

PARTNERSHIP AND LLP ACCOUNTS



UNIT – 1 INTRODUCTION TO PARTNERSHIP ACCOUNTS

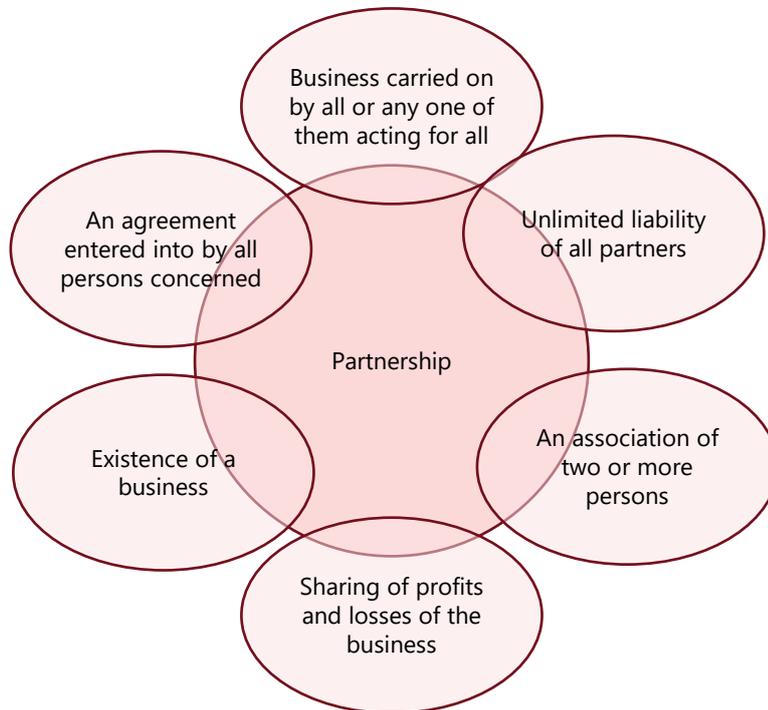
LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand the provisions of the Indian Partnership Act, 1932, Limited Liability Partnership Act, 2008 and Limited Liability Partnership Amendment Act, 2021
- ◆ Understand the features of a partnership firm and the need for a Partnership Deed.
- ◆ Understand the points to be covered in a Partnership Deed regarding accounts.
- ◆ Learn the technique of maintaining Profit and Loss Appropriation Account.
- ◆ Familiarize with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.
- ◆ Note that Capital Account balance as per Fluctuating Capital method is just equal to the sum of the balances of Capital Account and Current Account as per Fixed Capital Method.

- ◆ Learn how to arrive at the corrected net profit figure which is to be taken to be Profit and Loss Appropriation Account after rectification of errors. Rectification of errors may be necessary to arrive at the net profit of the partnership and preparing Profit and loss Appropriation Account.
- ◆ Learn that interest on capital and drawings, salaries/commissions are to be shown in the Profit and Loss Appropriation Account and not in the Profit and Loss Account. Also learn that drawings by partners will not appear in the Appropriation Account.

UNIT OVERVIEW



Accounts of Partnership firm

Accounts of Partnership firm		
Trading and Profit and Loss Account and Balance Sheet	Profit and Loss Appropriation Account	Capital accounts of partners (fixed capital method or fluctuating capital method)



1.1 INTRODUCTION: WHY PARTNERSHIP?

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



1.2 DEFINITION AND FEATURES OF PARTNERSHIP

As per **Section 4** of the Partnership Act, 1932:

“Partnership is the relation between persons who have agreed to share the profit of a business carried on by all or any of them acting for all.”

Features of a partnership,

- (i) **Existence of an agreement: As per section 5 of the Indian Partnership Act, 1932,** The relation of partnership arises from contract between parties and not from status as it happens in case of HUF (Hindu Undivided Family). **A formal or written agreement is not necessary to create a partnership.**
- (ii) **Business:** A partnership can exist only in business. Thus, it is not the agreement alone which creates a partnership. A partnership comes into existence only when partners begin to carry on business in accordance with their agreement. **Section 2 (b) of Indian Partnership Act, 1932 only states that business includes every trade, occupation and profession.**
- (iii) **Sharing of profit:** The persons concerned must agree to **share the profits of the business.** Because no person is a partner unless he or she has the right to share the profits of the business. **Section 4 of Indian Partnership Act, 1932** does not insist upon sharing of losses. Thus, a provision for sharing of loss is not necessary.
- (iv) **Mutual agency:** It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

- (v) **Minor as a partner:** A minor can be added in partnership firm. But the condition is that he can be admitted to share profit only. He cannot be made to share losses of the firm. If the partnership firm suffers loss than it will be borne by other major partners in their profit-sharing ratio.

Number of Partners: Minimum Partners: Two

Maximum Partners: As per Section 464 of the Companies Act, 2013, no association or partnership consisting of more than 100 number of persons as may be prescribed shall be formed for the purpose of carrying on any business. Rule 10 of Companies (incorporation) Rules 2014 specifies the limit as 50. Thus, maximum number of members in a partnership firm are 50.



1.3 LIMITED LIABILITY PARTNERSHIP

The Indian Partnership Act of 1932 provides for a general form of partnership which has inherent shortcoming of unlimited liability of all partners for business debts and legal consequences, regardless of their holding or profit-sharing ratio, as the firm is not a legal entity. General partners are also jointly and severally liable for tortuous acts of co-partners. In case of liquidation personal assets of partners can be liquidated to meet liabilities of the firm.

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

The Government felt that with Indian professionals increasingly transacting with or representing multi-nationals in international transactions, the extent of the liability they could potentially be exposed to, is extremely high. Hence, in order to encourage Indian professionals to participate in the international business community without apprehension of being subject to excessive liability, the need for having a legal structure like the LLP is encouraged. Thus, in convergence towards global scenario, Limited Liability Partnership Act, 2008 was introduced.

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

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

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

Summary of key advantages and challenges associated with formation of LLP could be presented as below:

Advantages:

- (i) LLP is organized and operates on the basis of an agreement.
- (ii) Enables professional/technical expertise and initiative to combine with financial risk taking capacity in an innovative and efficient manner.
- (iii) Limited liability of partners as in case of corporate entities along with flexibility of a partnership without imposing detailed legal and procedural requirements;
- (iv) Lower registration costs as compared to corporate entities;
- (v) Audit not mandatory (subject to turnover / capital contribution benchmark)

Challenges:

- (i) Public disclosure of financial statements;
- (ii) No option for Equity investments;
- (iii) Extensive penal provisions for non-compliance

The Limited Liability Partnerships (LLPs) in India were introduced by Limited Liability Partnership Act, 2008 which lay down the law for the formation and regulation of Limited Liability Partnerships. Later, the Ministry of Law and Justice made amendments to the Limited Liability Partnership Act, 2008 (LLP Act) through the LLP (Amendment) Act, 2021.

1.3.1 Definition of LLP

Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines **limited liability partnership** as a partnership formed and registered under this Act; and **“limited liability partnership agreement”** means any written agreement between the partners of the limited

liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership.

“Small limited liability partnership” means a limited liability partnership—

- (i) the contribution of which, does not exceed twenty-five lakh rupees or such higher amount, not exceeding five crore rupees, as may be prescribed; and
- (ii) the turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees or such higher amount, not exceeding fifty crore rupees, as may be prescribed; or

1.3.2 Nature of Limited Liability Partnership

- (1) A limited liability partnership is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.
- (2) A limited liability partnership should have perpetual succession.
- (3) Any change in the partners of a limited liability partnership should not affect the existence, rights, or liabilities of the limited liability partnership.

1.3.3 Non-applicability of the Indian Partnership Act, 1932

Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 shall not apply to a limited liability partnership.

1.3.4 Minimum number of partners in case of LLP

As per the LLP Act, any individual or body corporate may be a partner in a limited liability partnership; provided that an individual shall not be capable of becoming a partner of a limited liability partnership, if-

- (a) he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;
- (b) he is an undischarged insolvent; or
- (c) he has applied to be adjudicated as an insolvent and his application is pending.

Every limited liability partnership shall have at least two partners.

If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that it so carries on business after those six months and has the knowledge

of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

1.3.5 Designated partners

As per Section 7 of the LLP Act, every limited liability partnership should have at least two designated partners who are individuals and at least one of them should be a resident in India:

Provided that in case of a limited liability partnership in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such limited liability partnership or nominees of such body corporate will act as designated partners.

Explanation. -For the purposes of this section, the term "resident in India" means a person who has stayed in India for a period of not less than 120¹ days during the immediately preceding one year.

Subject to the provisions of the Act,

- (1) if the incorporation document-
 - (a) specifies who are to be designated partners, such persons should be designated partners on incorporation; or
 - (b) states that each of the partners from time to time of limited liability partnership is to be designated partner, every such partner will be a designated partner;
- (2) any partner may become a designated partner by and in accordance with the limited liability partnership agreement and a partner may cease to be a designated partner in accordance with limited liability partnership agreement.
- (3) An individual will not become a designated partner in any limited liability partnership unless he has given his prior consent to act as such to the limited liability partnership in such form and manner as may be prescribed.
- (4) Every limited liability partnership should file with the registrar the particulars of every individual who has given his consent to act as a designated partner in such form and manner as may be prescribed within thirty days of his appointment.
- (5) An individual eligible to be a designated partner should satisfy such conditions and requirements as may be prescribed.

¹ Amended as per Limited Liability Partnership (Amendment) Act, 2021

1.3.6 Liabilities of designated partners

As per LLP Act, unless expressly provided otherwise in this Act, a designated partner should be-

- (a) responsible for the doing of all acts, matters, and things as are required to be done by the limited liability partnership in respect of compliance of the provisions of this Act including filing of any document, return, statement, and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and.
- (b) liable to all penalties imposed on the limited liability partnership for any contravention of those provisions.

1.3.7 Limitation of Liability of an LLP and its partners

- ◆ Under the LLP Act, 2008 an obligation of an LLP arising out of a contract or otherwise, will be solely the obligation of the LLP;
- ◆ The Liabilities of an LLP should be met out of the properties of the LLP;
- ◆ A partner is not personally liable, directly or indirectly, for an obligation referred to above, solely by reason of being a partner in the LLP;
- ◆ an LLP is not bound by anything done by a partner in dealing with a person, if:
 - The partner does not have the authority to act on behalf of the LLP in doing a particular act; and
 - The other person knows that the partner has no authority or does not know or believe him to be a partner in the LLP

The liability of the LLP and the partners perpetrating fraudulent dealings will be unlimited for all or any of the debts or other liabilities of the LLP. However, in case any such act is carried out by a partner, the LLP is liable to the same extent as the partner unless it is established by the LLP that such act was without the knowledge or the authority of the LLP.

- ◆ The LLP is liable if a partner of LLP is liable to any person as a result of wrongful or omission on his part in the course of business of the LLP or with his authority.

1.3.8 Financial Disclosures & Returns

- ◆ Every LLP should maintain such proper books of accounts as may be prescribed relating to its affairs for each year of its existence on cash basis or accrual basis and according to the double-entry system of accounting and should maintain the same at its registered office for such period as may be prescribed;
- ◆ Every LLP should within six months of the end of each financial year prepare a Statement of Account and Solvency for the said financial year as at the last day of the said financial year, in such form as may be prescribed, and such statement should be signed by the designated partners of the LLP;
- ◆ Every LLP should file within the prescribed time, the Statement of Account and Solvency with the Registrar every year in such form and manner and accompanied by such fee as may be prescribed;
- ◆ The accounts of an LLP must be audited in accordance with such rules as may be prescribed. Provided that the Central Government may, by notification in the Official Gazette, exempt any class or classes of limited liability partnerships from the requirements of this sub-section.



1.4 DISTINCTION BETWEEN AN ORDINARY PARTNERSHIP FIRM AND AN LLP

	Basis	LLP	Partnership firm
1.	Regulating Act	The Limited Liability Partnership Act, 2008.	The Indian Partnership Act, 1932.
2.	Body corporate	It is a body corporate.	It is not a body corporate,
3.	Separate legal entity	It is a legal entity separate from its members.	It is a group of persons with no separate legal entity.
4.	Creation	It is created by a legal process called registration under the LLP Act, 2008.	It is created by an agreement between the partners.
5.	Registration	Registration is mandatory. LLP can sue and be sued in its own name.	Registration is voluntary. Only the registered partnership firm can sue the third parties.
6.	Perpetual succession	The death, insanity, retirement or insolvency of the partner(s) does not	The death, insanity, retirement or insolvency of the partner(s) may

		affect its existence of LLP. Members may join or leave but its existence continues forever.	affect its existence. It has no perpetual succession.
7.	Name	Name of the LLP to contain the word limited liability partners (LLP) as suffix.	No guidelines. The partners can have any name as per their choice.
8.	Liability	Liability of each partner limited to the extent to agreed contribution except in case of willful fraud.	Liability of each partner is unlimited. It can be extended upto the personal assets of the partners.
9.	Mutual agency	Each partner can bind the LLP by his own acts but not the other partners.	Each partner can bind the firm as well as other partners by his own acts.
10.	Designated partners	At least two designated partners and atleast one of them shall be resident in India.	There is no provision for such partners under the Partnership Act, 1932.
11.	Number of Partners	Minimum 2 but no maximum limit	Minimum 2 and maximum 50.
12.	Legal compliances	Only designated partners are responsible for all the compliances and penalties under this Act.	All partners are responsible for all the compliances and penalties under the Act.
13.	Foreign partnership	Foreign nationals can become a partner in a LLP.	Foreign nationals cannot become a partner in a partnership firm.
14.	Minor as partner	Minor cannot be admitted to the benefits of LLP.	Minor can be admitted to the benefits of the partnership with the prior consent of the existing partners.



1.5 MAIN CLAUSES IN A PARTNERSHIP DEED

The relation between the partners is governed by mutual agreement known as partnership deed. It should be comprehensive to avoid disputes later on. It is usual therefore, to find the following clauses in a Partnership Deed which may or may not be registered.

1. Name of the firm and the partners;

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

Registration of the firm is not compulsory, but non-registration restricts the partners or the firm from taking any legal action. Often there is no written Partnership Deed or, if there is one, it may be silent on a particular point. In that case the relevant sections of the Partnership Act will apply. If on any point the Partnership Deed contains a clause, it will hold good; otherwise the provisions of the Act relating to the questions will apply.

Rules in the absence of Partnership Deed

In the absence of any agreement to the contrary;

- No partner has the right to a salary,
- No interest is to be allowed on capital,
- No interest is to be charged on the drawings,
- Interest at the rate of 6%.p.a is to be allowed on a partner's loan to the firm, and
- Profits and losses are to be shared equally.

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

Example

A and B commenced business in partnership on 1 January 2022. No partnership agreement was made either oral or written. They contributed ₹ 40,000 and ₹ 10,000 respectively as capital. In addition, A also advanced ₹ 20,000 on 1 July 2022. A met with an accident on 1 April 2022 and could not attend to the partnership business upto 30 June 2022. The profits for the year ended on 31 December 2022 amounted to ₹ 50,600. Disputes having been arisen between them for sharing the profits.

A claims: (i) He should be given interest at 10% p.a. on capital and loan (ii) Profit should be distributed in proportion of capital.

B claims: (i) Net profit should be shared equally. (ii) He should be allowed remuneration of ₹ 1,000 p.m. during the period of A's illness. (iii) Interest on capital and loan should be given @ 6% p.a. You are required to settle the dispute between them and distribute the profits according to law. State reasons for your answer.

Answer

Since there is no written or oral partnership agreement, allowing rules are applicable as per Indian partnership act 1932

- (a) No interest is allowed on capital.
- (b) 6% p.a. interest is allowed on the loan advanced.
- (c) Profits and losses shall be shared equally.
- (d) No remuneration is allowed to any partner for taking part in the conduct of the business.

Thus

- a) neither of A nor B will be allowed interest on capital
- b) 6% interest will be allowed to both A and B
- c) Profit and losses shall be shared equally between A and B
- d) No remuneration shall be allowed to B.

Net profit for the year	=	50,600
Less: Int. on A's loan 20,000 × 6% × 6/12	=	<u>600</u>
Net Profit	=	50,000
A's 50%		25,000
B's 50%		25,000

Example

A, B and C are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capitals were ₹ 15,00,000, ₹ 30,00,000 and ₹ 60,00,000 respectively. For the year 2022 interest on capital was credited to them @ 12% instead of 10%. Pass the necessary adjustment entry.

Particulars	A	B	C	Firm
Interest that should have been credited @ 10%	1,50,000	3,00,000	6,00,000	10,50,000
Interest already credited @ 12%	1,80,000	3,60,000	7,20,000	12,60,000
Excess credit in partners account	(30,000)	(60,000)	(1,20,000)	(2,10,000)
By recovering the extra amount paid, the share of profits will increase and it will be credited in the ratio of 2:3:5	42,000	63,000	105,000	2,10,000
Net effect	12,000	3,000	(15,000)	-

The necessary journal entry will be:

Particulars	Debit (₹)	Credit (₹)
C's Current A/c	15,000	
To A's Current A/c		12,000
To B's Current A/c		3,000
(Interest less charged now rectified)		

1.6 POWERS OF PARTNERS

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

- Buying and selling of goods;
- Receiving payments on behalf of the firm and giving valid receipt;
- Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

- (d) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;
- (e) Engaging servants for the business of the firm.

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

- (a) Submitting a dispute relating to the firm arbitration;
- (b) Opening a bank account on behalf of the firm in the name of a partner;
- (c) Compromise or relinquishment of any claim or portion of claim by the firm;
- (d) Withdrawal of a suit or proceeding filed on behalf of the firm;
- (e) Admission of any liability in a suit or proceedings against the firm;
- (f) Acquisition of immovable property belonging to the firm;
- (g) Entering into partnership on behalf of the firm.

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



1.7 ACCOUNTS

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

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



1.8 PROFIT AND LOSS APPROPRIATION

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

In a partnership, profit has to be divided between the partners in a certain profit sharing ratio after making necessary adjustments stated in the partnership deed such as interest on capitals, drawings and loans; salaries or/and commission to partners etc. Accordingly, an additional account is prepared and net profit is transferred from the debit side of the profit and loss account to the credit side of this new account which is called Profit and Loss Appropriation Account and before the profit is divided between partners, it is necessary to record the above stated adjustments in this account.

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

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

ILLUSTRATION 1

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Give journal entries relating to division of profit.

SOLUTION**Journal Entries**

2022	Particulars	Dr. (₹)	Cr. (₹)
Dec. 31	Profit and Loss Appropriation Account Dr. To B's Capital Account (Salary due to B @ ₹ 500 per month)	6,000	6,000
	Profit and Loss Appropriation Account Dr. To A's Capital Account To B's Capital Account (Interest due on Capital @ 6% per month)	3,000	1,800 1,200
	Profit and Loss Appropriation Account Dr. To A's Capital Account To B's Capital Account (Remaining profit of ₹ 16,000 divide between A and B in the ratio of 5:3)	16,000	10,000 6,000

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

ILLUSTRATION 2

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

- (i) *Ram, who has contributed maximum capital demands interest on capital at 10% p.a. and share of profit in the capital ratio. But Rahim and Karim do not agree.*
- (ii) *Rahim has devoted full time for running the business and demands salary at the rate of ₹ 500 p.m. But Ram and Karim do not agree.*
- (iii) *Karim demands interest on loan of ₹ 2,000 advanced by him at the market rate of interest which is 12% p.a.*

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

SOLUTION

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

- (i) No interest on capital is payable to any partner. Therefore, Ram is not entitled to interest on capital.
- (ii) No remuneration is payable to any partner. Therefore, Rahim is not entitled to any salary.
- (iii) Since interest on loan payable to partner is not an appropriation of profit. It will be charged to Profit and Loss Account.
- (iv) The profits should be distributed equally.

Profit and Loss Appropriation Account for the year ended...

	Particulars		₹	Particulars	₹
To	Reserve A/c – 10% of ₹ 44,880		4,488	By Profit and Loss A/c - ₹ (45,000-120)	44,880
To	Share of Profit A/c:			(Net profit)	
	Ram capital A/c	₹ 13,464			
	Rahim capital A/c	₹ 13,464			
	Karim capital A/c	₹ 13,464	40,392		
			44,880		44,880

ILLUSTRATION 3

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Profit and Loss Appropriation Account.

SOLUTION**Profit and Loss Appropriation Account for the year ended 31-Dec-22**

Particulars	₹	Particulars	₹
To B's Capital Account-Salary	6,000	By Net Profit	25,000

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

NOTE: Since date of drawing & rate of interest on drawing is not given, it is assumed drawings are made on last day of year.

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

ILLUSTRATION 4

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022, the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Capital Accounts of Partners A and B.

SOLUTION

Dr.		A's Capital Account		Cr.	
2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Bank A/c- (Drawings)	8,000	Jan. 1	By Bank A/c	30,000
	To Balance c/d	33,800	Dec. 31	By Profit and Loss appropriation A/c	
				Interest	1,800
				By Profit and Loss appropriation A/c-(5/8 Profit)	10,000
		41,800			41,800
			2023		
			Jan. 1	By Balance b/d	33,800

Dr.		B's Capital Account				Cr.
2022	Particulars	₹	2022	Particulars	₹	
Dec. 31	To Bank A/c (Drawings)	10,000	Jan. 1	By Bank A/c	20,000	
Dec. 31	To Balance c/d	23,200	Dec. 31	By Profit and Loss appropriation A/c		
				- Salary	6,000	
				- Interest	1,200	
				By Profit and Loss appropriation A/c	6,000	
				- (3/8 Profit)		
		33,200			33,200	
			2023			
			Jan. 1	By Balance b/d	23,200	



1.9 FIXED AND FLUCTUATING CAPITAL

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

Thus, there are two methods of accounting –

- i) **Fixed capital method and**
- ii) **Fluctuating capital method.**

In Fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In Fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

1.9.1 Interest on Capital

A partner is not entitled to interest on his capital as a matter of right. But if there is an agreement, that partner would receive interest on his capital it is paid at the agreed rate only out of profits. Interest on capital is generally calculated on the opening balance and allowance is made for any additions of capital or withdrawals there from during the accounting period.

- ◆ The amount of interest is debited to interest on capital accounts and credited to the capital accounts, if capitals are fluctuating and current accounts, if capitals are fixed. Interest on capital account is then closed by transfer to profit and loss appropriation account.
- ◆ Alternatively, credit the capital (or current) account of the partner concerned and debit the profit and loss appropriation account.

For interest on capital

Profit and Loss Appropriation Account

Dr.

To (Individual) Capital (or Current) Accounts of Partners

Interest is generally allowed on capitals of the partners. Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business. Normally, it is charged for full year on the balance of capital at the beginning of the year unless some fresh capital is introduced during the year. On the additional capital introduced, interest for the relevant period of utilization is calculated. For example, A has ₹30,000 capital in the beginning of the year and introduces ₹10,000 during the year. If rate of interest on capital is 20 % p.a., interest on A's capital is calculated as follows:

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

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

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

Example

Shilpa and Sanju are partners with a capital of ₹1,00,000 and ₹1,60,000 on January 1, 2022 respectively. Shilpa introduced additional capital of ₹30,000 on July 1, 2022 and another ₹20,000 on October 31, 2022. Calculate interest on capital for the year ending 2022. The rate of interest is 9% p.a.

Solution**Interest on Capital (Shilpa):**

$$\begin{aligned} \text{On ₹1,00,000 for 12 month @ 9\%} &= 1,00,000 \times 9/100 \times 12/12 \\ &= ₹ 9,000 \end{aligned}$$

$$\begin{aligned} \text{On ₹30,000 for 6 month @ 9\%} &= 30,000 \times 9/100 \times 6/12 \\ &= ₹ 1,350 \end{aligned}$$

$$\begin{aligned} \text{On ₹20,000 for 2 month @ 9\%} &= 20,000 \times 9/100 \times 2/12 \\ &= ₹300 \end{aligned}$$

$$\begin{aligned} \text{Total interest on shilpa capital} &= ₹ 9,000 + ₹ 1350 + ₹ 300 \\ &= ₹10,650 \end{aligned}$$

By product method

Amount (₹)	Months	Product
1,00,000	12	12,00,000
30,000	6	1,80,000
20,000	2	40,000
Total product		14,20,000

$$\text{Interest on capital } 14,20,000 \times 9/100 \times 1/12 = ₹ 10,650$$

Interest on Capital (Sanju):

$$\text{On ₹1,60,000 for 12 month @ 9\%} = 1,60,000 \times 9/100 \times 12/12 = ₹14,400$$

$$\text{By product method: } = 1,60,000 \times 12 = 19,20,000 = 19,20,000 \times \frac{9}{100} \times \frac{1}{12} = 14,400$$

1.9.2 Interest on Drawings

Sometimes interest is not only allowed on the capitals, but is also charged on drawings. In such a case, interest will be charged according to the time that elapses between the taking out of the money and the end of the year.

Method 1: Product Method: When Unequal amount is withdrawn at different time period.

Suppose X, a partner, has drawn the following sum of money –

	₹
On 29th February, 2022	500
On 31st March, 2022	400
On 30th June, 2022	600
On 31st October, 2022	800

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

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

Alternatively, it can be calculated as follows:

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

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

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

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

beginning of each quarter, interest can be calculated by $\text{Total drawings} \times \text{Rate} \times 100 \times 7.5/12$. However, if withdrawals are at end of each quarter, the formula : $\text{Total drawings} \times \text{Rate} \times 100 \times 4.5/12$ will apply.

1.9.3 Guarantee of Minimum Profit

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

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

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

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

1.9.4 Capital ratio

Partners may agree to share profits and losses in the capital ratio. When capitals are fixed, profits will be shared in the ratio of given capitals. But if capitals are fluctuating and partners introduce or withdraw capitals during the year, the capitals for the purpose of ratio would be determined with reference to time on the basis of weighted average method.

Example

A and B formed a partnership with a capital contribution of ₹50,000 and ₹30,000 respectively on 1st January 2022. The profits were to be shared in the capital ratio. Calculate the capital ratio on the basis of following details:

	Capital Introduced		Capital Withdrawn	
	A (₹)	B (₹)	A (₹)	B (₹)
31 March	5,000	–	–	2,000
1 July	–	9,000	3,000	–
1 September	5,500	–	–	1,000
1 November	–	4,000	4,500	–

Answer**Total Capital Employed by A for one Month**

Capital (₹)	Months for which capital has been used in the business	Product (₹)
50,000	3	1,50,000
55,000	3	1,65,000
52,000	2	1,04,000
57,500	2	1,15,000
53,000	2	1,06,000
Total		6,40,000

Total Capital Employed by B for one Month

Capital	Months for which capital has been used in the business	Product
(₹)		(₹)
30,000	3	90,000
28,000	3	84,000
37,000	2	74,000
36,000	2	72,000
40,000	2	80,000
Total		4,00,000

On the basis of products of both the partners, the capital ratio between A and B is 64: 40 or 8 : 5.

ILLUSTRATION 5

A and B are partners sharing profits and losses in the ratio of their effective capital. They had ₹ 1,00,000 and ₹ 60,000 respectively in their Capital Accounts as on 1st January, 2022.

A introduced a further capital of ₹ 10,000 on 1st April, 2022 and another ₹ 5,000 on 1st July, 2022. On 30th September, 2022 A withdrew ₹ 40,000.

On 1st July, 2022, B introduced further capital of ₹ 30,000.

The partners drew the following amounts in anticipation of profit.

A drew ₹ 1,000 per month at the end of each month beginning from January, 2022. B drew ₹ 1,000 on 30th June, and ₹ 5,000 on 30th September, 2022.

12% p.a. interest on capital is allowable and 10% p.a. interest on drawings is chargeable. Date

of closing 31.12.2022. Calculate: (a) Profit-sharing ratio; (b) Interest on capital; and (c) Interest on drawings.

