goodwill.
- Understand the types of Joint Life Policy.

3.1 INTRODUCTION

You know as the business expands, one needs more capital and more number of persons to manage the business and share its risks. In such a situation, businessman usually adopts the partnership form of organization in which two or more persons come together to establish business and share its profits. The present chapter discusses some basic aspects of partnership such as meaning and characteristics of partnership, valuation of goodwill, partnership deed, change in profit sharing ratio, and Joint Life Policy etc.

3.2 MEANING OF PARTNERSHIP

A partnership is like a proprietorship in many ways except that it has two or more co-owners. The partners share the profits and losses according to a sharing pattern already agreed. Section 4 of the Indian Partnership Act 1932 defines partnership as the 'relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'. Persons who have entered into partnership with one another are individually called 'partners' and collectively called 'firm'. The name under which the business is carried is called the 'firm's name'. A partnership firm has no separate legal entity, apart from the partners constituting it.

3.3 CHARACTERISTICS OF PARTNERSHIP

The following are the key characteristics of a partnership firm:

1. **Two or More Persons:** A partnership firm should have at least two persons and their objective should be the same. The Partnership Act does not put any restrictions on maximum number of partners. However, Companies Act prohibits partnership consisting of more than 20 members. If a firm is engaged in the banking business, it can have a maximum of 10 partners while in case of any other business, the maximum number of partners can be 20.
2. **Agreement:** Partnership is the result of an agreement between two or more persons to do business and share its profits/losses. It is not necessary that such agreement is in written form.
3. **Business**: The partnership agreement should be for some business purpose. For example, if Sachin and Sunder jointly purchase a plot of land, they become the joint owners of the property and not the partners. But if they are in the business of purchase and sale of land for the purpose of making profit, they will be called partners.

4. **Mutual Agency**: Mutual agency is the legal ability of each partner, acting as an agent of the business, to enter into and bind it to contracts within the scope of the partnership. However, the firm would not be bound if any partner makes any transaction outside the purpose of an accounting business.
5. **Sharing of Profits:** The partners must come together to share profits and losses of the business. Thus, sharing of profits and losses is important. If some persons join hands for the purpose of some charitable activity, it will not be termed as partnership.
6. **Liability of Partnership**: Each partner is liable jointly with all the other partners and also severally to the third party for all the acts of the firm done while he is a partner. Not only that the liability of a partner for acts of the firm is also unlimited. This implies that his private assets can also be used for paying off the firm's debts.

3.4 PARTNERSHIP DEED

Partnership comes into existence as a result of agreement among the partners. The agreement can be either oral or written. The Partnership Act does not require that the agreement must be in written. But wherever it is in written, the agreement is called 'Partnership Deed'. It generally contains the details about the objective of business, capital of each partner, ratio in which the profits and the losses will be shared by the partners and entitlement of partners to interest on capital, interest on loan, etc. The partnership Deed usually includes the following:

(i) Name and address of the firm.

(ii) Names and addresses of all partners.

(iii) Date of commencement of partnership.

(iv) Capital to be contributed by each partner.

(v) Whether interest is to be allowed on capitals.

(vi) Whether any partner is to be allowed salary.

(vii) The profit-sharing ratio.

(viii) The duties of each partner.

(ix) Mode of settlement of accounts in case of retirement/death of a partner.

(x) Interest on Capital.

(xi) Interest on Drawings.

(xii) Remuneration of Partners

(xiii) Valuation of Goodwill.

Normally, the partnership deed covers all matters affecting relationship of partners among themselves. However, if there is no written (Partnership Deed) agreement, the provisions of the Indian Partnership Act, 1932 shall apply.

Provisions Applicable in the Absence of Partnership Agreement/Partnership Deed:

- Interest is not allowed on Partners' Capitals or charged on Drawings.
- Partner is not entitled to salary or remuneration for the work done for the firm.
- Interest @ 6% p.a. is allowed on the loans advanced by any partner.
- Profit or loss is distributed equally among the partners.

3.5 PARTNERSHIP ACCOUNTING

Accounting treatment for partnership firm is similar to that of a sole proprietorship business with the exception of the following aspects:

• Maintenance of Partners' Capital Accounts;

• Distribution of Profit and Loss among the partners;

• Adjustments for Wrong Appropriation of Profits in the Past;

• Reconstitution of the Partnership Firm; and

• Dissolution of Partnership Firm.

The first three aspects mentioned above have been taken up in the following sections of this chapter. The remaining aspects have been covered in the subsequent lessons.

- **Maintenance of Partners' Capital Accounts:**

  The Partners' Capital Accounts may be maintained according to Fixed Capital Method or Fluctuating Capital Method**.**

  Fixed Capital Method: Under this method, the capital of partners *remains unchanged* except in special circumstances. In case of the fixed capital, *two* accounts are maintained for each partner, *viz.*, (*i*) Fixed Capital Account and (*ii*) Current Account. All adjustments regarding drawings, interest on drawings, salary, and interest on capital, commission and share of profit or loss are recorded in *Current Account*.

  Fluctuating Capital Method: Under the fluctuating capital method, only one account, i.e. capital account is maintained for each partner. All the adjustments such as share of profit and loss, interest on capital, drawings, interest on drawings, salary or commission to partners, etc are recorded directly in the capital accounts of the partners. This makes the balance in the capital account to fluctuate from time to time. That's the reason why this method is called fluctuating capital method.

- **Distribution of Profit and Loss among the Partners:**

  The profits and losses of the firm are distributed among the partners in an agreed ratio. However, if the partnership deed is silent, the firm's profits and losses are to be shared equally by all the partners. In case of partnership, however, certain adjustments such as interest on drawings, interest on capital, salary to partners, and commission to partners are required to be made. For this purpose, it is customary to prepare a Profit and Loss Appropriation Account of the firm and ascertain the final figure of profit and loss to be distributed among the partners, in their profit sharing ratio.

- ***Profit and Loss Appropriation Account*:**

Profit and Loss Appropriation Account is merely an extension of the Profit and Loss Account of the firm. It shows how the profits are appropriated or distributed among the partners. The journal entries for preparation of Profit and Loss Appropriation Account and making various adjustments through it are given as follows:

Journal Entries:

1. Transfer of the balance of Profit and Loss Account to Profit and Loss Appropriation Account:

(a) If Profit and Loss Account shows a credit balance (net profit):

Profit and Loss A/c   Dr.

To Profit and Loss Appropriation A/c

(b) If Profit and Loss Account shows a debit balance (net loss)

Profit and Loss Appropriation A/c   Dr.

To Profit and Loss A/c

2. Interest on Capital:

(a) For crediting interest on capital to partners' capital account:

Interest on Capital A/c   Dr.

To Partner's Capital/Current A/c

(b) For transferring interest on capital to Profit and Loss Appropriation Account:

Profit and Loss Appropriation A/c Dr.

To Interest on Capital A/c

- Interest on Drawings:

(a) For charging interest on drawings to partners' capital accounts:

Partners Capital/Current A/c's (individually) Dr.

To Interest on Drawings A/c

(b) For transferring interest on drawings to Profit and Loss Appropriation Account:

Interest on Drawings A/c Dr.

To Profit and Loss Appropriation A/c

4. Partner's Salary:

(a) For crediting partner's salary to partner's capital account:

Salary to Partner A/c Dr.

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

(b) For transferring partner's salary to Profit and Loss Appropriation Account:

Profit and Loss Appropriation A/c Dr.

To Salary to Partner's A/c

5. Partner's Commission:

(a) For crediting commission to a partner, to partners' capital account:

Commission to Partner A/c Dr.

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

(b) For transferring commission paid to partners to Profit and Loss Appropriation Account.

Profit and Loss Appropriation A/c Dr.

To Commission to Partners Capital/Current A/c

6. Share of Profit or Loss after appropriations:

If Profit:

Profit and Loss Appropriation A/c Dr.

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

If Loss:

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

To Profit and Loss Appropriation A/c

The Performa of Profit and Loss Appropriation Account is given as follows:

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
Profit & Loss (if there is a loss) Interest on capital Salary to partner Commission to partner Interest on partner's loan Partner's capital a/c (Distribution of profits)		Profit & Loss (if there is a profit) Interest on drawings Partner's capital (Distribution of Loss)	

- **Calculation of Interest on Capital:**

Interest on drawings can be calculated by the following methods:

1. ***Direct Method:*** Under direct method simple interest is to be calculated by taking the principal amount, period and rate of interest.
2. ***Product Method:*** Under this method the amount of interest is calculated by converting the principal amount into monthly products depending upon number of months for which principal amount remained in business. Then the interest is calculated by taking monthly rate of interest.

- **Calculation of Interest on Drawings:**

  The following are the methods of calculating interest on drawings:

  1. Simple Average method

2. Product method

Simple Average Method:

A fixed amount may be withdrawn every month/half yearly/annually. The interest has to be calculated for the period for which the amount has been utilized for personal purposes by the partners. The following example explains the computation of interest on drawings by using simple average method.

Product method:

Under this method the amount of interest is calculated by converting the principal amount into monthly products depending upon number of months for which principal amount remained in business. Then the interest is calculated by taking monthly rate of interest**.**

Guarantee of Profit to a Partner:

Sometimes a partner is admitted into the firm with a guarantee of certain minimum amount by way of his share of profits of the firm. Such assurance may be given by all the old partners in a certain ratio or by any of the old partners, individually to the new partner. The minimum guaranteed amount shall be paid to such new partner when his share of profit as per the profit-sharing ratio is less than the guaranteed amount.

Adjustments for Wrong Appropriation of Profits in the Past:

Sometimes a few omissions or errors in the recording of transactions or the preparation of summary statements are found after the final accounts have been prepared and the profits distributed among the partners. The omission may be in respect of interest on capitals, interest on drawings, interest on partners' loan, partner's salary, partner's commission or outstanding expenses. There may also be some changes in the provisions of partnership deed or system of accounting having impact with retrospective effect. All these acts of omission and commission need adjustments for correction of their impact**.**

The following procedure may be helpful in recording necessary adjustments:

1. If, interest on capital is one of the items of omissions, then first verify the partners' capital at the beginning. This can be done by deducting partners' share of current year's profit from their capitals at the end and adding their drawings thereto.

2. Work out the amounts of omitted items that are to be credited to partners' capital accounts such as interest on capital, salaries to partners, etc. The following journal entry for the adjustment is recorded:

Profit and Loss Adjustment A/c Dr.

To Partners' Capital A/c (individually)

3. Work out the amounts of omitted items which are to be debited to the Partners' Capital Accounts such as interest on drawings. The following adjustment entry recorded:

Partners' Capital (individually) A/c Dr.

To Profit and Loss Adjustment A/c

4. Work out the balance of the Profit and Loss Adjustment Account. The credit balance of the Profit and Loss Adjustment Account reflects to the profit and the debit balance and the loss. This is to be distributed among the partners.

5. The balance of the Profit and Loss Adjustment Account as worked out in point 4 above be transferred to the partners' capital accounts in their profit sharing ratio. Thus, the Profit and Loss Adjustment Account will stand closed. It will involve the following journal entry:

If it is a credit balance (profit)

Profit and Loss Adjustment A/c Dr.

To Partners' Capital (individually) A/c

If it is a debit balance (loss)

Partners' Capital (individually) A/c Dr.

To Profit and Loss Adjustment A/c

The adjustment can also be made directly in the Partners' Capital Accounts without preparing a Profit and Loss Adjustment Account. In such a situation, we shall prepare a statement to find out the net effect of omissions and commissions and then to debit the capital account of the partner who had been credited in excess and credit the capital account of the partner who had been debited in excess.

3.6 VALUATION OF GOODWILL

Goodwill

Goodwill is the value of benefit or advantage that a business has because of the factors that help in increasing its profitability. It may be because of its location, favorable contracts, access to supplies and customer loyalty, etc.

Purchased Goodwill

Purchased Goodwill means the goodwill for which a consideration has been paid.

Self-Generated Goodwill

Self-generated Goodwill is the goodwill that has been generated by the business because of which it is able to earn higher profits.

Methods of Calculating Goodwill

The following are the key methods of calculating goodwill:

1. Average Profit Method
2. Super Profit Method
3. Capitalization Method

1. Average Profit Method

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

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

Weighted Average Profit Method

It is calculated by multiplying the profit for each year with the weight assigned to it. The amounts so arrived at are totaled and divided by the total of weights. The weighted average profit is multiplied by the number of years of purchase.

Goodwill = Weighted Average Profit × No. of Years' Purchase

Example: Calculate the amount of goodwill on the basis of two year's purchase of average profit of last 5 years. The profit and losses for the last five years are as under:

`

1st Year		20,000
2nd Year		16,000
3rd Year		28,000
4th Year	(Loss)	12,000
5th Year		42,000

Solution:

Total Profits of last 5 years:

` 20,000 + ` 16,000 + ` 28,000 – ` 12,000 + ` 42,000 = ` 94,000.

Average Profit = $\frac{\text{Total Profit}}{\text{No.of Years}}$ = ` $\frac{94{,}000}{5}$ = ` 18,800

Goodwill = Average Profit ` No. of Years of Purchase = 18,800 ` 2 = ` 37,600.

Gopal purchased Ravi's business from 1st January, 2018. The Profits disclosed by Ravi's business for the last four years were as follows:

2015 – ` 74,000

2016 – ` 66,000 (After charging an Abnormal loss ` 12,000)

2017 – ` 1,28,000 (Including an Abnormal gain of ` 10,000)

2018 – ` 88,000 (Excluding ` 8,000 as insurance premium of firm's property which is done in this year.)

Calculate the value of firm's goodwill on the basis of 2 years purchase of the average profit for the last four years.

Solution:

1. Calculation of Total Profits of last four years:

	`	`
Profit for 2015	--------	74,000
Profit for 2016	66,000	
Add: Abnormal Loss	12,000	78,000
Profit for 2017	1,28,000	
Less: Abnormal gain	10,000	1,18,000
Profit for 2018	88,000	
Less: Insurance Premium	8,000	80,000
Total Profits		3,50,000

2. Calculation of Average Profit = $\frac{\text{Total Profit}}{\text{No.of Years}}$ = ` $\frac{3{,}50{,}000}{4}$ = ` 87,500

3. Value of Goodwill = Average Profit ` No. of Years of Purchase = 87,500 × 2 = ` 1,75,000.

2. **Super Profit Method**

The goodwill under the super profits method is ascertained by multiplying the super profits by certain number of years' purchase. The steps involved under the method are:

1. Calculate the average profit,

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

Return.

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

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

Normal profit = $$\frac{\textbf{Capital employed X Normal rate of return}}{\textbf{100}}$$

Super Profit = Actual Profit – Normal Profit

Goodwill = Super Profit × No. of Years' Purchase

Example: The profits of a firm during last 5 years were as follows: 2004 – ` 45,000; 2005 – ` 55,000; 2006 – ` 80,000; 2007 – ` 60,000; 2008 – ` 90,000.The capital invested in the firm is ` 5,00,000. A reasonable return in such a business is 10%. Find out the value of goodwill on the basis of 3 years purchase of the average super profits of last five years.

Solution:

(a) Total profits of last 5 years:

` 45,000 + ` 55,000 + ` 80,000 + ` 60,000 + ` 90,000 = ` 3,30,000

(b) Average Profit = $\frac{\text{Total Profit}}{\text{No.of Years}}$ = ` $\frac{3,30,000}{5}$ = ` 66,000

(c) Normal Profit = Capital invested × $\frac{\text{Normal Rate of Return}}{100}$

= 5,00,000 × $\frac{10}{100}$ = ` 5 0,000

(d) Super Profit = Average Profit – Normal Profit = ` 66,000 – ` 50,000 = ` 16,000

(e) Value of Goodwill: Super Profit × No. of Years of Purchase = ` 16,000 × 3 = ` 48,000

3. Capitalization Method

Under this method the goodwill can be calculated in two ways:

(a) By capitalizing the average profits

(b) By capitalizing the super profits

(a) Capitalization of Average profit*:* In this method, the value of goodwill is assumed to be excess of the capital value of average profit over the actual capital employed. The key steps involved in this method are as follows:

1. Computation of average profit

Average Profits × 100/Normal Rate of Return

2. Computation of capital employed

Capital Employed = Total Assets (excluding goodwill) – outside liabilities

3. Computation of goodwill

Goodwill = Capitalized value of profits – Capital employed.

(b) Capitalization of Super Profit

Under this method, super profit is capitalized at the normal rate of return.

$$\textbf{Goodwill} = \textbf{Super Profit} \times \frac{\textbf{100}}{\textbf{Normal Rate of Return}}$$

Example: Calculate the value of goodwill according to the capitalization method from the following figures:

(a) Average Profit = ` 65,000

(b) Normal Rate of Return = 13%

(c) Capital Employed = ` 3,70,000

Solution:

1. As per the Capitalisation of Super Profit Method:

Average Profit = ` 65,000

Normal Profit = $\frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100}$

$= \frac{3,70,000 \times 13}{100}$ = ` 48,100

Super Profit = Average Profit – Normal Profit = ` 65,000 – ` 48,000 = ` 16,900

Value of Goodwill = $\frac{\text{Super Profit} \times 100}{\text{Normal Rate of Return}} = \frac{16,900 \times 100}{13}$ = ` 1,30,000

2. As per the Capitalisation of Average Profit Method:

Average Profit = ` 65,000

Capitalised Value of Average Profit: Actual Average Profit × $\frac{100}{Normal\ Rate\ of\ Return}$

$= \frac{65,000 \times 100}{13}$ = ` 5,00,000

Actual Capital Employed = ` 3,70,000

Goodwill = Capitalised Value of Actual Average Profit – Actual Capital Employed = 5,00,000 – 3,70,000 = ` 1,30,000

3.7 JOINT LIFE POLICY

Life Insurance Policy

Life Insurance policy is a policy issued by the life insurance company which is taken by the firm on the lives of partners. The main purpose of taking this policy is to make a provision for the payment of amount due to deceased partner on the death of a partner; otherwise the payment is to be made by selling the assets of the firm. The insurance policies to be taken on the lives of partners are of following two types:

1. Joint Life Insurance Policy: When an insurance policy is taken jointly on the lives of all partners, then it is known as joint life insurance policy. The premium of such a policy is paid by the firm. The insurance company pays the full amount of insurance policy to the firm on the death of a partner. There are following four methods of dealing with the premium paid for joint life insurance policy:

A. Premium is treated as Business Expense: Under this method, the premium paid is treated as business expense and is debited to profit and loss account. On the death of a partner, the joint life policy account is credited with amount to be received from insurance company which is to be written off by transferring to the capital account of partners in their profit sharing ratio including the deceased partner. The following entries are passed under this method:

1. For making the payment of Premium:

Joint Life Policy Premium A/c Dr.

To Bank A/c

(Payment of Premium)

2. For transferring the premium of Profit and Loss Account:

Profit and Loss A/c Dr.

To Joint Life Policy Premium A/c

(Premium transferred to Profit & Loss A/c)

Above entries will be passed every year upto the date of maturity. In case of death of a partner or on the maturity of the policy, the following entries will be passed:

3. For amount of insurance claim due:

Insurance co's. A/c Dr.

To Joint Life Policy A/c

(Insurance claim due on death or maturity)

4. For receiving the amount of insurance claim:

Bank A/c Dr.

To Insurance Co's. A/c

(Amount of claim received)

5. For distributing the amount among partners:

Joint Life Policy A/c Dr.

To All Partners' Capita[A/cs

(Amount of joint life policy transferred to partners'capital a/cs in their profit sharing ratio)

But the above method has the drawback and it does not disclose the true net profit or loss of the firm because on one side the premium paid is treated as business expense and is debited to profit and loss account and the other side the amount of joint life policy is not shown in the balance sheet whereas it is actually an asset of the firm.

B. Premium is treated as an Asset: Under this method, the premium paid is treated as an asset. The joint life policy account is shown as an asset in the balance sheet. The following entries are passed under this method:

1. For making the payment of premium:

Joint Life Policy A/c Dr.

To Bank A/c

(Payment of premium)

Above entry will be passed every year up to the date of maturity. In case of death of a partner or on the maturity of the policy, the following entries will be passed:

2. For amount of insurance claim due:

Insurance Co.'s A/c Dr.

To Joint Life Policy A/c

(Amount of claim due on death or maturity)

3. For receiving the amount of insurance claim:

Bank A/c Dr.

To Insurance Co.'s A/c

(Amount of claim received)

4. For transferring the balance of Joint Life Policy Account:

Joint Life Policy A/c Dr.

To All Partners' Capital A/cs

(Balance of joint life policy a/c transferred to Partners' Capital A/cs)

The drawback of this method is that the joint life policy account is shown at a higher value than its surrender value in the balance sheet. Therefore, the balance sheet as well as profit and loss account does not disclose true position of the business.

C. Surrender Value of Policy is treated as an Asset: Under this method, the surrender value of policy is treated as an asset. The joint life policy account is debited and bank account is credited with the amount of premium paid. At the end of the year, the amount of premium in excess of surrender value is treated as a loss and is credited to joint life policy amount and is debited to profit and loss account as it reduces the balance in joint life policy account. The credit balance of joint life policy account depicts the profit which is transferred to the capital account of partners in their profit sharing ratio. The advantage of this method is that the surrender value is shown in the balance sheet. But the drawback of this method is that the premium paid is not shown in the profit and loss account at its full value. The following entries are passed under this method:

1. For making the payment of premium:

Joint life Policy A/c Dr.

To Bank A/c

(Payment of premium)

2. For the Joint Life Policy Account brought down to its surrender value:

Profit and Loss A/c Dr.

To Joint Life Policy A/c

(Joint life policy a/c brought down to its surrender value)

Above two entries will be passed every year up to the date of maturity. In case of death of a partner or on the maturity of the policy the following entries will be passed:

3. For amount of insurance claim due:

Insurance Co.'s A/c Dr.

To Joint Life Policy A/c

(Insurance claim due on death or maturity)

4. For receiving the amount of insurance claim:

Bank A/c Dr.

To Insurance Co.'s A/c

(Insurance claim received)

5. For transferring the balance of joint life policy account:

Joint Life Policy A/c Dr.

To All Partners' Capital A/cs

(Balance of joint life policy a/c transferred to Partners' Capital A/cs)

D. Premium is treated as an Investment and Preparation of Joint Life Policy Account and Joint Life Policy Reserve Account: Under this method, the premium paid is treated as an investment and the following procedure is adopted for accounting treatment:

1. The premium paid is debited to joint life policy account.
2. An amount equal to premium paid is debited to profit and loss appropriation account and credited to joint life policy reserve account at the end of each year.
3. The joint life policy account and joint life policy reserve account are so adjusted that each account shows a balance equal to surrender value of the policy.

On the death of a partner, the joint life policy account is credited with the amount received from the insurance company. Joint life policy reserve account is closed by transferring its credit balance to joint life policy account and then joint life policy account is also closed by transferring it to the capital accounts of partners in their profit sharing ratio. Under this method, the surrender value of policy is shown in the asset side and joint life policy reserve account in the credit side of balance sheet.

The major advantage of this method is that the surrender value is shown in the balance sheet and the premium paid is fully written in the profit and loss adjustment account. The following entries are passed under this method:

1. **For making the payment of premium:**

   Joint Life Policy A/c Dr.

   To Bank A/c

   (Payment of premium)

2. **For creating the joint life policy reserve account:**

   Profit & Loss Appropriation A/c Dr.

   To Joint Life Policy Reserve A/c

   (Amount equal to premium provided out of divisible profit)

3. **For the joint life policy account brought down to its surrender value:**

   Joint Life Policy Reserve A/c Dr.

   To Joint Life Policy A/c

   (Joint life policy a/c brought down to its surrender value)

   Above entries will be passed every year up to the date of maturity. In case of death of a partner or on the maturity of the policy, the following entries will be passed:

4. **For amount of insurance claim due:**

   Insurance Co.'s A/c Dr.

   To Joint Life Policy A/c

   (Claim due on death or maturity)

5. **For receiving the amount of insurance claim:**

   Bank A/c Dr.

   To Insurance Co's A/c

   (Insurance claim received)

6. **For closing the joint life policy reserve account:**

   Joint Life Policy Reserve A/c Dr.

To Joint Life Policy

(Closing of joint life policy reserve a/c)

7. **For distributing the amount of joint life policy amongst partners:**

Joint Life Policy A/c Dr.

To All Partners' Capital A/c

(Amount of joint life policy distributed amongst partners')

3.8 CHANGES IN PROFIT SHARING RATIO

A. At the time of Admission of a Partner:

1. **When only new partner's share is given:** When only new partner's share is given and it is not clear that in what ratio the new partner gets his share from the old partners, then it is presumed that there will be no change in the profit sharing ratio of old partners. Hence, the old partners will share their profit or loss in the same ratio as they were sharing before the admission of new partner.

Example: Deepak and Ravi share profit and loss in the ratio of 3:2. They admitted Rohit as a partner for 1/4th Share. Calculate the new profit sharing ratio of partners.

Solution:

Total Profit of Firm = 1

Rohit' Share = $\frac{1}{4}$

Thus, Remaining Profit = $1 - \frac{1}{4} = \frac{3}{4}$

Hence, Deepak's New Share = $\frac{3}{4} \times \frac{3}{5} = \frac{9}{20}$

Ravi's New Share = $\frac{3}{4} \times \frac{2}{5} = \frac{6}{20}$

Rohit's Share = $\frac{1}{4}$

Hence, New Profit Sharing Ratio will be = $\frac{9}{20} : \frac{6}{20} : \frac{1}{4} = 9 : 6 : 5$

2. **When new partner acquire his share from old partners in a certain ratio:** In this case, the share acquired by the new partner will be deducted from the share of old partner. The remaining share of old partner will be treated as new share of old partners. This can be calculated with the help of the following formula:

New Ratio = Old Ratio – Sacrifice Ratio

Example: X and Y are partners in a firm sharing profit and losses in the ratio of 3:2. A new partner Z is admitted. X surrenders 1/5th of his profit in favour of Z and Y surrenders 2/5th of his share in favour of Z. Calculate the new profit sharing ratio of partners.

Solution:

Sacrifice by X for Z = $\frac{3}{5} \times \frac{1}{5} = \frac{3}{25}$

Sacrifice by Y for Z = $\frac{2}{5} \times \frac{2}{5} = \frac{4}{25}$

Total Share of Z = $\frac{3}{25} + \frac{4}{25} = \frac{7}{25}$

X's New Share = $\frac{3}{5} - \frac{3}{25} = \frac{15}{25} - \frac{3}{25} = \frac{12}{25}$

Y's New Share = $\frac{2}{5} - \frac{4}{25} = \frac{10}{25} - \frac{4}{25} = \frac{6}{25}$

Hence New Profit Sharing Ratio of X, Y and Z will be = $= \frac{12}{25} : \frac{6}{25} : \frac{7}{25}$ = 12 : 6 : 7

3. **When the share of sacrifice by old partners is given:** When the shares of sacrifice by old partners are given in the question, then the new profit sharing ratio is calculated by deducting the share of sacrifice from the old profit sharing ratio of old partners. It can be understood from the following illustration:

Example: 'A' and 'B' are partners sharing profit and loss in the ratio of 4:3. They admitted 'C' for $3/10^{th}$ share in the firm. He acquires $\frac{2}{10}$ share from 'A' and $\frac{1}{10}$ share from 'B'. Calculate the new profit sharing ratio of partners.

Solution:

New Ratio = Old Ratio – Sacrifice Ratio

A's New Share = $\frac{4}{7} - \frac{2}{10} = \frac{40}{70} - \frac{14}{70} = \frac{26}{70}$

B's New Share = $\frac{3}{7} - \frac{1}{10} = \frac{30}{70} - \frac{7}{70} = \frac{23}{70}$

Hence, the new profit Sharing of A, B and C will be: $\frac{26}{70} : \frac{23}{70} : \frac{3}{10}$ = 26 : 23 : 21

B. At the time of Retirement/Death of a Partner:

At the time of retirement of a partner, the new profit sharing, in different circumstances, is calculated by the following methods:

1. **When Profit Sharing ratio of Remaining Partners is not given on the Retirement of Partner:** If the profit sharing ratio of remaining partners is not given in the question on the retirement of a partner, then the ratio left except the retiring partner's share, will be the new profit sharing ratio of remaining partners.

Example: X, Y and Z are partners in a firm sharing profits and losses in the ratio of 3:2:1. Calculate new profit sharing ratio, if:

(a) X retires.

(b) Y retires.

(c) Z retires.

Solution:

In the above situations the new profit sharing ratio will be as follows:

(a) When X retires, the new profit sharing between Y and Z will be 2:1.

(b) When Y retires, the new profit sharing between X and Z will be 3:1.

(c) When Z retires, the new profit sharing between X and Y will be 3:2.

2. **When Remaining Partners receive the share of Retiring Partner in a certain ratio:** If it is given in the question that the remaining partners receive the share of retiring partner in a certain ratio, then the new profit sharing ratio is calculated by adding this share in the old ratio of remaining partners. It has been explained in the following illustration.

Example: A, B and C are partners in a firm sharing profits and losses in the ratio of 2:2:1. A retires and B and C receive his share in the ratio of 3:2. Calculate new profit sharing ratio.

Solution:

A's share will be divided between B and C in the ratio of 3:2.

Therefore, B's Gain = $\frac{3}{5}$ of $\frac{2}{5} = \frac{6}{25}$

C's Gain = $\frac{2}{5}$ of $\frac{2}{5} = \frac{4}{25}$

Hence, B's New Share = $\frac{2}{5} + \frac{6}{25} = \frac{16}{25}$

C's New Share = $\frac{1}{5} + \frac{4}{25} = \frac{9}{25}$

The New profit Sharing Ratio between B and C will be 16:9.

3.9 SUMMARY

Business man's when needs more capital and more manpower to manage the business and share its risks than businessman usually adopts the partnership form of organization in which two or more persons come together to establish business and share its profits. As per Indian Partnership Act 1932 defines partnership as the 'relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'. Persons who have entered into partnership are individually called 'partners' and collectively called 'firm'. The name under which the business is carried is called the 'firm's name'. A partnership firm has no separate legal entity, apart from the partners constituting it. Partnership comes into existence as a result of agreement among the partners. The agreement can be either oral or written. But wherever it is in written, the agreement is called 'Partnership Deed'. It generally contains the details about the objective of business, capital of each partner, ratio in which the profits and the losses will be shared by the partners and entitlement of partners to interest on capital, interest on loan, etc. Goodwill is the value of benefit or advantage that a business has because of the factors that help in increasing its profitability. It may be because of its location, favorable contracts, access to supplies and customer loyalty, etc. The following are the key methods of calculating goodwill:

- Average Profit Method
- Super Profit Method
- Capitalization Method

3.10 KEYWORDS

Partnership: Relationship between persons who agreed to share the profits or losses of a business.

Partnership Deed: An agreement which contains the terms of the agreement between the partners.

Fixed Capital: The capital of partners remains unchanged.

Goodwill: The reputation or advantage that a business has.

Joint Life Policy: An insurance policy taken out by the partnership firm on the joint lives of partners.

3.11 SELF ASSESSMENT QUESTIONS

Q.1 What do you understand by Partnership? Explain the characteristics of Partnership in detail.

Q.2 Define the term Partnership Deed. Discuss the contents of Partnership Deed.

Q.3 Explain the provisions applicable in the absence of Partnership Deed.

Q.4 What do you mean by the term Goodwill? Discuss the method of Valuation of Goodwill.

Q.5. What do you understand by Joint Life Policy? Explain the objectives and accounting treatment of Joint Life Policy.