SOLUTION**(a) Calculation of Effective Capital**

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

(b) Calculation of Interest on Capital

$$A = ₹ 12,00,000 \times \frac{12}{100} \times \frac{1}{12} = ₹ 12,000$$

$$B = ₹ 9,00,000 \times \frac{12}{100} \times \frac{1}{12} = ₹ 9,000$$

(c) Calculation of Interest on Drawings

$$A = ₹ 12,000 \times \frac{10}{100} \times \frac{5.5}{12} = ₹ 550$$

$$B = ₹ 1,000 \times \frac{10}{100} \times \frac{6}{12} = ₹ 50$$

$$₹ 5,000 \times \frac{10}{100} \times \frac{3}{12} = ₹ 125$$

Effective capital is in the ratio 12 : 9 therefore profit sharing ratio is 12 : 9 i.e. 4 : 3.

ILLUSTRATION 6

Ram and Rahim start business with capital of ₹50,000 and ₹30,000 on 1st January, 2022. Rahim is entitled to a salary of ₹ 400 per month. Interest is allowed on capitals and is charged on

drawings at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year, Ram withdrew ₹ 8,000 and Rahim withdrew ₹ 10,000. The profit for the year before allowing for the terms of the Partnership Deed came to ₹ 30,000. Assuming the capitals to be fixed, prepare the Profit and Loss Appropriation Account and the Capital and Current Accounts relating to the partners.

SOLUTION**Profit & Loss (Appropriation) Account**

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Rahim's Current A/c		Dec. 31	By Net Profit	30,000
	Salary	4,800		By Sundries-Interest on Drawings:	
	To Sundries-Interest on Capitals :			Ram's Current A/c	
	Ram's Current A/c	3,000		(6% on ₹ 8,000 for 6 months)	240
	Rahim's Current A/c	1,800		Rahim's Current A/c	
	To Profit transferred to			(6% on ₹ 10,000 for 6 months)	300
	Ram's Current A/c (1/2)	10,470			
	Rahim's Current A/c (1/2)	10,470			
		30,540			30,540

ILLUSTRATION 7

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

SOLUTION**Ram's Capital Account**

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Balance c/d	50,000	Jan. 1	By Bank A/c	50,000
			2023		
			Jan. 1	By Balance b/d	50,000

Rahim's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Balance c/d	30,000	Jan. 1	By Bank A/c	30,000
			2023		
			Jan. 1	By Balance b/d	30,000

Ram's Current Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Cash Bank A/C (Drawings)	8,000	Dec. 31	By Profit and Loss appropriation A/c - Interest	3,000
	To Profit and Loss appropriation A/c - Interest on Drawings	240		By Profit and Loss appropriation A/c - 1/2 profit	10,470
	To Balance c/d	5,230			
		13,470			13,470
			2023		
			Jan. 1	By Balance b/d	5,230

Rahim's Current Account

2022	Particulars	₹	2022	Particulars	₹
	To Cash Bank A/c (Drawings)	10,000	Dec. 31	By Profit and Loss appropriation A/c Salary	4,800
Dec. 31	To Interest on Drawings	300		By Interest	1,800
	To Balance c/d	6,770		By Profit and Loss appropriation A/c Profit	10,470
		17,070			17,070
			2023		
			Jan. 1	By Balance b/d	6,770

ILLUSTRATION 8

A and B were partners in a firm sharing profits and losses in the ratio of 3:2. They admit C for 1/6th share in profits and guaranteed that his share of profits will not be less than ₹250,00,000. Total profits of the firm for the year ended 31st March, 2022 were ₹900,00,000. Calculate share of profits for each partner when:

1. Guarantee is given by firm.
2. Guarantee is given by A
3. Guarantee is given by A and B equally.

SOLUTION

Case1. When Guarantee is given by firm.

Profit and Loss Appropriation Account
For the year ending on 31st March, 2022

Particulars	₹	Particulars	₹
To A's Capital A/c (3/5 of ₹ 650,00,000)	3,90,00,000	By Profit and Loss, A/c	9,00,00,000
To B's Capital A/c (2/5 of ₹ 650,00,000)	2,60,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000 or ₹ 25,00,00,000 which ever is more)	2,50,00,000		
	9,00,00,000		

Case2. When Guarantee is given by A

Profit and Loss Appropriation Account
For the year ending on 31st March, 2022

Particulars	₹	Particulars	₹
To A's Capital A/c (3/6 of ₹ 9,00,00,000)	4,50,00,000	By Profit and Loss, A/c (net profits)	9,00,00,000
Less: Deficiency borne for C (1,00,00,000)	3,50,00,000		
To B's Capital A/c (2/6 of ₹ 9,00,00,000)	3,00,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000)	1,50,00,000		
Add: Deficiency Recovery from A (1,00,00,000)	2,50,00,000		
	9,00,00,000		

Case3. When Guarantee is given by A and B equally.

Profit and Loss Appropriation Account
For the year ending on 31st March, 2022

Particulars		₹	Particulars	₹
To A's Capital A/c (3/6 of ₹ 9,00,00,000)	4,50,00,000		By Profit and Loss, A/c (net profits)	9,00,00,000
Less: Deficiency borne for C (1/2 of 1,00,00,000)	<u>(50,00,000)</u>	4,00,00,000		
To B's Capital A/c (2/6 of ₹ 9,00,00,000)	3,00,00,000			
Less: Deficiency borne for C (1/2 of 1,00,00,000)	<u>(50,00,000)</u>	2,50,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000)	1,50,00,000			
Add: Deficiency Recovery from A	50,00,000			
Add: Deficiency Recovery from B	<u>50,00,000</u>	2,50,00,000		
		9,00,00,000		9,00,00,000

SUMMARY

- ◆ The Indian Partnership Act defines partnership as “the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all.”
- ◆ The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature.
- ◆ In the partnership firm relations among the partners will be governed by mutual agreement. The agreement is known as Partnership Deed which is to be properly stamped.
- ◆ In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.
- ◆ During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year.
- ◆ There are two methods of accounting –

- i. Fixed capital method and
- ii. Fluctuating capital method.

In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

- ◆ Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business.
- ◆ Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.
- ◆ Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

TEST YOUR KNOWLEDGE

True and False

1. *In absence of any agreement partners share profits of the business in the ratio of their capital contribution.*
2. *Profit sharing ratio and capital contribution ratio need not be same.*
3. *Every partnership firm must register itself with Registrar of firms.*
4. *A partner can advance loan to the partnership firm in addition to capital contributed by him.*

5. *A partner can demand interest on capital even if it is not provided in the partnership deed.*
6. *If a partner does not take part in day to day business activities of the firm then he is not entitled to any share of profit.*
7. *Interest should be paid @ 6% p.a. on partners' loan even if it is not provided in the partnership deed.*
8. *Husband and wife cannot be partners in the same firm.*
9. *One senior partner is Principal and other partners are his agents.*
10. *Partners are the agents of the firm and each other.*

Multiple Choice Questions

1. *If a firm prefers Partners' Capital Accounts to be shown at the amount introduced by the partners as capital in firm then entries for salary, interest, drawings, interest on capital and drawings and profits are made in*
 - (a) *Trading Account*
 - (b) *Profit and Loss Account*
 - (c) *Partners' Current Account*
2. *In the absence of any agreement, partners are liable to receive interest on their Loans @*
 - (a) *12% p.a.*
 - (b) *10% p.a.*
 - (c) *6% p.a.*
3. *The relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all is known as*
 - (a) *Partnership.*
 - (b) *Joint Venture.*
 - (c) *Association of Persons.*
4. *Firm has earned exceptionally high profits from a contract which will not be renewed. In such a case the profit from this contract will not be included in*
 - (a) *Profit sharing of the partners.*
 - (b) *Calculation of the goodwill.*
 - (c) *Both.*

5. *In the absence of an agreement, partners are entitled to*
- (a) *Interest on Loan and Advances.*
 - (b) *Commission.*
 - (c) *Salary.*
6. *Partners are supposed to pay interest on drawings only when by the*
- (a) *Provided, Agreement.*
 - (b) *Agreed, Partners*
 - (c) *Both (a) & (b) above.*
7. *When a partner is given a guarantee by the other partner, loss on such guarantee will be borne by*
- (a) *Partner who gave the guarantee*
 - (b) *All the other partners.*
 - (c) *Partnership firm.*
8. *A, B and C had capitals of ₹ 50,000; ₹ 40,000 and ₹ 30,000 respectively for carrying on business in partnership. The firm's reported profit for the year was ₹ 80,000. As per provisions of the Indian Partnership Act, 1932, find out the share of each partner in the above amount after taking into account that no interest has been provided on an advance by A of ₹ 20,000, in addition to his capital contribution.*
- (a) *₹ 26,267 for Partner B and C & ₹ 27,466 for partner A.*
 - (b) *₹ 26,667 each partner.*
 - (c) *₹ 33,333 for A, ₹ 26,667 for B and ₹ 20,000 for C.*
9. *X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and X wanted interest on capital @ 20% as his capital contributions was ₹ 1,00,000 as compared to that of Y and Z which was ₹ 75,000 and ₹ 50,000 respectively.*
- (a) *Profits of ₹ 6,000 will be distributed equally with no interest on either Capital.*
 - (b) *X will get the interest of ₹ 20,000 and the loss of ₹ 14,000 will be shared equally.*
 - (c) *All the partners will get interest on capital and the loss of ₹ 39,000 will be shared equally.*
10. *X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and*

Y determined interest @ 24% p.a. on his loan of ₹ 80,000. There was no agreement on this point.

Calculate the amount payable to X, Y and Z respectively.

- (a) ₹ 2,000 to each partner.
 - (b) Loss of ₹ 4,400 for X and Z & Y will take home ₹ 14,800.
 - (c) ₹ 400 for X, ₹ 5,200 for Y and ₹ 400 for Z.
11. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Z demanded minimum profit of ₹ 5,000 as his financial position was not good. However, there was no written agreement. Profits to be distributed to X, Y and Z will be
- (a) Other partners will pay Z the minimum profit and will suffer loss equally.
 - (b) Other partners will pay Z the minimum profit and will suffer loss in capital ratio.
 - (c) ₹ 2,000 to each of the partners.

Theory questions

1. Write short notes on:
 - (a) Features of Partnership
 - (b) Powers of Partners
2. Distinguish between fixed capital and fluctuating capital.
3. What are the liabilities of designated partners in case of LLP.

Practical questions

1. A, B and C entered into partnership on 01.04.2021 to share profits and losses in the ratio of 5 : 3 : 2. A personally guaranteed that C's share of profit after charging interest on capitals at 5% p.a. would not be less than ₹ 30,000 in any year. Capitals of A, B and C were ₹ 3,20,000, ₹ 2,00,000 and ₹ 1,60,000 respectively.

Profits for the year ending 31.03.2022 before providing for interest on partners capital was ₹ 1,59,000.

You are required to prepare the Profit and Loss Appropriation Account.
2. Weak, Able and Lazy are in partnership sharing profits and losses in the ratio of 2:1:1. It is agreed that interest on capital will be allowed @ 10% per annum and interest on

drawings will be charged @ 8 % per annum. (No interest will be charged/allowed on Current Accounts).

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

	Weak	Able	Lazy
	₹	₹	₹
Capital (1.1.2022)	75,000	40,000	30,000
Current Account (1.1.2022)	10,000	5,000	(Dr.) 5,000
Drawings	15,000	10,000	10,000

The draft accounts for 2022 showed a net profit of ₹ 60,000 before taking into account interest on capitals and drawings and subject to following rectification of errors:

- Life Insurance premium of Weak amounting to ₹ 750 paid by the firm on 30th June, 2022 has been charged to Miscellaneous Expenditure A/c.
- Repairs of Machinery amounting to ₹ 10,000 has been debited to Plant Account and depreciation thereon charged @ 20%.
- Travelling expenses of ₹ 3,000 of Able for a pleasure trip to U.K. paid by the firm on 30th June, 2022 has been debited to Travelling Expenses Account.

You are required to prepare the Profit and Loss Appropriation Account, Current Accounts of partners Weak, Able and Lazy for the year ended 31st December, 2022.

- Ram and Rahim are in partnership sharing profits and losses in the ratio of 3:2. As Ram, on account of his advancing years, feels he cannot work as hard as before, the chief clerk of the firm, Ratan, is admitted as a partner with effect from 1st January, 2022, and becomes entitled to 1/10th of the net profits and nothing else, the mutual ratio between Ram and Rahim remaining unaltered.

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

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

The net profit for the year ended December 31, 2022 is ₹ 1,10,000. Show the distribution of net profit amongst the partners.

- X and Y are partners. As per terms of agreement interest is allowed on capital at 8% p.a. and charged on drawings at 10% p.a. X withdrew ₹ 40,000 pm at the end of each month

and Y withdrew ₹ 120,000 at the end of each quarter. You are required to fill the missing figures in following accounts:

Profit and Loss Appropriation Account for the year ended March 31, 2022

Particulars	₹	Particulars	₹
To ...?		By Profit and Loss A/c (Net profit)	?
To Interest on Capital A/c		By Interest on Drawings A/c	?
X 160,000		X ?	
Y ?	288,000	Y ?	
To profit transferred to Capital A/c			
X (2/3) ?			
Y (1/3) 280,000	?		
	?		?

Partner's Capital Accounts

Particulars	X	Y	Particulars	X	Y
To ...?	?	?	By ...?	?	?
To ...?	?	?	By Salary A/c	3,60,000	-
To ...?	?	?	By ...?	?	?
			By ...?	?	?
	?	?		?	?

ANSWERS/HINTS

True and False

1. False: In absence of any agreement partners share profits equally and not in capital contribution ratio.
2. True: Profit sharing can be different from the that of the capital introduced by each of the partner. Not necessary that partner contributing more capital should have a higher profit sharing ratio and vice versa.
3. False: Registration of firms is not compulsory under Indian Partnership Act, 1932.

4. True: Where the partnership deed is absent, then the interest shall be paid at 6% per annum. So the interest on the loan to be paid to the partner.
5. False: Interest on capital can be paid only if it is provided in the partnership deed.
6. False: Every partner need not take part in the business. Even if a partner does not take part in the business he is entitled for his share of profit.
7. True: In absence of Partnership deed, Interest at the rate of 6%.p.a is to be allowed on a partner's loan to the firm.
8. False: Husband and wife can be partners in the same firm.
9. False: There is no senior or junior partner. Every partner is agent/principal of other partners.
10. True: Concept of agency applies to every partner and the firm as well. So each partner is a principal to and agent of every other partner and to the firm.

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(a)	4.	(b)	5.	(a)	6.	(c)
7.	(a)	8.	(a)	9.	(a)	10.	(c)	11.	(c)		

Theoretical Questions

1. (a) The following four essential features of a partnership, namely:
 - (i) Partnership is the result of an agreement: It means that the relation of partnership arises from contract and not from status.
 - (ii) Business: A partnership can exist only in business.
 - (iii) Sharing of profit: The persons concerned must agree to share the profits of the business.
 - (iv) Mutual agency: It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.
- (b) Powers of partners are the following:
 - (i) Buying and selling of goods;
 - (ii) Receiving payments on behalf of the firm and giving valid receipt;

- (iii) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;
- (iv) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;
- (v) Engaging servants for the business of the firm.

2. (a) In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

3. Please refer para 1.3.6

Practical Problems

1. Profit and Loss Appropriation Account

for the year ended 31st March, 2022

Dr.				Cr.		
		₹	₹			
To	Interest on capital			By	Net profit	1,59,000
	A (5% of ₹ 3,20,000)	16,000			b/d	
	B (5% of ₹ 2,00,000)	10,000				
	C (5% of ₹ 1,60,000)	<u>8,000</u>	34,000			
To	Partners' capital accounts: [profit (₹ 1,59,000 – ₹ 34,000) transferred]					
	A $\left(\frac{5}{10} \text{ of } ₹ 1,25,000\right)$	62,500				
	Less: Transferred to C	<u>5,000</u>	57,500			
	B $\left(\frac{3}{10} \text{ of } ₹ 1,25,000\right)$		37,500			

C $\left(\frac{2}{10} \text{ of } ₹1,25,000 \right)$	25,000			
Add: Transferred from A	<u>5,000</u>	<u>30,000</u>		
		<u>1,59,000</u>		<u>1,59,000</u>

2.

Weak, Able & Lazy**Profit and Loss Appropriation Account for the year ended****31st December, 2022**

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

Working Notes:**(i) Adjusted Profit**

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

(ii) Interest on Drawings :

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

Partners' Current Accounts

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

2.

Amount due to Ratan as a Chief Clerk

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

Profit and Loss Appropriation Account for the year ended December 31, 2022

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

3. Profit and Loss Appropriation Account for the year ended March 31, 2022

Particulars	₹	Particulars	₹
To Salary to X	3,60,000	By Profit and Loss A/c (Net profit)	14,48,000
To Interest on Capital A/c		By Interest on Drawings A/c	40,000
X 1,60,000		X 22,000	
Y <u>1,28,000</u>	2,88,000	Y <u>18,000</u>	
To profit transferred to Capital A/c			
X (2/3) 5,60,000			
Y (1/3) <u>2,80,000</u>	8,40,000		
	14,88,000		14,88,000

Partner's Capital Accounts

Particulars	X	Y	Particulars	X	Y
To Drawing A/c	4,80,000	4,80,000	By Balance b/d	20,00,000	16,00,000
To Interest on Drawings A/c	22,000	18,000	By Salary A/c	3,60,000	-
To Balance c/d	25,78,000	15,10,000	By Interest on Capital A/c	1,60,000	1,28,000
			By Profit and Loss App A/c	5,60,000	2,80,000
	30,80,000	20,08,000		30,80,000	2,008,000

Working Notes:

- X's Share of Profit $2,80,000 \times \frac{3}{1} \times \frac{2}{3} = 5,60,000$
- Interest on Drawings
 $X = 4,80,000 \times \frac{11}{2} \times \frac{1}{12} \times \frac{10}{100} = 22,000$
 $Y = 4,80,000 \times \frac{9}{2} \times \frac{1}{12} \times \frac{10}{100} = 18,000$
- Y's Interest on Capital $2,88,000 - 1,60,000 = 128,000$

UNIT – 2: TREATMENT OF GOODWILL IN PARTNERSHIP ACCOUNTS

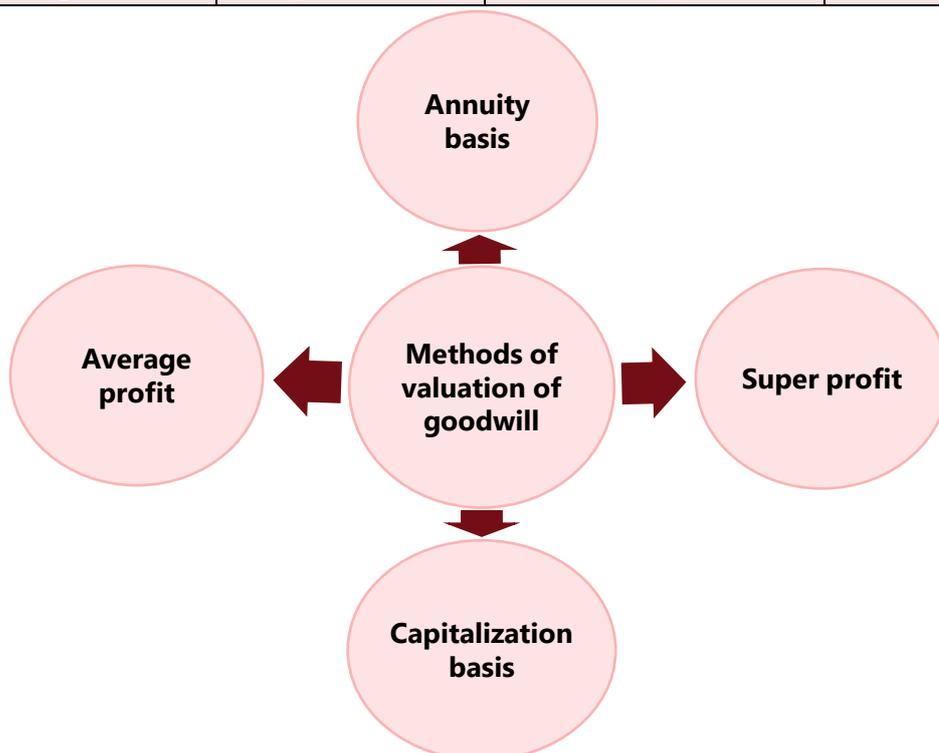
LEARNING OUTCOMES

After studying this unit, you will be able to:

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

UNIT OVERVIEW

Necessity for valuation of goodwill			
Change in profit sharing ratio	Admission of partner	Retirement or death of partner	When business is dissolved or sold





2.1 GOODWILL

Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.

In simpler terms, Goodwill is nothing more than the probability that old customer will resort to old place again and again. The capacity of a business to earn super profits in the future is basically what is meant by term goodwill. **Goodwill is an intangible asset;** it cannot be seen; it cannot be felt; it cannot be transported physically. **Even then it is very real.** From accounting point of view, it is necessary that it has some monetary or saleable value. The implication of the term over and above is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, personal reputation of the partner or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases:

- a) When the profit sharing ratio amongst the partners is changed;
- b) When a new partner is admitted;
- c) When a partner retires or dies; and
- d) When the business is dissolved or sold.

Let us take a simple example. There is a small Book business owned by a firm. Its net worth i.e. Asset–liabilities, is ₹ 140,000. Now if a purchaser is willing to pay ₹ 150,000 for it, the extra ₹ 10,000 is known in accounting as goodwill. The next question is: Why the purchaser is willing to pay ₹ 10,000 for goodwill.

One reason may be the future capability of the business to earn more profit than the normal profit. It may be on account of favourable location.

The major factors which affect value of goodwill are as follows:

The list is in no way exhaustive but only provides the basic guidelines:

- (i) The quality of the goods sold.
- (ii) The personal reputation of the owners i.e., their ability to attract the customers.
- (iii) The location of the business premises e.g., a good position in a congested market.
- (iv) The possession of near monopoly right e.g. main agent for a particular vehicle like, Maruti car, Bajaj scooter, etc.
- (v) The possession of trademarks and patents.
- (vi) The presence of managerial skill.

- (vii) The cost of research and development which enables the production at low cost and of good quality.
- (viii) The possession of special contracts for the availability of materials

RECOMMENDATION OF ACCOUNTING STANDARD

Accounting Standards require an enterprise to recognize an intangible asset, only if and only if, certain conditions are satisfied, namely:

- (i) An intangible asset must have the **characteristics of an asset**. It means that it must have some value and must be clearly identifiable, so that it can be sold without disposing other assets or future benefits flowing from other assets.
- (ii) An intangible asset should be recognized only if the **future probable economic benefits** (i.e., increased revenue from sales) will flow to the business enterprise and not to others. It means that management can make reasonable estimates of future benefits.
- (iii) The cost of the intangible asset can **be measured reliably**, that is, the cost is objectively verifiable. If the cost cannot be measured reliably, then it cannot be recognized as an asset.

It is thus clear that none of the conditions is satisfied by internally generated goodwill or inherent goodwill. The reasons are simple to explain. First, it is not an identifiable resource like patent, trademark or copyright. Second, it is very difficult to assess its future benefits. Finally, the cost of internally generated goodwill cannot be reliably measured in the absence of any consideration in money or money' worth. There is no documentary evidence to support the value of goodwill as a resource.

Goodwill should be recorded in the books only when some consideration in money or money' worth has been paid for it. Accordingly, on admission or retirement/death of a partner or even when there is a change in profit sharing ratio amongst the existing partners, goodwill should not be raised in the books of account of the partnership firm because no consideration in money or money' worth has been paid for it. The conclusion is that only purchased goodwill should be recorded in the books of account whether the payment is made directly in cash or money' worth. For example, 'A' and 'B' purchase the net assets (assets minus liabilities) of 'C' amounting to ₹ 2,50,000 for ₹ 3,00,000 in cash, the additional payment of ₹ 50,000 is a payment for goodwill in cash. It is a case of purchased goodwill (an asset) and can be validly recorded in the books of A and B. When no payment is made for the purchase of goodwill and goodwill account is raised in the books, it is a case of internally generated goodwill or inherent goodwill and as per Accounting Standards, it is not permitted. For example, in the event of reconstitution of the firm due to admission, or retirement or death of a partner or even a change in the profit sharing ratio without reconstitution, goodwill of the firm is evaluated. In

such a situation, the value of goodwill should not be brought into books of account because it is inherent or self-generated goodwill since no money or money' worth has been paid for it. The only way out is that the value of goodwill as calculated with the help of different valuation methods should be adjusted through capital accounts of the partner(s) of the firm. In no case the goodwill account is to be raised in the books of account, either on the reconstitution of the firm or change in the profit sharing ratio.

The amount of goodwill is written off over a period of time. In case when the goodwill account exists at the time of reconstitution of firm, it should be written off immediately whether it is internally generated or goodwill has been bought for some consideration.



2.2 METHODS FOR GOODWILL VALUATION

There are three methods for valuation of goodwill

- 1) Average profit basis,-Simple and Weighted
- 2) Super profit basis,-Number of Year Purchase, Annuity basis, and Capitalization of Super Profit
- 3) Capitalization basis- Average Profits

(1) Average Profit Basis: In this case the average profits of past years are adjusted for any expected change in future. The number of year are decided on the basis of judgement and negotiation.

- ◆ For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.
- ◆ Let us suppose profits of a partnership firm for the last five years were ₹ 30,000, ₹ 40,000, ₹ 50,000, ₹ 60,000 and ₹ 70,000. In this case, a clear increasing trend is noticed and therefore, average profit may be arrived at by assigning appropriate weights as shown below :

1	2	3	4 = 2 × 3
Year	Profit	Weight	Weighted Profit
	₹		₹
1	30,000	1	30,000
2	40,000	2	80,000

3	50,000	3	1,50,000
4	60,000	4	2,40,000
5	70,000	5	3,50,000
		15	8,50,000

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

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

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

Weighted average is used when profit has increasing or decreasing Trend. Highest weight is always given to current year, as it reflects the more realistic view of the future profitability

Example

The past profits of five years of a partnership firm are: ₹ 50,000; ₹ 40,000; ₹ 52,000; ₹ 48,000 and ₹ 56,000 respectively. Calculate the value of goodwill on the basis of 4 years' purchase of the average profits of the last five years.

Answer

Total profits for five years = ₹ (50,000 + 40,000 + 52,000 + 48,000 + 56,000) = ₹ 2,46,000

Average profit = Sum of profits/No. of years

Average Profit = ₹ 2,46,000 ÷ 5 = ₹ 49,200

Value of goodwill (being four years' purchase of the average profit of five years) = 4 × ₹ 49,200 = ₹ 1,96,800.

(2) Super Profit Basis: In case of super profit method, goodwill is valued on the basis of super profits earned by the firm.

Super Profit=Actual Profit-Normal Profit

Actual Profit is average maintainable profit

Normal Profit=Normal rate of Return (NRR) x Capital Employed

The rationale for using the super profit is the partner who gains excess earning owing to reconstitution of firm should compensate to partners sacrificing their share in the reconstitution. Super profit means, excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because normal profit he can earn by joining any partnership firm. Under super profit method, what excess profit a partnership firm can earn is to be determined first.

Calculation of super profit:

- (i) Identify the capital employed by the partnership firm;
- (ii) Identify the average profit earned by the partnership firm based on past few years' figures;
- (iii) Determine normal rate of return prevailing in the locality of similar firms;
- (iv) Apply normal rate of return on capital employed to arrive at normal profit;
- (v) Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

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

- (a) **Number of Years Purchase Method:** Goodwill is generally valued by multiplying the amount of super profit by certain number of years depending upon the expectation about the maintenance of such profit in future. If it is expected that the super profit can be maintained for another five years in future, then value of goodwill may be taken as $₹ 3,000 \times 5 = ₹ 15,000$.