Q.6. The expected net profits of Sai Limited are ` 1,32,000 per year. Average capital invested in the firm is ` 6,20,000. The rate of return expected from capital in this case of business is 15%. The remuneration of the partners is estimated to be ` 15,000 for the year. Find out the value of goodwill on the basis of three year's purchase of super profits.

3.12 SUGGESTED/FURTHER READINGS

1. S.N. Maheshwari: Advanced Accountancy, Vikas Publishing House Pvt. Ltd.
2. J.R. Monga: Basic Financial Accounting, MKM Publishers Pvt. Ltd.
3. D.K. Goyal: Accountancy, Arya Publications.
4. R.K.Mittal: Financial Accounting, V.K. Publications Ltd.

Course: **Financial Accounting-II**	
Course Code: **BC 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **4**	

PARTNERSHIP ACCOUNTS: ADMISSION OF A PARTNER

STRUCTURE:

4.0 OBJECTIVES

After going through this lesson, you should be able:

- To know the need of admitting of a new partner in the firm.
- To understand the meaning and computation of sacrificing ratio.
- To know the revaluation of assets and liabilities.
- To know the adjustment of undistributed profits/losses, reserves and capital accounts of partners.

4.1 INTRODUCTION

When a business organization requires additional capital or managerial help or both for expansion of the business it may admit a new partner to increase its resources. In case of a sole proprietorship, it is converted into a partnership on the admission of a new person as an owner of the business enterprise. According to the Partnership Act, 1932, no new partner can be introduced into a firm without the consent of all the existing partners. On admission of a new partner, the partnership firm is reconstituted with a new agreement. For example, Amit and Sunil are partners sharing profit in the ratio of 5:3. On April 1, 2019 they admitted Neha as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Neha as partner, the firm stands reconstituted.

4.2 ADJUSTMENTS AT THE TIME OF ADMISSION OF A PARTNER

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

(i) Adjustment in profit sharing ratio.

(ii) Adjustment of Goodwill.

(iii) Adjustment for revaluation of assets and liabilities.

(iv) Distribution of accumulated profits and reserves; and

(v) Adjustment of partners' capitals.

4.2.1 Calculation of a New Profit Sharing Ratio

The new partner acquires his share in profits from the old partners. It means, on the admission of a new partner, the old partners sacrifice a share of their profit in favor of the new partner. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The new partner acquires his/her share of future profits either from one or more existing partners**.** Following cases may arise for the calculation of new profit sharing ratio:

Case 1: Only the new partner's share is given.

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

Case 2: When new partner acquired his/her share of the profit from the existing partner in a particular ratio.

It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Case 3: Existing partners surrender a particular portion of their share in favour of a new partner.

In this case, sacrificed share of the each partner is ascertained by multiplying the existing partner share in the ratio of their sacrifice. The share sacrificed by the existing partners should be deducted from his existing share. Therefore, the new share of the existing partners is determined.

4.2.2 Calculation of Sacrificing Ratio:

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

Sacrificing Ratio = Existing Ratio – New Ratio

4.3 ACCOUNTING TREATMENT OF GOODWILL AT THE TIME OF ADMISSION OF A NEW PARTNER

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

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

From accounting point of view, there may be different situations related to treatment of goodwill which are discussed below:

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

- **When the amount of goodwill is paid privately by the new partner:**

If the goodwill premium is paid privately by the new partner to the old partners outside the business then the same is not recorded in the books of accounts and hence no journal entry is recorded.

- **When the new partner brings his/her share of goodwill in cash:**

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

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

Old Partners Capital A/c Dr.

To Goodwill A/c

(Existing goodwill written off in the old profit sharing ratio)

(ii) For bringing cash for Capital and goodwill

Cash/Bank A/c Dr.

To Premium for Goodwill A/c

To New partner's Capital A/c

(Cash brought in for capital and goodwill)

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

Premium for Goodwill A/c Dr.

To Old Partner’s Capital/current A/c

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

The amount of goodwill is withdrawn by the existing partners:

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

To Cash/Bank A/c

(The amount of goodwill withdrawn by the existing partners)

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

When the new partner does not bring his/her share of goodwill in cash:

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

New Partner’s Capital A/c Dr.

To Existing Partner’s Capital A/c

(New partner’s share in goodwill credited to existing partner’s in sacrificing ratio)

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

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

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

When new partner is not able to bring the full amount of his/her share of goodwill in cash and brings only a part of cash. In this case, the amount of goodwill brought by him is credited to goodwill account. At the time of goodwill transferred to capital account of existing partner's, new partner's capital account is debited with his unpaid share of goodwill besides debiting goodwill account with the amount of goodwill is paid by him.

The journal entries is as

Bank A/c Dr.

To Premium for Goodwill A/c

(Part Amount of goodwill brought by new partner)

Premium for Goodwill A/c Dr.

New Partner's Capital A/c Dr.

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

(Credit given to sacrificing partner by new partner's in full share of goodwill)

4.4 REVALUATION OF ASSETS AND LIABILITIES

At the time of admission of a new partner, it is always desirable to ascertain whether the assets of the firm are shown in books at their current values. In case the assets are overstated or understated, these are revalued. Similarly, a revaluation of the liabilities is also done so that these are brought in the books at their correct values. At times there may be some unrecorded assets with the business, these are also recorded and similarly if there is any unrecorded liability which the firm has to pay, the same is also recorded**.** For this purpose a 'Revaluation Account' is prepared. This account is credited with all increases in the value of assets and decrease in the value of liabilities. It is debited with decrease on account of value of assets and increase in the value of liabilities. The balance of this account shows a profit or loss on revaluation which is transferred to the old partner's capital account in old profit sharing ratio The following journal entries made for this purpose are:

(i) For increase in the value of assets:

Asset A/c Dr.

To Revaluation A/c

(Increase in Value of Assets)

(ii) For decrease in the value of Asset

Revaluation A/c Dr.

To Asset A/c

(Decrease in the value of assets)

(iii) For increase in the value of Liabilities:

Revaluation A/c Dr.

To Liabilities A/c

(Increase in the value of Liabilities)

(iv) For decrease in the value of Liabilities:

Liabilities A/c Dr.

To Revaluation A/c

(Decrease in the value of Liabilities)

(v) For unrecorded Assets

Asset A/c Dr.

To Revaluation A/c

(Unrecorded asset recorded at actual value)

(vi) For unrecorded Liability:

Revaluation A /c Dr.

To Liability A/c [unrecorded]

(Unrecorded Liability recorded at actual value)

(vii) For transfer of gain on revaluation:

Revaluation A/c Dr.

To Existing Partner's Capital/Current A/c

(Profit on revaluation transferred to capital account in existing ratio)

(viii) For transfer of loss on revaluation:

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

To Revaluation A/c

(Loss on revaluation transferred to capital account in existing ratio)

Performa of Revaluation account is given as under:

Revaluation account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
Assets (Decrease in Value) Liabilities (Increase in Value) Liabilities (unrecorded) Profits transferred to Capital A/c (Individually in Existing Ratio)		Assets (Increase in Value) Liabilities (Decrease in Value) Assets (unrecorded) Loss transferred to Capital A/c (Individually in Existing Ratio)	

Example: Hari and Prem are partners in a firm sharing profit and losses in the ratio of 2:1. Their balance sheet as on 31st December, 2016 was as follows:

Liabilities		**Amount**	**Assets**	**Amount**
		`		`
Creditors		61,000	Land and Building	2,50,000
Bank Overdraft		26,000	Plant & Machinery	1,75,000
Provision for Bad & Doubtful Debts		5,000	Stock	1,20,000
Capital Accounts:	`		Debtors	95,000
Hari	4,23,000		Bills Receivable	38,000
Prem	2,05,000	6,28,000	Cash in hand	42,000
		7,20,000		7,20,000

They admitted Sandeep as Partner for $\frac{1}{4}$ th share of profits on the following terms:

1. Sandeep will bring ` 1,75,000 as capital and ` 15,000 as share of goodwill.
2. Land & Building was to be revalued at ` 3,00,000.
3. The value of Plant and Machinery was to be reduced by 12%.
4. Provision for doubtful debts was to be increased to ` 7,400.
5. Prepaid insurance has not been shown in the balance sheet ` 2,200.
6. The amount of goodwill was to be withdrawn by the old partners.

Pass necessary journal entries and prepare Revaluation A/c, Capital A/cs and, Opening Balance Sheet of new firm.

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
			`	`
	Land and Building A/c Dr.		50,000	
	Prepaid Insurance A/c Dr.		2,200	
	To Revaluation A/c			52,200
	(Increase in the value of assets)			
	Revaluation A/c Dr.		23,400	
	To Plant & Machinery A/c			21,000
	To Provision for Bad & Doubtful Debts A/c			2,400
	(Decrease in the value of assets)			
	Revaluation A/c Dr.		28,800	
	To Hari's Capital A/c			19,200
	To Prem's Capital A/c			9,600
	(Profit on revaluation transferred to Old Partner's Capital A/cs in old ratio)			
	Cash A/c Dr.		1,90,000	
	To Sandeep's Capital A/c			1,75,000
	To Premium or Goodwill A/c			15,000
	(Amount of capital and Premium or Goodwill brought in cash by Sandeep)			
	Premium or Goodwill A/c		15,000	

	To Hari's Capital A/c			10,000
	To Prem's Capital A/c			5,000
	(Premium or Goodwill credited to Old Partner's Capital A/cs in t heir sacrificing ratio i.e. 2:1)			
	Hari's Capital A/c Dr.		10,000	
	Prem's Capital A/c Dr.		5,000	
	To Cash A/c			15,000
	(Premium or Goodwill withdrawn by old partners)			

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

Particulars		Amount	Particulars	Amount
		`		`
To Plant & Machinery A/c		21,000	By Land & Building A/c	50,000
To Provision for Bad & Doubtful debts A/c		2,400	By Prepaid Insurance A/c	2,200
To Profit transferred to:	`			
Hari's Capital A/c	19,200			
Prem's Capital A/c	9,600	28,800		
		52,200		52,200

Dr. **Partner's Capital Account** **Cr.**

Particulars	Hari	Prem	Sandeep	Particulars	Hari	Prem	Sandeep
	`	`	`		`	`	`
To Cash A/c	10,000	5,000	–	By Balance b/d	4,23,000	2,05,000	–
To Balance c/d	4,42,200	2,14,600	1,75,000	By Revaluation A/c	19,200	9,600	–
				By Cash A/c	–	–	1,75,000
				By Premium A./c			
				Goodwill A/c	10,000	5,000	–
	4,52,200	2,19,600	1,75,000		4,52,200	2,19,600	1,75,000

Opening Balance Sheet

Liabilities	Amount	Assets	Amount
	`		`
Creditors	61,000	Land & Building	3,00,000
Bank Overdraft	26,000	Plant & Machinery	1,54,000
Provision for Bad & Doubtful Debts	7,400	Stock	1,20,000
Capital Accounts: `		Debtors	95,000

Hari	4,42,200		Bills Receivable	38,000
Prem	2,14,600		Cash in hand	2,17,000
Sandeep	1,75,000	8,31,800	Prepaid Insurance	2,200
		9,26,200		9,26,200

4.5MEMORANDUM OF REVALUATION ACCOUNT

At the time of admission of a partner after revaluation of assets and liabilities, if all the partners do not want to show the revised value of assets and liabilities in their new balance sheet, then under such circumstances the revaluation A/c is reopened, which is known as Memorandum revaluation A/c. In such case, all entries passed through revaluation account are reversed. The memorandum revaluation A/c is closed by transferring the balance to all the partners including new one in new profit sharing ratio.

Performa of Memorandum Revaluation Account

Decrease in Assets		Increase in Assets	
Increase in Liabilities		Decrease in Liabilities	
Unrecorded Liabilities		Unrecorded Assets	
Outstanding Expenses		Accrued Incomes	
Profit : A's Capital A/c		Loss: A's Capital A/c	
B's Capital A/c		B's Capital A/c	
Decrease in Assets		Increase in Assets	
Increase in Liabilities		Decrease in Liabilities	
Unrecorded Liabilities		Unrecorded Assets	
Outstanding Expenses		Accrued Incomes	
Profit : A's Capital A/c		Loss: A's Capital A/c	
B's Capital A/c		B's Capital A/c	
C's Capital A/c		C's Capital A/c	

Example: In the above example, if the partners decided that the revised values of assets and liabilities are not to be recorded in the books then, pass journal entries and prepare Memorandum Revaluation Account and also Balance Sheet.

Solution:

Ist Part

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			`	`
	Land and Building A/c Dr. Prepaid Insurance A/c Dr. To Memorandum Revaluation A/c (Increase in the value of assets)		50,000 2,200	 52,200
	Memorandum Revaluation A/c Dr. To Plant & Machinery A/c To Provision for Bad & Doubtful Debts A/c (Decrease in the value of assets)		23,400	 21,000 2,400
	Memorandum Revaluation A/c Dr. To Hari's Capital A/c To Prem's Capital A/c (Profit on revaluation transferred to Old Partner's Capital A/cs in old ratio)		28,800	 19,200 9,600

2nd Part

Date	Particulars	L.F.	Debit Amount	Credit Amount
			`	`
	Memorandum Revaluation A/c Dr. To Land and Building A/c To Prepaid Insurance A/c (Reversal of first original entry)		52,200	 50,000 2,200
	Plant & Machinery A/c Dr. Provision for Bad & Doubtful Debts A/c Dr. To Memorandum Revaluation A/c (Reversal of second original entry)		21,000 2,400	 23,400
	Hari's Capital A/c Dr.		14,400	

	Prem's Capital A/c Dr.		7,200	
	Sandeep's Capital A/c Dr.		7,200	
	To Memorandum Revaluation A/c			28,800
	(Loss on revaluation transferred to All 'Old' Partner's Capital A/cs in their new ratio i.e. 2:1:1)			

Note: The other entries will remain same as shown in earlier example.

Dr. Memorandum Revaluation Account Cr.

Particulars		Amount	Particulars		Amount
I[st] Part		`			`
To Plant & Machinery A/c		21,000	By Land & Building A/c		50,000
To Provision for Bad & Doubtful debts A/c		2,400	By Prepaid Insurance A/c		2,200
To Profit transferred to:	`				
Hari's Capital A/c	19,200				
Prem's Capital A/c	9,600	28,800			
		52,200			52,200
2[nd] Part					
To Land & Building A/c		50,000	By Plant & Machinery A/c		21,000
To Prepaid Insurance A/c		2,200	By Provision for Bad & Doubtful Debts A/c		2,400
			By Loss transferred to:	`	
			Hari's Capital A/c	14,400	
			Prem's Capital A/c	7,200	
			Sandeep's Capital A/c	7,200	28,800
		52,200			52,200

Dr. Partner's Capital Account Cr.

Particulars	Hari	Prem	Sandeep	Particulars	Hari	Prem	Sandeep
	`	`	`		`	`	`
To Cash A/c	10,000	5,000	–	By Balance b/d	4,23,000	2,05,000	–
To Mem. Rev. A/c	14,400	7,200	7,200	By Mem. Rev. A/c	19,200	9,600	–
To Balance c/d	4,27,800	2,07,400	1,67,800	By Cash A/c	–	–	1,75,000
				By Premium A./c			
				Goodwill A/c	10,000	5,000	–
	4,52,200	2,19,600	1,75,000		4,52,200	2,19,600	1,75,000

Opening Balance Sheet

Liabilities		Amount	Assets	Amount
		`		`
Creditors		61,000	Land & Building	2,50,000
Bank Overdraft		26,000	Plant & Machinery	1,75,000
Provision for Bad & Doubtful Debts		5,000	Stock	1,20,000
Capital Accounts:	`		Debtors	95,000
Hari	4,27,800		Bills Receivable	38,000
Prem	2,07,400		Cash in hand	2,17,000
Sandeep	1,67,800	8,03,000		
		8,95,000		8,95,000

4.6 TREATMENT OF UNDISTRIBUTED PROFIT/LOSSES AND RESERVES

Sometimes a firm may have accumulated profits not yet transferred to capital accounts of the partners. These are usually in the firm of general reserve, reserve fund and/or Profit and Loss Account balance. The new partner is not entitled to have any share in such accumulated profits. These are distributed among the partners by transferring it to their capital accounts in old profit sharing ratio. Similarly, if there are some accumulated losses in the form of a debit balance of profit and loss account appearing in the balance sheet of the firm.

For this purpose the following journal entries are made as:

(i) For distribution of undistributed profit and reserve.

Reserves A/c Dr

Profit & Loss A/c (Profit) Dr.

To Partner's Capital A/c

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

(ii) For distribution of loss

Partner's Capital A/c Dr.

To Profit and Loss A/c [Loss]

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

4.7 ADJUSTMENTS OF PARTNER'S CAPITAL

Sometimes, at the time of admission, the partners agree that their capitals should also be adjusted so as to be proportionate to their profit sharing ratio. In such a situation, if the capital of the new partner is given, the same can be used as a base for calculating the new capitals of the old partners. The capitals thus ascertained should be compared with their old capitals after all adjustments relating to goodwill reserves and revaluation of assets and liabilities, etc. have been made; and then the partner whose capital falls short, will bring in the necessary amount to cover the shortage and the partner who has a surplus, will withdraw the excess amount of capital. The partners can decide to maintain their new capital on the following basis:

On the Basis of new Partner's Capital and his Profit Sharing Ratio

If the capital of the new partner is given, the entire capital of the new firm will be determined on the basis of the new partner's capital and his profit sharing ratio. Therefore the capital of other partners is ascertained by dividing the total capital as per his profit sharing ratio. If the existing capital of the partner after adjustment is in excess of his new capital, the excess amount is withdrawn by partner or transferred to the credit of his current account. If the existing capital of the partner is less than his new capital, the partner brings the short amount or makes transfer to the debit of his current account.

The journal entries are made as under:

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

Existing Partner's Capital A/c Dr.

To Bank A/c or Partner Current A/c

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

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

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

To Existing Partner's Capital A/c

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

X and Y are partners in a firm sharing profits and losses in the ratio of 3:1. Their balance sheet on 31st March, 2018 was as follows:

Liabilities		Amount	Assets	Amount
		`		`
Sundry Creditors		92,000	Cash in hand	12,000
Capital Accounts:	`		Sundry Debtors	62,000
X	2,50,000		Stock	1,00,000
X	1,00,000	3,50,000	Furniture and fixtures	45,000
			Investments	78,000
			Plant & Machinery	1,45,000
		4,42,000		4,42,000

They agreed to admit Z as partner on the following terms:

1. Plant & Machinery is to be depreciated @ 10%.
2. Stock is to be reduced by 5%.
3. Furniture and Fixtures are to be taken at 90% of their value.
4. Provision for doubtful debts is to be made @ 5%.
5. Market value of Investments is ` 85,100.
6. Z will bring ` 24,000 as Premium for Goodwill for 1/5th share of profits of the firm and he is to bring in capital sufficient to make it proportionate to his share in profit after the above adjustments.

Pass Journal Entries, and prepare necessary accounts and opening balance sheet of the new firm.

Solution:

Journal

Date	Particulars		L.F.	Debit Amount	Credit Amount
				`	`
	Revaluation A/c	Dr.		27,100	
	To Plant & Machinery				14,500
	To Stock A/c				5,000
	To Furniture and Fixtures A/c				4,500
	To Provision for Doubtful Debts A/c				3,100
	(Decrease in the value of assets)				
	Investments A/c	Dr.		7,100	
	To Revaluation A/c				7,100

	(Increase in the value of assets)			
	X's Capital A/c Dr. Y's Capital A/c Dr. To Revaluation A/c (Loss on revaluation transferred to Old Partner's Capital A/cs in their old ratio)		15,000 5,000	 20,000
	Cash A/c Dr. To Premium or Goodwill A/c (Amount of goodwill brought in cash by Z)		24,000	 24,000
	Premium or Goodwill A/c Dr. To X's Capital A/c To Y's Capital A/c (Premium or Goodwill credited to Old Partner's Capital A/cs in t heir sacrificing ratio i.e. 3:1) Cash A/c Dr. To Z's Capital A/c (Amount of capital brought in cash by new partner)		24,000 88,500	 18,000 6,000 88,500

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

Particulars	Amount	Particulars		Amount
	`		`	`
To Plant & Machinery A/c	14,500	By Investments A/c		7,100
To Stock A/c	5,000	By Loss transferred to:		
To Furniture and Fixture A/c	4,500	X's Capital A/c	15,000	
To Provision for Doubtful Debts A/c	3,100	Y's Capital A/c	5,000	20,000
	27,100			27,100

Dr. **Partner's Capital Account** **Cr.**

Particulars	X	Y	Z	Particulars	X	Y	Z
	`	`	`		`	`	`
To Revaluation A/c	15,000	5,000	–	By Balance b/d	2,50,000	1,00,000	–
To Balance c/d	2,53,000	1,01,000	–	By Premium or Goodwill A/c	18,000	6,000	–
	2,68,000	1,06,000	–		2,68,000	1,06,000	–
To Balance c/d	2,53,000	1,01,000	88,500	By Balance A/c			

				(after adjustments)	2,53,000	1,01,000	–
				By Cash A/c	–	–	88,500
	2,53,000	1,01,000	88,500		2,53,000	1,01,000	88,500

Opening Balance Sheet

Liabilities		Amount	Assets		Amount
		`			`
Sundry Creditors		92,000	Cash in hand	`	1,24,500
Capital:	`		Sundry Debtors	62,000	
X	2,53,200		Less: Provision for Bad Debits	3,100	58,900
Y	1,01,000		Stock		95,000
Z	88,500	4,42,500	Furniture and Fixtures		40,500
			Investments		85,100
			Plant & Machinery		1,30,500
		5,34,500			5,34,500

On the Basis of the Existing Partner's Capital Account Balances

Sometimes the capital of the new partner is calculated on the basis of existing partners. The partner is required to bring an amount proportionate to his/her share of profit. In such a case, new partner's capital will be calculated on the basis of adjusted capital of the existing partners.

The following is the balance sheet of A, B and C sharing profits and losses in proportion of 6:5:3.

Liabilities		Amount	Assets	Amount
		`		`
Creditors		18,900	Cash	1,890
Bills Payable		6,300	Debtors	26,460
General Reserve		10,500	Stock	29,400
Capital Accounts:	`		Furniture	7,350
A	35,400		Land & Building	45,150
B	29,850		Goodwill	5,250
C	14,550	79,800		
		1,15,500		1,15,500

They agreed to take D into partnership and give him 1/8th share on the following terms:

1. That Furniture will be depreciated by ` 920.
2. An old customer, whose account was written off as bad, has promised to pay ` 2,000 in full settlement of his full debt.
3. That a provision of ` 1,320 be made for outstanding repair bills.
4. That the value of Land and Building having appreciated be brought upto ` 54,910.
5. That D will bring in ` 14,070 as his share of goodwill in cash.
6. That D will bring in ` 14,700 as his capital.
7. That after making the above adjustments, the capital accounts of old partners be adjusted on the basis of the proportion of D's capital to his share in business i.e. actual cash to be paid off or brought in by old partner's as the case may be.

Pass the necessary Journal Entries, and prepare the balance sheet of the new firm.

Solution:

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
			`	`
	General Reserve A/c Dr.		10,500	
	To A's Capital A/c			4,500
	To B's Capital A/c			3,750
	To C's Capital A/c			2,250
	(Transfer of general reserve to Old Partner's Capital A/cs)			
	Revaluation A/c Dr.		2,240	
	To Furniture A/c			920
	To Provision for Repair A/c			1,320
	(Decrease in the value of assets and increase in the value of liabilities)			
	Debtors A/c Dr.		2,000	
	Land & Building A/c Dr.		9,760	
	To Revaluation A/c			11,760
	(Increase in the value of assets)			
	Revaluation A/c Dr.		9,520	
	To A's Capital A/c			4,080

	To B's Capital A/c			3,400
	To C's Capital A/c			2,040
	(Profit on revaluation transferred to Old Partner's Capital A/cs in old ratio i.e. 6:5:3)			
	A's Capital A/c Dr.		2,250	
	B's Capital A/c Dr.		1,875	
	C's Capital A/c Dr.		1,125	
	To Goodwill A/c			5,250
	(Existing goodwill written off from the books)			
	Cash A/c Dr.		28,770	
	To Premium or Goodwill A/c			14,070
	To D's Capital A/c			14,700
	(Amount of goodwill and capital brought in by D)			
	Premium or Goodwill A/c Dr.		14,070	
	To A's Capital A/c			6,030
	To B's Capital A/c			5,025
	To C's Capital A/c			3,015
	(D's share of goodwill transferred to Old Partner's Capital A/cs in sacrificing ratio)			
	Cash A/c Dr.		1,320	
	To C's Capital A/c			1,320
	(Deficit of cash brought in by C)			
	A's Capital A/c Dr.		3,660	
	B's Capital A/c Dr.		3,400	
	To Cash A/c			7,060
	(Excess cash paid to A and B)			

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

Particulars		Amount	Particulars	Amount
		`		`
To Furniture A/c		920	By Debtors A/c	2,000
To Provision for Repairs A/c		1,320	By Land & Building A/c	9,760
To Profit transferred to:	`			
A	4,080			
B	3,400			
C	2,040	9,520		

	11,760		11,760

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	D	Particulars	A	B	C	D
	`	`	`	`		`	`	`	`
To Goodwill A/c	2,250	1,875	1,125	–	By Balance b/d	35,400	29,850	14,550	–
To Balance c/d	47,760	40,150	20,730	14,700	By General Reserve A/c	4,500	3,750	2,250	–
					By Revaluation A/c	4,080	3,400	2,040	–
					By Premium or Goodwill A/c	6,030	5,025	3,015	–
					By Cash A/c	–	–	–	14,700
	50,010	42.025	21,855	14,700		50,010	42,025	21,855	14,700
To Cash c/d	3,660	3,400	–	–	By Balance b/d	47,760	40,150	20,730	14,700
To Balance c/d	44,100	36,750	22,050	14,700	By Cash A/c	–	–	1,320	–
	47,760	40,150	22,050	14,700		47,760	40,150	22,050	14,700

Opening Balance Sheet

Liabilities		Amount	Assets	Amount
		`		`
Creditors		18,900	Cash	24,920
Bills Payable		6,300	Debtors	28,460
Provision for Repairs		1,320	Stock	29,400
Capital Accounts:	`		Furniture	6,430
A	44,100		Land & Building	54,910
B	36,750			
C	22,050			
D	14,700	1,17,600		
		1,44,120		1,44,120

Dr. **Cash Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Balance b/d	1,890	By A's Capital A/c	3,660
To Premium or Goodwill A/c	14,070	By B's Capital A/c	3,400
To D's Capital A/c	14,700	By Balance c/d	24,920
To C's Capital A/c	1,320		
	31,980		31980

4.8 SUMMARY

When a business organization requires additional capital or managerial help or both for expansion of the business it may admit a new partner to increase its resources. In case of a sole proprietorship, it is converted into a partnership on the admission of a new person as an owner of the business enterprise. According to the Partnership Act, 1932, no new partner can be introduced into a firm without the consent of all the existing partners. On the admission of a new partner, the following adjustments become necessary:

(i) Adjustment in profit sharing ratio.

(ii) Adjustment of Goodwill.

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

(iv) Distribution of accumulated profits and reserves; and

(v) Adjustment of partners' capitals.

4.9 KEYWORDS

Sacrificing Ratio: The ratio in which old partners surrender their profits for new partner.

Revaluation Account: An account for the adjustment of valuation of assets and liabilities.

Memorandum Revaluation Account: An account prepared to show the assets and liabilities at their old values even after the revaluation.

Goodwill: The reputation or advantage that a business has.

4.10 SELF ASSESSMENT QUESTIONS

Q.1 Why there is need of admission of a new partner? Discuss the adjustments at the time of admission of a new partner.

Q.2 What is Goodwill? Explain the accounting treatment of goodwill at the time of admission of a partner.

Q.3 What do you understand by Revaluation account? Explain the objectives and Performa of Revaluation account.

Q.4 What is Memorandum of Revaluation Account? How it differs from Revaluation Account.

Q.5. Writes notes on the following:

i) Sacrificing Ratio

ii) Change in Profit sharing Ratio

iii) Undistributed Profits/losses

Q.6. Seeta and Geeta are partners in a firm sharing profits and losses in the ratio of 2:1. On 31st December, 2019 their balance sheet was as follows:

Liabilities	Amount	Assets	Amount
	`		`
Capital Accounts: `		Land & Building	5,00,000
Seeta 7,05,000		Plant & Machinery	3,40,000
Geeta 3,20,000	10,25,000	Investments	65,000
Creditors	49,000	Stock	88,000
Bills Payable	51,000	Debtors	70,000
Provision for Bad & Doubtful Debts	2,500	Bills Receivable	42,000
Taxation Reserve	71,000	Cash in hand	1,07,000
General Reserve	37,500	Advertisement Expenses	24,000
	12,36,000		12,36,000

They admit Anita into partnership on the following terms:

1. Provision on Debtors is to be increased by ` 2,800.
2. Land & Building and Plant & Machinery should be revalued at ` 5,25,000 and ` 3,29,000 respectively.
3. Prepaid Insurance ` 3,100 has not been shown in balance sheet.
4. Market value of Investments in ` 72,000. Seeta has taken over the Investments at this value.
5. New profits sharing ratio of partners will be 3:2:1.
6. Anita will bring ` 1,95,000 as per capital and her share of goodwill.
7. Goodwill is to be valued at twice of the average profit of the last 4 years which were ` 86,000, ` 78,000, ` 62,000 and ` 98,000 respectively.
8. 60% of the amounts of goodwill are withdrawn by old partners.

Give Journal Entries. Prepare Revaluation A/c, Capital A/cs and opening Balance Sheet of the new firm.

4.11 SUGGESTED/FURTHER READINGS

1. S.N. Maheshwari: Advanced Accountancy, Vikas Publishing House Pvt. Ltd.
2. J.R. Monga: Basic Financial Accounting, MKM Publishers Pvt. Ltd.
3. D.K. Goyal: Accountancy, Arya Publications.
4. R.K.Mittal: Financial Accounting, V.K. Publications Ltd.

Course: **Financial Accounting-II**	
Course Code: **BC 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **5**	

PARTNERSHIP ACCOUNTS: RETIREMENT AND DEATH OF A PARTNER

STRUCTURE:

5.0 OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning and calculation of Gaining Ratio.

- To understand the accounting treatment of goodwill, undistributed profits/losses and reserves.
- To know the revaluation of assets and liabilities.
- To know the calculation of amount payable to retiring/ deceased partners.

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5.1 INTRODUCTION

When one or more partners leave the firm and the remaining partners continue the business of the firm, is known as retirement of a partner. An existing partner may decide to retire from the partnership due to some reasons like old age, poor health, strained relations etc. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions. At the time of retirement the retiring partner's claim is settled. There are three ways in which a partner may retire from the firm, viz., (i) he may retire at any time with the consent of all other partners; (ii) where there is an agreement between the partners about retirement, and retirement in accordance with the terms of the agreement; (iii) where the partnership is at will, a partner may retire by giving to his partners a notice of his intention to retire.

5.2 ADJUSTMENTS AT THE TIME OF RETIREMENT AND DEATH OF A PARTNER

5.2.1 Calculation of New Profit Sharing Ratio:

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

Various cases of new ratio are illustrated as follows:

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

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

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

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

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

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

5.2.2 Calculation of Gaining Ratio:

Sacrificing ratio is calculated in the case of admission of a new partner; and the gaining ratio is computed at the time of retirement or death of a partner. The gaining ratio of each remaining partner is calculated by deducting the old share of profit from the new share of profit.