Example

A firm of A, B and C has a total capital investment of ₹ 4,50,000. The firm earned net profits during the last four years as: I-₹ 70,000; II-₹ 80,000; III-₹ 1,20,000 and IV-₹ 1,00,000. The reasonable expected return is 15 per cent having regard to the risk involved. The value of goodwill of the business, if it is based on 3 years' purchase of the average super profits of the past four years is as follows:

Average Profit = Sum of profits/no. of years

Normal Profit = NRR x Capital Employed

Super Profit = Average maintainable profit- Normal Profit

	₹
Total profits earned during four years :	3,70,000
Average annual profit ₹ 3,70,000 ÷ 4	92,500
Normal Profit (15% of ₹ 4,50,000)	67,500
Super Profit ₹ 92,500–₹ 67,500	25,000
Value of goodwill (being 3 years' purchase of the average super profit: ₹ 25,000 x 3 =	75,000

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

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

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

The word annuity is used to mean identical annual amount of super profit. So, for discounting it is possible to refer to annuity table. As per the annuity table, present value of ₹ 1 to be received at the end of each year for 5 years @15% interest p.a. is 3.3522. So value of goodwill under annuity method is ₹ 3,000×3.3522 = ₹ 10,056.60.

Example

Calculate the goodwill by annuity method of super profit from the following facts:

- Annual maintainable profit after tax is ₹ 65,000.
- Capital employed is ₹ 4,00,000.
- Normal rate of return is expected at 12% p.a.
- Present value of an annuity of ₹ 1 for five years @ 12% interest is 3.604776.

Answer

	₹
Annual maintainable profit	65,000
Less: Normal profit based on capital employed and normal rate of return i.e., 12% of ₹ 4,00,000	(48,000)
Super profit	17,000
The present value of an annuity of ₹ 1 for five years at 12% compound interest is	3.604776

The present value of annuity of ₹ 17,000 for five years at 12% compound interest = $17,000 \times 3.604776 = ₹ 61,281$ (Approx.)

Capitalization of Super Profit:

$$\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return (NRR)}} = \frac{17,000}{12\%} = ₹ 14,1667$$

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

- Determine the normal rate of return.
- Find out the average profit of the partnership firm for which goodwill is to be determined.
- Determine the capital employed by the partnership firm for which goodwill is to be determined.
- Find out normal value of the business by dividing average profit by normal rate of return.

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

Goodwill = Normal Capital - Actual Capital

Normal capital = Average Profit/NRR

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

Normal Value of business = $\frac{20,000}{15\%} = ₹ 1,33,333$ Value of goodwill = ₹ 1,33,333 – ₹ 1,00,000 = ₹ 33,333

Example

The net tangible assets of a firm are worth ₹ 4,10,000 and the average profit of last four years amounts to ₹ 60,000. Find out of the value of goodwill under capitalization method if the reasonable return on capital invested is 12%.

Answer

	₹
Capital invested in the business	4,10,000
Normal rate of return	12%
Average profit earned by the firm	60,000
Value of the firm (Capitalization of average profit): $60,000/12\% =$	5,00,000
Goodwill = Value of the firm – Net Assets = ₹ 5,00,000 – ₹ 4,10,000	90,000

Above methods are explained below with the help of following illustrations:

ILLUSTRATION 1

Lee and Lawson are in equal partnership. They agreed to take Hicks as one-fourth partner. For this it was decided to find out the value of goodwill. M/s. Lee and Lawson earned profits during 2019-2022 as follows:

Year	Profits (₹)
2019	1,20,000
2020	1,25,000
2021	1,30,000
2022	1,50,000

On 31.12.2022 capital employed by M/s. Lee and Lawson was ₹5,00,000. Rate of normal profit is 20%.

Required

Find out the value of goodwill following various methods.

SOLUTION

Average Profit:

Year	Profit	Weight	Weighted Profit ₹
2019	1,20,000	1	1,20,000
2020	1,25,000	2	2,50,000
2021	1,30,000	3	3,90,000
2022	1,50,000	4	6,00,000
		10	13,60,000

Weighted Average Profit = ₹ 13,60,000 divided by 10 = ₹ 1,36,000

Method (1): Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase

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

Method (2): Super Profit Basis

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

Assumption: Goodwill is valued at 3 years' purchase.

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

Method (3): Annuity Basis

Assumptions:

- Interest rate is equivalent to normal profit rate i.e. 20%p.a.
- Goodwill is valued at 3 years' purchases

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

Method (4): Capitalisation Basis

Normal Value of business: $\frac{₹ 1,36,000}{20} \times 100$	=	₹ 6,80,000
Less: Capital Employed in M/s. Lee and Lawson	=	(₹ 5,00,000)
Goodwill	=	<u>₹ 1,80,000</u>

ILLUSTRATION 2

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

		₹
(1)	Capital Invested	1,50,000
(2)	Trading Results:	
	2019	Profit 40,000
	2020	Profit 36,000
	2021	Loss 6,000
	2022	Profit 50,000
(3)	Market Rate of interest on investment	10%
(4)	Rate of risk return on capital invested in business	2%
(5)	Remuneration from alternative employment of the proprietor (if not engaged in business).	₹ 6,000 per annum

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

SOLUTION

Average maintainable profits:		₹
Trading profit during	2019	40,000
	2020	36,000
	2021	50,000
		<u>1,26,000</u>

Less: Loss during	2022	(6,000)
Total		1,20,000
Average Profits		30,000
Less: Remuneration for the proprietor		(6,000)
Average maintainable Profit		24,000
Less: Normal Profit (12% on capital employed of ₹ 1,50,000)		(18,000)
Super Profit		6,000
Goodwill at 5 year's purchase of super Profit		30,000

Hidden or Inferred or implied Goodwill

Sometimes the value of goodwill is not specifically given and has to be inferred or implied from the arrangement of capital or profit-sharing ratio. For example A's capital is ₹ 20,000 and B's Capital is ₹ 15,000 and they share profits equally. C is admitted as a partner with ₹ 18,000 as his capital for 1/4 share in the profits. The total capital of the firm now ought to be ₹ 72,000 for the simple reason that if C contributes ₹ 18,000 for 1/4 share, then for full or unit profit he ought to have contributed ₹ 72,000 (18,000 x 4). But the total capital of A, B and C becomes only ₹ 53,000. So the hidden value of the goodwill should be taken as ₹ 19,000 so that the total capital becomes ₹ 72,000



2.3 NEED FOR VALUATION OF GOODWILL

Whenever there is any change in the existing relationship of the partners in terse, some partners have to sacrifice their future profit and some others would gain. Those who are sacrificing future profit should be compensated by the others who are gaining. This adjustment of the partnership rights may arise due to admission of a new partner, change in the profit sharing ratio, retirement or death of a partner and a dissolution of the partnership. The partners, who gain in terms of profit sharing ratio, have to pay for such gain as a proportion to the value of goodwill. The partners, who lose in terms of profit sharing ratio, receive payments for the sacrifice as a proportion to the value of goodwill.



2.4 VALUATION OF GOODWILL IN CASE OF ADMISSION OF A PARTNER

When a new partner is admitted into a partnership, certain adjustments in accounts become necessary. Chiefly, this is because the new partner will acquire a share in the profits of the firm and because of this, the old partners will stand to lose. Suppose, A and B are partners sharing profits in the ratio of 3:2. If their profits are ₹ 20,000, A will get ₹ 12,000 and B will get ₹ 8,000. If C is admitted and given one fourth share in profits, then out of ₹ 20,000 he will get ₹ 5,000. The remaining ₹ 15,000 will be divided between A and B; A will get ₹ 9,000 and B will get ₹ 6,000. Thus on C's admission A loses ₹ 3,000 per year and B loses ₹ 2,000 per year. C will have to compensate A and B for this loss. It is no argument to say that on C's admission the profits will not remain at ₹ 20,000; extra profits will arise and therefore, A and B will both get more than what they previously got. But it should be noted that the additional profits will be earned by the combined efforts of all the partners A, B and C. Therefore, if A and B get a share of the extra profits they are not particularly obliged to C. Out of the present profits of ₹ 20,000 they have to give up a share in favour of C and, therefore, they are entitled to a compensation. The problem of compensation is the chief problem while dealing with admission of a partner. This is tackled through goodwill.

But one point should be made clear here. Goodwill is a compensation to old partners for their sacrifice in connection with admission of a new partner. So it is to be credited to the partners according to their profit sacrificing ratio. Whatever share the new partner is getting, it may be sacrificed by the old partners in proportion to their old profit sharing ratio or in different proportion.

For example, Nigam and Dhameja are in partnership sharing profits and losses equally. They agreed to take Ghosh as one-third partner. Now one-third share of Ghosh may come out of sacrifice made by Nigam and Dhameja equally (i.e. at their old profit sharing ratio). See the following profit sharing pattern:

Profit Sharing Pattern

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

In other words, one-third share of Ghosh was borne by Nigam and Dhameja at their old profit sharing ratio. By this process Nigam sacrificed $\frac{1}{2} - \frac{1}{3} = \frac{1}{6}$ in share and Dhameja sacrificed

$1/2 - 1/3 = 1/6$ in share. So the profit sacrificing ratio becomes:

Nigam = Dhameja

$1/6 = 1/6$

1 : 1

Which is the same as old profit sharing ratio.

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

Nigam = $1/2 - 4/9 = 1/18$

Dhameja = $1/2 - 2/9 = 5/18$

i.e. 1 : 5

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

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

Journal Entry

Ghosh's Capital Account	Dr.	9,000	
To Nigam's Capital Account			1,500
To Dhameja's Capital Account			7,500
(Goodwill adjustment in the profit sacrificing ratio)			

Nigam - ₹ 27,000 × $1/18$

Dhameja - ₹ 27,000 × $5/18$

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



2.5 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF ADMISSION OF A NEW PARTNER

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

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

The necessary journal entry will be:

Bank A/c	Dr.	₹ 40,000	
To A's Capital A/c			₹ 4,000
To B's Capital A/c			₹ 4,000
To C's Capital A/c			₹ 2,000

To D's Capital A/c (Amount brought in by D as Capital and premium for goodwill which is credited to the old partners' Capital accounts in profit sacrificing ratio which is same as old profit sharing ratio)		₹ 30,000
--	--	----------

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

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

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

$$A = 1/6 \times ₹ 1,20,000 = ₹ 20,000 \quad (\text{Cr.})$$

$$B = 1/6 \times ₹ 1,20,000 = ₹ 20,000 \quad (\text{Cr.})$$

$$C = 1/3 \times ₹ 1,20,000 = ₹ 40,000 \quad (\text{Dr.})$$

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

Old Share – New Share = Share Sacrificed

$$A = 1/2 - 3/6 = 0$$

$$B = 1/2 - 2/6 = 1/6$$

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

Cash A/c	Dr.	₹ 60,000	
To B's Capital A/c			₹ 60,000

(Goodwill brought in by C credited to B's Capital A/c)

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

Old Share – New Share = Share Sacrificed

$$A = 1/3 - 3/10 = 1/30$$

$$B = 1/3 - 3/10 = 1/30$$

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

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

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

ILLUSTRATION 3

The following is the Balance Sheet of Yellow and Green as at 31st December, 2022:

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

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

	₹		₹
2019	9,000	2021	12,000
2020	14,000	2022	13,000

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

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

SOLUTION

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

Balance Sheet as at 31st December, 2022

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

Note: Calculation of Profit Sacrificing Ratio

Old Share – New Share = Share Sacrificed

$$\text{Yellow } \frac{3}{5} - \frac{6}{16} = \frac{18}{80}$$

$$\text{Green } \frac{2}{5} - \frac{5}{16} = \frac{7}{80}$$

Calculation of Goodwill

$$\text{Average profit} = \frac{9,000 + 14,000 + 12,000 + 13,000}{4} = 12,000$$

$$\text{Goodwill of the firm} = 3 \times 12,000 = 36,000$$

$$\text{Black share} = \left(\frac{36,000}{16} \right) \times 5 = 11,250$$

ILLUSTRATION 4

With the information given in illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash.

SOLUTION

Goodwill brought in cash

Bank Account	Dr.	31,250	
To Black's Capital Account			20,000
To Yellow's Capital Account			8,100
To Green's Capital Account			3,150
(Amount brought in by Black as capital and as goodwill; goodwill credited to Yellow and Green's Capital accounts in the profit sacrificing ratio)			

Balance Sheet as at 31st December, 2022

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

ILLUSTRATION 5

Continuing with the same illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash, but withdrawn.

SOLUTION

Goodwill brought in cash, but withdrawn

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

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

Balance Sheet as at 31st December, 2022

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

ILLUSTRATION 6

On the basis of information given in illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is paid privately.

SOLUTION

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

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

Balance Sheet as at.....

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



2.6 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF CHANGE IN PROFIT SHARING RATIO

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

ILLUSTRATION 7

A, B & C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. Make the necessary journal entries. Goodwill of the firm is valued at ₹ 90,000.

SOLUTION

Journal Entry

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

In this case due to change in profit sharing ratio

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

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

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

So, A should compensate C to the extent of $1/9$ th of goodwill i.e. ₹ 90,000 × $1/9 = ₹ 10,000$

ILLUSTRATION 8

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

SOLUTION

Partner	New Share	Old Share	Difference
A	$\frac{7}{20}$	$\frac{4}{10}$	$\left(\frac{1}{20}\right)$
B	$\frac{7}{20}$	$\frac{3}{10}$	$\frac{1}{20}$
C	$\frac{6}{20}$	$\frac{3}{10}$	0

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

Journal Entry

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

ILLUSTRATION 9

A, B, C and D are in partnership sharing profits and losses equally. They mutually agreed to change the profit sharing ratio to 3:3:2:2. Goodwill of the firm is valued at ₹ 20,000. Give necessary journal entry.

SOLUTION

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

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

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

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

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

Journal Entry

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



2.7 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF RETIREMENT OR DEATH OF A PARTNER

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

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

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

ILLUSTRATION 10

Antoo, Bantoo and Chintoo were in partnership sharing profits and losses 3:4:3 respectively. The accounts of the firm are made up to 31st March every year. The partnership provided, inter alia, that: On the retirement of a partner the goodwill was to be valued at three years' purchase of average profits of the past four years up to the date of the retirement after deducting interest @ 12%p.a. on capital employed and remuneration of ₹ 2,000 p.m. to each partner. On 1st April 2022, Antoo retired and it was agreed on his retirement to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet. It was agreed that the capital employed would be ₹ 6,50,000. Bantoo and Chintoo were to continue the partnership, sharing profits and losses equally after the retirement of Antoo. The following were the amounts of profits of earlier years before charging salary to partners and interest on capital employed.

Year	Profit
2018-19	2,60,000
2019-20	2,75,000
2020-21	2,65,000
2021-22	2,80,000

You are required to compute the value of goodwill and show the adjustment there of in the books of the firm.

SOLUTION**Valuation of Goodwill****Calculation of Average Profit**

2018-19	2,60,000	
2019-20	2,75,000	
2020-21	2,65,000	
2021-22	<u>2,80,000</u>	
Total	<u>10,80,000</u>	
Average Profit (10,80,000/4)		2,70,000
Less: Interest on capital @ 12%p.a.		78,000
Less: Salaries of partners'(3 x 12 x 2,000)		<u>72,000</u>
Adjusted Average profit		1,20,000
Goodwill (3 years purchase = 3 x 1,20,000)		3,60,000
Antoo's Share of Goodwill (3/10) i.e.		1,08,000

Adjustment Journal entry for Goodwill

Particulars	Dr. ₹	Cr. ₹
Bantoo's Capital Account	Dr. 36,000	
Chintoo's Capital Account	Dr. 72,000	
To Antoo's Capital Account		1,08,000
(Adjusting entry passed for share of goodwill of Antoo through remaining partners' capital accounts in gaining ratio)		

Working Note:

Partner	New Share	Old Share	Difference
Antoo	0	3/10	= -3/10
Bantoo	1/2	4/10	= 1/10
Chintoo	1/2	3/10	= 2/10

ILLUSTRATION 11

Cu and Au were in partnership sharing profits and losses in the ratio 5:3. On 1st April 2022, they decided to admit Ag the partnership on the following terms:

1. Ag will bring ₹ 2,00,000/- as capital for $\frac{1}{4}$ share.
2. New profit sharing ratio shall be 2:1:1 among Cu, Au and Ag.
3. Cu was entitled to salary of ₹ 2,000/- p.m., it was revised to ₹ 3,000 p.m. from 1st October 2020.
4. Interest on capital was paid at 8% p.a.
5. Capitals as on 31st March 2022 were Cu ₹ 4,00,000 Au ₹ 3,00,000, which had remained unchanged since last four years.
6. Goodwill was to be valued on the basis of 3 years purchase of average adjusted weighted average profits of past 4 years after deducting salaries to partners and interest on capital. The profits of previous four years, before charging interest on capital and salary to Cu were as follows:

Year	Profit
2018-19	2,10,000
2019-20	2,60,000
2020-21	2,10,000
2021-22	3,05,000

These profits were subject to following rectification

- (a) A machine costing ₹ 40,000 purchased on 1st October, 2020 was wrongly charged to revenue. The machinery was depreciated at 20% p.a. on written down value method
 - (b) Stock on 31st March 2020 was over valued by ₹ 20,000/-
 - (c) There was a loss by fire amounting to ₹ 10,000/- in the year 2018-19 which was not considered in trading account but correctly debited in the Profit & Loss a/c for that year.
 - (d) Debtors as on 31st March 2022 included bad debts of ₹ 5,800/-
7. Ag shall bring his share of goodwill in cash.

You are required to calculate amount of goodwill Ag is supposed to bring and journal entry for the same.

SOLUTION

Valuation of goodwill

Particulars	2018-19	2019-20	2020-21	2021-22
Profits	2,10,000	2,60,000	2,10,000	3,05,000
Less: Salary to Cu	(24,000)	(24,000)	(30,000)	(36,000)
Less: Interest on Capital of Partners	(56,000)	(56,000)	(56,000)	(56,000)
Add: Machine to be capitalised			40,000	
Less: Depreciation on above			(4,000)	(7,200)
Less: Over valuation of closing stock		(20,000)		
Add: Over valuation of opening stock			20,000	
Add: Loss by fire	10,000			
Less: Bad debts to be written off				(5,800)
Adjusted profits	1,40,000	1,60,000	1,80,000	2,00,000
Weights	1	2	3	4
Product	1,40,000	3,20,000	5,40,000	8,00,000

Weighted Average profit = total product/ total weights

$$= 18,00,000/10 = 1,80,000$$

Goodwill (3 years purchase) = 3 x 1,80,000 = 5,40,000

Ag's share $\frac{1}{4}^{\text{th}}$ = 5,40,000/4 = 1,35,000

Adjustment Journal entry for Goodwill

Particulars	Dr. ₹	Cr. ₹
Bank A/c	Dr. 1,35,000	
To Cu's Capital Account		67,500
To Au's Capital Account		67,500
(Adjusting amount brought in by Ag towards goodwill credited to remaining partners' capital accounts in sacrifice ratio)		

Working Note:

Partner	New Share	Old Share	Difference
Cu	$\frac{2}{4}$	$\frac{5}{8}$	$\frac{1}{8}$
Au	$\frac{1}{4}$	$\frac{3}{8}$	$\frac{1}{8}$
Ag	$\frac{1}{4}$		$\frac{1}{4}$

SUMMARY

- ◆ **Goodwill** is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.
- ◆ **Necessity for valuation of goodwill in a firm arises in the following cases:**
 - When the profit sharing ratio amongst the partners is changed;
 - When a new partner is admitted;
 - When a partner retires or dies, or
 - When the business is dissolved or sold.
- ◆ **Methods for valuation of goodwill:-**
 - (1) **Average profit basis :**

Average Profit = Total profit/Number of years

Goodwill = Average Profit x No. of Years' purchased

The profits taken into consideration are adjusted with abnormal losses, abnormal gains, return on non-trade investments and errors. The average can be simple average or weighted average depending upon the circumstances.
 - (2) **Super profit basis:**

Calculate Capital Employed

Assets
Less: Liability
Capital Employed

 - Find the normal Rate of Return (NRR)
 - Find Normal Profit=Capital Employed X Normal rate of Return
 - Find Average Actual Profit
 - Find Super Profit=Average Actual Profit-Normal Profit
 - Find Goodwill=Super Profit X Number of Years Purchased
 - (3) **Annuity basis:**

Goodwill=Super Profit x Annuity Number
 - (4) **Capitalization basis:**

Goodwill = Super Profit / Normal Rate of Return

TEST YOUR KNOWLEDGE

True and False

1. *Goodwill is intangible asset therefore it cannot be valued.*
2. *Goodwill is valued whenever there is change in the profit sharing ratio among the partners.*
3. *Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.*
4. *At the time of admission or retirement of a partner, goodwill can be raised in the books of accounts and shown as an asset.*
5. *Only simple average method can be used for valuation of goodwill.*
6. *Super profit means excess of actual average profit over normal profit.*
7. *Normal profit means profit earned by similar companies in the same industry.*
8. *Normal profit depends upon Normal Rate of Return and past profits.*
9. *At the time of admission/retirement of a partner, since goodwill can not be raised in the books of accounts is recorded through capital accounts of the partners.*
10. *At the time of admission of a partner, goodwill brought in by the new partner is shared equally by old partners.*

Multiple Choice Questions

1. *Goodwill brought in by incoming partner in cash for joining in a partnership firm is taken away by the old partners in their.....ratio.*
 - (a) *Capital.*
 - (b) *New Profit Sharing.*
 - (c) *Sacrificing.*
2. *A & B are partners sharing profits and losses in the ratio 5:3. On admission, C brings ₹ 70,000 cash and ₹ 48,000 against goodwill. New profit sharing ratio between A, B and C are 7:5:4. Find the sacrificing ratio of A:B.*
 - (a) *3:1.*
 - (b) *4:7.*
 - (c) *5:4.*

3. *Following are the factors affecting goodwill except:*
- (a) *Nature of business.*
 - (b) *Efficiency of management.*
 - (c) *Location of the customers.*
4. *Weighted average method of calculating goodwill should be followed when:*
- (a) *Profits has increasing trend.*
 - (b) *Profits has decreasing trend.*
 - (c) *Either 'a' or 'b'.*
5. *In the absence of any provision in the partnership agreement, profits and losses are shared*
- (a) *In the ratio of capitals.*
 - (b) *Equally.*
 - (c) *In the ratio of loans given by them to the partnership firm.*
6. *The profits and losses for the last 4 years are 2018-19 Losses ₹ 10,000; 2019-20 Losses ₹ 2,500; 2020-21 Profits ₹ 98,000 & 2021-22 Profits ₹ 76,000. The average capital employed in the business is ₹ 2,00,000. The rate of interest expected from capital invested is 12%.*
- The remuneration of partners is estimated to be ₹ 1,000 per month not charged in the above losses/profits. Calculate the value of goodwill on the basis of two years purchase of super profits based on the average of four years.*
- (a) *₹ 9,000.*
 - (b) *₹ 8,750.*
 - (c) *₹ 8,250.*
7. *A, B and C are partners sharing profits and losses in the ratio 3:2:1. They decide to change their profit sharing ratio to 2:2:1. To give effect to this new profit sharing ratio they decide to value the goodwill at ₹ 30,000. Pass the necessary journal entry if Goodwill not appearing in the old balance sheet and should not appear in the new balance sheet.*
- (a) *B's Capital Account Dr. ₹ 2,000*
C's Capital Account Dr. ₹ 1,000
To A's Capital Account ₹ 3,000

- (b) Goodwill Account Dr. ₹ 30,000
 To A's Capital Account ₹ 15,000
 To B's Capital Account ₹ 10,000
 To C's Capital Account ₹ 5,000
- (c) A's Capital Account Dr. ₹ 12,000
 B's Capital Account Dr. ₹ 12,000
 C's Capital Account Dr. ₹ 6,000
 To Goodwill Account ₹ 30,000

Theory questions

1. Write short note on methods for valuation of goodwill.
2. Explain Accounting treatment of goodwill in case of change in profit sharing ratio. Distinguish between Super profit basis and Capitalisation Basis.

Practical questions

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

The partnership provided, inter alia, that:

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

On 30th June, 2022, Wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet.

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

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

	₹
2019	67,200
2020	75,600
2021	72,000
2022	62,400

You are required to compute the value of goodwill and show the adjustment there of in the books of the firm.

ANSWERS/HINTS

True and False

1. False: Even though Goodwill is intangible asset it can be valued in terms of money.
2. True: Goodwill has to be valued every time whenever there is a reconstitution.
3. True: Goodwill is the brand image the firm has in the market due to which it enjoys an advantageous position over the other players in the market.
4. False: At the time of admission or retirement of a partner, goodwill should not be raised in the books of account of partnership firm because no consideration in money or money worth has been paid for it.
5. False: Weighted average profit method, capitalisation method, super profits methods also can be used for valuation of Goodwill.
6. True: Super profit means excess profit that can be earned by the firm over and above the normal profit usually earned by similar firms under similar circumstances.
7. True: The rate of return is considered as an average for the industry, which is applied to the capital employed in the concerned firm.
8. False: Normal profit depends upon Normal rate of return only and not on past profits.
9. True: Generally, the goodwill at the time of admission is adjusted through the capital accounts and not shown in the books of the firm.
10. False: Goodwill brought in by new partner is shared by old partners in sacrificing ratio and not equally.

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(c)	4.	(c)	5.	(b)	6.	(b)
7.	(a)										

Theoretical Questions

- There are three methods for valuation of goodwill
 - Average profit basis - Simple and Weighted
 - Super profit basis - Number of Year Purchase, Annuity basis, and Capitalization of Super Profit
 - Capitalization basis

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

- Super Profit Basis:** In case of average profit basis, goodwill is calculated on the basis of average profit multiplied by certain number of years.

Super Profit = Actual Profit - Normal Profit

Actual Profit is average profit and Normal Profit = Normal rate of Return (NRR)

Capitalization Basis: Under this basis, value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill.

Practical Questions

- Computation of the value of goodwill:**

(i)	Average Profit for three years, ending 30th June; before death:		
	Year ending 30th June, 2020:	₹	₹
	1/2 of 2019 profits	33,600	
	1/2 of 2020 Profits	37,800	71,400

	Year ending 30th June, 2021:		
	1/2 of 2020	37,800	
	1/2 of 2021 Profits	36,000	73,800
	Year ending 30th June, 2022:		
	1/2 of 2021	36,000	
	1/2 of 2022 Profits	31,200	67,200
	Total		2,12,400
	Average Profits		
	Alternatively it can be calculated as below :		
	1/2 profit of 2019 + profit of 2020 + profit of 2021 + profit of 2022 = $\frac{33,600+75,600+72,000+31,200}{3}$ =		70,800
	70,800		
(ii)	Average future maintainable profit :		
	Average profits earned		70,800
	Less : Partner's remuneration	45,000	
	Less: 8% on capital employed	12,480	(57,480)
			13,320
(iii)	Goodwill of the firm @ three years' purchase		39,960
(iv)	Wise's share of Goodwill = 4/10 of 39,960 =15,984		

Adjustment entry for Goodwill**Journal Entry**

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

Working Note:

Partner	New Share	Old Share	Difference
Wise	-	4/10	4/10
Clever	1/2	3/10	2/10
Dull	1/2	3/10	2/10

There is no change in profit sharing ratio of containing partners therefore gain ratio will be same as profit sharing ratio.