Gaining Ratio = New Ratio – Existing Ratio

This is always that portion of the share of profit of the retiring or deceased partner which has been acquired.

5.2.3 Distinguish between Sacrificing Ratio and Gaining Ratio:

Difference	**Sacrificing Ratio**	**Gaining Ratio**
1. Meaning	It is the ratio in which old partners agree to sacrifice their share of profit in favor of new partner.	It is the ratio in which continuing partner acquires the share of profit from outgoing partner.
2. Calculation	Sacrificing Ratio = Old Ratio – New Ratio	Gaining Ratio = New Ratio – Old Ratio
3. Time	It is calculated at the time of admission of new partner/partners.	It is calculated at the time of retirement/death of old partner/partners.
4. Objective	It is calculated to ascertain the share of profit and loss given up by the existing partners in favor of new partners/partner.	It is calculated to ascertain the share of profit and loss acquired by the remaining partners from the retiring or deceased partner.
5. Effect	It reduces the profit share of the existing partners.	It increases the profit share of the remaining partners.

5.3 ACCOUNTING TREATMENT OF GOODWILL

At the time of retirement or death of a partner the retiring partner is entitled to his share of goodwill because the goodwill has been earned by the firm with the efforts of all the existing partners. The valuation of goodwill will be done as per the agreement among the partners. It is possible that firm will earn abnormal profit in near future because of the existing goodwill of the firm. Therefore, the retiring/deceased partner should be compensated for the same by the continuing partners in their gaining ratio. As per Accounting Standard, goodwill is recorded in the books only when some consideration in money is paid for it. Therefore, goodwill is recorded in the books only when it is purchased and the goodwill account cannot be raised on its own. Therefore, in case of retirement of a partner, the goodwill is adjusted through partner's capital accounts. The retiring partner's capital account is credited with. his/her share of goodwill and remaining partner's capital account is debited in their gaining ratio.

The journal entry is made as under:

Remaining Partners' Capital A/c Dr.

To Retiring Partner's Capital A/c

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

When the Goodwill Account already appears in the Books

If at the time of retirement/death of a partner, goodwill appears in the Balance Sheet of the firm, it will be written off by debiting all the partners' capital account in their existing profit sharing ratio and crediting the goodwill account. In such a case, the following journal entry is made:

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

To Goodwill A/c

(Existing goodwill written-off in the old profit sharing ratio)

5.4 REVALUATION OF ASSETS AND LIABILITIES

At the time of retirement of a partner the assets and liabilities of the firm are revalued and Revaluation Account is prepared in the same way as in case of admission of a partner. This is done to adjust the changes in value of assets and liabilities at the time of retirement/death of a partner.

Any profit or loss due to revaluation is divided amongst all the partners including retiring/deceased in their existing profit sharing ratio. Following journal entries are made for this purpose:

(i) For increase in value of assets:

Assets A/c Dr.

To Revaluation A/c

(Increase in the value of assets)

(ii) For decrease in value of assets:

Revaluation A/c Dr.

To Assets A/c

(Decrease in the value of asset)

(iii) For increase in value of Liabilities:

Revaluation A/c Dr.

To Liabilities A/c

(Increase in the value of liabilities)

(iv) For decrease in value of Liabilities:

Liabilities A/c Dr.

To Revaluation A/c

(Decrease in the value of liabilities)

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

(v) For Profit on Revaluation:

Revaluation A/c Dr. (Individually)

To Partner’s Capital A/c

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

(vi) For loss on Revaluation:

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

To Revaluation A/c

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

Example: A, B and C are partners in a firm sharing profits and loses in the ratio of their capitals. Their balance sheet as on 31st December, 2019 is given below:

Liabilities		Amount	Assets		Amount
		`			`
Sundry Creditors		5,000	Cash at Bank		1,000
Capital Accounts:	`		Sundry Debtors	10,000	
A	30,000		Less: Provision	1,000	9,000
B	40,000		Stock		8,000
C	30,000	1,00,000	Furniture		10,000
General Reserve		10,000	Plant & Machinery		25,000
			Land & Building		62,000
		1,15,000			1,15,000

C retires and the remaining partners agree to settle his account on the following terms:

1. The value of goodwill of the firm was fixed at ` 21,000. The share of C should be adjusted into the accounts of A and B who agree to share future profits and losses in the ratio of 3:4.
2. The value of Furniture and Plant and Machinery was to be depreciated @ of 15% and 20% respectively.
3. The Stock was revalue at ` 6,500.
4. The value of Land and Building is to be appreciated by 20%.

Pass necessary journal entries in the books of the firm to give effect to these arrangements and also prepare the Balance Sheet of the new firm.

Solution:

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
			`	`
	Revaluation A/c Dr. To Stock A/c To Furniture A/c To Plant & Machinery (Decrease in the value of assets)		8,000	 1,500 1,500 5,000
	Land & Building A/c Dr. To Revaluation A/c (Increase in the value of land & building)		12,400	 12,400
	General Reserve A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Transfer of general reserve to Capital A/cs of all partners in old ratio)		10,000	 3,000 4,000 3,000
	Revaluation A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Transfer of profit on revaluation to Capital A/cs in old ratio)		4,400	 1,320 1,760 1,320
	A's Capital A/c Dr. B's Capital A/c To C's Capital A/c (C's share of goodwill distributed between A and B in their gaining ratio)		2,700 3,600	 6,300
	C's Capital A/c Dr. To C's Loan A/c (Balance of capital of C transferred to his loan account)		40,620	 40,620

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

Particulars	**Amount**	**Particulars**	**Amount**

		`		`
To Stock A/c		1,500	By Land & Building A/c	12,400
To Furniture A/c		1,500		
To Plant & Machinery		5,000		
To Profit transferred to:	`			
A's Capital A/c	1,320			
B's Capital A/c	1,760			
C's Capital A/c	1,320	4,400		
		12,400		12,400

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	Particulars	A	B	C
	`	`	`		`	`	`
To C's Capital A/c	2,700	3,600	–	By Balance b/d	30,000	40,000	30,000
To C's Loan A/c	–	–	40,620	By General Reserve A/c	3,000	4,000	3,000
To Balance c/d	31,620	42,160	–	By Revaluation A/c	1,320	1,760	1,320
				By A's Capital A/c	–	–	2,700
				By B's Capital A/c	–	–	3,600
	34,320	45,760	40,620		34,320	45,760	40,620

Balance Sheet of New Firm

Liabilities		Amount	Assets		Amount
		`			`
Sundry Creditors		5,000	Cash at Bank		1,000
C's Loan		40,620	Sundry Debtors	10,000	
Capital Accounts:	`		Less: Reserves	1,000	9,000
A	31,620		Stock		6,500
B	42,160	73,780	Furniture		8,500
			Plant & Machinery		20,000
			Land & Building		74,400
		1,19,400			1,19,400

5.5 TREATMENT OF UNDISTRIBUTED PROFIT/LOSS AND RESERVES

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

(i) For distribution of undistributed profit and reserve.

Reserves A/c Dr.

Profit and loss A/c (Profits i.e. credit balance) Dr.

To All partners' capital A/c (individually)

(Reserves and undistributed profit transferred to partner's capital A/c in old profit sharing ratio)

(ii) For distributing losses among all partners in the old ratio

All Partners, Capital A/c Dr.

To P&L A/c (accumulated losses, i.e. debit balance)

To Deferred Revenue Expenditure A/c

The surplus available on some specific funds like workmen's compensation fund or investment fluctuation fund to meet certain obligations in future will be transferred to capital accounts of all the partners in their old ratio. For the purpose, the following journal entries are recorded:

Workman's Compensation Fund A/c Dr.

Investment Fluctuation fund A/c Dr.

To All Partners' capital A/c

(Surplus available on workmen's compensation fund and investment fluctuation fund transferred to partner's capital A/c in old profit sharing ratio).

5.6 AMOUNT PAYABLE TO RETIRING PARTNER

When a partner retires from business, his claim against the firm is determined by preparing his capital account incorporating therein all the adjustments in respect of his share of goodwill, accumulated profits or losses, profit/loss on revaluation of assets and liabilities, etc. Now the settlement of the claim depends on the provisions of the partnership deed. If nothing is given in the problem to be solved in respect of settlement of claim, the amount of claim is usually transferred to the Retiring partner's Loan Account for which the following entry is passed:

Retiring Partner's Capital A/c Dr

To Retiring Partner's Loan A/c

The retiring partners' claim consists of

Particulars	**Amount**
Items to added • The credit balance of Capital Account • His/her share in the Goodwill of the firm • His/her share in the Revaluation Profit • His/her share in General Reserve and Accumulated Profit • Interest on Capital	
Total	
(B) Items to be Deducted • His/her share in the Revaluation loss • His/her Drawings and Interest on Drawings up to the date of retirement • His/her share of any accumulated losses • Loan taken from the firm	
Total	
Retiring Partner's Interest (A – B)	

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

(i) Payment in Lump Sum

Retiring partners' claim is paid either out of the funds available with the firm or out of funds brought in by the remaining partners. The following journal entry is made for disposal of-the amount payable to the retiring partner:

On payment of cash in lump sum:

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

(Amount paid to the retiring partner)

Payment in Installments

In this case the amount due to retiring partner is paid in installments. In the absence of any agreement, section 37 of the Indian Partnership Act, 1932 is applicable. An installment consists of two parts:

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

(ii) Interest at an agreed rate.

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

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

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

To Retiring Partner's Loan A/c

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

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

Retiring Partner's Capital A/c Dr.

To Retiring Partner’s Loan A/c

(Total amount due transferred to loan A/c)

(iii) For interest due

Interest on loan A/c Dr.

To Retiring Partners’ Loan A/c

(Interest due on loan)

(iv) For payment of installment

Retiring Partners’ Loan A/c Dr.

To Cash/Bank A/c

(Installment inclusive of interest paid)

On 30th June, 2019 the balance sheet of A, B and C who were sharing profits and losses in the proportion to their capital stood as follows:

Liabilities		**Amount**	**Assets**		**Amount**
		`			`
Sundry Creditors		17,400	Cash at Bank		1,000
Capitals:	`		Customers	23,500	
A	40,000		Less: Provision	1,200	22,300
B	30,000		Stock		21,700
C	20,000	90,000	Machinery		35,000
		12,600	Land & Building		40,000
		1,20,000			1,20,000

On this date B decided to retire and for this purpose it was agreed that:

1. Goodwill of the entire firm was fixed at ` 25,200 and B’s share of it be adjusted into the accounts of A and C who will share future profits in the ratio of 4:3.
2. Land & Building is appreciated by 10%.
3. Machinery will be reduced by 20%.
4. The provision for bad debts is no longer necessary.

5. The entire capital of the firm as newly constituted will be fixed at ` 70,000, which will remain between A and C in the proportion of 4:3. Such excess or deficit to be paid off or brought in cash, as the case may be.

Pass journal entries. Prepare capital accounts and the Balance Sheet of the new firm.

Solution:

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
			`	`
	Profit & Loss A/c Dr.		12,600	
	To A's Capital A/c			5,600
	To B's Capital A/c			4,200
	To C's Capital A/c			2,800
	(Undistributed profits transferred to Partner's Capital A/cs in their old ratio 4:3:2)			
	Revaluation A/c Dr.		7,000	
	To Machinery			7,000
	(Decrease in the value of asset)			
	Land & Building A/c Dr.		4,000	
	Provision for Bad Debts A/c Dr.		1,200	
	To Revaluation A/c			5,200
	(Increase in the value of assets and decrease in the amount of provision for bad debts)			
	A's Capital A/c Dr.		800	
	B's Capital A/c Dr.		600	
	C's Capital A/c Dr.		400	
	To Revaluation A/c			1,800
	(Loss on revaluation transferred to Partners' Capital A/cs in their old ratio 4:3:2)			
	A's Capital A/c Dr.		3,200	
	C's Capital A/c Dr.		5,200	
	To B's Capital A/c			8,400
	(B's share of goodwill adjusted to the accounts of continuing partner's in their gaining ratio 8:13)			

	B's Capital A/c Dr. To B's Loan A/c (Transfer of B's Capital A/c to B's Loan A/c)		42,000	42,000
	A's Capital A/c Dr. To Bank A/c (Excess amount of capital paid to A)		1,600	1,600
	Bank A/c Dr. To C's Loan A/c (Deficit amount of capital brought in by C)		12,800	12,800

Dr. Partner's Capital Account Cr.

Particulars	A	B	C	Particulars	A	B	C
	`	`	`		`	`	`
To Revaluation A/c	800	600	400	By Balance b/d	40,000	30,000	20,000
To B's Capital A/c	3,200	–	5,200	By Profit & Loss A/c	5,600	4,200	2,800
To B's Loan A/c	–	42,000	–	By A's Capital A/c	–	3,200	–
To Balance c/d	41,600	–	17,200	By C's Capital A/c	–	5,200	-
	45,600	42,600	22,800		45,600	42,600	22,800
To Bank A/c	1,600	–	–	By Balance b/d	41,600	–	17,200
To Balance c/d	40,000	–	30,000	By Bank A/c	–	-	12,800
	41,600	–	30,000		41,600	–	30,000

Balance Sheet of New Firm

Liabilities	Amount	Assets	Amount
	`		`
Sundry Creditors	17,400	Cash at Bank	12,200
B's Loan	42,000	Customers	23,500
Capital Accounts: `		Stock	21,700
A 40,000		Machinery	28,000
B 30,000	70,000	Land & Building	44000

	1,29,400		1,29,400

Example: A, B and C were partners in a firm sharing profits and losses in the ratio of 2:2:1. They had taken a Joint Life Policy of ` 2,00,000, whose surrender value of Ist January, 2019 was ` 42,000. On this date the Balance Sheet of firm stood as follows:

Liabilities		Amount	Assets	Amount
		`		`
Sundry Creditors		65,000	Cash at Bank	2,06,000
Outstanding Expenses		5,880	Sundry Debtors	80,000
Reserve Fund		33,000	Stock	65,000
Capitals Accounts:	`		Investments	40,000
A	3,00,000		Computers	25,000
B	2,85,000		Machinery	1,10,000
C	1,37,120	7,22,120	Factory Building	3,00,000
		8,26,000		8,26,000

B retired on the above date and the new profit sharing ratio between A and C will be 4:3. The revaluation of assets and liabilities is to be adjusted in following way:

1. To make a provision of 5% on Sundry Debtors for doubtful debts.
2. To depreciate Computers by 20% and Machinery by 5%.
3. Factory building to be revalued at ` 3,35,000.
4. Stock to be appreciated by 10%.
5. Salaries outstanding (not provided for as yet) was ` 2,200.
6. Goodwill of the firm is valued at ` 87,500 and the adjustment in this respect are made without raising a goodwill A/c. The joint life insurance policy was also not to appear in the Balance Sheet.
7. A and C decided that their capitals will be in their new profit sharing ratio. For this cash to be brought in or paid off to the partners B's A/c will be transferred to his loan account.
8. B is paid off ` 1,59,920 on the date of retirement and the remaining amount was to be paid in four equal installments together with interest at the rate of 12% p.a. on the outstanding balance.

Pass necessary Journal entries; prepare Revaluation A/c, Capital A/cs, New Balance Sheet and B's Loan A/c for 4 years.

Solution:

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
			`	`
	Revaluation A/c Dr. To Provision for Doubtful Debts A/c To Computers A/c To Machinery A/c To Outstanding Salaries A/c (Decrease in the value of assets and increase in the value of liabilities)		8,000	1,500 1,500 5,000
	Factory Building A/c Dr. Stock A/c To Revaluation A/c (Increase in the value of assets)		12,400	12,400
	Revaluation A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Profit on revaluation transferred to Partner's Capital A/cs in old ratio)		10,000	3,000 4,000 3,000
	Reserve Fund A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Reserve Fund transferred to Capital A/cs of Old Partners' A/cs in old ratio)		4,400	1,320 1,760 1,320
	A's Capital A/c Dr. C's Capital A/c To B's Capital A/c (Goodwill adjusted in the gaining ratio 3:4)		15,000 20,000	35,000
	A's Capital A/c Dr. C's Capital A/c To B's Capital A/c (B's share in the surrender value of joint life policy adjusted in gaining ratio 3:4)		7,200 9,600	16,800

	B's Capital A/c Dr. To Bank A/c (Cash paid to B)		1,59,920	1,59,920
	B's Capital A/c Dr. To Bank A/c (Balance of B's Capital A/c transferred to B's Loan A/c)		2,00,000	2,00,000
	A's Capital A/c Dr. To Bank A/c (Amount paid to A to bring his capital to profit sharing ratio)		60,920	60,920
	Bank A/c Dr. To C's Capital A/c (Amount brought by C to raise his capital to profit sharing ratio)		60,920	60,920

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

Particulars		Amount	Particulars	Amount
		`		`
To Provision for Doubtful Debts A/c		4,000	By Factory Building A/c	35,000
To Computer A/c		5,000	By Stock A/c	6,500
To Machinery A/c		5,500		
To Outstanding Salaries A/c		2,200		
To Profit transferred to:	`			
A's Capital A/c	9,920			
B's Capital A/c	9,920			
C's Capital A/c	4,960	24,800		
		41,500		41,500

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	Particulars	A	B	C
	`	`	`		`	`	`
To B's Capital A/c (Goodwill)				By Balance b/d By Revaluation A/c	3,00,000	2,85,000	1,37,120

To B's Capital A/c	15,000	–	20,000	By Reserve Fund A/c	9,920	9,920	4,960
(Life Policy)				By A's Capital A/c	13,200	13,200	6,600
To Balance c/d	7,200	–	9,600	(Goodwill)			
	3,00,920	3,59,920	1,19,080	By C's Capital A/c	–	15,000	–
				(Goodwill)			
				By A's Capital A/c	–	20,000	–
				(Life Policy)			
				By C's Capital A/c	–	7,200	–
				(Life Policy)			
To Bank A/c	3,23,120	3,59,920	1,48,680		–	9,600	–
To B's Loan A/c	–	1,59,920	–	By Balance b/d	3,23,120	3,59,920	1,48,680
To Bank A/c	–	2,00,000	–	By Bank A/c	3,00,920	3,59,920	1,19,080
To Balance c/d	60,920		–		–	–	60,920
	2,40,000		–				
	3,00,920	3,59,920	1,80,000		3,00,920	3,59,920	1,80,000

Balance Sheet of New Firm

Liabilities	**Amount**	**Assets**		**Amount**
	`			`
Sundry Creditors	65,000	Cash at Bank		46,080
Outstanding Expenses	5,880	Sundry Debtors	80,000	
Outstanding Salaries	2,200	Less: Provision	4,000	76,000
B's Loan	2,00,000	Stock		71,500
Capital Accounts: `		Investments		40,000
A 2,40,000		Computers		20,000
C 1,80,000	4,20,000	Machinery		1,04,500
		Factory Building		3,35,000
	6,93,080			6,93,080

Dr. **B's Loan Account** **Cr.**

Date	**Particulars**	**J.F.**	**Amount**	**Date**	**Particulars**	**J.F.**	**Amount**
2009			`	2009			`

Dec.31	To Bank A/c			Jan.1	By B's Capital A/c		2,00,000
	(50,000 + 24,000)		74,000	Dec.31	By Interest A/c		
Dec. 31	To Balance c/d		1,50,000		(12% on 2,00,000)		24,000
			2,24,000				2,24,000
				2010			
2010				Jan.1	By Balance b/d		1,50,000
Dec.31	To Bank A/c			Dec.31	By Interest A/c		
	(50,000 + 18,000)		68,000		(12% on 1,50,000)		18,000
Dec.31	To Balance c/d		1,00,000				1,68,000
			1,68,000				
2011				2011			
Dec.31	To Bank A/c			Jan.1	By Balance b/d		1,00,000
	(50,000 + 12,000)		62,000	Dec.31	By Interest A/c		
Dec.31	To Balance c/d		50,000		(12% on 1,00,000)		12,000
			1,12,000				1,12,000
2012				2012			
Dec.31	To Bank A/c			Jan.1	By Balance b/d		50,000
	(50,000 + 6,000)		56,000	Dec.31	By Interest A/c		
					(12% on 50,000)		6,000
			56,000				56,000

5.7 Accounting Treatment of Joint Life Insurance Policy

Usually, firm takes joint as well as individual life insurance policies on the lives of partners, the premium of which is paid by the firm. The retiring partner is also entitled to share the proceeds of life insurance policy. This share is given out of surrender value of the policy. The surrender value is that amount which is given by insurance company to the firm when the life policy is surrendered before the maturity of policy. At the time of retirement of a partner, the joint life insurance policy can be recorded in following two ways:

1. **If Premium is considered as Revenue Expenditure:** If the joint life policy premium is considered as revenue expenditure, then the following entry is passed with its surrender value:

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
	Joint Life Policy A/c Dr.		`	`

	To All Partners' Capital A/cs (Surrender value of joint life policy credited to all partners accounts in old ratio)			

If, after the retirement, the remaining partners decide that the joint life policy will not be shown in the books, then this account is written off by passing the following entry:

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			`	`
	Continuing Partners' Capital A/cs Dr. To Joint Life Policy A/c (Existing joint life policy written off to continuing partners in their new ratio)			

2. **If Premium is considered as Capital Expenditure:** If the joint life policy premium is considered as capital expenditure, then the joint life policy has already been shown in the balance sheet. Therefore, no further treatment is made of joint life policy at the time of retirement of a partner. However, if the remaining partners decide that the joint life policy will not be shown in the books, then it is written off by passing the following entry:

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			`	`
	Continuing Partners' Capital A/cs Dr. To Joint Life Policy A/c (Existing joint life policy written off to continuing partners in their gaining ratio)			

Example: Firm A B C consisted of three partners A, B and C, sharing profits and losses in the ratio of 5:3:2. The partner A died on February 20, 2019. The profit and loss account for the period up to the date of death and the Balance Sheet as on that date were prepared:

Liabilities	Amount	Assets	Amount
	`		`
Capitals Accounts: `		Goodwill	6,000
A 12,000		Machinery	35,000

B	16,000		Furniture	6,000
C	12,000	40,000	Stock	9,000
Loan from A		5,000	Debtors	15,000
General Reserve		7,000	Bank	3,000
Creditors		22,000		
		74,000		74,000

In addition to the assets shown above, the firm had three Life Insurance Policies in the name of each partner, at an insured value of ` 20,000 each, the premium of which were charged to the Profit & Loss Account.

According to the partnership deed, on the death of a partner, the assets and liabilities are to be revalued by a valuer. The revalued figures were:

1. Goodwill ` 21,000; Machinery ` 45,000; Debtors are subject to provision for Doubtful Debts at 10%; and Furniture at ` 7,000.
2. Provision for taxation to be created for ` 1,500.
3. Death claim for policy in the name of A will be realised in full and the surrender value of the other two policies was ` 7,500 each.
4. Deceased partner is entitled to his share in reserves.

The business will be continued by B and C, henceforth sharing profits and losses equally. The net balance due to A is transferred to his Executor's Account, which will be paid off later.

Show the Revaluation Account, Capital Accounts and the new Balance Sheet of the firm.

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

Particulars		**Amount**	**Particulars**	**Amount**
		`		`
To Provision for Doubtful Debts A/c		1,500	By Machinery A/c	10,000
To Provision for Taxation A/c		1,500	By Furniture A/c	1,000
To Profit transferred to:	`			
A's Capital A/c	4,000			
B's Capital A/c	2,400			
C's Capital A/c	1,600	8,000		
		11,000		11,000

Dr. **Partner's Capital Account** **Cr.**

Particulars	**A**	**B**	**C**	**Particulars**	**A**	**B**	**C**

	`	`	`		`	`	`
To Goodwill A/c	3,000	1,800	1,200	By Balance b/d	12,000	16,000	12,000
To A's Capital A/c	-	–	–	By General Reserve A/c	3,500	–	–
(Goodwill)	–	4,200	6,300	By B's Capital A/c (Goodwill)	4,200	–	–
To A's Executor's A/c	44,500	–	–	By C's Capital A/c (Goodwill)	6,300	–	–
To Balance c/d	–	22,900	13,100	By Revaluation A/c	4,000	2,400	1,600
				By Life Policy A/c	17,500	10,500	7,000
	47,500	28,900	20,600		47,500	28,900	20,600

Dr. **A's Executor's Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Balance c/d	49,500	By A's Loan A/c	5,000
		By A's Capital A/c	44,500
	49,500		49,500

Balance Sheet

Liabilities	Amount	Assets	Amount
	`		`
Provision for Taxation	1,500	Bank	23,000
Creditors	22,000	Debtors 15,000	
A's Executor's A/c	49,500	Less: Provision 1,500	13,500
General Reserve	3,500	Stock	9,000
Capital Accounts: `		Life Policies (Surrender Value)	15,000
A 22,900		Furniture	7,000
B 13,100	36,000	Machinery	45,000
	1,12,500		1,12,500

5.8 Determination of Amount Payable to Deceased Partner:

The key difference between the retirement and death of partner is that normally the retirement takes place at the end of an accounting period whereas death can occur at any time. On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner, When the partner dies the amount payable to him/her is paid to his/her legal representatives. Section 37 of the Partnership Act provides that if the amount is not paid immediately, the executors of the deceased partner would be entitled, at their choice, to receive interest @ 6% p.a. from the date of death to the date of actual payment.

The deceased partners' claim consists of:

Particulars	**Amount**
(A) Items to be credited • The amount standing to the credit to the capital account of the deceased Partner • Interest on capital, if provided in the partnership deed up to the date of death • Share of goodwill of the firm • Share of undistributed profit or reserves • Share of profit on the revaluation of assets and liabilities • Share of profit up to the date of death • Share of Joint Life Policy	
Total	
(B) Items to be Deducted • His/her share in the Revaluation loss • His/her Drawings and Interest on Drawings up to the date of retirement • His/her share of any accumulated losses • Loan taken from the firm	
Total	
Deceased Partner's Claim (A – B)	

Calculation of profit up to the date of death of a partner.

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

(i) Time Basis

(ii) Turnover or Sales Basis

On the Basis of Time

There are two methods used in ascertainment of profit on the basis of time:

1. **On the basis of average profit of certain years*:*** Under this method the calculation of profit is based on the average annual profit for the past few years say, 3 to 5 years. Then, the profit for the proportionate period is found out.

2. **On the basis of last year's profit:** Calculation of profit is based on the last year's profit.

On the Basis of Turnover

Under this method, the share of profit is calculated on the basis of the profit and the total sales of the last year. Thereafter, the profit up to the date of death is estimated on the basis of the sale of the last year.

Settlement of Executor's Account:

After the death of a partner the total amount due to him is transferred to his, executor's account and paid off as per the provisions of the partnership deed immediately or in installments together with interest on outstanding balance. As explained earlier the amount due to the deceased partner should include the amount standing to the credit of his Capital Account, a share in the accumulated profits, goodwill, joint life policy (if any), profit on revaluation of assets/liabilities, etc.

The following entries should be passed for disposal of amount due to the deceased partner:

(a) The amount standing to the credit of deceased partner's capital is transferred to his executor's account, by recording the following entry:

Deceased partner's capital A/c Dr

To Deceased partner's executor's A/c

Deceased partner's executor's account will be settled as per the agreement between the firm and executor's of the deceased partner.

(b) When the full amount is paid in cash, following entry is recorded:

Executor's A/c Dr

To Cash/Bank A/c

(c) When the settlement is made in installments, the following entries are made:

(i) For interest due:

Interest on executor's A/c Dr

To Executor's A/c

(ii) For payment of installment on loan account

Executor's A/c Dr

To Cash/Bank A/c

5.9 SUMMARY

When one or more partners leave the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Thus, due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. At the time of retirement the retiring partner's claim is settled. The following adjustments are made at the time of Retirement and Death of a Partner:

Calculation of New Profit Sharing Ratio:

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

Calculation of Gaining Ratio:

As we calculate the sacrificing ratio in the case of admission of a new partner, we have to calculate the gaining ratio at the time of retirement or death of a partner. The gaining ratio of each remaining partner is calculated by deducting the old share of profit from the new share of profit. Gaining Ratio = New Ratio – Existing Ratio

Accounting Treatment of Goodwill:

At the time of retirement or death of a partner the retiring partner is entitled to his share of goodwill because the goodwill has been earned by the firm with the efforts of all the existing partners. Therefore, in case of retirement of a partner, the goodwill is adjusted through partner's capital accounts. The retiring partner's capital account is credited with. his/her share of goodwill and remaining partner's capital account is debited in their gaining ratio.

Revaluation of Assets and Liabilities:

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

Treatment of Undistributed Profit/Loss and Reserves:

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

5.10 KEYWORDS

Gaining Ratio: The ratio in which the remaining partners shares increases after retirement/ death of a partner.

Revaluation Account: Account for the adjustment of valuation of assets and liabilities.

Goodwill: The reputation or advantage that a business has.

Undistributed Profits: The profits which are not distributed among partners.

5.11 SELF ASSESSMENT QUESTIONS

Q.1 What is goodwill? Discuss how it is treated at the time of death of a partner.

Q.2 What do you understand by Gaining Ratio? How it differs from sacrificing Ratio?

Q.3 What is Revaluation account? Why there is need of preparation of Revaluation account at the time of retirement of a partner.

Q.4 What do you mean by Joint Life Policy? Discuss the objectives and accounting treatment of Joint Life Policy.

Q.5. M, N and R were Partners sharing profits and losses in the ratio of 3:2:1. On 30th April, 2018 their balance sheet was as follows:

Liabilities		**Amount**	**Assets**	**Amount**
		`		`
Creditors		36,000	Cash in Hand	62,000
Bills Payable		25,000	Stock	1,12,000
Outstanding Expenses		8,000	Debtors	80,000
General Reserve		48,000	Computers	25,000
Bank Loan		50,000	Furniture	35,000
Capital A/cs:	`		Land & Building	2,50,000
M	1,95,000			
N	1,10,000			
R	92,000	3,97,000		
		5,64,000		5,64,000

On the above date R retired on the following terms:

1. The Goodwill of the firm was valued at ` 66,000.
2. The value of Land & Building should be appreciated by ` 36,000.
3. Outstanding expenses to be brought down to ` 5,600.
4. Depreciate Computers @ 20% and Furniture @ 15%.
5. Create a provision @ 5% for doubtful debts on Debtors.
6. R, be paid ` 55,000 in cash and the balance be transferred to his loan account.

Pass necessary journal entries in the books of the firm to give effect to these arrangements and also prepare the Balance Sheet of the new firm.

Q.6. The Balance Sheet of A, B and C who were sharing profits and losses in proportion of their capital stood as follows on 31st December, 2004:

Liabilities	Amount	Assets	Amount
	`		`
Sundry Creditors	6,900	Cash at Bank	5,500
Investment Fluctuation Fund	7,500	Sundry Debtors 5,000	
Capitals Accounts: `		Less: Provision 100	4,900
A 18,000		Stock	8,000
B 13,500		Investments	11,500
C 9,000	40,500	Land & Building	25,000
	54,900		54,900

B retired on the above date and the following was agreed upon:

1. The Stock is depreciated by 6%.
2. That the Provision for Doubtful Debts be brought up to 5% on Debtors.
3. The Land and Building be appreciated by 20%.
4. That a provision of ` 770 be made in respect of outstanding legal charges.
5. Investments are brought down to ` 8,500.
6. That the Goodwill of the firm be fixed at `10,800 and B's share of goodwill will be adjusted into the accounts of A and C who are going to share future profits in the ratio of 5:3 (No Goodwill Accounts is to be raised).
7. That the entire capital of the firm as newly constituted be fixed at ` 28,000 between A and C in the proportionate of 5:3. The capital accounts of both will be adjusted on this basis and the deficit or excess to be brought in or paid off in cash as the case may be.