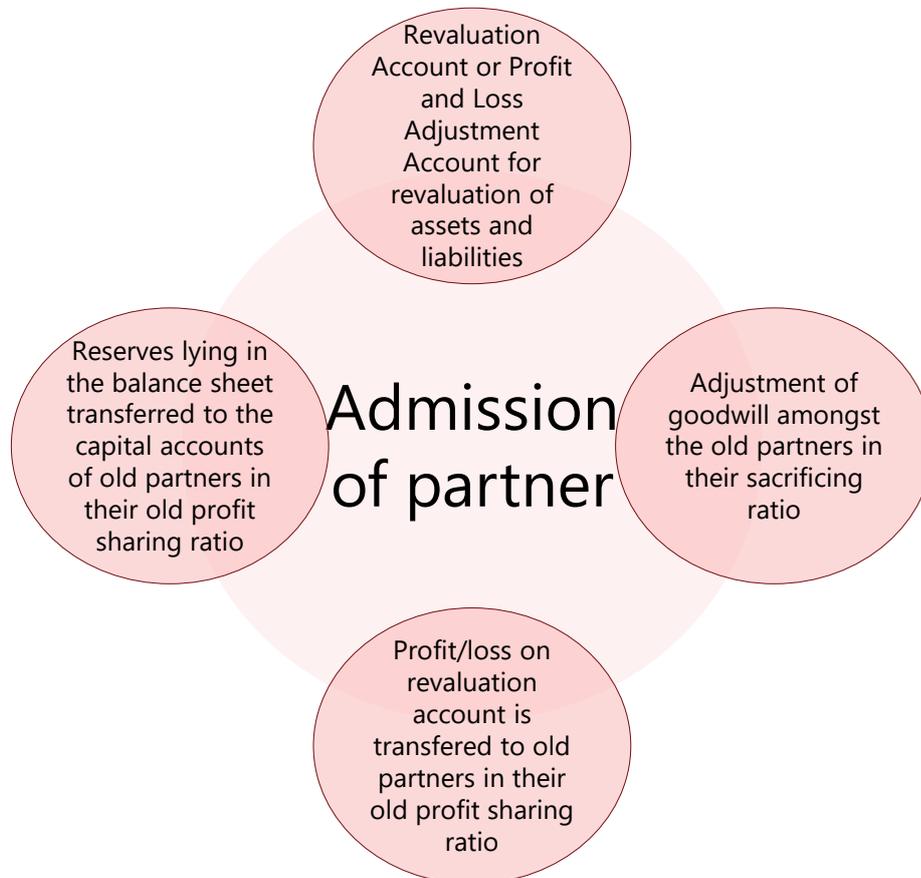
UNIT – 3: ADMISSION OF A NEW PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

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

UNIT OVERVIEW



3.1 INTRODUCTION

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

result of passing of such entries, any subsequent profits or losses will be automatically shared by the incoming partner along with old partners.

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

3.2 REVALUATION ACCOUNT OR PROFIT AND LOSS ADJUSTMENT ACCOUNT

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

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

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

When the revised values are not to be Recognised in the books

Sometimes all the partners including the new partner may agree to keep the assets and liabilities at the old values even when they agree to revalue them. To record these, a Memorandum Revaluation Account is opened. This account is divided into two parts.

(a) In the first part the entries for the revaluation of assets and liabilities are made in the usual way as explained earlier. No record for the revaluation of assets and liabilities is made through the respective ledger accounts. The resultant profit or loss on revaluation in the first part of this account is transferred to the capital accounts of old partners only in the old profit and loss sharing ratio.

(b) In order to complete the double entry, entries made in the first part of Memorandum Revaluation Account are reversed in the second part so that the values of the assets and liabilities remain unchanged. The balance of the second part is transferred to the capital accounts of all the partners including new partner in their new profit and loss sharing ratio. Thus if there is a profit in the first part there will be a loss of the same amount in the second part. The only point to be remembered is that the result of the first part of Memorandum Revaluation Account is shared by old partners in the old profit sharing ratio, while the result of the second part is shared by all partners including the new one in the new profit sharing ratio.

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

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

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

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

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

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

Memorandum Revaluation Account Dr.

 To Old Partners' Capital Accounts

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

Old Partners' Capital Accounts Dr.

 To Memorandum Revaluation Account

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

Memorandum Revolution Account Dr.

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

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

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

 To Memorandum Revaluation Account

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

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

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

Difference between Revaluation Account and Memorandum Revaluation Account

1. Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the new or revalued figures. Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities which of course are recorded at their old figures in the new balance sheet.
2. Revaluation account is not divided into two parts. But the memorandum revaluation account has two parts: first part for old partners and second part for all partners including the new partner.
3. The net result of revaluation of assets and liabilities in the revaluation account is transferred to old partners' capital accounts in the old profit sharing ratio. In the case of memorandum revaluation account the first part is used to record the changes in the values of assets and liabilities due to revaluation and in the second part the effect of the first part is cancelled. The balance of the first part is transferred to old partner's capital accounts in the old profit sharing ratio while the balance of the second part is transferred to all partners including the new partner in the new profit sharing ratio.

ILLUSTRATION 1

The following is the Balance Sheet of Ram and Mohan, who share profits in the ratio of 3:2 as on 1st January, 2022:

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

On this date Shyam was admitted on the following:

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

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

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

Give journal entries to record the above. Also, give the Balance Sheet of the partnership firm after Shyam's admission.

SOLUTION

Journal Entries

2022		Dr. (₹)	Cr. (₹)
Jan. 1	Bank Account Dr. To Shyam's Capital Account (Being amount brought in by Shyam for capital and goodwill)	35,000	35,000
	Shyam's Capital Account Dr. To Ram's Capital Account To Mohan's Capital Account (Being Shyam's share of goodwill adjusted to existing partners' capital accounts in the profit sacrificing ratio 1:1)	10,000	5,000 5,000
	Revaluation Account Dr. To Plant and Machinery Account To Provisions for Doubtful Debts Account To Trade payables Account (Being recording of the reduction in the value of assets and the liability which had been previously omitted)	5,000	3,000 500 1,500
	Building Account Dr. To Revaluation Account (Being increase in the value of building brought into account)	7,000	7,000

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

Working Note:

Profit sacrificing ratio:

$$\text{Ram} = 3/5 - 1/2 = 1/10$$

$$\text{Mohan} = 2/5 - 3/10 = 1/10$$

Balance Sheet of Ram, Mohan and Shyam as at January 1, 2022

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

ILLUSTRATION 2

A and B are partners sharing profits and losses in the ratio of 3:2. Their Balance Sheet as on 31.3.2022 is given below:

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

On 1.4.2022 they admit C on the following terms:

- (1) C will bring ₹ 50,000 as a capital and ₹ 10,000 for goodwill for 1/5 share;
- (2) Provision for doubtful debts is to be made on Trade receivables @ 2%
- (3) Inventory to be written down by 10%.
- (4) Freehold premises is to be revalued at ₹ 2,40,000, plant at ₹ 35,000, furniture ₹ 25,000 and office equipment ₹ 27,500.
- (5) Partners agreed that the values of the assets and liabilities remain the same and, as such, there should not be any change in their book values as a result of the above mentioned adjustments.

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

SOLUTION

Memorandum Revaluation Account

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

Partners' Capital Accounts

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

Note: Amount brought in by new partner shall be distributed among the old partner's in their profit sacrificing ratio, which is same as old profit sharing ratio in this case.

Balance Sheet as at April 1, 2022

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

ILLUSTRATION 3

A and B are partners in a firm, sharing profits and losses in the ratio of 3:2. The Balance Sheet of A and B as on 1.1.2022 was as follows:

Liabilities	₹	Amount ₹	Assets	₹	Amount ₹
Trade payables		17,000	Building		26,000
			Furniture		5,800
Bank overdraft		9,000	Inventories		21,400

Capital accounts:			Trade receivables	35,000	
A	44,000		Less: Provision	(200)	34,800
B	36,000	80,000	Investment		2,500
			Cash		15,500
		1,06,000			1,06,000

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

- C is admitted for 1/6 share in the future profits and to introduce a capital of ₹ 25,000.
- The new profit sharing ratio of A, B and C will be 3:2:1 respectively.
- 'C' is unable to bring in cash for his share of goodwill, they decide to calculate goodwill on the basis of C's share in the profits and the capital contribution made by him to the firm.
- Furniture is to be written down by ₹ 870 and Inventory to be depreciated by 5%. A provision is required for trade receivables @ 5% for bad debts. A provision would also be made for outstanding wages for ₹ 1,560. The value of buildings having appreciated be brought upto ₹ 29,200. The value of investments is increased by ₹ 450.
- It is found that the trade payables included a sum of ₹ 1,400, which is not to be paid off.

Prepare the following:

- Revaluation account.
- Partners' capital accounts.

SOLUTION

Revaluation Account

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

Partners' Capital Accounts

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

Working Notes:

1. Calculation of goodwill:

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

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

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

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

C's share 1/6th = 7,500

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

2. Calculation of sacrificing ratio

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

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

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

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



3.3 RESERVES IN THE BALANCE SHEET

Whenever a new partner is admitted, any reserve etc. appearing in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio.

The necessary journal entry would be:

Debit: Reserves or Profit and Loss Account

Credit: Old Partners' Capital Accounts (In the old profit sharing ratio)

ILLUSTRATION 4

Dalal, Banerji and Mallick are partners in a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March, 2022 is as below:

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

The partners have agreed to take Mr. Mistri as a partner with effect from 1st April, 2022 on the following terms:

- (1) Mr. Mistri shall bring ₹ 5,000 towards his capital.
- (2) The value of Inventory should be increased by ₹ 2,500 and Furniture should be depreciated by 10%.
- (3) Reserve for bad and doubtful debts should be provided at 10% of the Trade receivables.
- (4) The value of land and buildings should be enhanced by 20%.
- (5) The value of the goodwill be fixed at ₹ 15,000.
- (6) General Reserve will be transferred to the Partners' Capital Accounts.
- (7) The new profit sharing ratio shall be: Mr. Dalal 5/15, Mr. Banerji 5/15, Mr. Mallick 3/15 and Mr. Mistri 2/15.

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

Prepare (i) Revaluation Account, (ii) The Capital Accounts of the partners, (iii) Balance Sheet of the firm after admission of Mr. Mistri.

SOLUTION**Revaluation Account**

2022		₹	2022		₹
April 1	To Provision for bad and doubtful debts	550	April 1	By Inventory in trade	2,500
	To Furniture and fittings	650		By Land and Building	5,000
	To Capital A/cs: (Profit on revaluation transferred)				
	Dalal	2,520			
	Banerji	2,520			
	Mallick	1,260			
		6,300			
		7,500			7,500

Partners' Capital Accounts

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

Working Note:**Calculation of sacrificing ratio**

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

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

Balance Sheet of M/s. Dalal, Banerji, Mallick and Mistri as at April 1, 2022

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

**3.4 COMPUTATION OF NEW PROFIT SHARING RATIO**

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

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

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

$$1 - 1/5 = 4/5$$

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

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

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

(iii) New profit sharing ratio is

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

Computation of New profit sharing ratio- Cases

Case I: When new partner's share is given but the question is silent about the sacrifice made by the old partners: In this case it is assumed that the old partner will share the remaining share in their old profit sharing ratio.

Example: A and B are partners sharing profits in the ratio 3:2. They admit C for 1/3 share in future profits. Calculate the new ratio.

Solution

Share in Firm = 1

C's Share = 1/3

Remaining Profit = 1 - 1/3 = 2/3

This remaining share of 2/3 is divided between A and B in the ratio 3:2

So A's share = 2/3 × 3/5 = 6/15

B's share = 2/3 × 2/5 = 4/15

C's share = 1/3 × 5/5 = 5/15

New ratio = 6/15: 4/15: 5/15 = 6:4:5

Case II: When new partner purchases his share from old partner's in a particular ratio: In this case the new ratio of the old partners will be calculated by deducted the proportion given to the new partner from the shares of old partner.

Example: A and B are partners sharing in the ratio 3:2. They admit C as a new partner for 1/3rd share in future profits which he gets 1/9 from A and 2/9 from B. Calculate the new ratio.

Solution

A's old share = $\frac{3}{5}$; A sacrifice in favour of C = $\frac{1}{9}$

So A's new share = $\frac{3}{5} - \frac{1}{9} = \frac{22}{45}$

B's old share = $\frac{2}{5}$; B sacrifice in favour of C = $\frac{2}{9}$

So B's new share = $\frac{2}{5} - \frac{2}{9} = \frac{8}{45}$

C's new share = $\frac{3}{9} + \frac{5}{15} = \frac{15}{45}$

New ratio = 22: 8: 15

Case III: When the old partners surrender a particular fraction of their share in favour of new partner: In this case following steps are followed:

1. Determine the share surrendered by the old partners.
2. Find the new share of the old partners by deducting share surrendered from their old share.
3. Calculate share of the new partner by taking the sum of surrendered share of old partners.
4. Calculate the new ratio.

Example

A and B are partners sharing in the ratio 3:2. They admit C as the new partner. A surrenders $\frac{1}{3}$ rd of his share and B surrenders $\frac{2}{3}$ rd of his share in favour of C. calculate the new ratio.

Solution

A's old share = $\frac{3}{5}$; A surrender in favour of C = $\frac{3}{5} \times \frac{1}{3} = \frac{3}{15}$

A's new share = $\frac{3}{5} - \frac{3}{15} = \frac{6}{15}$

B's old share = $\frac{2}{5}$; B surrender in favour of C = $\frac{2}{5} \times \frac{2}{3} = \frac{4}{15}$

B's new share = $\frac{2}{5} - \frac{4}{15} = \frac{2}{15}$

C's share = $\frac{3}{15} + \frac{4}{15} = \frac{7}{15}$

New ratio = 6:2:7

Case IV: When the new partner acquires his share entirely from any one partner: In this case the sacrificing partner share is calculated by deducting his sacrifice from his old share.

Example: A and B are partners sharing in the ratio 3:2. They admit C for $\frac{1}{5}$ th share in profits which he acquires entirely from A. Calculate the new ratio.

Solution

A's old share = $\frac{3}{5}$; Sacrifice in favour of C = $\frac{1}{5}$

A's new share = $\frac{3}{5} - \frac{1}{5} = \frac{2}{5}$

B's share = $\frac{2}{5}$

C's share = $\frac{1}{5}$

New ratio = 2:2:1

Case V: When the new partner acquires his share from the old partners in the certain ratio: In this the sacrifice of each partner is deducted from their old shares.

Example: A and B are partners sharing profits in the ratio 3:2. C is admitted for $\frac{1}{5}$ th share which he acquires from A and B in the ratio of 2:1. Calculate the new ratio.

Solution

A's old share = $\frac{3}{5}$, A's sacrifice = $\frac{1}{5} \times \frac{2}{3} = \frac{2}{15}$

A's new share = $\frac{3}{5} - \frac{2}{15} = \frac{7}{15}$

B's old share = $\frac{2}{5}$, B's sacrifice = $\frac{1}{5} \times \frac{1}{3} = \frac{1}{15}$

B's new share = $\frac{2}{5} - \frac{1}{15} = \frac{5}{15}$

C's share = $\frac{1}{5} \times \frac{3}{3} = \frac{3}{15}$

New ratio = 7:5:3

Sacrificing Partner:

The partners whose shares have decreased as a result of change are known as sacrificing partners.

Sacrificing Ratio:

Ratio in which the old partners sacrifice their share in favour of new partner is called sacrificing ratio. This ratio is calculated by taking out the difference between old profit shares and new profit shares

Sacrificing ratio = Old Profit sharing ratio – New Profit sharing ratio

Gaining Partners

The partners whose shares have increased as a result of change are known as gaining partners.

Gaining Ratio

The ratio in which the partners have agreed to gain their shares in profit from the other partner or partners, is known as gaining ratio. This ratio is calculated by taking out the difference between new profit shares and old profit shares

Example: X and Y are partners in a firm sharing profits and losses in the ratio 5:3. They admit Z into partnership. The new ratio 3:2:1. Calculate the Sacrificing Ratio.

Solution

X's sacrifice = X's old share - X's new ratio = $5/8 - 3/6 = 6/48$

Y's sacrifice = Y's old share - Y's new ratio = $3/8 - 2/6 = 2/48$

Thus, sacrificing ratio = 6:2 or 3:1

Example: A, B and C are sharing profits and losses in the ratio of 5:3:2. Calculate the new profit sharing ratio and the sacrificing ratio in each of the following alternative cases:

Case (a) If C acquires 1/10th share from B

Case (b) If C acquired 1/10th share equally from A and B

Case (c) If C's share is increased by 1/10th share by acquiring from A.

Case (d) If C's share is increased to 3/10th by acquiring from B.

Case (e) if A, B and C decide to share future profits and losses in the ratio of 5:2:3.

Case (f) if A, B and C decide to share future profits and losses in the ratio of 2:3:5.

Case (g) if A, B and C decide to share future profits and losses in the ratio of 2:1:2.

Case (h) if A, B and C decide to share future profits and losses equally.

Case(i) If A, B and C decide that the future profit sharing ratio between B and C shall be the same as existing between A and B

Solution

Case (a)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-	-1/10	+1/10
Their new shares	5/10	2/10	3/10

New Profit sharing ratio of A, B and C = 5 : 2 : 3

Share sacrificed by B = 1/10

Case (b)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from A and B	-1/20	-1/20	+1/10
Their new shares	9/20	5/20	3/10

New Profit sharing ratio of A, B and C = 9 : 5 : 6

Sacrificing ratio of A and B = 1 : 1

Case (c)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-1/10	-	+1/10
Their new shares	4/10	3/10	3/10

New Profit sharing ratio of A, B and C = 4 : 3 : 3

Share sacrificed by A = 1/10

Share acquired by C = New Share – Old share = 3/10 - 2/10 = 1/10

Case (d)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-	-1/10	+1/10
Their new shares	5/10	2/10	3/10

New Profit sharing ratio of A, B and C = 5 : 2 : 3

Share sacrificed by B = 1/10

Case (e)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	5/10	2/10	3/10
	-	1/10	-1/10

C gains by 1/10th share and B sacrifice 1/10th Share

Case (f)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	2/10	3/10	5/10
	3/10	-	-3/10

C gains by 3/10th share and A sacrifice 3/10th Share

Case (g)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	2/5	1/5	2/5
	1/10	1/10	-2/10

C gains by 2/10th share and A sacrifices 1/10th Share & B sacrifices 1/10th share.

Case (h)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	1/3	1/3	1/3
	5/30	-1/30	-4/30

B gains by 1/30th share, C gains by 4/30th share and A sacrifices by 5/30th Share

Case (i)

Ratio of A and B = 5 : 3

Ratio of B and C should be 5 : 3

Since B's share in relation to A is $\frac{3}{5}$ or 60% of A's share, C's share should also be 60% of B's share

Thus C's share (60% of 3) = 1.8

New ratio of A, B and C = 5 : 3 : 1.8 or 25 : 15 : 9

	A	B	C
Their existing shares	5/10	3/10	2/10
Their new share	25/49	15/49	9/49
	-5/490	-3/490	8/490

C sacrifices by 8/490 and A gains by 5/490 and B gains by 3/490

ILLUSTRATION 5

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

- (i) C purchases 1/10 share from A
- (ii) A and B agree to sacrifice 1/10th share to C in the ratio of 2:3
- (iii) Simply gets 1/10th share of profit.

SOLUTION

(i) New profit sharing ratio:

$$A = 3/5 - 1/10 = 5/10$$

$$B = 2/5 \text{ i.e. } 4/10$$

$$C = 1/10$$

i.e. 5:4: 1

(ii) A's sacrifice $1/10 \times 2/5 = 2/50$

$$B's \text{ sacrifice } 1/10 \times 3/5 = 3/50$$

New profit sharing ratio

$$A = 3/5 - 2/50 = 28/50$$

$$B = 2/5 - 3/50 = 17/50$$

$$C = 1/10 \text{ i.e. } 5/50$$

i.e. 28:17: 5

(iii) Let total share be 1

$$C's \text{ share} = 1/10$$

$$\text{Remaining share} = 1 - 1/10 = 9/10$$

Distribution:

$$A = 9/10 \times 3/5 = 27/50$$

$$B = 9/10 \times 2/5 = 18/50$$

$$C = 1/10 \text{ i.e. } = 5/50$$

i.e. 27:18: 5

ILLUSTRATION 6

A and B are in the partnership sharing profits and losses in the proportion of three-fourth and one-fourth respectively. Their balance sheet as on 31st March, 2022 was as follows:

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

On 1st April, 2022, they admitted C into partnership on the following terms:

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

- (ii) Further profits and losses are to be shared by A, B and C equally.
- (iii) Plant and machinery is to be reduced by 10% and ₹ 500 is to be provided for estimated bad debts. Inventory is to be taken at a valuation of ₹ 24,940.
- (iv) By bringing in or withdrawing cash, the capitals of A and B are to be made proportionate to that of C on their profit-sharing basis.

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

SOLUTION

Journal Entries
as on 1st April, 2022

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

A's capital Account	Dr.	9,030	
B's capital Account	Dr.	10	
To Cash Account			9,040
(Excess amount of capital withdrawn)			

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To A's capital A/c	-	500	2,000	By Balance b/d	15,000	10,000	-
To Cash	9,030	10		By Revaluation A/c	1,530	510	-
To Balance c/d	10,000	10,000	10,000	By Cash		-	12,000
				By C's Capital A/c	2,000		
				By B's Capital A/c	500		
	19,030	10,510	12,000		19,030	10,510	12,000

Working Note:

Calculation of goodwill

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

Gaining ratio:

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

$$C: 1/3$$

Goodwill to be paid to A:

$$\text{By B ₹ } 6,000 \times 1/12 = \text{₹ } 500$$

$$\text{By C ₹ } 6,000 \times 1/3 = \text{₹ } 2,000$$

$$\text{Total} \quad \quad \quad \text{₹ } 2,500$$

ILLUSTRATION 7

A and B are partners of X llp. sharing profits and losses in 3:2 ratio between themselves. On 31st March, 2022, the balance sheet of the firm was as follows:

Balance Sheet of X llp as at 31.3.2022

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

X agrees to join the business on the following conditions as and from 1.4.2022:

- (a) He will introduce ₹ 25,000 as his capital and pay ₹ 15,000 to the partners as premium for goodwill for 1/3rd share of the future profits of the firm.
- (b) A revaluation of assets of the firm will be made by reducing the value of plant and machinery to ₹ 15,000, Inventory by 10%, furniture and fitting by ₹ 1,000 and by making a provision of bad and doubtful debts at ₹ 750 on trade receivables.

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

SOLUTION**Profit and Loss Adjustment Account**

2022, April 1	₹	2022, April 1	₹
To Plant and machinery A/c	5,000	By Partners' capital accounts	
To Inventory A/c	1,500	- Loss on revaluation	
To Furniture and fitting A/c	1,000	(3/5) A	4,950
To Provision for bad and doubtful debts	750	(2/5) B	<u>3,300</u>
	8,250		8,250

Partners' Capital Accounts

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

Working Notes:

(i) New profit sharing ratio:

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

$$A: 2/3 \times 1/2 = 1/3$$

$$B: 2/3 \times 1/2 = 1/3$$

$$X: 1/3$$

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

(ii) Adjustment of goodwill:

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

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

Sacrificing ratio:

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

$$B: 2/5 - 1/3 = 1/15$$

Hence, sacrificing ratio is 4:1

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

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

3.5 HIDDEN GOODWILL

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

Particulars	₹
Incoming partner's capital x Reciprocal of share of incoming partner	xxx
Less: Total capital of old partners + Net Accumulated Profits and Reserves (if any) + capital brought in by incoming partner	xxx
Value of Goodwill	xxx

ILLUSTRATION 8

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

SOLUTION

Journal Entry

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

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

ILLUSTRATION 9

A and B are in partnership sharing profits and losses equally. The Balance Sheet M/s. A and B as on 31.12.2022, was as follows:

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

On 1.1.2023 they agreed to take C as 1/3rd partner to increase the capital base to ₹ 1,35,000. C agrees to pay ₹ 60,000. Show the necessary journal entries and prepare partners' capital accounts.

SOLUTION**In the Books of M/s. A, B and C****Journal Entries**

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

Workings:

- (1) Old Profit Sharing Ratio: 1: 1
- (2) New Profit Sharing Ratio: 1:1:1
- (3) C's share of capital ₹ 1,35,000 × 1/3 = ₹ 45,000
- (4) Goodwill ₹ 60,000 – ₹ 45,000 = ₹ 15,000 for 1/3rd share.

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

Partners' Capital A/cs

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

Note : In this problem it is mentioned that total capital should be at ₹ 1,35,000 hence excess capital is to be withdrawn by partners hence third entry is passed.

ILLUSTRATION 10

Leena and Meena were in business sharing profits and losses in the ratio of 2:3

Their Balance Sheet as on 31st March, 2022 was as follows:

Liabilities	₹	Assets	₹
Capital Accounts:		Building	60,000
Leena	60,000	Plant	45,000
Meena	1,40,000	Furniture	23,500
General Reserve	40,000	Debtors	38,400
Creditors	42,600	Bills Receivable	12,500
Bills Payable	17,400	Stock	42,600
		Bank	78,000
	3,00,000		3,00,000

On 1st April, 2022, they decided to admit Neena into the partnership giving her a 1/5th share in future profits. She brings in ₹80,000 as her share of capital. Goodwill was valued at ₹1,00,000 at the time of admission of Neena. The partners decided to revalue the Assets as follows:

Plant ₹ 40,000, Debtors ₹ 38,000, Stock ₹ 42,000, Building ₹ 90,000, Furniture ₹ 20,000, Bills Receivable ₹ 12,000.

You are required to show the following accounts in the books of the firm:-

- Profit & Loss Adjustment Account
- Partners' Capital Accounts
- The Balance Sheet of the new firm.

SOLUTION**In the books of Leena, Meena and Neena****(a) Profit & Loss Adjustment Account**

Particulars	₹	Particulars	₹
To Plant	5,000	By Building	30,000
To Debtors	400		
To Stock	600		

To Furniture	3,500		
To Bills receivable	500		
To Profit on revaluation			
Leena	8,000		
Meena	12,000		
	30,000		30,000

Partners' Capital A/c

Particulars	Leena	Meena	Neena	Particulars	Leena	Meena	Neena
To Leena, Meena Goodwil adjustment entry			20,000	By Balance b/d	60,000	1,40,000	
To Balance c/d	92,000	1,88,000	60,000	By Bank			80,000
				By Neena	8,000	12,000	
				By General Reserve	16,000	24,000	
				By Revaluation	8,000	12,000	
	92,000	1,88,000	80,000		92,000	1,88,000	80,000

Balance Sheet as at 1st April, 2022 (after admission)

Liabilities	₹	Assets	₹
Capital Accounts:		Building	90,000
Leena	92,000	Plant	40,000
Meena	188,000	Furniture	20,000
Neena	60,000	Debtors	38,000
Creditors	42,600	Bills Receivable	12,000
Bills Payable	17,400	Stock	42,000
		Bank	1,58,000
	4,00,000		4,00,000

ILLUSTRATION 11

Alpha and Beeta were partners in a LLP namely Meta-Chem LLP sharing profits and losses equally.

Balance Sheet of Meta-Chem LLP as on 31st March, 2022

Liabilities	₹	Assets	₹
Capital :		Factory Building	4,78,000
Alpha 3,00,000		Plant & Machinery	3,41,000
Beeta <u>2,00,000</u>	5,00,000	Office Furniture	55,850
General Reserve	1,80,000	Inventory	77,740
Workmen compensation fund	60,000	Trade Receivables	1,43,210
Term loan from IDFC bank	2,78,000	Bank	44,200
Trade payables	1,22,000		
	11,40,000		11,40,000

They agreed to admit Gyama as partner from 1st April 2022 on the following terms:

1. He shall have one-sixth share in future profits.
2. New profit sharing ratio would be 3:2:1
3. He shall bring ₹ 2,50,000 as his capital.
4. Goodwill of the firm is valued at ₹ 3,00,000
5. Factory Building is to be appreciated by 20% and inventory is revalued at ₹ 70,000.
6. Machinery to be appreciated by 20%.and Office furniture to be revalued at ₹ 50,000
7. Of the trade receivables ₹ 3,210 are bad and 5% be provided for bad & doubtful debts.
8. There is no actual liability towards workman.