Pass journal entries and show the Balance Sheet after transferring B's share to a separate Account in his name.

5.12 Suggested/Further Readings:

1. S.N. Maheshwari: Advanced Accountancy, Vikas Publishing House Pvt. Ltd.
2. J.R. Monga: Basic Financial Accounting, MKM Publishers Pvt. Ltd.
3. D.K. Goyal: Accountancy, Arya Publications.
4. R.K.Mittal: Financial Accounting, V.K. Publications Ltd.

Course: **Financial Accounting-II**	
Course Code: **BC 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **6**	

PARTNERSHIP ACCOUNTS: DISSOLUTION OF PARTNERSHIP AND ACCOUNTING TREATMENT

STRUCTURE:

6.0 OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning of dissolution of partnership and partnership firm.
- To understand the modes of dissolution of firm.
- To know the accounting treatment at the time of dissolution of firm.
- To know the rules and accounting treatment in case of insolvency of partners.

6.1 INTRODUCTION

When the relationship between the partners discontinues, it is called dissolution of partnership and when it relates to the business of partnership, it is called dissolution of the firm. According to the Partnership Act, 1932, the dissolution of partnership between all the partners of a firm is called the dissolution of the firm. Therefore, the act distinguishes between the dissolution of partnership and dissolution of the firm. For example, where X, Y and Z were partners in a firm and Z died or was declared insolvent, the partnership firm would come to an end; but if the partners had agreed that the death, retirement, insolvency of the partner would not dissolve the firm on the happening of these contingencies, the 'partnership' would certainly come to an end although the 'firm' or as the Act calls it, a 'reconstituted firm', might continue under the same name. Thus, a reconstitution of a firm involves a change in the relation of partners whereas in the case of dissolution of firm, there is complete end of relationship between all partners.

6.2 MEANING OF DISSOLUTION OF PARTNERSHIP AND PARTNERSHIP FIRM

Dissolution of Partnership: The dissolution of partnership means termination of the old partnership agreement and may or may not result into closing down of the business as the retiring partners may agree to carry on the business under a new agreement. The partnership is deemed to have been dissolved in any of the following circumstances:

i) Expiry of the period of partnership

ii) Completion of the venture for which it was formed

iii) Admission of a partner

iv) Retirement of a partner

v) Death of a partner

vi) Insolvency of a partner

In all the above-mentioned cases, the old partnership comes to an end but the business may be carried on in the same name and style with a new partnership coming into existence.

Dissolution of Partnership Firm: Dissolution of partnership firm means that the firm closes down its business and the assets of the firm are sold and liabilities are paid. Dissolution of a partnership firm may take place without the intervention of court or by the order of a court, in any of the ways specified later in this section. It may be noted that dissolution of the firm necessarily brings in dissolution of the partnership.

6.3 MODES OF DISSOLUTION OF FIRM

There are essentially two modes of dissolution of the firm i.e. (a) Dissolution without the order of the court, and (b) Dissolution by the order of the court**.**

Dissolution without the order of the court:

A Partnership firm is dissolved without the order of the court in any one of the following ways:

1. Dissolution by Agreement: A firm is dissolved:

(a) With the consent of all the partners or

(b) In accordance with a contract between the partners.

2. Compulsory Dissolution: A firm is dissolved compulsorily in the following cases:

(a) When all the partners or all but one partner, become insolvent, rendering them incompetent to sign a contract;

(b) When the business of the firm becomes illegal; or

(c) When some event has taken place which makes it unlawful for the partners to carry on the business of the firm in partnership, e.g., when a partner who is a citizen of a country becomes an alien enemy because of the declaration of war with his country and India.

3. On the happening of certain contingencies: Subject to contract between the partners, a firm is dissolved:

(a) If constituted for a fixed term, by the expiry of that term;

(b) If constituted to carry out one or more ventures, by the completion thereof;

(c) By the death of a partner;

(d) By the declaration of a partner as an insolvent.

4. Dissolution by Notice: In case of partnership at will, the firm may be dissolved if any one of the partners gives a notice in writing to the other partners, signifying his intention of seeking dissolution of the firm.

Dissolution by Court:

Under Section 44, the court can order dissolution of the firm on the following grounds:

(a) When a partner becomes insane;

(b) When a partner becomes permanently incapable of performing his duties as a partner;

(c) When a partner is guilty of misconduct which is likely to adversely affect the business of the firm;

(d) When a partner persistently commits breach of partnership agreement;

(e) When a partner has transferred the whole of his interest in the firm to a third party;

(f) When the business of the firm cannot be carried on except at a loss; or

(g) When, on any ground, the court regards dissolution to be just and equitable.

6.4 DISTINGUISH BETWEEN DISSOLUTION OF PARTNERSHIP AND PARTNERSHIP FIRM

BASIS FOR	DISSOLUTION OF PARTNERSHIP	DISSOLUTION OF FIRM
Meaning	Dissolution of a partnership refers to the discontinuance of the relation between partner and other partners of the firm.	Dissolution of firm implies that entire firm ceases to exist, including the relation among all the partners.
Nature	Voluntary	Voluntary or Compulsory
Business	Business of the firm continues as before.	Business of the firm comes to an end.

BASIS FOR	DISSOLUTION OF PARTNERSHIP	DISSOLUTION OF FIRM
Economic relationship	Continues to exist but in a changed form.	Comes to an end.
Account	Revaluation account is created.	Realisation account is prepared.
Books of accounts	Books of accounts are not closed	Books of accounts are closed.

6.5 ACCOUNTING TREATMENT AT THE TIME OF DISSOLUTION OF FIRM

Usually the Partnership Deed contains an accounting clause according to which the final accounts between partners are settled. In the absence of such an agreement, the following procedure is used:

- The losses, including losses on capital, must be paid, first from profits, next out of capital and lastly, if necessary, by contribution of each partner in proportion to his share in profits.
- The assets of the firm, including sums contributed by partners to make up deficiency of capital, shall be applied as follows: (a) in paying debts of the firm to outsiders; (b) in paying each partner for advances made by him to the firm as distinct from capital; (c) in paying each partner, amount due for capital contribution, and (d) the residue in paying each partner in accordance with his share in the profits of the firm.
- If a partner becomes insolvent or otherwise cannot pay his share of the contribution, the solvent partners must share ratably the available assets (including their own contribution to the capital deficiency).

Treatment of Firm's Debts and Private Debts:

Where both the debts of the firm and private debts of a partner co-exist, the following rules, as stated in Section 49 of the Act, shall apply.

(a) The property of the firm shall be applied first in the payment of debts of the firm and then the surplus, if any, shall be divided among the partners as per their claims, which can be utilised for payment of their private liabilities.

(b) The private property of any partner shall be applied first in payment of his private debts and the surplus, if any, may be utilized for payment of the firm's debts, in case the firm's liabilities exceed the firm's assets.

It may be noted that the private property of the partner does not include the personal properties of his wife and children. Thus, if the assets of the firm are not adequate enough to pay off firm's liabilities, the partners have to contribute out of their private assets.

Realisation Account:

As we discussed earlier that in case of dissolution of a partnership firm the business activities of a firm comes to an end and the firm get dissolved. As soon as the partners decide to discontinue the business of the firm, it becomes necessary to settle its accounts. For this purpose, all the assets have to be sold and the liabilities are to be paid off. For this purpose a separate account called 'Realisation Account' is opened. The following journal entries are made to transfer all the assets and liabilities in the Realisation Account:

Journal Entries:

1. For transfer of assets

All asset accounts excluding cash, bank and the fictitious assets, if any are closed by transfer to the debit of Realisation Account at their book values. It may be noted that sundry debtors are transferred at gross value and the provision for doubtful debts is transferred to the credit side of Realisation Account along with liabilities. The same thing will apply to fixed assets, if provision for depreciation account is maintained.

Realisation A/c Dr.

To Assets A/c

2. For transfer of liabilities

All external liability accounts including provisions, if any, are closed by transferring them to the credit of Realisation account.

Liabilities A/c Dr.

To Realisation A/c

3. For sale of assets

Bank A/c Dr.

To Realisation A/c

4. For an asset taken over by a partner

Partner’s Capital A/c Dr.

To Realisation A/c

5. For payment of liabilities

Realisation A/c Dr.

To Bank A/c

6. For a liability which a partner takes responsibility to discharge

Ralisation A/c Dr.

To Partner’s Capital A/c

7. For settlement with the creditor through transfer of assets when a creditor accepts an asset in full and final settlement of his account, journal entry needs to be recorded. But, if the creditor accepts an asset only as part payment of his/her dues, the entry will be made for cash payment only.

Realisation A/c Dr.

To Bank A/c

However, when a creditor accepts an asset whose value is more than the amount due to him, he/she will pay cash to the firm for the difference for which the entry will be:

Bank A/c Dr.

To Realisation A/c

8. For payment of realisation expenses

(a) When some expenses are incurred and paid by the firm in the process of realisation of assets and payment of liabilities:

Realisation A/c Dr.

To Bank A/c

(b) When realisation expenses are paid by a partner on behalf of the firm:

Realisation A/c Dr.

To Partner's Capital A/c

(c) When a partner has agreed to undertake the dissolution work for an agreed remuneration bear the realisation expenses:

(i) If payment of realisation expenses is made by the firm

Partner's Capital A/c Dr.

To Bank A/c

(ii) If the partner himself pays the realisation expenses, no entry is required

(iii) For agreed remuneration to such partner

Realisation A/c Dr.

To Partner's Capital A/c

9. For realisation of any unrecorded assets including goodwill, if any

Bank A/c Dr.

To Realisation A/c

10.For settlement of any unrecorded liability

Realisation A/c Dr.

To Bank A/c

11.For transfer of profit and loss on realisation

(a) In case of profit on realisation

Realisation A/c Dr.

To Partners' Capital A/c (individually) A/c

(b) In case of loss on realisation

Partners' Capital A/c (individually) Dr.

To Realisation A/c

12.For transfer of accumulated profits in the form of reserve fund or general reserve:

Reserve Fund/General Reserve A/c Dr.

To Partners' Capital A/c

13.For transfer of fictitious assets, if any, to partners' capital accounts in their profit sharing ratio:

Partners' Capital A/c Dr.

To Fictitious Asset A/c

14.For payment of loans due to partners

Partner's Loan A/c Dr.

To Bank A/c

15.For settlement of partners' accounts

If the partner's capital account shows a debit balance, he brings in the necessary cash for which the entry will be:

Bank A/c Dr.

To Partner's Capital A/c

The balance is paid to partners whose capital accounts show a credit balance and the following entry is recorded.

Partners' Capitals A/cs Dr.

To Bank A/c

It may be noted that the aggregate amount finally payable to the partners must equal to the amount available in bank and cash accounts. Thus, all accounts of a firm are closed in case of dissolution. Performa of the Realisation Account is given below:

Realisation Account

Particulars	Amount	Particulars	Amount
Land and Building Plant and Machinery Furniture and Fittings Bills receivables Sundry debtors Cash/Bank (payment of liabilities) Cash/Bank (payment of unrecorded liabilities) Partner's capital account (liability assumed by the partner) Profit (transferred to partners' capital account's in their profit sharing ratio)		Sundry creditors Bills payables Bank overdraft Outstanding expenses Provision for doubtful debts Cash/Bank (sale of assets) Partner's capital account (assets taken by the partner) Loss (transferred to partners capital accounts)	
Total		**Total**	

Example: A, B and C were partners in a firm sharing profits and losses in the ratio of 3:2:1. On 31st December, 2018 their Balance Sheet was as follows:

Liabilities	Amount	Assets	Amount

		`		`
Bank Loan		26,000	Cast at Bank	35,000
Creditors		20,000	Debtors	15,000
B's Loan		10,000	Stock	32,000
Capital Accounts:	`		Furniture	10,000
A	1,94,000		Computer	20,000
B	1,50,000		Patents	8,000
C	1,00,000	4,44,000	Plant	80,000
			Building	3,00,000
		5,00,000		5,00,000

The firm was dissolved on 1st January, 2009. Assets were realised as under: Debtors `14,000, Stock ` 29,000, Patents ` 3,500, Plant `71,000 and Building `3,10,000. A took over Furniture for `9,500 and C took over Computer for `21,000. Creditors were paid off at a discount of 5%. Realisation expenses amounted to `2,100.

Pass Journal Entries and prepare necessary Ledger Accounts.

Solution.

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			`	`
	Realisation A/c To Debtors A/c To Stock A/c To Furniture A/c To Computer A/c To Patents A/c To Plant A/c To Building A/c (Transfer of various assets to Realisation A/c at their book value)		4,65,000	15,000 32,000 10,000 20,000 8,000 80,000 3,00,000
	Creditors A/c Dr. Bank Loan A/c Dr. To Realisation A/c		20,000 26,000	46,000

	(Transfer of outside liabilities to Realisation A/c at their book value)			
	Bank A/c Dr. To Realisation A/c (Assets realised in cash)		4,27,500	 4,27,500
	A's Capital A/c Dr. C's Capital A/c Dr. To Realisation A/c (Assets taken over by the partners)		9,500 21,000	 30,500
	Realisation A/c Dr. To Bank A/c (Payment of outside liabilities)		45,000	 45,000
	Realisation A/c Dr. To Bank A/c (Payment of realisation expenses)		2,100	 2,100
	B's Loan A/c Dr. To Bank A/c (Payment of B's Loan)		10,000	 10,000
	A's Capital A/c Dr. B's Capital A/c Dr. C's Capital A/c Dr. To Realisation A/c (Loss on realisation transferred to Partners' Capital A/cs in their profit sharing ratio 3:2:1)		4,050 2,700 1,350	 8,100
	A's Capital A/c Dr. B's Capital A/c Dr. C's Capital A/c Dr. To Bank A/c (Final payment made to the partners)		1,80,450 1,47,300 77,650	 4,05,400

Ledger Accounts

Dr. **Realisation Account** **Cr.**

Liabilities	Amount	Assets	Amount
To Debtors A/c	`	By Creditors A/c	`

To Stock A/c		15,000	By Bank Loan A/c		20,000
To Furniture A/c		32,000	By Bank A/c (Assets realised): `		26,000
To Computer A/c		10,000	Debtors	14,000	
To Patents A/c		20,000	Stock	29,000	
To plant A/c		8,000	Patents	3,500	
To Building A/c		80,000	Plant	71,000	
To Bank A/c (Liabilities paid): `		3,00,000	Building	3,10,000	
					4,27,500
Creditors	19,000		By A's Capital A/c (Assets taken)		
					9,500
Bank Loan	26,000		By C's Capital A/c (Assets taken)		
		45,000			21,000
To Bank A/c (Expenses)					
		2,100			
A	1,94,000				
		5,12,100			5,04,000
B	1,50,000		By Loss Transferred to:		
C	1,00,000		A's Capital A/c	4,050	
			B's Capital A/c	2,700	
		5,12,100	C's Capital A/c	1,350	
					8,100
					5,12,100

Dr. **B's Loan Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Bank A/c	10,000	By Balance b/d	10,000
	10,000		10,000

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	Particulars	A	B	C
	`	`	`		`	`	`
To Realisation A/c (Assets taken)	9,500	–	21,000	By Balance b/d	1,94,000	1,50,000	1,00,000
To Realisation A/c (Loss)	4,050	2,700	1,350				
To Bank A/c (Final Payment)	1,80,450	1,47,300	77,650				

	1,94,000	1,50,000	1,00,000		1,94,000	1,50,000	1,00,000

Dr. **Bank Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Balance b/d	35,000	By Realisation A/c (liabilities paid)	45,000
To Realisation A/c (Assets realised)	4,27,500	By Realisation A/c (Expenses)	2,100
		By B's Loan A/c	10,000
		By A's Capital A/c	1,80,450
		By B's Capital A/c	1,47,300
		By C's Capital A/c	77,650
	4,62,500		4,62,500

Accounting Treatment of Reserve or Provision

From the point of view of dissolution of firm, the reserves or provisions may be divided into three parts:

1. **General Reserve:** If general reserve, reserve fund, credit balance of profit and loss account etc are given in the balance sheet, then these are not transferred to realisation account. These have been transferred to partners' capital accounts in the profit sharing ratio. The entry is passed as under:

   General Reserve A/c Dr.