You are required to prepare:

1. Revaluation account
2. Partners' capital accounts.
3. Bank account.
4. Balance Sheet after admission.

SOLUTION**In the books of Meta-Chem LLP****Revaluation A/c**

Liabilities	₹	Assets	₹
To Bad debts	3,210	By Factory Building	95,600
To Provision for Doubtful Debts	7,000	By Plant and Machinery	68,200

To Office Furniture		5,850		
To Inventory		7,740		
To Profit on revaluation				
Alpha	70,000			
Beeta	<u>70,000</u>	1,40,000		
		1,63,800		1,63,800

Partners' Capital A/c

Particulars	Alpha	Beeta	Gyama	Particulars	Alpha	Beeta	Gyama
To Beeta			50,000	By balance b/d	3,00,000	2,00,000	
To Balance c/d	4,90,000	4,40,000	2,00,000	By Bank			2,50,000
				By Gyama		50,000	
				By General Reserve	90,000	90,000	
				By Workman comp. fund	30,000	30,000	
				By Revaluation A/c	70,000	70,000	
	4,90,000	4,40,000	2,50,000		4,90,000	4,40,000	2,50,000

Bank A/c

Particulars	₹	Particulars	₹
To balance b/d	44,200	By Balance c/d	2,94,200
To Gyama's capital	2,50,000		
	2,94,200		2,94,200

Balance Sheet of Meta-Chem LLP as at 1st April 2022 (after admission)

Liabilities	₹	Assets	₹
Capital Accounts:		Factory Building	5,73,600
Alpha	4,90,000	Plant & Machinery	4,09,200
Beeta	4,40,000	Office Furniture	50,000
Gyama	<u>2,00,000</u>	Inventory	70,000
Term Loan from IDFC bank	2,78,000	Trade Receivables	1,40,000

Trade Payables	1,22,000	Less: Provision for Doubtful Debts	1,33,000
		<u>7,000</u>	
		Bank	2,94,200
	15,30,000		15,30,000

Working Note:

Partner	New Share		Old Share		Difference
Alpha	1/2	–	3/6	=	0
Beeta	1/2	–	2/6	=	1/6
Gyama		–	1/6 (gain)	=	1/6 (gain)

SUMMARY

- ◆ New partners are admitted for the benefit of the partnership firm. New partner is admitted either for increasing the partnership capital or for strengthening the management of the firm.
- ◆ When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio.
- ◆ Whenever a new partner is admitted, any reserve etc. appearing in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio.

TEST YOUR KNOWLEDGE**True or False**

1. A newly admitted partner does not have same rights as old partners.
2. When a new partner is admitted, old partners have to forego certain share in profits of the firm, this is called as sacrifice ratio.
3. Revaluation account is also called as Profit and Loss Adjustment Account.

4. Any appreciation in the value of an asset is credited to Revaluation account.
5. All the partners may decide not to change the values of assets and liabilities in the books of accounts.
6. New partner is entitled to have share in reserves appearing in the balance sheet prior to his admission.
7. If revaluation account shows credit balance then it represents profit and therefore it is credited to all partners equally.
8. New partner brings necessary amount as his capital.
9. New partner is entitled to share in revaluation profit.

Multiple Choice Questions

1. A and B are partners sharing profits and losses in the ratio 5:3. They admitted C and agreed to give him $\frac{3}{10}$ th of the profit. What is the new ratio after C's admission?
 - (a) 35:42:17.
 - (b) 35:21:24.
 - (c) 49:22:29.
2. A and B are partners sharing profits in the ratio 5:3, they admitted C giving him $\frac{3}{10}$ th share of profit. If C acquires $\frac{1}{5}$ from A and $\frac{1}{10}$ from B, new profit sharing ratio will be:
 - (a) 5:6:3.
 - (b) 2:4:6.
 - (c) 17:11:12
3. C was admitted in a firm with $\frac{1}{4}$ th share of the profits of the firm. C contributes ₹ 15,000 as his capital, A and B are other partners with the profit sharing ratio as 3:2. Find the required capital of A and B, if capital should be in profit sharing ratio taking C's as base capital:
 - (a) ₹ 27,000 and ₹ 16,000 for A and B respectively.
 - (b) ₹ 27,000 and ₹ 18,000 for A and B respectively.
 - (c) ₹ 32,000 and ₹ 21,000 for A and B respectively.
4. A, B and C are partners sharing profits and losses in the ratio 6:3:3, they agreed to take D into partnership for $\frac{1}{8}$ th share of profits. Find the new profit sharing ratio.
 - (a) 12:27:36:42.

- (b) 14:7:7:4.
- (c) 1:2:3:4.
5. A and B are partners sharing profits and losses in the ratio of 3:2 (A's Capital is ₹ 30,000 and B's Capital is ₹ 15,000). They admitted C and agreed to give 1/5th share of profits to him. How much C should bring in towards his capital?
- (a) ₹ 9,000.
- (b) ₹ 12,000.
- (c) ₹ 11,250.
6. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who brings in ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. In what ratio will this amount will be shared among the old partners A & B.
- (a) ₹ 8,000: ₹ 2,000.
- (b) ₹ 5,000: ₹ 5,000.
- (c) Old partners will not get any share in the goodwill brought in by C.
7. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who is supposed to bring ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. C brought cash for his share of Capital and agreed to compensate to A and B outside the firm. How this will be treated in the books of the firm.
- (a) Cash brought in by C will only be credited to his capital account.
- (b) Goodwill will be raised to full value in old ratio.
- (c) Goodwill will be raised to full value in new ratio.
8. X and Y are partners sharing profits in the ratio of 3: 1. They admit Z as a partner who pays ₹ 4,000 as Goodwill the new profit sharing ratio being 2:1: 1 among X, Y and Z respectively. The amount of goodwill will be credited to:
- (a) X and Y as ₹ 3,000 and ₹ 1,000 respectively.
- (b) X only
- (c) Y only.
9. P and Q are partners sharing Profits in the ratio of 2:1. R is admitted to the partnership with effect from 1st April on the term that he will bring ₹ 20,000 as his capital for 1/4th share and pays ₹ 9,000 for goodwill, half of which is to be withdrawn by P and Q. If profit

on revaluation is ₹ 6,000 and opening capital of P is ₹ 40,000 and of Q is ₹ 30,000, find the closing balance of each capital.

- (a) ₹ 47,000: ₹ 33,500: ₹ 20,000
 (b) ₹ 50,000: ₹ 35,000: ₹ 20,000.
 (c) ₹ 40,000: ₹ 30,000: ₹ 20,000
10. Adam, Brain and Chris were equal partners of a firm with goodwill ₹ 1,20,000 shown in the balance sheet and they agreed to take Daniel as an equal partner on the term that he should bring ₹ 1,60,000 as his capital and goodwill, his share of goodwill was evaluated at ₹ 60,000 and the goodwill account is to be written off before admission. What will be the treatment for goodwill?
- (a) Write off the goodwill of ₹ 1,20,000 in old ratio.
 (b) Cash brought in by Daniel for goodwill will be distributed among old partners in sacrificing ratio.
 (c) Both (a) & (b)

Theory Questions

- Write short note on Revaluation account.
- What is the difference between revaluation account and memorandum revaluation account?

Practical Questions

- The following was the balance sheet of A, B and C who were equal partners on January 1, 2022

Liabilities	₹	Assets	₹
Bills Payable	3,000	Cash	1,000
Creditors	6,000	Debtors	10,000
Capital Accounts :		Stock	12,000
A	20,000	Furniture	5,000
B	15,000	Buildings	25,000
C	10,000	Bills Receivable	1,000
	54,000		54,000

They agree to take D into partnership and give him a 1/4 share in the profits on the following terms:

- (1) D should bring in ₹ 6,000 for goodwill and ₹ 10,000 as capital;
- (2) one-half of the goodwill shall be withdrawn by old partners;
- (3) stock and furniture be depreciated by 10%.
- (4) a liability of ₹ 1,300 be created against bills discounted;
- (5) the building be valued at ₹ 40,000;
- (6) the values of liabilities and assets other than cash are not to be altered.

Give the necessary entries to give effect to the above arrangement; prepare memorandum revaluation account and opening balance sheet of the firm as newly constituted.

2. Gopal and Govind are partners sharing profits and losses in the ratio 60:40. The firms' balance sheet as on 31.03.2022 was as follows:

Liabilities	₹	Assets	₹
Capital accounts:		Fixed assets	3,00,000
Gopal	1,20,000	Investments	50,000
Govind	80,000	Current assets	2,00,000
Long term loan	2,00,000	Loans and advances	1,00,000
Current liabilities	2,50,000		
	6,50,000		6,50,000

Due to financial difficulties, they have decided to admit Guru as partner in the firm from 01.04.2022 on the following terms:

Guru will be paid 40% of the profits.

Guru will bring in cash ₹ 1,00,000 as capital. It is agreed that goodwill of the firm will be valued at 2 years' purchase of 3 years' normal average profits of the firm and Guru will bring in cash his share of goodwill. It was also decided that the partners will not withdraw their share of goodwill nor will the goodwill appear in the books of account.

The profits of the previous three years were as follows:

For the year ended 31.3.2020: profit ₹ 20,000 (includes insurance claim received of ₹ 40,000).

For the year ended 31.3.2021: loss ₹ 80,000 (includes voluntary retirement compensation paid ₹ 1,10,000).

For the year ended 31.3.2022: profit of ₹ 1,05,000 (includes a profit of ₹ 25,000 on the sale of assets).

It was decided to revalue the assets on 31.03.2022 as follows:

	₹
<i>Fixed assets (net)</i>	<i>4,00,000</i>
<i>Investments</i>	<i>Nil</i>
<i>Current assets</i>	<i>1,80,000</i>
<i>Loans and advances</i>	<i>1,00,000</i>

The new profit sharing ratio after the admission of Guru was 35:25:40.

Pass journal entries on admission, show goodwill calculation and prepare revaluation account, partners' capital accounts and balance sheet as on 01.04.2022 after the admission of Guru.

ANSWERS/HINTS

True or False

1. False: All the partners have same rights at all times, unless contrary is provided in the partnership deed/or agreed by the partners.
2. True: With every new partner, remaining old partners have to foregone a proportion in their share which is called as sacrificing ratio.
3. True: Revaluation is also called as profit and loss adjustment account.
4. True: Increase in asset is an income hence credited to revaluation account.
5. True: This can be done by opening Memorandum Revaluation Account.
6. False: New partner is not entitled to have any share in the reserves of the firm prior to his admission. Such reserves are distributed to old partners in their old profit sharing ratio.
7. False: If revaluation account shows credit balance then it represents profit and therefore it is credited to all partners in their profit sharing ratio and not equally.
8. True: Every incoming partner shall bring in some amount of capital for the firm.
9. False: New partner is not entitled to profit on revaluation, it belongs to old partners in their old profit sharing ratio.

Multiple Choice Questions

1.	(b)	2.	(c)	3.	(b)	4.	(b)	5.	(c)	6.	(a)
7.	(a)	8.	(b)	9.	(a)	10.	(c)				

Theoretical Questions

- When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio.
- Difference between revaluation account and memorandum revaluation account
 - Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the new or revalued figures. Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities which of course are recorded at their old figures in the new balance sheet.
 - Revaluation account is not divided into two parts. But the memorandum revaluation account has two parts: first part for old partners and second part for all partners including the new partner.

Practical Problems

1.

		₹	₹
Cash Account	Dr.	16,000	
To D's Capital Account			16,000
(Amount of goodwill and capital brought in by D)			
D's Capital Account	Dr.	6,000	
To A's Capital Account			2,000
To B's Capital Account			2,000

To C's Capital Account (Goodwill brought in by D credited to old partners in sacrifice ratio)			2,000
A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	
C's Capital Account	Dr.	1,000	
To Cash Account (Half the amount of goodwill withdrawn by existing partners)			3,000
Memorandum Revaluation Account	Dr.	12,000	
To A's Capital Account			4,000
To B's Capital Account			4,000
To C's Capital Account (Profit on revaluation credited to old partners)			4,000
A's Capital Account	Dr.	3,000	
B's Capital Account	Dr.	3,000	
C's Capital Account	Dr.	3,000	
D's Capital Account	Dr.	3,000	
To Memorandum Revaluation Account (The profit credited previously to old partners written off to all partners including D in the new profit-sharing ratio)			12,000

Memorandum Revaluation Account

Stock	1,200	Buildings	15,000
Furniture	500		
Liability for bills discounted	1,300		
Profit transferred to capital accounts:			
A	4,000		

B	4,000		
C	4,000		
	15,000		15,000
Buildings	15,000	Stock	1,200
		Furniture	500
		Liability for bills discounted	1,300
		Loss transferred to capital accounts:	
		A	3,000
		B	3,000
		C	3,000
		D	3,000
	15,000		15,000

Balance Sheet of M/s. A, B, C and D

As at 1st January, 2022

Liabilities		₹	Assets	₹
Bills Payable		3,000	Cash	14,000
Creditors		6,000	Debtors	10,000
Capital Accounts:			Stock	12,000
A	22,000		Furniture	5,000
B	17,000		Buildings	25,000
C	12,000		Bills Receivable	1,000
D	7,000	58,000		
		67,000		67,000

2. (i) Calculation of Profit/ Loss for the year ended

	31.3.2020	31.3.2021	31.3.2022
Profit/(loss) for the year	20,000	(80,000)	1,05,000
Add/(less): Abnormal items	(40,000)	1,10,000	(25,000)
Net Profit/(loss)	(20,000)	30,000	80,000

$$\text{Average profit} = \frac{(20,000) + 30,000 + 80,000}{3} = ₹ 30,000$$

Two years' purchase of average profits = ₹ 30,000 x 2 = ₹ 60,000

Goodwill to be brought in by Guru = ₹ 60,000 x 40% = ₹ 24,000

Goodwill brought in by Guru shared (at the profit sacrificing ratio) by:

	₹
Gopal (₹ 24,000 x 5/8)	15,000
Govind (₹ 24,000 x 3/8)	9,000
	24,000

(ii)

Journal Entries

Date	Particulars	Dr. ₹	Cr. ₹
1.4.2022	Bank A/c Dr. To Guru's capital A/c (Amount of capital and goodwill brought in by Guru)	1,24,000	1,24,000
1.4.2022	Guru's capital A/c Dr. To Gopal's capital A/c To Govind's capital A/c (Amount of goodwill brought in by Guru credited to capital accounts of the old partners in the profit sacrificing ratio 5:3)	24,000	15,000 9,000
1.4.2022	Revaluation A/c Dr. To Investment A/c To Current assets A/c (Writing down the value of investments to nil and current assets from ₹ 2,00,000 to ₹ 1,80,000 on the occasion of admission of Guru)	70,000	50,000 20,000
1.4.2022	Fixed assets A/c Dr. To Revaluation A/c (Writing up the value of fixed assets from ₹ 3,00,000 to ₹ 4,00,000 on the occasion of admission of Guru)	1,00,000	1,00,000

1.4.2022	Revaluation A/c	Dr.	30,000	
	To Guru's capital A/c			18,000
	To Govind's capital A/c			12,000
	(Net revaluation profit credited to the capital accounts of the old partner in the old profit sharing ratio of 60:40)			

(iii)

Revaluation Account

Particulars	₹	Particulars	₹
To Investments A/c	50,000	By Fixed assets A/c	1,00,000
To Current assets A/c	20,000		
To Partner's capital A/c: (Profit on revaluation)			
Gopal (60%)	18,000		
Govind (40%)	12,000		
	1,00,000		1,00,000

(iv)

Partner's Capital Account

Particulars	Gopal ₹	Govind ₹	Guru ₹	Particulars	Gopal ₹	Govind ₹	Govind ₹
To Balance c/d	1,53,000	1,01,000	1,00,000	By Balance b/d	1,20,000	80,000	1,00,000
				By Bank A/c	15,000	9,000	-
				By Profit on revaluation A/c	18,000	12,000	-
	1,53,000	1,01,000	1,00,000		1,53,000	1,01,000	1,00,000

**Balance Sheet (after admission of Guru)
as at 1st April, 2022**

Liabilities		₹	Assets	₹
Capital accounts:			Fixed assets	4,00,000
Gopal	1,53,000		Current assets	3,04,000

Govind	1,01,000		(including bank balance of ₹ 1,24,000)	
Guru	<u>1,00,000</u>	3,54,000		
Long term loan		2,00,000	Loans & advances	1,00,000
Current liabilities		2,50,000		
		8,04,000		8,04,000

Working Notes:

- Calculation of profit sacrificing ratio
 Profit sacrificed by Gopal = $60\% - 35\% = 25\%$
 Profit sacrificed by Govind = $40\% - 25\% = 15\%$
 Sacrificing ratio = $25\% : 15\%$ or 5:3
- Bank balance after admission of Guru:

Bank Account

Particulars	₹	Particulars	₹
To Guru's capital A/c	1,24,000	By Balance c/d	1,24,000
	1,24,000		1,24,000

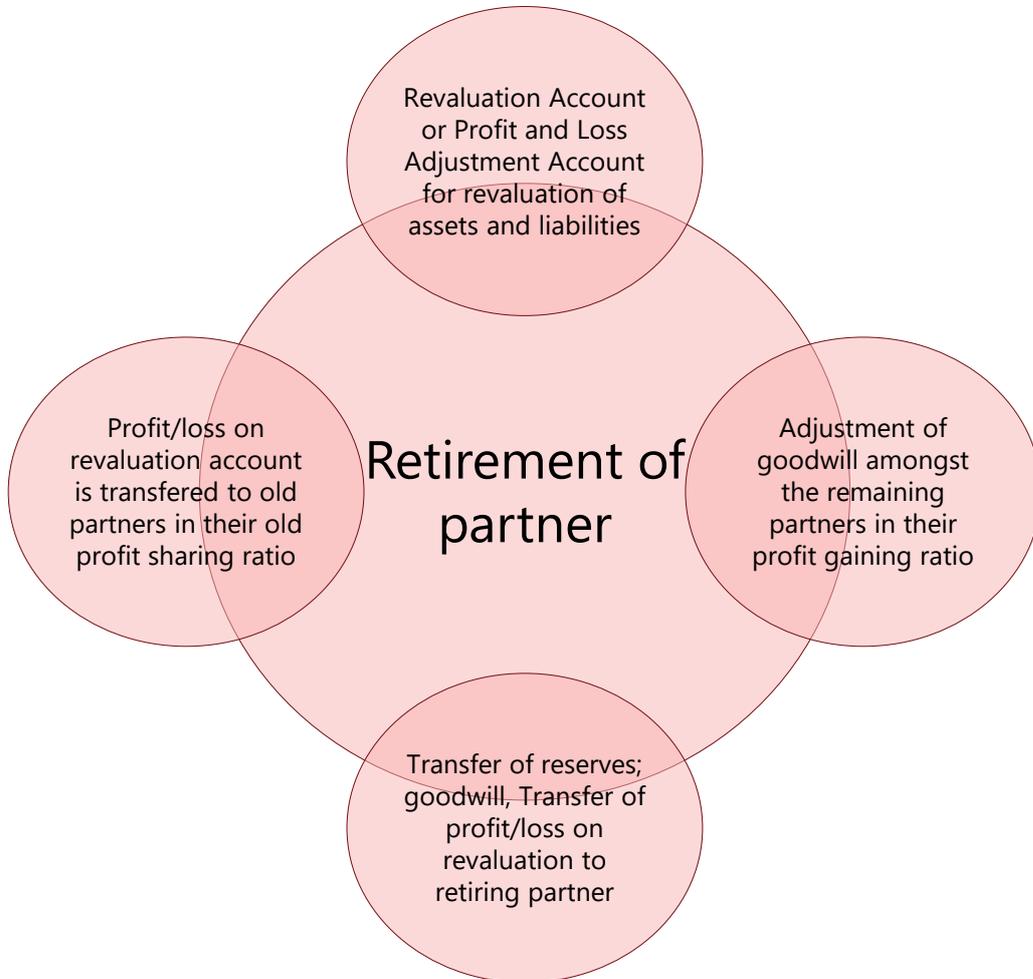
UNIT – 4: RETIREMENT OF A PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

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

UNIT OVERVIEW



4.1 INTRODUCTION

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



4.2 CALCULATION OF GAINING RATIO

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

Example: Amir, Jamir and Samir are in partnership sharing profits and losses at the ratio of 3:2:1. Now Amir wants to retire and Jamir and Samir want to continue at the ratio of 3:2. In this case, Jamir gains $\frac{8}{30}$ th of share of partnership ($\frac{3}{5}$ less $\frac{2}{6}$) whereas Samir gains $\frac{7}{30}$ th ($\frac{2}{5}$ less $\frac{1}{6}$) share of the partnership. So gaining ratio between Jamir and Samir is 8:7. On the other hand, if Jamir and Samir would decide to continue sharing profits and losses at the ratio of 2:1, then Jamir would gain $\frac{2}{6}$ th share of partnership i.e. [$(\frac{2}{3}) - (\frac{2}{6})$], and Samir would gain $\frac{1}{6}$ th share of partnership i.e. [$(\frac{1}{3}) - (\frac{1}{6})$]. So it appears that in such a case gaining ratio of Jamir and Samir would be 2:1. i.e., the existing profit sharing ratio between them.

Thus, on the retirement or death of a partner, his share in the profit would be taken by the remaining partners. In other words, they get additional share which is obviously a gain or benefit. The calculation of gaining ratio or benefit ratio is done as follows:

- (i) When the new ratio is given, gaining ratio is calculated by deducting their old share of profits from the new share.
- (ii) When the new profit sharing ratio is not given and the remaining partners share the future profits in the same ratio as before, the gaining ratio would be the old profit sharing ratio.

Observe the following table:

Ratio between Remaining Partners

		New Ratio	Gaining or Benefit Ratio
1.	When new ratio is given	As given in the examination problem	New Ratio minus Old ratio
2.	When the new Ratio is not given	The same old ratios between them	The same old ratios between them
3.	When gaining or benefit ratio is given	Old ratio + Gaining ratio	As given in the question

Calculation of New Profit Sharing Ratio

Case 1 When nothing is given about the new profit sharing ratio of the remaining partners: Under this situation the calculation of new ratio is done by striking out the share of the retiring partner.

Example : Alok, Bhaskar and Chetan are partners sharing in the ratio 3:2:1. Calculate new ratio if:

- (a) If Alok retires.
- (b) If Bhaskar retires.
- (c) If Chetan retires.

Solution

Old Profit ratio = 3:2:1

- (a) If Alok retires new profit ratio will be 2:1
- (b) If Bhaskar retires new profit ratio will be 3:1
- (c) If Chetan retires new profit ratio will be 3:2

Case 2: When gains of the continuing partners are specifically given in the question: In such a case, the new shares of the continuing partners are calculated by adding their respective gain to their old share.

New share = Old share + Gain

Example

Aarav, Banta and Chunmun are partners sharing in the ratio 3:2:1. Aarav retires and his share is taken over by the remaining partners as follow

Banta takes $\frac{2}{6}$ th from Aarav.

Chunmun takes $\frac{1}{6}$ th from Aarav.

Calculate new ratio.

Solution

Banta's New Share = Banta's old share + Banta's gain = $\frac{2}{6} + \frac{2}{6} = \frac{4}{6}$

Chunmun's New Share = Chunmun's old share + Chunmun's gain = $\frac{1}{6} + \frac{1}{6} = \frac{2}{6}$

So the new share = $\frac{4}{6} : \frac{2}{6} = 2:1$

Case 3: When the ratio in which the remaining partners acquire the share of the outgoing partner is given:

Example

Deepu, Tasha and Honey are partners sharing profits in the ratio 3:2:1. Tasha retires and his share was acquired by Deepu and Honey in the ratio 2:1. Calculate new ratio.

Solution

Share acquired by Deepu = $\frac{2}{6} \times \frac{2}{3} = \frac{4}{18}$

Share acquired by Honey = $\frac{2}{6} \times \frac{1}{3} = \frac{2}{18}$

Deepu's new Share = Deepu's old share + Deepu's gain = $\frac{3}{6} + \frac{4}{18} = \frac{13}{18}$

Honey's new Share = Honey's old share + Honey's gain = $\frac{1}{6} + \frac{2}{18} = \frac{5}{18}$

New Ratio = 13:5

Calculation of Gaining Ratio**Case – 1**

A, B and C are partners sharing profits and losses in the ratio of $\frac{1}{2}$, $\frac{3}{10}$ and $\frac{1}{5}$ respectively. B retires from the firm and A&C decide to share future profits and losses in the ratio of 3:2.

		A	C
Their new shares	(a)	$\frac{3}{5}$	$\frac{2}{5}$
Their old shares	(b)	$\frac{1}{2}$	$\frac{1}{5}$
Difference being gain		(a – b)	$\frac{1}{10}$
		$\frac{2}{10}$	

Gaining ratio of A and C = $\frac{1}{10} : \frac{2}{10} = 1 : 2$

Case – 2

W, A, B and C are partners sharing profits and losses in the ratio of $\frac{1}{3}$, $\frac{1}{6}$, $\frac{1}{3}$ and $\frac{1}{6}$ respectively. B retires and W, A and C decide to share future profits and losses equally.

		W	A	C
Their new shares	(a)	$\frac{1}{3}$	$\frac{1}{3}$	$\frac{1}{3}$
Their old shares	(b)	$\frac{1}{3}$	$\frac{1}{6}$	$\frac{1}{6}$
Difference being gain (a – b)		-	$\frac{1}{6}$	$\frac{1}{6}$

Gaining ratio of A and C = $\frac{1}{6} : \frac{1}{6} = 1 : 1$

Case – 3

A, B and C are partners sharing profits and losses in the ratio of 25:15:9. B retires and it is decided that profit sharing ratio between A&C will be the same as existing between B and C.

Ratio of B and C = 15 : 9 = 5 : 3

Therefore new ratio of A and C should be 5 : 3

		A	C
Their new shares	(a)	5/8	3/8
Their old shares	(b)	25/49	9/49
Difference being gain	(a-b)	45/392	75/392

Gaining ratio of A and C = 45 : 75 = 3 : 5

Case – 4

A, B and C are partners sharing profits and losses in the ratio of 4/9, 1/3 and 2/9. B retires and surrenders 1/9th of his share in favour of A and remaining in favour of C.

		A	C
Their existing shares	(a)	4/9	2/9
Share surrendered by B	(b)	$1/9 \times 1/3 = 1/27$	$8/9 \times 1/3 = 8/27$
New share of remaining partner (a + b)		13/27	14/27

New ratio of A and C = 13 : 14

Gaining ratio = $1/27 : 8/27 = 1 : 8$

Case – 5

A, B & C are partners sharing profits and losses in the ratio of 1/2, 3/10 and 1/5 respectively. B retires and his share is taken by A and C in the ratio of 2:1. Then immediately W is admitted for 1/4th share of profit, half of which was gifted by A and remaining share was taken by W equally from A and C.

		A	C
Their existing shares	(a)	1/2	1/5
Share acquired by remaining partners	(b)	$2/3 \times 3/10 = 2/10$	$1/3 \times 3/10 = 1/10$
New shares of remaining partners	(c= a + b)	7/10	3/10
Share gifted by A	(d)	$1/2 \times 1/4 = 1/8$	-

Share acquired by W (other than gift) (e)	$1/2 \times 1/8 = 1/16$	$1/2 \times 1/8 = 1/16$
New Shares	(c - d - e)	19/80
New ratio of A , C and W = 41/80 : 19/80 : 20/80 = 41 : 19 : 20		



4.3 REVALUATION OF ASSETS AND LIABILITIES ON RETIREMENT OF A PARTNER

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

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

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

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

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

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

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

		₹	₹
1)	Sundry Fixed Assets A/c	Dr.	10,000
	Trade payables A/c	Dr.	2,000
	To A's Capital A/c		4,000
	To B's Capital A/c		4,000
	To C's Capital A/c		4,000
	(Distribution of Revaluation Profit amongst the existing partners in the old profit sharing ratio)		
2)	B's Capital A/c	Dr.	6,000
	C's Capital A/c	Dr.	6,000
	To Sundry Fixed Assets A/c		10,000
	To Trade payables A/c		2,000
	(Being revalued assets and liabilities are not required to be shown in the Balance Sheet)		

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



4.4 RESERVE

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

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

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

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

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

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

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

Gaining Ratio: X: Y

4: 1

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

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

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

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



4.5 FINAL PAYMENT TO A RETIRING PARTNER

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

- (i) Transfer of reserve,
- (ii) Transfer of goodwill,
- (iii) Transfer of profit/loss on revaluation.

After adjustment of the above mentioned items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him.

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

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

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

Retiring partner's Capital A/c

Dr.

To Retiring Partner's Loan A/c

To Bank A/c

As a rule, the payment is made according to terms of partnership agreement which might provide one of the following alternatives:

- Repayment may be made in instalments over a period of time and the interest is paid on outstanding balance which will be treated as a loan of the outgoing partner.
- The amount due may be treated as a loan to the firm and in return the firm will either pay interest at a fixed rate or share of the profit of the firm.
- An annuity may be paid to a retired partner for life or for an agreed number of years for the life of some dependent.

ILLUSTRATION 1

A and B are partners in a business sharing profit and losses as A-3/5th and B-2/5th. Their balance sheet as on 1st January, 2022 is given below:

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

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

- The goodwill of the firm is valued at ₹ 25,000.*
- Depreciate Plant & Machinery by 7.5% and Inventories by 15%.*
- Doubtful debts provision is raised against trade receivables at 5% and a discount reserve against trade payables at 2%.*

Required:

Journalize the above transactions in the books of the firm and close the Partners' Accounts as on 1st January 2022. Give also the opening Balance Sheet of A.

SOLUTION

Journal Entries

2022		Dr. (₹)	Cr. (₹)
Jan 1.	A's Capital Account To B's Capital Account (The amount of share of goodwill adjusted on B's retirement)	Dr. 10,000	10,000
	Reserve Account To A's Capital Account To B's Capital Account (Transfer of reserve to A's Capital Account and B's Capital Account in the profit sharing ratio)	Dr. 15,000	9,000 6,000
	Profit and Loss Adjustment Account To Plant and Machinery Account To Inventory Account To Provision for Doubtful Debts Account (Reduction in the values, assets and creation of provision for doubtful debts as per agreement with B)	Dr. 4,650	1,500 2,400 750
	Reserve for Discount on Trade payables A/c To Profit and Loss Adjustment Account (Creation of reserve for discount on trade payables at 2%)	Dr. 150	150
	A's Capital Account B's Capital Account To Profit and Loss Adjustment Account (Transfer of loss on revaluation of assets and liabilities to Capital Accounts of A and B in the profit sharing ratio)	Dr. 2,700 Dr. 1,800	4,500
	B's Capital Account To B's Loan Account (Transfer of B's Capital Account to his Loan A/c)	Dr. 29,200	29,200

Note: Here it is assumed that amount payable to B is transferred to his loan a/c.

Balance Sheet of A as at 1st January, 2022

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

ILLUSTRATION 2

F, G and K were partners in LLP sharing profits and losses at the 2:2: 1. K wants to retire on 31.12.2022. Given below is the Balance Sheet of the partnership as well as other information:

Balance Sheet as at 31.12.2022

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

F and G agree to share profits and losses at the ratio of 3: 2 in future. Value of Goodwill is taken to be ₹ 50,000. Sundry Fixed Assets are revalued upward by ₹ 30,000 and Inventories by ₹ 10,000. Bills Receivable dishonoured ₹ 5,000 on 31.12.2022 but not recorded in the books. Dishonour of bill was due to insolvency of the customer. F and G agree to bring sufficient cash to discharge claim of K and to make their capital proportionate. Also they wanted to maintain ₹ 75,000 bank balance for working capital.

Required:

Pass necessary journal entries, capital accounts of partners and draft the Balance Sheet of Ms/ F & G after K's retirement.

SOLUTION

Journal Entries

			₹	₹
(1)	F's Capital A/c To K's Capital A/c (Being the adjustment for goodwill on K's retirement) - Refer W.N.	Dr.	10,000	10,000
(2)	Reserve A/c To F's Capital A/c To G's Capital A/c To K's Capital A/c (Transfer of Reserve to Partners' Capital A/cs on K's retirement)	Dr.	10,000	4,000 4,000 2,000
(3)	Sundry Fixed Assets A/c Inventory A/c To Profit and Loss Adjustment A/c (Increase in the value of Sundry Fixed Assets and inventory recorded)	Dr. Dr.	30,000 10,000	40,000
(4)	Profit and Loss Adjustment A/c To Trade Receivable A/c (Loss arising out of dishonoured bill recorded)	Dr.	5,000	5,000
(5)	Profit and Loss Adjustment A/c To F's Capital A/c To G's Capital A/c To K's Capital A/c (Profit on revaluation transferred to Partners' Capital A/cs on K's retirement)	Dr.	35,000	14,000 14,000 7,000
(6)	Bank A/c To F's Capital A/c To G's Capital A/c (Cash brought in by F and G as per agreement)	Dr.	1,04,000	70,000 34,000
(7)	K's Capital A/c To Bank A/c (Payment made to K on retirement)	Dr.	79,000	79,000

Working Note:

Adjusting entry for goodwill

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

Adjusting entry:

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

Balance Sheet (after K's retirement)

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

Partners' Capital Accounts

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

Working Notes:

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

2. Bank Account

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

ILLUSTRATION 3

A, B & C were in partnership sharing profits in the proportions of 5:4:3. The balance sheet of the firm as on 31st March, 2022 was as under:

Liabilities	₹	Assets	₹
Capital accounts:		Fixtures	8,200
A	1,35,930	Inventories	1,57,300
B	95,120	Trade receivables	93,500
C	61,170	Cash	74,910
Trade payables	41,690		
	3,33,910		3,33,910

A had been suffering from ill-health and gave notice that he wished to retire. An agreement was, therefore, entered into as on 31st March, 2022, the terms of which were as follows:

- (i) The profit and loss account for the year ended 31st March, 2022 which showed a net profit of ₹ 48,000 was to be re-opened. B was to be credited with ₹ 4,000 as bonus, in consideration of the extra work which had devolved upon him during the year. The profit sharing was to be revised from 1st April, 2021, as 3:4:4.
- (ii) Goodwill was to be valued at two years' purchase of the average profits of the preceding five years. The fixtures were to be valued by an independent valuer. The valuations arising out of the above agreement were goodwill ₹ 56,800 and fixtures ₹ 10,980. A provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book values.

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

Required:

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

SOLUTION

Journal Entries

Particulars		Dr. (₹)	Cr. (₹)
A's Capital Account	Dr.	20,000	
B's Capital Account	Dr.	16,000	
C's Capital Account	Dr.	12,000	
To Profit and Loss Adjustment Account (Profit written back for making adjustments)			48,000
Profit and Loss Adjustment Account	Dr.	4,000	
To B's Capital account (Bonus Credited to B's Capital Account)			4,000
Profit and Loss Adjustment Account	Dr.	44,000	
To A's Capital Account			12,000
To B's Capital Account			16,000
To C's Capital Account (Distribution of profits in the new ratio)			16,000
Fixtures Account	Dr.	2,780	
To Provision for Doubtful debts Account @ 2%			1,870

To A's Capital Account			248
To B's Capital Account			331
To C's Capital Account			331
(Revaluation of assets on A's retirement)			
A's Capital Account	Dr.	1,43,669	
To A's Loan Account			1,43,669
(Transfer of A's Capital Account to his Loan Account)			
B's Capital Account	Dr.	2,244	
C's Capital Account	Dr.	1,496	
To Provision for Doubtful Debts Account			3,740
(Raising provision for bad debts)			
B's Capital Account	Dr.	13,425	
C's Capital Account	Dr.	2,066	
To A's Capital Account			15,491
(Adjusting entry of goodwill passed through partners' capital accounts in gaining/sacrificing ratio)			

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To Profit and Loss Adjustment A/c	20,000	16,000	12,000	By Balance b/d	1,35,930	95,120	61,170
To A's Loan A/c	1,43,669	–	–	By Profit and Loss Adjustment A/c	–	4,000	–
To Provision for Doubtful Debts A/c	–	2,244	1,496	By Profit and loss Adjustment A/c	12,000	16,000	16,000
To A	–	13,425	2,066	By Fixtures Less provision for Doubtful Debts A/c	248	331	331
To Balance c/d	–	83,782	61,939	By B	13,425		
				By C	2,066		
	1,63,669	1,15,451	77,501		1,63,669	1,15,451	77,501

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

Working Note:

Calculation for adjustment of Amount of Goodwill

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

ILLUSTRATION 4

K, L & M are partners sharing profits and losses in the ratio 5:3:2. Due to illness, L wanted to retire from the firm on 31.3.2022 and admit his son N in his place.

Balance Sheet of K, L and M as at 31.3.2022

Liabilities	₹	₹	Assets	₹
Capital:			Furniture	20,000
K	40,000		Trade receivables	50,000
L	60,000		Inventory in Trade	50,000
M	30,000	1,30,000	Cash and Bank balances	80,000
Reserve		50,000		
Trade payables		20,000		
		2,00,000		2,00,000

On retirement of L assets were revalued: Furniture ₹ 10,000 and Inventory in trade ₹ 30,000. 50% of the amount due to L was paid off in cash and the balance was retained in the firm as capital of N. On admission of the new partner, goodwill was valued at ₹ 50,000. Partners are being paid off their extra balances to make capital proportionate by keeping N's capital as base.

You are required to give:

(i) Necessary journal entries; (ii) balance sheet of M/s K, M and N as on 1.4.2022; (iii) capital accounts of partners.

SOLUTION

Journal Entries

Date	Particulars	Dr. (₹)	Cr. (₹)
31.3.2022	Profit and Loss Adjustment A/c Dr.	30,000	
	To Furniture A/c		10,000
	To Inventory in Trade A/c		20,000
	(Being revaluation of Furniture and inventory in trade recorded)		
	K's Capital A/c Dr.	15,000	
	L's Capital A/c Dr.	9,000	
	M's Capital A/c Dr.	6,000	
	To Profit and Loss Adjustment A/c		30,000
	(Being net revaluation loss debited to capital accounts of K, L and M in the ratio 5 : 3 : 2)		
	Reserve A/c Dr.	50,000	
	To K's Capital A/c		25,000
	To L's Capital A/c		15,000
	To M's Capital A/c		10,000
	(Being reserve transferred to capital accounts, K, L and M)		
	N's Capital A/c Dr.	15,000	
	To L's Capital A/c		15,000
	(Being adjusting entry for goodwill passed in gaining/ sacrificing ratio)		
	L's Capital A/c Dr.	81,000	
	To Cash and Bank A/c		40,500
	To N's Capital A/c		40,500
	(Being 50% of the amount due to L was paid off in cash and balance was retained in the firm as capital of N)		

K's Capital A/c	Dr.	7,500	
M's Capital A/c	Dr.	17,000	
To Cash and Bank A/c			24,500
(Being amount paid to K and M to make their capital proportionate)			

Working Note:

- Calculation for adjustment of Amount of Goodwill

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

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

Partner	Capital Balance	P/L Ratio	Excess Capital Paid Off
K	50,000	5	7,500
N	25,500	3	–
M	34,000	2	17,000

Partners' Capital Accounts

	K ₹	L ₹	M ₹	N ₹		K ₹	L ₹	M ₹	N ₹
To Profit and Loss Adjustment A/c	15,000	9,000	6,000		By Balance b/d	40,000	60,000	30,000	
					By Reserve	25,000	15,000	10,000	
To Cash & Bank A/c	-	40,500	-	-	By L's Capital A/c	-	-	-	40,500
To N's Capital A/c	-	40,500	-	-	By N's Capital A/c	-	15,000	-	-
To L's Capital A/c	-	-	-	15,000					
To Cash & Bank A/c									
(Balancing figure)	7,500	-	17,000	-					

To Balance c/d	42,500	-	17,000	25,500				
	65,000	90,000	40,000	40,500		65,000	90,000	40,000
					By Balance b/d	35,000	-	14,000
								25,500

Balance Sheet of M/s K, M & N

as at 1st April, 2022

Liabilities	₹	₹	Assets	₹
Capital Accounts:			Furniture	10,000
K	42,500		Trade receivables	50,000
M	17,000		Inventory in Trade	30,000
N	25,500	85,000	Cash and Bank balance	15,000
Trade payables		20,000		
		1,05,000		1,05,000

ILLUSTRATION 5

Dowell llp. with partners Mr. A, Mr. B and Mr., C, are sharing profits and losses in the ratio of 10:6:4. The balance sheet of the firm as at 31st March, 2022 is as under:

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

It was mutually agreed that Mr. B will retire from partnership and in his place Mr. D will be admitted as a partner with effect from 1st April, 2022. For this purpose, the following adjustments are to be made:

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

- (b) Buildings and plant and machinery are to be depreciated by 5% and 20% respectively. Investments are to be taken over by the retiring partner at ₹ 15,000. Provision of 20% is to be made on Trade receivables to cover doubtful debts.
- (c) In the reconstituted firm, the total capital will be ₹ 2 lakhs which will be contributed by Mr. A, Mr. C and Mr. D in their new profit sharing ratio, which is 2:2:1.
- (i) The surplus funds, if any, will be used for repaying bank overdraft.
- (ii) The amount due to retiring partner shall be transferred to his loan account.

Required:

Prepare

- (a) Revaluation account;
- (b) Partners' capital accounts;
- (c) Bank account; and
- (d) Balance sheet of the reconstituted firm as on 1st April, 2022.

SOLUTION**Revaluation Account**

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

A's Capital Account

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

B's Capital Account

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

C's Capital Account

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

D's Capital Account

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

Bank Account

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

Balance Sheet of Dowell Iip.**as at 1st April, 2022**

Liabilities		₹	Assets		₹
Capital Accounts:			Land		10,000
A	80,000		Buildings		1,90,000
C	80,000		Plant and Machinery		1,04,000
D	40,000	2,00,000	Furniture		43,000
Long Term Debts		3,00,000	Inventories		1,30,000
Trade payables		1,70,000	Trade receivables	1,39,000	

B's Loan Account		22,760	Less: Provision for Doubtful Debts)	(27,800)	1,11,200
			Balance at Bank		1,04,560
		6,92,760			6,92,760

Note: Even though the problem says goodwill ₹ 1,00,000 to appear in new Balance Sheet, it is written off so as to comply with Accounting Standard. Net entry for goodwill is:

C's capital	Dr.	20,000	
D's capital	Dr.	20,000	
To A's capital			10,000
To B's capital			30,000



4.6 PAYING A PARTNER'S LOAN IN INSTALMENT

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

Retiring Partner's Loan Account

		₹			₹
I Year	To Cash (7,500 + 1,800)	9,300	I Year	By Capital A/c	30,000
	To Balance c/d	22,500		By Interest A/c	1,800
		31,800			31,800
II Year	To Cash (7,500 + 1,350)	8,850	II Year	By Balance b/d	22,500

III Year	To Balance c/d	15,000	III Year	By Interest A/c (6% on ₹ 22,500)	1,350
		23,850			23,850
	To Cash	8,400		By Balance b/d	15,000
IV Year	To Balance c/d	7,500	IV Year	By Interest Account	900
		15,900			15,900
	To Cash	7,950		By Balance b/d	7,500
		7,950		By Interest A/c	450
		7,950		7,950	

ILLUSTRATION 6

M/s X is a partnership firm with the partners A, B and C sharing profits and losses in the ratio of 3:2:5. The balance sheet of the firm as on 30th June 2022, was as under:

Balance Sheet of M/s. X as at 30.06.2022

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

It was mutually agreed that B will retire from partnership and in his place D will be admitted as a partner with effect from 1st July, 2022. For this purpose, the following adjustments are to be made:

- Goodwill of the firm is to be valued at ₹ 2 lakhs due to the firm's locational advantage but the same will not appear as an asset in the books of the reconstituted firm.
- Buildings and plant and machinery are to be valued at 90% and 85% of the respective balance sheet values. Investments are to be taken over by the retiring partner at ₹ 25,000.

Trade receivables are considered good only upto 90% of balance sheet figure. Balance be considered bad.

- (c) In the reconstituted firm, the total capital will be ₹ 3 lakhs, which will be contributed by A, C and D in their new profit sharing ratio, which is 3:4:3.
- (d) The amount due to retiring partner shall be transferred to his loan account.

Required:

Prepare Revaluation Account and Partners' Capital Accounts.

SOLUTION

Revaluation Account

2022		₹	2022			₹
July 1	To Building	20,000	July 1	By Investments		3,000
	To Plant and Machinery	57,000		(25,000 - 22,000)		
	To Bad Debts	13,900		By Partners' Capital A/cs		
				(Loss on revaluation)		
				A (3/10)	26,370	
				B (2/10)	17,580	
				C (5/10)	43,950	87,900
		90,900				90,900

Partners' Capital Accounts

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

Working Notes:

1. Adjustment of goodwill

Goodwill of the firm is valued at ₹ 2 lakhs

Sacrificing ratio:

$$\begin{aligned} A & \quad 3/10 - 3/10 & = & 0 \\ B & \quad 2/10 - 0 & = & 2/10 \\ C & \quad 5/10 - 4/10 & = & 1/10 \end{aligned}$$

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

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

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

2. Capital of partners in the reconstituted firm :

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



4.7 JOINT LIFE POLICY

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

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

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

Accounting entries are:

- On payment of premium

Joint Life Policy Insurance Premium A/c Dr.
 To Bank A/c

(b) On charging to Profit and Loss Account
 Profit and Loss Account Dr.
 To Joint Life Policy Insurance Premium A/c

(c) On maturity of the Policy
 Insurance Company/ Bank Account Dr.
 To Partners' Capital A/cs (individually)
 (Including the account of the representative of a deceased partner)

- 2. When premium paid is treated as an asset:** In this case insurance premium paid is first debited to life policy account and credited to bank account. At the end of the year the amount in excess of surrender value is treated as a loss and is transferred to Profit and Loss Account. In this case the amount received from the insurance company in excess of the surrender value results in a gain at the time of receipt of such amount which is transferred to Capital Accounts of the partners in the profit sharing ratio.
- 3. Creation of Joint Policy Reserve Account:** Under this method, premium paid is debited to policy account and credited to bank account. At the end of the year, amount equal to premium is transferred from Profit and Loss Appropriation Account to Policy Reserve Account. After this, policy account is brought down to its surrender value by debiting the life policy reserve account with amount which exceeds the surrender value of the policy. Thus, in this method, policy account appears on the assets side and policy reserve account appears on the liabilities side of the Balance Sheet until it is realized. Both these accounts appear in the Balance Sheet at the surrender value of the policy. This method is different from the method discussed in (2) above only in respect of reserve account.

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

ILLUSTRATION 7

Red, White and Black shared profits and losses in the ratio of 5:3:2. They took out a joint life Policy in 2018 for ₹ 50,000, a premium of ₹ 3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2018 nil; 2019 ₹ 900; 2020 ₹ 2,000; 2021 ₹ 3,600. Black retires on 15th April, 2022.

Required

Prepare ledger accounts assuming no Joint Life Policy Account is maintained.

SOLUTION**Joint Life Policy Premium Account**

		₹			₹
10th June, 2018	To Bank A/c	3,000	31st Dec., 2018	By Profit and Loss A/c	3,000
10th June, 2019	To Bank A/c	3,000	31st Dec., 2019	By Profit and Loss A/c	3,000
10th June, 2020	To Bank A/c	3,000	31st Dec., 2020	By Profit and Loss A/c	3,000
10th June, 2021	To Bank A/c	3,000	31st Dec., 2021	By Profit and Loss A/c	3,000

Profit and Loss Account

		₹		₹
31st Dec., 2018	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2019	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2020	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2021	To Joint Life Policy Premium A/c	3,000		

Joint Life Policy Account

		₹			₹
15th April, 2022	To Capital A/cs: (Transfer)		15th April, 2022	By Bank A/c	3,600
	Red 5/10	1,800			
	White 3/10	1,080			
	Black 2/10	720			
		3,600			3,600

ILLUSTRATION 8

Red, White and Black shared profits and losses in the ratio of 5: 3: 2. They took out a Joint Life Policy in 2018 for ₹ 50,000, a premium of ₹ 3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2018 nil; 2019

₹ 900; 2020 ₹ 2,000; 2021 ₹ 3,600.

Black retires on 15th April, 2022.

Required:

Prepare ledger accounts assuming Joint Life Policy Account is maintained on surrender value basis.

SOLUTION

Joint Life Policy Account

		₹			₹
10th June, 2018	To Bank A/c	3,000	31st Dec., 2018	By Profit and Loss A/c	3,000
10th June, 2019	To Bank A/c	3,000	31st Dec., 2019	By Profit and Loss A/c	2,100
				By Balance c/d	900
		3,000			3,000
1st January, 2020	To Balance b/d	900	31st Dec., 2020	By Profit and Loss A/c	1,900
10th June, 2020	To Bank A/c	3,000		By Balance c/d	2,000
					3,900
		3,900			3,900
1st January, 2021	To Balance b/d	2,000	31st Dec., 2021	By Profit and Loss A/c	1,400
10th June, 2021	To Bank A/c	3,000		By Balance c/d	3,600
					5,000
		5,000			5,000
1st January, 2022	To Balance b/d	3,600	15th April, 2022	By Bank	3,600
		3,600			3,600

Profit and Loss Account

		₹			₹
31st Dec., 2018	To Joint Life Policy A/c	3,000			
31st Dec., 2019	To Joint Life Policy A/c	2,100			
31st Dec., 2020	To Joint Life Policy A/c	1,900			
31st Dec., 2021	To Joint Life Policy A/c	1,400			

ILLUSTRATION 9

A, B and C are in partnership sharing profits and losses at the ratio of 5:3: 2. The balance sheet of the firm on 31.12.2021 was as follows:

Balance Sheet

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

On 1.1.2022, A wants to retire, B and C agreed to continue at 2:1. Joint Life Policy was taken on 1.1.2017 for ₹ 1,00,000 and its surrender value as on 31.12.2021 was ₹ 25,000. For the purpose of A's retirement goodwill was raised for ₹ 1,00,000. Sundry Fixed Assets was revalued for ₹ 1,10,000. But B and C did not prefer to show such an increase in assets in the balance sheet. Also they agreed to bring necessary cash to discharge 50% of the A's claim, to make the bank balance ₹ 25,000 and to make their capital proportionate.

Required:

Prepare necessary journal entries to give the effect in capital accounts of partners.

SOLUTION**Journal Entries**

			₹	₹
1.	B's Capital A/c	Dr.	49,500	
	C's Capital A/c	Dr.	18,000	
	To A's Capital A/c			67,500
	(Share of memorandum revaluation profit ₹ 67,500 including good will due to A borne by B and C at the gaining ratio 11 : 4)			
2.	A's Capital A/c	Dr.	1,17,500	
	To A's Loan A/c			58,750

	To Bank A/c (Settlement of A's claim on his retirement by payment of 50% in case and transferring the balance to his Loan A/c).		58,750
3.	Bank A/c	Dr.	73,750
	To B's Capital A/c		60,333
	To C's Capital A/c		13,417
	(Cash brought in by the continuing partners).		

Working Notes:

1. Memorandum Revaluation Profit	₹
Goodwill	1,00,000
Sundry Fixed Assets	30,000
Joint Life Policy	5,000
	<u>1,35,000</u>

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

2. Gaining Ratio

$$B : \quad 2/3 - 3/10 = 11/30$$

$$C : \quad 1/3 - 2/10 = 4/30$$

Gaining Ratio :	B	:	C
	11	:	4

3. Total Capital

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

4. Partners' Capital Accounts

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To A's Capital		49,500	18,000	By Balance b/d	50,000	40,000	30,000
To Bank A/c	58,750			By B & C's Capital a/c	67,500		
To A's Loan	58,750			By Bank A/c		60,333	13,417
To Balance c/d		50,833	25,417				
	1,17,500	1,00,333	43,417		1,17,500	1,00,333	43,417



4.8 SEPARATE LIFE POLICY

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

Example: Sona, Gabbu and Amit are partners Profit sharing ratio is 3:1:1

	SONA	GABBU	AMIT
Policy	1,00,000	2,00,000	3,00,000
Surrender Value	10,000	20,000	30,000

If Amit retires, then, Amit will get ₹ 60,000 × 1/5 = 12,000

ILLUSTRATION 10

Aarav, Nirav and Purav are partners in LLP sharing profits and losses in the ratio of 3:2:1. Their Balance Sheet as on 31st March, 2022 was as follows:

Balance Sheet as at 31st March, 2022

Liabilities	₹	Assets	₹
Capital : Aarav	80,000	Building	50,000
Nirav	50,000	Machinery	67,500
Purav	35,000	Debtors	65,000
General Reserve	60,000	Stock	80,000
Trade Creditors	50,000	Bank	12,500
	2,75,000		2,75,000

Purav retired from the business on 1st April 2022 on the following terms:

1. Goodwill was to be valued at 2 years purchase of average profit of past 3 years.
31st March, 2020 ₹ 41,000
31st March, 2021 ₹ 50,000
31st March, 2022 ₹ 55,000
2. Goodwill was not to be raised in the books of accounts.
3. Provision for Doubtful Debts was to be created on debtors at 5%. Machinery is to be depreciated by 10% and stock is revalued at ₹ 71,000.
5. Building to be appreciated by 20%.
6. Aarav and Nirav to bring in additional capital of ₹ 35,000 and ₹ 25,000 respectively.
7. Balance payable to Purav must be paid immediately.

You are required to prepare:

1. Revaluation account
2. Partners capital accounts.
3. Bank account.
4. Balance Sheet after retirement.

SOLUTION

In The Books of Aarav Nirav and Purav Revaluation A/c

Particulars	₹	Particulars	₹
To Provision for Doubtful Debts	3,250	By Building	10,000
To Machinery	6,750	By Loss on revaluation	
To Stock	9,000	Aarav	4,500
		Nirav	3,000
		Purav	<u>1,500</u>
	19,000		9,000
			19,000

Partners Capital A/c

Particulars	Aarav	Nirav	Purav	Particulars	Aarav	Nirav	Purav
To Loss on Revaluation	4,500	3,000	1,500	By Balance b/d	80,000	50,000	35,000
To Bank			60,500	By General Reserve	30,000	20,000	10,000
To Purav capital	10,200	6,800		By Aarav, Nirav capital			17,000
To Balance c/d	1,30,300	85,200		By Bank	35,000	25,000	
	1,45,000	95,000	62,000		1,45,000	95,000	62,000

Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	12,500	By Purav's Capital	60,500
To Aarav's Capital	35,000	By Balance c/d	12,000
To Nirav's Capital	25,000		
	72,500		72,500

Balance Sheet as at April 1st, 2022

Liabilities	₹	Assets	₹
Capital : Aarav 1,30,300		Building	60,000
Nirav 85,200	2,15,500	Machinery	60,750
Trade Creditors	50,000	Debtors	65,000
		Less: Provision for doubtful Debts	3,250
		Stock	71,000
		Bank	12,000
	2,65,500		2,65,500

Working note :

Valuation of Goodwill (as per weight average method)

31st March 2020	₹ 41,000 X 1 = 41,000
31st March 2021	₹ 50,000 X 2 = 1,00,000
31st March 2022	₹ 55,000 X 3 = <u>1,65,000</u>
Total	₹ <u>3,06,000</u>

Weighted average profit (3,06,000/6) = 51,000

Goodwill (2 years purchase) = 2 x 51,000 = ₹ 1,02,000

Purav's share = 1/6th = 1,02,000/6 = 17,000

Journal entry for adjustment of goodwill

Aarav capital A/c	Dr.	10,200	
Nirav capital	Dr.	6,800	
	To Purav capital		17,000

ILLUSTRATION 11

Satyam, Shivam & Sunderam are partners of M/s. Great Stationers sharing profits and losses in the ratio of 1:1:2.

On 31st March, 2022 their Balance Sheet was as under :

Liabilities		₹	Assets		₹
Capitals :			Building		2,50,000
Satyam	1,95,000		Plant		1,60,000
Shivam	1,48,000		Investments		85,000
Sunderam	<u>1,12,000</u>	4,55,000	Stock		45,280
General Reserve		80,000	Trade Receivable		68,000
Loan from Satyam		94,000	Bank		95,720
Sundry Creditors		75,000			
		<u>7,04,000</u>			<u>7,04,000</u>

On 1st April 2022 Shivam retired on the following terms:

1. Goodwill is to be valued at ₹ 1,20,000 but the same will not appear as an asset in the books of the reconstituted firm.
2. Buildings is to be appreciated by 20% and Plant is to be depreciated by 10 %.
3. Investments are to be taken over by the Satyam in full settlement of his loan.
4. Provision of 5% is to be made on trade receivables to cover doubtful debts.
5. In the reconstituted firm, the total capital will be ₹ 3,00,000/- which will be contributed by Satyam and Sunderam in their new profit sharing ratio, which is 2:3.
6. The amount due to retiring partner shall be transferred to his loan account.