   Reserve Fund A/c Dr.

   Profit & Loss A/c Dr.

   Workmen's Compensation Fund A/c Dr.

   To Partners' Capital A/cs

   (Transfer or undistributed profits to Patners' Capital A/cs in their profit sharing ratio)

2. **Loss or Nominal Assets:** If the debit balance of profit and loss account or nominal assets such as advertisement expenses etc are given in the asset side of balance sheet, then these have been transferred to partners' capital accounts by passing the following entry:

   Partners' Capital A/cs Dr.

   To Profit & Loss A/c

   To Advertisement Expenses A/c

   (Transfer to undistributed losses or nominal assets a Partners' Capital A/cs in their profit sharing ratio)

3. **Special Reserve or Provision:** The reserve or provision which is created to achieve a specific objective is called special reserve, such as provision for doubtful debts, provision for depreciation, investment fluctuation fund etc. These reserves are not transferred to partners' capital accounts. However, these are closed by transferring to realisation account. The following entry is passed for this:

(a) For transfer of special reserves or provisions which have credit balance:

Provision for Doubtful Debts A/c Dr.

Provision for Discount on Debtors A/c Dr.

Provision for Depreciation A/c Dr.

Joint Life Policy Reserve A/c Dr.

Investment Fluctuation Reserve A/c Dr.

To Realisation A/c

(Transfer of special reserve or provision to Realisation A/c)

(b) For transfer of special reserve or provision which has debit balance:

Realisation A/c Dr.

To Provision for Discount on Creditors A/c

Example: P, Q and R are partners sharing profits and losses equally. On 31-3-2015 their balance sheet stood as follows:

Liabilities		**Amount**	**Assets**	**Amount**
		`		`
Bills payable		16,000	Cash at Bank	15,000
Creditors		1,19,000	Debtors	1,25,000
Loan from Q		25,000	Stock	2,90,000
General reserve		30,000	Furniture	40,000
P's Current Account		15,000	Machinery	1,20,000
Q's Current Account		15,000	R's Current Account	30,000
Capital Accounts:	`			
P	2,00,000			
Q	1,00,000			
R	1,00,000	4,00,000		
		6,20,000		6,20,000

The firm was dissolved on the above mentioned date. P agreed to pay creditors at par. Q took over the entire Furniture for `36,000. The remaining assets were sold for ` 5,53,000. Bills Payable were retired for a discount of ` 100 received for payment before the due dates of maturity. Expenses of dissolution amounted to ` 1,200.

Prepare important ledger accounts and cash book. The current accounts and the capital accounts may be prepared in columnar.

Solution:

Dr. **Realisation Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Debtors A/c	1,25,000	By Bills Payable A/c	16,000
To Stock A/c	2,90,000	By Creditors A/c	1,19,000
To Furniture A/c	40,000	By Q's Current A/c (Furniture)	36,000
To Machinery A/c	1,20,000	By Bank A/c (Debtors, Stock and Machinery)	5,53,000
To P's Current A/c (Creditors)	1,19,000		
To Bank A/c (Bills Payable 16,000–100)	15,900		
To Bank A/c (Expenses)	1,200		
	7,11,100		7,24,000
To Profit transferred to: `			
P's Current A/c 4,300			
Q's Current A/c 4,300			
R's Current A/c 4,300	12,900		
	7,24,000		7,24,000

Dr. **Q's Loan Account** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Bank A/c	25,000	By Balance b/d	25,000
	25,000		25,000

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	Particulars	A	B	C
	`	`	`		`	`	`
To Balance b/d	–	–	30,000	By Balance b/d	15,000	15,000	–
To Realisation A/c (Furniture)	–	36,000		By general Reserve A/c	10,000	10,000	10,000
				By Realisation A/c			

To P's Capital A/c (Transfer)	1,48,300	–	–	(Creditors)	1,19,000	–	–
				By Realisation A/c (Profit)	4,300	4,300	4,300
				By Q's Capital A/c (Transfer)	–	6,700	–
				By R's Capital A/c (Transfer)	–	–	15,700
	1,48,300	36,000	30,000		1,48,300	36,000	30,000

Dr. **Partner's Capital Account** **Cr.**

Particulars	P	Q	R	Particulars	P	Q	R
	`	`	`		`	`	`
To Q's Current A/c	–	6,700	–	By Balance b/d	2,00,000	1,00,000	1,00,000
To R's Current A/c	–	–	15,700	By P's Current A/c	1,48,300	–	–
To Bank A/c (Settlement)	3,48,300	93,300	84,300				
	3,48,300	1,00,000	1,00,000		3,48,300	1,00,000	1,00,000

Dr. **Cash Book (Bank Column Only)** **Cr.**

Particulars	Amount	Particulars	Amount
	`		`
To Balance b/d	15,000	By Realisation A/c (Bills Payable)	15,900
To Realisation A/c (Debtors, Stock and Machinery)	5,53,000	By Realisation A/c (Expenses)	1,200
		By Q's Loan A/c	25,000
		By P's Capital A/c	3,48,300
		By Q's Capital A/c	93,300
		By R's Capital A/c	84,300
	5,68,000		5,68,000

Treatment of Goodwill

The Act provides that in settling the accounts of a firm after dissolution, goodwill shall, subject to contract between the partners. Where the goodwill of a firm is sold after dissolution, a partner may carry on a business competing with that of the buyer and he may advertise such business but subject to agreement between him and the buyer, he may not (a) use the firm's name; (b) represent himself as carrying on business of the firm; or (c) solicit the custom of persons who were dealing with the firm before its dissolution. There is nothing special in treatment of goodwill on dissolution of a firm. On dissolution of a firm:

- If goodwill appears in the Balance Sheet, it is treated like any other asset and is transferred to realisation account.
- If goodwill does not appear in the balance sheet, no entry is passed for this.
- If something is realized or Goodwill is purchased by any one of the partners, then either Cash Account is debited or Partner's Capital A/c is debited and Realization Account is credited.

6.6 INSOLVENCY OF PARTNER/PARTNERS

The firm is normally dissolved when one or more partners become insolvent. The procedure for closing the books under insolvency is almost the same as under simple dissolution i.e. marketable assets and external liabilities are transferred to a newly opened Realisation Account and they are realized and paid off through the same account and the loss or profit on realisation transferred to the capital accounts of the partners. Thereafter if the capital account of a partner shows a debit balance, he should pay the amount to the firm. But in case the partner is insolvent he will not be able to pay at least the full amount. The sum not recoverable from the insolvent partner is a loss to the firm. Now the question arises in which ratio this loss should be borne by the solvent partners? Prior to the decision in Garner vs. Murray case this was also treated as normal loss and borne by the solvent partners in their profit sharing ratios. But in Garner vs. Murray case it was decided that such a loss was not a trading loss but a capital loss which should be borne by the solvent partners in the ratio of their capitals on the date of dissolution, for which the solvent partners should bring the realisation loss in cash so that their capital accounts may show the balance as on the date of dissolution. Let us now learn how to compute the amount of deficiency of an insolvent partner to be borne by the solvent partners in case of fixed and fluctuating capitals.

Fixed Capital:

If the capital accounts of the partners are kept on fixed basis, each partner will have two accounts- one capital account and the other current account. 'The capital account of each partner will show a fixed balance (the same balance) year after year. All entries relating to drawings, profit or loss, interest on capital or drawings etc. will be made in the current account of each partner. The current account of a partner may show a debit balance or a credit balance but the capital account of each partner will show the same fixed credit balance year after year. Hence the deficiency of the insolvent partner will be borne by the solvent partners in the ratio of their fixed capitals.

Fluctuating Capital:

If the capital accounts of partners are kept on fluctuating basis, there will be only one capital account and all entries relating to drawings, profit or loss. Interest on capital or drawings is made in the capital account. Thus, the balance in the capital accounts of each partner will fluctuate every year and every time an entry is made. Under such situation, the deficiency of the insolvent partner will be borne by the solvent partners in the ratio of their capitals as on the date of insolvency. This means that all the accumulated profits or losses should first be divided among all the partners including the insolvent one in their profit sharing ratios which will make the capital accounts of the partners as on the date of insolvency. But no other entry need be made. That is why when realisation loss is debited to the partners the Garner vs. Murray decision requires the solvent partners to bring the realisation loss in cash.

Example: A, B, C and D are partners in a firm sharing profits and losses in the ratio of 4:1:2:3. The following was their balance sheet as at 31-3-2004:

Liabilities	Amount	Assets	Amount
	`		`
Sundry Creditors	3,00,000	Sundry Debtors 3,50,000	
Capital Accounts: `		Less: Provision for Bad Debts 50,000	3,00,000
A 7,00,000		Stock	2,00,000
D 3,00,000	10,00,000	Cash in hand	1,40,000
		Other Assets	3,10,000
		Capital A/cs: `	
		B 2,00,000	
		C 1,50,000	3,50,000
	13,00,000		13,00,000

The firm was dissolved on the following terms:

1. A is to take over Sundry Debtors at 80% of book value.
2. D is to take over Stock at 95% of the book value.
3. C is to discharge Sundry Creditors.
4. Other assets realised ` 3,00,000 and expenses of realisation come to `30,000.

5. B is found insolvent and `21,900 is realised from his estate.

Prepare Realisation Account, Capital Accounts of the partners and the Cash Account. Strictly apply the decision in Gamer Vs. Murray case.

Solution:

Dr. **Realisation Account** **Cr.**

Particulars	Amount	Particulars		Amount
	`			`
To Debtors A/c	3,50,000	By Creditors A/c		3,00,000
To Stock A/c	2,00,000	By Provision for Doubtful debts A/c		50,000
To Other Assets A/c	3,10,000	By A's Capital A/c (Debtors)		2,80,000
To C's Capital A/c (Creditors)	3,00,000	By D's Capital A/c (Stock)		1,90,000
To Cash A/c (Expenses)	30,000	By Cash A/c (Assets realised)		3,00,000
	11,90,000			11,20,000
		By Loss transferred to:	`	
		A's Capital A/c	28,000	
		B's Capital A/c	7,000	
		C's Capital A/c	14,000	
		D's Capital A/c	21,000	7,00,000
	11,90,000			11,90,000

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	D	Particulars	A	B	C	D
	`	`	`	`		`	`	`	`
To Balance c/d	–	2,00,000	1,50,000	–	By Balance b/d	7,00,000	–	–	3,00,000
To Realisation A/c	2,80,000	–	–	1,90,000	By Realisation A/c	–	–	3,00,000	–
To Realisation A/c (Loss)	28,000	7,000	14,000	21,000	By Cash A/c (Solvent Partners)	28,000	–	–	21,000
					By Cash A/c	–	21,900	–	–
To B's Capital A/c (Insolvency loss)	1,29,570	–	–	55,530	By A's Capital A/c (7/10)	–	1,29,570	–	–
To Cash A/c	2,90,430	–	1,36,000	54,470	By D's Capital A/c (3/10)	–	55,530	–	–
	7,28,000	2,07,000	3,00,000	3,21,000		7,28,000	2,07,000	3,00,000	3,21,000

Dr. **Cash Account** **Cr.**

Particulars	Amount	Particulars	Amount

	`		`
To Balance b/d	1,40,000	By Realisation A/c	30,000
To Realisation A/c	3,00,000		
To Capital A/cs: `		To Capital A/cs: `	
A 28,000		A 2,90,430	
D 21,000		C 1,36,000	
B 21,900	70,900	D 54,470	4,80,900
	5,10,900		5,10,900

6.7 SUMMARY

According to the Partnership Act, 1932 "The dissolution of partnership between all the partners of a firm is called the dissolution of the firm" Therefore, the act distinguishes between the dissolution of partnership and dissolution of the firm. Thus, a reconstitution of a firm involves a change in the relation of partners whereas in the case of dissolution of firm, there is complete severance of relationship between all partners. There are essentially two modes of dissolution of the firm i.e. (a) Dissolution without the order of the court, and (b) Dissolution by the order of the court**.** Usually the Deed of Partnership contains on the basis of which the final accounts between partners are settled. In the absence of such an agreement, the following rules will be applicable:

- The losses must be paid from profits first, next out of capital and lastly, if necessary, by contribution of each partner in profit sharing ratio.
- The assets of the firm, including sums contributed by partners to make up deficiency of capital in the sequence i.e. (i) in paying debts of the firm to outsiders; (b) in paying each partner for advances made by him to the firm; (c) amount on account of capital contribution, and (d) the surplus is paid if any in their profit sharing ratio.
- If a partner becomes insolvent or otherwise cannot pay his share of the contribution, the solvent partners have to pay.
- The property of the firm shall be applied first in the payment of debts of the firm and then the surplus, if any, shall be divided among the partners as per their claims.
- The private property of any partner shall be applied first in payment of his private debts and the surplus, if any, may be utilized for payment of the firm's debts if required.

- As soon as the partners decide to discontinue the business of the firm, all the assets have to be sold and the liabilities are to be paid off and for this purpose a separate account called 'Realization Account' is opened.

6.8 KEYWORDS

Dissolution of Partnership Firm: Discontinuation of the relationship between all the partners of the firm.

Realization Account: Account to know the profit/loss of firm on the realization of assets and payment of liabilities.

6.9 SELF ASSESSMENT QUESTIONS:

Q.1 What do you mean by dissolution of partnership and partnership firm? Also distinguish between the two.

Q.2 Elaborate the modes of Dissolution of Firm.

Q.3 What is Realization Account? Prepare a Performa of Realization Account.

Q.4 Write a detailed note on accounting treatment in case of insolvency of partners.

Q.5 A, B and C are partners sharing profits and losses in the ratio of 5:3:2. On 31st December, 2005 their Balance Sheet was follows:

Liabilities	Amount	Assets	Amount
	`		`
Creditors 30,000		Cash in Hand	17,000
Less: Provision for Discount 2,000	28,000	Debtors 50,000	
General Reserve	20,000	Less: Provision for bad debts 5,000	45,000
Reserve Fund	32,000	Stock	1,00,000
Investment Fluctuation Fund	7,500	Investments	40,000
Life Policy Fund	16,000	Furniture	20,000
Capital Accounts: `		Computer	30,000
A 3,15,500		Joint Life Policy	45,000
B 1,81,000		Machinery	2,00,000
C 1,50,000	6,46,500	Building	2,53,000
	7,50,000		7,50,000

On the above date the partners decided to dissolve the firm. Following transactions took place:

1. The assets were realised as follows; Stock ` 88,000, Furniture ` 14,000. Machinery ` 1,93,500 and Building ` 2,72,000.
2. Life Insurance policy surrendered for ` 34,000.
3. Creditors were settled @ 10% discount.

4. Investments were taken over by A for ` 29,000.
5. B took over the Computer @ 20% more than the book value.
6. Debtors realised 80% of book value.
7. Realisation expenses amount to ` 1,800 are met by B.

Give Journal Entries and draw up the necessary Ledge Account to close the books of the firm.

6.10 SUGGESTED/ FURTHER READINGS

1. S.N. Maheshwari: Advanced Accountancy, Vikas Publishing House Pvt. Ltd.
2. J.R. Monga: Basic Financial Accounting, MKM Publishers Pvt. Ltd.
3. D.K. Goyal: Accountancy, Arya Publications.
4. R.K.Mittal: Financial Accounting, V.K. Publications Ltd.