You are required to give journal entries to record above adjustments and also prepare Balance Sheet thereafter.

SOLUTION**In the books of Satyam Shivam & Sundaram****Journal entries**

Sr No	Particulars	Dr. ₹	Cr. ₹
1	General Reserve A/c To Satyam Capital A/c To Shivam Capital A/c To Sunderam Capital A/c (Being General reserve distributed among old partners)	Dr. 80,000	 20,000 20,000 40,000
2.	Satyam Capital A/c Sunderam Capital A/c To Shivam Capital A/c (Being adjustment entry for goodwill passed)	Dr. Dr. 18,000 12,000	 30,000
3.	Building A/c To Revaluation A/c (Being Building appreciated)	Dr. 50,000	 50,000
4.	Satyam loan A/c To Revaluation A/c To Investments A/c (Being investments taken over by Satyam)	Dr. 94,000	 9,000 85,000
5.	Revaluation A/c To Plant To Provision for Doubtful Debts (Being Assets revalued)	Dr. 19,400	 16,000 3,400
6.	Revaluation A/c To Satyam Capital A/c To Shivam capital A/c To Sundaram Capital A/c (Being profit on Revaluation distributed)	Dr. 39,600	 9,900 9,900 19,800

7	Shivam Capital A/c To Shivam loan a/c (Being amount payable to Shivam transferred to his Loan A/c)	Dr.	2,07,900	2,07,900
8.	Satyam Capital A/c To Bank A/c (Being Capital accounts adjusted in Profit sharing ratio)	Dr.	86,900	86,900
9.	Bank A/c To Sunderam Capital A/c (Being Capital accounts adjusted in Profit sharing ratio)		20,200	20,200

Balance Sheet as at April 1st, 2022

Liabilities		₹	Assets		₹
Capitals :			Building		3,00,000
Satyam	1,20,000		Plant		1,44,000
Sunderam	<u>1,80,000</u>	3,00,000	Stock		45,280
Shivam loan A/c		2,07,900	Trade Receivable	68,000	
Sundry Creditors		75,000	Less: Provision for Doubtful Debts	<u>3,400</u>	64,600
			Bank		29,020
		<u>5,82,900</u>			<u>5,82,900</u>

Working Note:**Revaluation A/c**

Particulars	₹	Particulars	₹
To Provision for Doubtful Debts	3,400	By building	50,000
To Plant	16,000	By Investments	9,000
To Revaluation profit			
Satyam	9,900		
Shivam	9,900		
Sunderam	<u>19,800</u>		
	<u>59,000</u>		<u>59,000</u>

Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	95,720	By Satyam Capital	86,900
To Sundaram Capital	20,200	By Balance c/d	29,020
	1,15,920		1,15,920

Partners Capital A/c

Particulars	Satyam	Shivam	Sundaram	Particulars	Satyam	Shivam	Sundaram
To Shivam	18,000		12,000	By Balance b/d	1,95,000	1,48,000	1,12,000
To Shivam loan A/c		2,07,900		By Satyam and Sunderam		30,000	
To bank	86,900			By General Reserve	20,000	20,000	40,000
To balance c/d	1,20,000		1,80,000	By Revaluation	9,900	9,900	19,800
	2,24,900	2,07,900	1,92,000	By bank			20,200
					2,24,900	2,07,900	1,92,000

Partner	Old Share		New share		Gain Share
Satyam	1/4	-	2/5	=	3/20
Shivam	1/4	-	-	=	(5/20)
Sunderam	2/4	-	3/5	=	2/20

ILLUSTRATION 12

On 31st March, 2022, the Balance Sheet of P, Q and R sharing profits and losses in proportion to their Capital stood as below:

Liabilities	₹	Assets	₹
Capital Account:		Land and Building	30,000
Mr. P	20,000	Plant and Machinery	20,000
Mr. Q	30,000	Stock of goods	12,000
Mr. R	20,000	Sundry debtors	11,000
Sundry Creditors	<u>10,000</u>	Cash and Bank Balances	<u>7,000</u>
	<u>80,000</u>		<u>80,000</u>

On 1st April, 2022, P desired to retire from the firm and remaining partners decided to carry on the business. It was agreed to revalue the assets and liabilities on that date on the following basis:

- (i) Land and Building be appreciated by 20%.
- (ii) Plant and Machinery be depreciated by 30%.
- (iii) Stock of goods to be valued at ₹ 10,000.
- (iv) Old credit balances of Sundry creditors, ₹ 2,000 to be written back.
- (v) Provisions for bad debts should be provided at 5%.
- (vi) Unrecorded investment realised and cash obtained ₹ 7,550.
- (vii) Goodwill of the entire firm is valued at ₹ 14,000 and P's share of the goodwill is adjusted in the A/c's of Q and R, who would share the future profits equally.
- (viii) The total capital of the firm is to be the same as before retirement. Individual capital is in their profit sharing ratio.
- (ix) Amount due to Mr. P is to be settled on the following basis:
50% on retirement and the balance 50% within one year.

Prepare (a) Revaluation account, (b) The Capital accounts of the partners, (c) Cash account and (d) Balance Sheet of the new firm M/s Q & R as on 1.04.2022.

SOLUTION**(a) Revaluation Account**

Date	Particulars	₹	Date	Particulars	₹
April	To Plant & Machinery	6,000	April	By Land and building	6,000
	To Stock of goods	2,000		By Sundry creditors	2,000
	To Provision for bad and doubtful debts	550		By Cash & Bank - unrecorded investment	7,550
	To Capital accounts (profit on revaluation transferred)				
	Mr. P (2/7) 2,000				
	Mr. Q (3/7) 3,000				
	Mr. R (2/7) <u>2,000</u>	<u>7,000</u>			
		<u>15,550</u>			<u>15,550</u>

(b) Partners' Capital Accounts

Dr.				Cr.			
Particulars	P (₹)	Q (₹)	R (₹)	Particulars	P (₹)	Q (₹)	R (₹)
To P's Capital A/c - goodwill	-	1,000	3,000	By Balance b/d	20,000	30,000	20,000
To Cash & bank A/c - (50% dues paid)	13,000	-	-	By Revaluation A/c	2,000	3,000	2,000
To P's Loan A/c - (50% transfer)	13,000	-	-	By Q & R's Capital A/cs - goodwill	4,000	-	-
To Balance c/d	-	35,000	35,000	By Cash & bank A/c - amount brought in (Balancing figures)	-	3,000	16,000
	<u>26,000</u>	<u>36,000</u>	<u>38,000</u>		<u>26,000</u>	<u>36,000</u>	<u>38,000</u>

(c) Cash and Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	7,000	By P's Capital A/c - 50% dues paid	13,000
To Revaluation A/c - unrecorded investment	7,550	By Balance b/d	20,550
To Q's Capital A/c	3,000		
To R's Capital A/c	<u>16,000</u>		
	<u>33,550</u>		<u>33,550</u>

(d) Balance Sheet of M/s Q & R as at 01.04.2022

Liabilities		₹	Assets		₹
Partners' Capital account			Land and Building	30,000	
Mr. Q	35,000		Add: Appreciation 20%	<u>6,000</u>	36,000
Mr. R	<u>35,000</u>	70,000	Plant & Machinery	20,000	
Mr. P's Loan account		13,000	Less: Depreciation 30%	<u>6,000</u>	14,000
Sundry Creditors		8,000	Stock of goods	12,000	
			Less: revalued	<u>2,000</u>	10,000

		Sundry Debtors	11,000	
		Less: Provision for bad debts 5%	<u>550</u>	10,450
		Cash & Bank balances		<u>20,550</u>
	<u>91,000</u>			<u>91,000</u>

Working Notes:

Adjustment for Goodwill:	
Goodwill of the firm	<u>14,000</u>
Mr. P's Share (2/7)	4,000
Gaining ratio of Q & R;	
Q = $\frac{1}{2} - \frac{3}{7} = \frac{1}{14}$	
R = $\frac{1}{2} - \frac{2}{7} = \frac{3}{14}$	
Q : R = 1:3	

Therefore, Q will bear – $\frac{1}{4} \times 4000$ or ₹ 1,000

R will bear = $\frac{3}{4} \times 4000$ or ₹ 3,000

SUMMARY

- ◆ Re-adjustment takes place in case of retirement of a partner likewise the case of admission of a partner. Whenever a partner retires, the continuing partners make gain in terms of profit sharing ratio. So they arrange for the amount to be paid to discharge the claims of the retiring partners.
- ◆ On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner. If there is revaluation profit/loss, then such profit/loss should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio.
- ◆ On the retirement of a partner any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio.
- ◆ Following adjustments are necessary in the Capital A/c of a retiring partner at the time of final payment:
 - (i) Transfer of reserve,
 - (ii) Transfer of goodwill,

(iii) Transfer of profit/loss on revaluation.

- ◆ There are three methods for treating premium paid on Joint Life Policy: firstly, it can be shown as an expense; alternatively it can be shown as an asset to the extent of surrender value and the balance as an expense; Thirdly, a joint Life Policy reserve can be created; On retirement of a partner, the surrender value of the Joint Life Policy is to be raised in the books of accounts if it is not shown already as an asset. If the surrender value is more than the value of joint Life Policy shown in the Balance Sheet, only the excess amount should be transferred to revaluation account.

TEST YOUR KNOWLEDGE

True and False

1. *Business of a partnership has to be closed if any one of the partners retires.*
2. *At the time of retirement of a partner no special treatment is required for any reserves appearing in the Balance Sheet.*
3. *After retirement of a partner, profit sharing ratio of continuing partners remains the same.*
4. *If any partner wants to retire from the business, he must retire on 1st day of the accounting year.*
5. *Retiring partner has to forego his share of goodwill in the firm.*
6. *If a partner retires in between the accounting year then he is not entitled to any profit from the date of beginning of the year till his date of retirement.*
7. *If the firm has taken any joint life policy then it is to be surrendered at the time of retirement of a partner.*
8. *Any joint life policy reserve appearing in the Balance Sheet is credited to all the partners in their old profit sharing ratio.*
9. *Revaluation of assets and liabilities is not necessary on retirement of a partner.*
10. *Profit on revaluation is credited to continuing partners, retiring partner is not entitled to any profit on revaluation.*

Multiple Choice Questions

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

- (a) ₹ 2,000: ₹ 4,000: ₹ 6,000.
- (b) ₹ 5,000: ₹ 5,000: ₹ 2,000.
- (c) ₹ 6,000: ₹ 4,000: ₹ 2,000.
2. A, B and C takes a Joint Life Policy, after five years B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement, A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy premium is fully charged to revenue as and when paid?
- (a) ₹ 50,000 credited to all the partners in old ratio.
- (b) ₹ 2,50,000 credited to all the partners in old ratio.
- (c) ₹ 2,00,000 credited to all the partners in old ratio.
3. A, B and C take a Joint Life Policy, after five years, B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy is maintained at the surrender value?
- (a) ₹ 50,000 credited to all the partners in old ratio.
- (b) ₹ 2,50,000 credited to all the partners in old ratio.
- (c) No treatment is required.
4. A, B and C are partners sharing profits in the ratio 2:2:1. On retirement of B, goodwill was valued as ₹ 30,000. Find the contribution of A and C to compensate B.
- (a) ₹ 20,000 and ₹ 10,000.
- (b) ₹ 8,000 and ₹ 4,000.
- (c) They will not contribute anything.
5. A, B and C were partners in a firm sharing profits and losses in the ratio of 2:2:1 respectively with the capital balance of ₹ 50,000 for A and B, for C ₹ 25,000. B declared to retire from the firm and balance in reserve on the date was ₹ 15,000. If goodwill of the firm was valued as ₹ 30,000 and profit on revaluation was ₹ 7,050 then what amount will be transferred to the loan account of B.
- (a) ₹ 70,820.
- (b) ₹ 50,820.
- (c) ₹ 25,820.

6. A, B and C are partners sharing profits and losses in the ratio of 3:2:1. C retires on a decided date and Goodwill of the firm is to be valued at ₹ 60,000. Find the amount payable to retiring partner on account of goodwill.
- (a) ₹ 30,000.
 (b) ₹ 20,000.
 (c) ₹ 10,000.
7. A, B and C were partners sharing profits and losses in the ratio of 3:2:1. A retired and Goodwill of the firm is to be valued at ₹ 24,000. What will be the treatment for goodwill?
- (a) Credited to Revaluation Account at ₹ 24,000.
 (b) Adjusted through partners' capital accounts in gaining/sacrificing ratio.
 (c) Only A's capital account credited with ₹ 12,000.
8. Balances of A, B and C sharing profits and losses in proportionate to their capitals, stood as A - ₹ 2,00,000; B - ₹ 3,00,000 and C - ₹ 2,00,000. A desired to retire from the firm, B and C share the future profits equally, Goodwill of the entire firm be valued at ₹ 1,40,000 and no Goodwill account being raised.
- (a) Credit Partner's Capital Account with old profit sharing ratio for ₹ 1,40,000.
 (b) Credit Partner's Capital Account with new profit sharing ratio for ₹ 1,40,000.
 (c) Credit A's Account with ₹ 40,000 and debit B's Capital Account with ₹ 10,000 and C's Capital Account with ₹ 30,000.

Theoretical questions

1. Write short notes on:
- (i) Calculation of gaining ratio.
 (ii) Final payment of a retiring partner.
2. What is joint life policy? What is the objective of taking such a policy?

Practical questions

1. On 31st March, 2022, the balance sheet of M/s Ram, Rahul and Rohit sharing profits and losses in proportion to their capital, stood as follows:

Liabilities	₹	₹	Asset	₹
Capital accounts:			Land & building	2,00,000
Ram	3,00,000		Machinery	2,00,000

Rahul	2,00,000		Closing stock	1,00,000
Rohit	<u>1,00,000</u>	6,00,000	Sundry debtors	2,00,000
Sundry creditors		2,00,000	Cash and bank balances	1,00,000
		<u>8,00,000</u>		<u>8,00,000</u>

On 31st March, 2022, Ram desired to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the assets and liabilities on that date on the following basis:-

1. Land and buildings be appreciated by 30%.
2. Machinery be depreciated by 20%.
3. Closing stock to be valued at ₹ 80,000.
4. Provision for bad debts be made at 5%.
5. Old credit balances of sundry creditors ₹ 10,000 be written off.
6. Joint life policy of the partners surrendered and cash obtained ₹ 60,000.
7. Goodwill of the entire firm be valued at ₹ 1,80,000 and Ram's share of the goodwill be adjusted in the accounts of Rahul and Rohit who share the future profits equally. No goodwill account being raised.
8. The total capital of the firm is to be the same as before retirement. Individual capital be in their profit sharing ratio.
9. Amount due to Ram is to be settled as 50% on retirement and the balance 50% within one year.

Prepare revaluation account, capital account of partners: Rahul & Rohit, loan account of Ram, cash account and balance sheet as on 1.4.2022 of M/s Rahul and Rohit.

2. A, B, C were in partnership sharing profits and losses in the ratio of 3:2:1. The balance sheet of the firm as on 31.3.2022 was as under:

Liabilities		₹	Assets		₹
Capital accounts:					
A	1,50,000		Fixtures	30,000	
B	1,00,000		Stock	1,70,000	
C	<u>50,000</u>	3,00,000	Sundry debtors	90,000	
Sundry creditors		40,000	Cash	50,000	
		<u>3,40,000</u>		<u>3,40,000</u>	

A, on account of ill-health, gave notice that he wished to retire from the firm. A retirement agreement was, therefore, entered as on 31.3.2022, the terms of which were as follows:

- (a) The profit and loss account for the year ended 31.3.2022, which showed a net profit of ₹42,000 was to be re-opened. B was to be credited with ₹6,000 as bonus, in consideration of the extra work, which had devolved upon him during the year. The profit sharing basis was to be revised and the revised ratio is to be 2:3:1 as and from 1st April 2021.
- (b) Goodwill was to be valued at two years' purchase of the simple average profits of five years. Profits for these five years ending on 31st March were as under:

	₹
31.3.2018	15,000
31.3.2019	23,000
31.3.2020	25,000
31.3.2021	35,000
31.3.2022	42,000

- (c) Fixtures are to be valued at ₹39,800 and a provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book value.
- (d) That the amount payable to A shall be paid by B.

B and C agreed, as between themselves, to continue the business, sharing profits and losses in the ratio of 3:1 and decided to retain fixtures in the books at the revised value and increase the provision for doubtful debts to 6%. Total capital of the firm will be ₹3 lakhs as before to be maintained in the new ratio as between B and C.

You are required to give the necessary entries to give effect to the above arrangements. Prepare capital accounts of partners, cash account and balance sheet of B and C after giving effect to the above arrangements on the retirement of A.

ANSWERS/HINTS

True and False

1. False: Business of a partnership is not closed if any one of the partners retires, remaining partners continue to carry on the business.
2. False: At the time of retirement of a partner all the reserves appearing in the balance sheet are transferred to all the partners in their old profit sharing ratio.

3. False: After retirement of a partner, profit sharing ratio of continuing partners does not remain the same.
4. False: A partner can retire on any day as per his own wish.
5. False: Retiring partner is entitled to his share of goodwill in the firm.
6. False: If a partner retires in between the accounting year then he is certainly entitled to the profit from the date of beginning of the year till his date of retirement.
7. True: The firm is eligible for the surrender value on the Joint Life Policy taken on the partners at the time of their retirement.
8. True: As per the surrender policy method, the JLP reserve is distributed to the partners in their profit sharing ratio through capital account.
9. False: Revaluation of assets and liabilities is necessary at the time of retirement of a partner.
10. False: Profit on revaluation is credited to all the partners in their profit sharing ratio.

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(c)	4.	(b)	5.	(a)	6.	(c)
7.	(b)	8.	(c)								

Theoretical Questions

1. (a) On retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. For example, if A, B and C were sharing profits and losses in the ratio of 5:3: 2 and B retires, then A and C have to decide at which ratio they will share profits and losses in future. If it is decided that the continuing partners will share profits and losses in future at the ratio of 3:2, then A gains $\frac{1}{10}$ th $[(\frac{3}{5})-(\frac{5}{10})]$ and C gains $\frac{2}{10}$ $[(\frac{2}{5})-(\frac{2}{10})]$. So the gaining ratio between A and C is 1:2. If A and C decide to continue at the ratio 5:2, this indicates that they are dividing the gained share in the previous profit sharing ratio.
- (b) The following adjustments are necessary in the Capital A/c: (i) Transfer of reserve, (ii) Transfer of goodwill, (iii) Transfer of profit/loss on revaluation. After adjustment of these items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him. The continuing partners may discharge the whole claim at the time of retirement.

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

Practical Questions

1. Revaluation Account

	₹		₹
To Machinery A/c	40,000	By Land and Buildings A/c	60,000
To Closing Stock A/c	20,000	By Sundry Creditors A/c	10,000
To Provision for Bad Debts A/c	10,000	By Cash and Bank A/c— Joint Life policy surrendered	60,000
To Partners' Capital A/cs:			
Ram	30,000		
Rahul	20,000		
Rohit	10,000		
	60,000		
	1,30,000		1,30,000

Partners' Capital Accounts

			Rahul	Rohit				Rahul	Rohit
			₹	₹				₹	₹
31.3.2022	To	Ram's Capital A/c	30,000	60,000	31-3-2022	By	Balance b/d	2,00,000	1,00,000
	To	Balance c/d	3,00,000	3,00,000		By	Revaluation A/c	20,000	10,000
						By	Cash & bank A/c — cash brought in by Rahul and Rohit	1,10,000	2,50,000
			3,30,000	3,60,000				3,30,000	3,60,000
					1-4-2022	By	Balance b/d	3,00,000	3,00,000

Ram's Loan Account

		₹			₹
31-3-2022	To Balance c/d	2,10,000	31-3-2022	By Ram's Capital A/c	2,10,000
		2,10,000			2,10,000
			1-4-2022	By Balance b/d	2,10,000

Cash and Bank Account

		₹			₹
31-3-2022	To Balance b/d	1,00,000	31-3-2022	By Ram's capital A/c	2,10,000
	To Revaluation A/c- joint life policy surrendered	60,000		By Balance c/d	3,10,000
	To Rahul's Capital A/c	1,10,000			
	To Rohit's Capital A/c	2,50,000			
		5,20,000			5,20,000
1-4-2022	To Balance b/d	3,10,000			

M/s Rahul & Rohit**Balance Sheet as on 1st April, 2022**

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Land and buildings		2,60,000
Rahul	3,00,000		Machinery		1,60,000
Rohit	3,00,000	6,00,000	Closing stock		80,000
Ram's loan account		2,10,000	Sundry debtors	2,00,000	
Sundry creditors		1,90,000	Less: Provision for bad debts	(10,000)	1,90,000
			Cash and bank balances		3,10,000
		10,00,000			10,00,000

Working Notes:**1. Gaining ratio of existing partners:**

$$\text{Rahul } 1/2 - 1/3 = 1/6$$

$$\text{Rohit } 1/2 - 1/6 = 2/6$$

2. Total goodwill of firm is ₹ 1,80,000

Ram's share ($1/2 \times ₹ 1,80,000$) = ₹ 90,000

Ram's share of goodwill is to be borne by Rahul and Rohit in their gaining ratios i.e.

Rahul = $1/3 \times ₹ 90,000 = ₹ 30,000$

Rohit = $2/3 \times ₹ 90,000 = ₹ 60,000$

3. Ram's Capital Account

		₹			₹
31-3-2022	To Cash and Bank A/c	2,10,000	31-3-2022	By Balance b/d	3,00,000
	To Ram's Loan A/c -Transfer	2,10,000		By Revaluation A/c	30,000
				By Rahul's Capital A/c - Goodwill	30,000
				By Rohit's Capital A/c- Goodwill	60,000
		4,20,000			4,20,000

2. Journal Entries

			₹	₹
1.	A's Capital account B's Capital account C's Capital account To Profit and loss adjustment account (Profit written back for making adjustments)	Dr. Dr. Dr.	21,000 14,000 7,000	42,000
2.	Profit and loss adjustment account To B's Capital account (Bonus credited to B's capital account)	Dr.	6,000	6,000
3.	Profit and loss adjustment account To A's Capital account To B's Capital account To C's Capital account (Distribution of profits in the new ratio)	Dr.	36,000	12,000 18,000 6,000
4.	Fixtures account To Provision for bad debts account To A's Capital account To B's Capital account	Dr.	9,800	1,800 2,667 4,000

	To C's Capital account (Revaluation of assets on A's retirement)			1,333
5.	B's capital account	Dr.	2,700	
	C's capital account	Dr.	900	
	To Provision for bad debts account (Raising provision for bad debts)			3,600
6.	A's capital account	Dr.	1,62,334	
	To B's Capital account (Amount payable to A paid by B)			1,62,334
7.	B's Capital account	Dr.	14,000	
	C's Capital account	Dr.	4,667	
	To A's Capital account (Adjusting entry of goodwill passed through partners' capital accounts in gaining/sacrificing ratio)			18,667

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To P & L adjustment A/c	21,000	14,000	7,000	By Balance b/d	1,50,000	1,00,000	50,000
To Provision for bad debts A/c	-	2,700	900	By P & L adjustment account	-	6,000	-
To B's Capital A/c	1,62,334	-	-	By P & L adjustment account	12,000	18,000	6,000
To Cash A/c	-	34,634	-	By Fixtures A/c	2,667	4,000	1,333
To A's Capital A/c		14,000	4,667	By A's capital A/c	-	1,62,334	-
				By B and C's capital A/c	18,667		
To Balance c/d	-	2,25,000	75,000	By Cash A/c			30,234
	1,83,334	2,90,334	87,567		1,83,334	2,90,334	87,567

Cash Account

	₹		₹
To Balance b/d	50,000	By B's capital A/c	34,634
To C's capital A/c	30,234	By Balance b/d	45,600
	80,234		80,234

Balance Sheet of B and C

as on 31st March, 2022 (after retirement of A)

Liabilities		₹	Assets	₹	₹
Capital accounts:			Fixtures		39,800
B	2,25,000		Stock		1,70,000
C	75,000	3,00,000	Sundry debtors	90,000	
Sundry creditors		40,000	Less: Provision for bad debts	(5,400)	84,600
			Cash		45,600
		3,40,000			3,40,000

Working Notes:

Calculation of goodwill:

1. Average of last five year's profit

Year ended on	Profit ₹
31.3.2018	15,000
31.3.2019	23,000
31.3.2020	25,000
31.3.2021	35,000
31.3.2022	42,000
	1,40,000

2. Goodwill at two years' purchase

$$₹ 28,000 \times 2 = ₹ 56,000$$

3. Calculation for adjustment of Amount of Goodwill

Partner	Old Share	New Share	Gain	Sacrifice
A	$\frac{2}{6}$	–	–	$\frac{2}{6}$
B	$\frac{3}{6}$	$\frac{3}{4}$	$\frac{3}{12}$	–
C	$\frac{1}{6}$	$\frac{1}{4}$	$\frac{1}{12}$	–

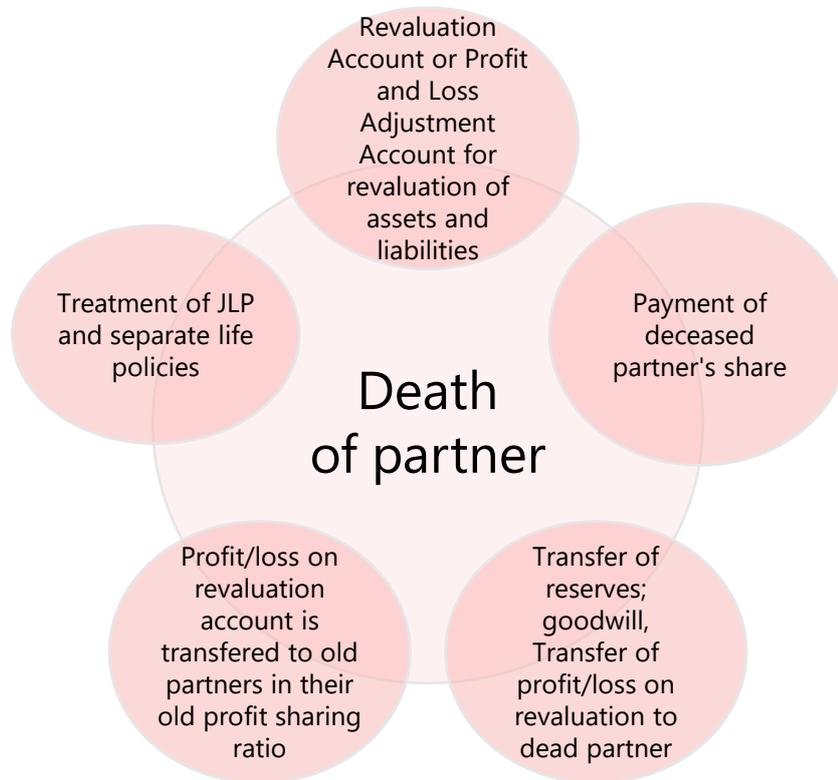
UNIT – 5 DEATH OF A PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

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

UNIT OVERVIEW



5.1 INTRODUCTION

Business of a partnership firm may not come to an end due to death of a partner as it is known as Reconstitution of Partnership. Other partners shall continue to run the business of the firm. The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the capital accounts of all partners including the deceased partner. Goodwill is dealt with exactly in the way already discussed in the case of retirement in the earlier unit. Treatment of joint life policy will also be same as in the case of retirement. However, in case of death of a partner, the firm would get the joint policy value.



5.2 RIGHT OF OUTGOING PARTNER IN CERTAIN CASES TO SHARE SUBSEQUENT PROFITS

As per provisions of Section 37 of the Indian Partnership Act., "Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent per annum on the amount of his share in the property of the firm.

Provided that whereby contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section. This way, the outgoing partner has the option to receive, interest at the rate of 6% p.a. or the share of profit earned on the unsettled amounts for the period till his dues are settled by the firm in the absence of any contract made to the contrary".

It may be noted that the outgoing partner is not bound to make election until the share of the profit that would be payable to him has been ascertained.

For example, A, B and C are in a partnership business-sharing profits and losses equally. C died on 31st October, 2021. The capitals of the partners, after all necessary adjustments stood at ₹ 50,000, ₹75,000 and ₹ 1,20,000 respectively. A and B continued to carry on the business further without settling the accounts of C. Final payment to C is made on February 1, 2022. The profit made during the period of three months amounts to ₹ 28,000.

Under Section 37 of the Partnership Act, C can exercise any of the following two options.

- (i) Share in subsequent profits of firm:

Profit made—₹ 28,000

$$C's \text{ share} = 28,000 \times \frac{1,20,000}{2,45,000} = ₹ 13,714$$

- (ii) Interest at 6% p.a.

$$1,20,000 \times \frac{6}{100} \times \frac{3}{12} = ₹ 1,800$$

Since, (i) option is beneficial for C, he will necessarily go for his proportionate share in profits.



5.3 AMOUNT PAYABLE TO LEGAL REPRESENTATIVES OF DEAD PARTNER

When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings:

- (a) The amount standing to the credit to the capital account of the deceased partner
- (b) Interest on capital, if provided in the partnership deed upto the date of death;
- (c) Share of goodwill of the firm;
- (d) Share of undistributed profit or reserves;
- (e) Share of profit on the revaluation of assets and liabilities;
- (f) Share of profit upto the date of death;
- (g) Share of Joint Life Policy.

Legal representatives are liable for:

- (i) Drawings
- (ii) Interest on drawings
- (iii) Share of loss on the revaluation of assets and liabilities;
- (iv) Share of loss that have occurred till the date of his/her death.

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

Such Profit is calculated through P&L Suspense account. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

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

- (i) Time Basis
- (ii) Turnover or Sales Basis

(i) Time Basis

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

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

(ii) Turnover or Sales Basis

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

Example

Arun, Tarun and Neha are partners sharing profits in the ratio of 3:2:1. Neha dies on 31st May 2022. Sales for the year 2021-2022 amounted to ₹ 4,00,000 and the profit on sales is ₹ 60,000. Accounts are closed on 31 March every year. Sales from 1st April 2022 to 31st May 2022 is ₹ 1,00,000. The deceased partner's share in the profit upto the date of death will be as follows.

Profit from 1st April 2022 to 31st May 2022 on the basis of sales:

If sales are ₹ 4,00,000, profit is ₹ 60,000

If the sales are ₹ 1,00,000 profit is: $60,000/4,00,000 \times 1,00,000 = ₹ 15,000$

Neha's share = $15,000 \times 1/6 = ₹ 2,500$

Alternatively profit is calculated as

Rate of profit = $\frac{60,000}{4,00,000} \times 100 = 15\%$

Sale upto date of death = 1,00,000

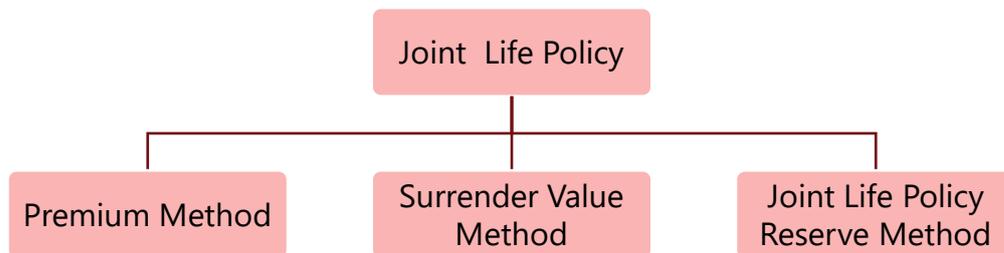
Profit = $1,00,000 \times 15/100 = ₹ 15,000$

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor. The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment



5.4 SPECIAL TRANSACTIONS IN CASE OF DEATH: JOINT LIFE POLICY

In case of Partnership, Partners generally get Joint Life Policy (JLP) in name of all partners. If partner expires, then partners are entitled for share in JLP.



Method 1: If Joint Life Policy does not appear in the Balance Sheet, then the firm will gain on the death of a partner. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

		₹	₹
(i)	Bank A/c To Joint Life Policy A/c (Policy value received from the insurance company on A's death)	Dr. 1,00,000	1,00,000
(ii)	Joint Life Policy A/c To A's Capital A/c To B's Capital A/c To C's Capital A/c (Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)	Dr. 1,00,000	50,000 30,000 20,000

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

The journal entries will appear as follows:

		₹	₹
(i)	Bank A/c To Joint Life Policy A/c (Policy value received from the insurance company on A's death)	Dr. 1,00,000	1,00,000
(ii)	Joint Life Policy A/c To A's Capital A/c To B's Capital A/c To C's Capital A/c (Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)	Dr. 90,000	45,000 27,000 18,000

Method 3:

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

The journal entries will appear as follows:

		₹	₹
(i)	Bank A/c To Joint Life Policy A/c (Policy value received from the insurance company on A's death)	Dr. 1,00,000	1,00,000
(ii)	Joint Life Policy A/c To A's Capital A/c To B's Capital A/c To C's Capital A/c (Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)	Dr. 90,000	45,000 27,000 18,000
(iii)	Joint Life Policy Reserve A/c To A's Capital A/c	Dr. 10,000	5,000



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

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

For example, A, B and C are in partnership sharing profits and losses at the ratio of 2:2:1. A died on 15th April, 2022. The firm closes its books of account as on 31st December every year. So the executor of A is entitled for 3½ months profit. If A's share is immediately paid off then profit for 2021 can be taken as base for calculating 3½ months profits in the year, 2022. If M/s. A, B & C earned ₹ 96,000 in year 2021, then 3½ months profit is ₹ 28,000. A's share comes to ₹ 28,000 × 2/5 i.e. ₹ 11,200.

Journal entry is:

Profit and Loss Suspense A/c *	Dr. ₹ 11,200
To A's Capital A/c	₹ 11,200
(Share of A 3½ months profit in 2022 is transferred to his Capital Account on death)	

*At the end of the year 2022, the Profit & Loss Suspense A/c will be transferred to Profit and Loss A/c.

ILLUSTRATION 1

The following was the Balance Sheet of Om & Co. in which X, Y, Z were partners sharing profits and losses in the ratio of 1:2:2 as on 31.3.2022. Mr. Z died on 31st December, 2022. His account has to be settled under the following terms.

Balance Sheet of Om & Co. as on 31.3.2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Building	1,20,000
Bank loan		50,000	Computers	80,000
General reserve		30,000	Inventories	20,000
Capital accounts:			Trade receivables	20,000
X	40,000		Cash at bank	50,000
Y	80,000		Investments	10,000
Z	80,000	2,00,000		
		3,00,000		3,00,000

Goodwill is to be calculated at the rate of two years purchase on the basis of average of three years' profits and losses. The profits and losses for the three years were detailed as below:

Year ending on	profit/loss
31.3.2022	30,000
31.3.2021	20,000
31.3.2020	(10,000) Loss

Profit for the period from 1.4.2022 to 31.12.2022 shall be ascertained proportionately on the basis of average profits and losses of the preceding three years.

During the year ending on 31.3.2022 a car costing ₹ 40,000 was purchased on 1.4.2021 and debited to traveling expenses account on which depreciation is to be calculated at 20% p.a. at written down value method. This asset is to be brought into account at the depreciated value.

Other values of assets were agreed as follows:

Inventory at ₹ 16,000, building at ₹ 1,40,000, computers at ₹ 50,000; investments at ₹ 6,000. Trade receivables were considered good.

Required:

- (i) Calculate goodwill and Z's share in the profits of the firm for the period 1.4.2022 to 31.12.2022.
- (ii) Prepare revaluation account assuming that other items of assets and liabilities remained the same.
- (iii) Prepare partners' capital accounts and balance sheet of the firm Om & Co. as on 31.12.2022.

SOLUTION

(i) Calculation of goodwill and Z's share of profit

(a)	Adjusted profit for the year ended 31.3.2022:	₹	₹
	Profit (Given)		30,000
	Add: Cost of car wrongly written off	40,000	
	Less: Depreciation for the year 2021-22 (20% on 40,000)	(8,000)	32,000
			62,000
(b)	Average of last three year's profits and losses	Profit/(loss)	
	Year ended on	₹	

	31.3.2020	(10,000)	
	31.3.2021	20,000	
	31.3.2022	62,000	
		72,000	
	Average profit (72,000/3)	24,000	
(c)	Goodwill at 2 years' purchase ₹ 24,000 x 2 = ₹ 48,000		
(d)	Z's share of profits from the period 1.4.2022 to 31.12.2022 ₹ 24,000 x 9/12 x 2/5 = ₹ 7,200		

(ii)

Revaluation Account

	₹		₹
To Inventory account	4,000	By Building account	20,000
To Computers account	30,000	By Car (32,000-4,800)	27,200
To Investments account	4,000		
To Profit transferred to			
X 1,840			
Y 3,680			
Z <u>3,680</u>	9,200		
	47,200		47,200

Partners' Capital Accounts

	X ₹	Y ₹	Z ₹		X ₹	Y ₹	Z ₹
To Z's Executor's A/c			1,22,080	By Balance b/d	40,000	80,000	80,000
To Z	6,400	12,800	–	By General reserve	6,000	12,000	12,000
To Balance c/d	41,440	82,880		By X and Y	–	–	19,200
				By Revaluation A/c	1,840	3,680	3,680
				By Profit and Loss suspense A/c	–	–	7,200
	47,840	95,680	1,22,080		47,840	95,680	1,22,080

Balance Sheet of Om & Co. as at 31st December, 2022

Liabilities	₹	Assets	₹
Trade payables	20,000	Building	1,40,000
Bank loan	50,000	Car	27,200
Capital accounts:		Inventories	16,000
X	41,440	Computers	50,000
Y	82,880	Investments	6,000
Z's Executor's account	1,22,080	Trade receivables	20,000
		Cash at bank	50,000
		Profit and Loss suspense Account	7,200
	3,16,400		3,16,400

Working Note:

Goodwill calculated at the time of death of partner Z ₹ 48,000

Partner	Old Share	New Share	Gain	Sacrifice
X	$\frac{1}{5}$	$\frac{1}{3}$	$\frac{2}{15}$	–
Y	$\frac{2}{5}$	$\frac{2}{3}$	$\frac{4}{15}$	–
Z	$\frac{2}{5}$	–	–	$\frac{2}{5}$

Adjusting entry:

X's Capital Account	Dr.	6,400	
Y's Capital Account	Dr.	12,800	
To Z's Capital Account			19,200

(Adjustment for goodwill on the death of Z on the basis of gaining ratio)

ILLUSTRATION 2

The partnership agreement of a firm consisting of three partners - A, B and C (who share profits in proportion of $\frac{1}{2}$, $\frac{1}{4}$ and $\frac{1}{4}$ and whose fixed capitals are ₹ 10,000; ₹ 6,000 and ₹ 4,000 respectively) provides as follows:

- (a) That partners be allowed interest at 10 per cent per annum on their fixed capitals, but no interest be allowed on undrawn profits or charged on drawings.

- (b) That upon the death of a partner, the goodwill of the firm be valued at two years' purchase of the average net profits (after charging interest on capital) for the three years to 31st December preceding the death of a partner.
- (c) That an insurance policy of ₹ 10,000 each to be taken in individual names of each partner, the premium is to be charged against the profit of the firm.
- (d) Upon the death of a partner, he is to be credited with his share of the profits, interest on capitals etc. calculated upon 31st December following his death.
- (e) That the share of the partnership policy and goodwill be credited to the deceased partner as on 31st December following his death.
- (f) That the partnership books be closed annually on 31st December.

A died on 30th September 2022, the amount standing to the credit of his current account on 31st December, 2021 was ₹ 450 and from that date to the date of death he had withdrawn ₹ 3,000 from the business.

An unrecorded liability of ₹ 2,000 was discovered on 30th September, 2022. It was decided to record it and be immediately paid off.

The trading result of the firm (before charging interest on capital) had been as follows: 2019 Profit ₹ 9,640; 2020 Profit ₹ 6,720; 2021 Profit ₹ 7,640; 2022 Profit ₹ 3,670.

Assuming the surrender value of the policy to be 20 percent of the sum assured.

Required

Prepare an account showing the amount due to A's legal representative as on 31st December, 2022.

SOLUTION

A's Capital Account

2022		₹	2022		₹
Sep. 30	To Current A/c (3,000 - 450)	2,550	Jan. 1	By Balance b/d	10,000
Dec. 31	To Profit and Loss Adjt. (Unrecorded Liability)	1,000	Dec. 31	By Profit and Loss app A/c :	
	To Balance Transferred to A's Executor's A/c	21,285		Interest on Capital	1,000
		24,835		Share of Profit	835
				B & C (Goodwill)	6,000
				Insurance Policies A/c	7,000
					24,835

Working Notes:**(i) Valuation of Goodwill**

Year	Profit before Interest on fixed capital	Interest	Profit after interest
	₹	₹	₹
2019	9,640	2,000	7,640
2020	6,720	2,000	4,720
2021	7,640	2,000	5,640
	24,000	6,000	18,000
			₹
Average			6,000
Goodwill at two years purchase of average net profits			12,000
Share of A in the goodwill			6,000
(ii) Profit on Separate Life Policy			
A's policy			10,000
B and C's policy @ 20%			4,000
			14,000
Share of A (1/2)			7,000
(iii) Share in profit for 2022			
Profit for the year			3,670
Less : Interest on capitals			(2,000)
			1,670
A's share in profit (1/2)			835

- (iv) As unrecorded liability of ₹ 2,000 has been charged to Capital Accounts through Profit and Loss Adjustment Account, no further adjustment in current year's profit is required.
- (v) Profits for 2019, 2020 and 2021 have not been adjusted (for valuing goodwill) for unrecorded liability for want of precise information.

ILLUSTRATION 3

The following is the Balance Sheet of M/s. ABC LLP as at 31st December, 2021.

Balance Sheet as at 31st December, 2021

Liabilities	₹	Assets	₹
Capital		Machinery	5,000
A	4,100	Furniture	2,800

B	4,100	Fixture		2,100
C	4,500	Cash		1,500
General Reserve	1,500	Inventories		950
Trade payables	2,350	Trade receivables	4,500	
		Less: Provision for Doubtful debts	300	4,200
	16,550			16,550

C died on 3rd January, 2022 and the following agreement was to be put into effect.

- Assets were to be revalued: Machinery to ₹ 5,850; Furniture to ₹ 2,300; Inventory to ₹ 750.
- Goodwill was valued at ₹ 3,000 and was to be credited with his share, without using a Goodwill Account
- ₹ 1,000 was to be paid away to the executors of the dead partner on 5th January, 2022.

Required

- The Journal Entry for Goodwill adjustment.
- The Revaluation Account and Capital Accounts of the partners.
- Which account would be debited and which account credited if the provision for doubtful debts in the Balance Sheet was to be found unnecessary to maintain at the death of C.

SOLUTION

(i) Journal Entry in the books of the firm

Date	Particulars	₹	₹
Jan 3, 2022	A's Capital A/c Dr. B's Capital A/c Dr. To C's Capital A/c (Being the required adjustment for goodwill through the partner's capital accounts)	500 500	1,000

(ii) Revaluation Account

Particulars	₹	Particulars	₹
To Furniture A/c (₹ 2,800 – 2,300)	500	By Machinery A/c (₹ 5,850 – 5,000)	850
To Inventory A/c (₹ 950 – 750)	200		
To Partners' Capital A/cs (A – ₹ 50, B – ₹ 50, C – ₹ 50)	150		
	850		850

Partners' Capital Accounts

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To C (Goodwill)	500	500	–	By Balance b/d	4,100	4,100	4,500
To Cash A/c	–	–	1,000	By General Reserve A/c	500	500	500
To Executors A/c	–	–	5,050	By Revaluation A/c (Profit)	50	50	50
To Balance C/d	4,150	4,150	–	By A (Goodwill)	–	–	500
				By B (Goodwill)	–	–	500
	4,650	4,650	6,050		4,650	4,650	6,050

- (iii) Provision for Doubtful Debts Account is a credit balance. To close, this account is to be debited. It becomes a gain for the partners. Therefore, either Partners' Capital Accounts (including C) or Revaluation Account is to be credited.

Working Note:**Statement showing the Required Adjustment for Goodwill**

Particulars	A	B	C
Right of goodwill before death	1/3	1/3	1/3
Right of goodwill after death	1/2	1/2	–
Gain/(Sacrifice)	(+) 1/6	(+) 1/6	(-) 1/3

Profit sharing ratio is equal before or after the death of C because nothing has been mentioned in respect of profit-sharing ratio.

ILLUSTRATION 4

B and N were partners. The partnership deed provides inter alia:

- (i) *That the accounts be balanced on 31st December each year.*
- (ii) *That the profits be divided as follows:*
B: One-half; N: One-third; and carried to Reserve Account: One-sixth
- (iii) *That in the event of death of a partner, his executor will be entitled to the following:*
- (a) *the capital to his credit at the date of death; (b) his proportion of profit to date of death based on the average profits of the last three completed years; (c) his share of goodwill based on three years' purchases of the average profits for the three preceding completed years.*

Trial Balance on 31st December, 2021

Particulars	Dr. (₹)	Cr. (₹)
B's Capital		90,000
N's Capital		60,000
Reserve		30,000
Bills receivable	50,000	
Investments	40,000	
Cash	1,10,000	
Trade payables		20,000
Total	2,00,000	2,00,000

The profits for the three years were 2019: ₹ 42,000; 2020: ₹ 39,000 and 2021: ₹ 45,000. N died on 1st May, 2022. Show the calculation of N (i) Share of Profits; (ii) Share of Goodwill; (iii) Draw up N's Executors Account as would appear in the firms' ledger transferring the amount to the Loan Account.

SOLUTION

(i) Ascertainment of N's Share of Profit		(ii) Ascertainment of Value of Goodwill	
2019	42,000	2019	42,000
2020	39,000	2020	39,000
2021	45,000	2021	45,000
Total Profit	1,26,000	Total Profit for 3 years	1,26,000
Average Profit	42,000	Average Profit	42,000
4 months' Profit	14,000	Goodwill - 3 years	
N's Share in Profit (2/5th* of ₹ 14,000)	5,600	Purchase of Average Profit	1,26,000
		N's Share of goodwill (2/5 of ₹ 1,26,000)	50,400

* Profit sharing ratio between B and N = 1/2; 1/3; = 3: 2, Therefore N's share of Profit = 2/5

N's Executors Account

Date	Particulars	₹	Date	Particulars	₹
2022			2022		
May 1,	To N's Loan A/c	1,28,000	Jan. 1	By Capital A/c	60,000
			May 1	By Reserves (2/5th of ₹ 30,000)	12,000

		May 1	By B's Capital A/c (Share of goodwill)	50,400
		May 1	By P/L Suspense A/c (Share of Profit)	5,600
	1,28,000			1,28,000

ILLUSTRATION 5

Diya, Riya & Kiya are partners of M/s. DRK Fabrics sharing profits and losses in the ratio of 2:1:2. On 31st March 2022 their Balance Sheet was as under:

Liabilities	₹	Assets	₹
<i>Capitals :</i>		<i>Land & Building</i>	<i>1,65,000</i>
<i>Diya</i>	<i>1,50,000</i>	<i>Furniture</i>	<i>75,000</i>
<i>Riya</i>	<i>1,80,000</i>	<i>Joint life Policy</i>	<i>60,000</i>
<i>Kiya</i>	<i>70,000</i>	<i>Inventory</i>	<i>88,740</i>
<i>General Reserve</i>	<i>1,40,000</i>	<i>Trade Receivable</i>	<i>96,750</i>
<i>Trade payables</i>	<i>60,000</i>	<i>Bank</i>	<i>1,14,510</i>
	<i>6,00,000</i>		<i>6,00,000</i>

Kiya died on 30th September, 2022.

The partnership deed provides as follows:

- (a) *That partners be allowed interest at 12% p.a. on their capitals, but no interest be charged on drawings.*
- (b) *Upon the death of a partner, the goodwill of the firm be valued at one years' purchase of the average net profits (after charging interest on capital) for the four years to 31st March preceding the death of a partner. The profits of the firm before charging interest on capitals were:*

2018-19 1,62,000

2019-20 1,99,000

2020-21 1,87,000

2021-22 1,96,000

Average capital during preceding four years may be assumed as ₹ 3,00,000.

- (c) *Profits till the date of death to be ascertained on the basis of average profit of previous four years.*

- (d) Upon the death of a partner, she is to be credited with her share of the profits, interest on capitals etc. calculated till the date of death.

After the death of Kiya

- ₹ 2,00,000 was received from insurance company against Joint life Policy.
- Land & Building was appreciated by 20%, Furniture to be depreciated by 10%, inventory to be revalued at ₹ 80,000. Bad debts amounted ₹ 1760.
- Amount payable to Kiya was paid in cash.

You are required to prepare

- Revaluation A/c
- Partners' Capital A/c
- Balance Sheet as on 30th September 2022, assuming other Assets and liabilities remaining the same.

SOLUTION

Revaluation A/c

Particulars	₹	Particulars	₹
To Furniture	7,500	By Land & Building	33,000
To Inventory	8,740		
To Bad Debts	1,760		
To Profit on Revaluation			
Diya	6,000		
Riya	3,000		
Kiya	<u>6,000</u>		
	15,000		
	33,000		33,000

Partners Capital A/c

Particulars	Diya ₹	Riya ₹	Kiya ₹	Particulars	Diya ₹	Riya ₹	Kiya ₹
To Kiya capital	40,000	20,000		By Balance b/d	1,50,000	1,80,000	70,000
To Bank			2,79,800	By General Reserve	56,000	28,000	56,000
To Balance c/d	2,28,000	2,19,000		By Joint life Policy	56,000	28,000	56,000

				By Interest on Capital			4,200
				By revaluation	6,000	3,000	6,000
				By Diya & Riya capital			60,000
				By Profit & loss suspense A/c			27,600
	2,68,000	2,39,000	2,79,800		2,68,000	2,39,000	2,79,800

Bank A/c

Particulars	₹	Particulars	₹
To Balance B/d	1,14,510	By Kiya's Capital	2,79,800
To Bank	2,00,000	By Balance c/d	34,710
	3,14,510		3,14,510

Balance Sheet as on 30th September, 2022

Liabilities	₹	Assets	₹
Capitals :		Land & Building	1,98,000
Diya	2,28,000	Furniture	67,500
Riya	2,19,000	Inventory	80,000
Trade payables	60,000	Trade Receivable	94,990
		Bank	34,710
		Profit and loss Suspense (27,600+4,200)	31,800
	5,07,000		5,07,000

Working Notes:

1. Goodwill valuation

2018-19 1,62,000

2019-20 1,99,000

2020-21 1,87,000

2021-22 1,96,000Total 7,44,000

Average = 7,44,000/4 = 1,86,000

Less: Interest on Capital 3,00,000 X 12% = 36,000

Adjusted Average Profit =1,50,000

Goodwill (1 year's purchase)	= 1,50,000
Kiya's share (2/5)	= 60,000

2. Journal entry for adjustment of goodwill

Particulars		₹	₹
Diya's Capital A/c	Dr.	40,000	
Riya's Capital A/c	Dr.	20,000	
To Kiya's Capital A/c			60,000
(Share of goodwill adjusted)			

3. Kiya's share of profit till the date of death

Average profit for full year before interest on capital	=	1,86,000
6 month's profit	=	93,000
Less: interest on capital 4,00,000 X 12% X 6/12	=	<u>24,000</u>
Adjusted profit till the date of death	=	69,000
Kiya's share 2/5th	=	27,600

4. The Joint life policy in this question is based on the surrender value method- where in the amount shown in the balance sheet shall be deducted from the JLP proceeds received from insurance co, on the death of a partner.

₹ 2,00,000- 60,000 (Balance Sheet value) = ₹ 1,40,000 (divided in profit sharing ratio between the partners.)

NOTE: The ICAI through guidance note (August,2023 edition) has recommended the formats of financial statements for Limited Liability Partnerships (LLPs). This would enable these entities to communicate their financial performance and financial position in standardised formats thereby enhancing their consistency and comparability. The said format of financial statements is being given as Annexure – II at the end of the chapter for awareness of students. It may be noted that this format does not form part of syllabus and has been given here for the knowledge of students only.

SUMMARY

- ◆ The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the Capital Accounts of all partners including the deceased partner. Goodwill is dealt with exactly in the way already discussed in the case of retirement.

- ◆ Treatment of joint life policy will also be same as in the case of retirement. However, in case of death of a partner, the firm would get the joint policy value. The only additional point is that as death may occur on any day, the representatives of the deceased partner will be entitled to the partner's share of profit from the beginning of the year to the date of death. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.
- ◆ If the death takes place during the accounting period, the Executor of the deceased partner is entitled to have a share of profit upto the date of death based on the profit earned in the immediately preceding year or some other agreed basis. For this purpose, the deceased partners' Capital Accounts is credited and Profit & Loss Suspense Account is debited.

TEST YOUR KNOWLEDGE

True and False

1. *Business of partnership comes to an end on death of a partner.*
2. *Legal heir of a deceased partner automatically becomes partner in the firm.*
3. *A revaluation account is opened in the books of accounts on death of a partner.*
4. *Any reserve appearing in the balance sheet on the date of death of a partner is transferred to all partners capital account in their profit sharing ratio.*
5. *Legal heirs of a deceased partner are entitled to his capital account balance only.*
6. *It is not necessary to adjust goodwill on death of a partner.*
7. *On death of a partner continuing partners can agree to change their capital contribution and profit sharing ratio.*
8. *On death of a partner, the firm gets surrender value of the joint life policy.*
9. *Only legal heirs of deceased partner are entitled to amount received from joint life policy.*

Multiple Choice Questions

1. *In the absence of proper agreement, representative of the deceased partner is entitled to the Dead partner's share in*
 - (a) *Profits till date, goodwill, joint life policy, share in revalued assets and liabilities.*
 - (b) *Capital, goodwill, joint life policy, interest on capital, share in revalued assets and liabilities.*

- (c) Capital, profits till date, goodwill, joint life policy, share in revalued assets and liabilities.
2. A, B and C are the partners sharing profits and losses in the ratio 2:1:1. Firm has a joint life policy of ₹ 1,20,000 and in the balance sheet it is appearing at the surrender value i.e. ₹ 20,000. On the death of A, how this JLP will be shared among the partners.
- (a) ₹ 50,000: ₹ 25,000: ₹ 25,000.
(b) ₹ 60,000: ₹ 30,000: ₹ 30,000.
(c) ₹ 40,000: ₹ 35,000: ₹ 25,000.
3. R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2022. It was decided to value the goodwill on the basis of three year's purchase of last five years average profits. If the profits are ₹ 29,600; ₹ 28,700; ₹ 28,900; ₹ 24,000 and ₹ 26,800. What will be D's share of goodwill?
- (a) ₹ 20,700.
(b) ₹ 27,600.
(c) ₹ 82,800.
4. R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2022 and profits for the accounting year 2021-2022 were ₹ 24,000. How much share in profits for the period 1st April 2022 to 30th June 2022 will be credited to D's Account.
- (a) ₹ 6,000.
(b) ₹ 1,500.
(c) ₹ 2,000.
5. Revaluation account is prepared at the time of
- (a) Admission and retirement of a partner
(b) Death of a partner
(c) All of the above
6. If three partners A, B & C are sharing profits as 5:3:2, then on the death of a partner A, how much B & C will pay to A's executor on account of goodwill. Goodwill is to be calculated on the basis of 2 years purchase of last 3 years average profits. Profits for last three years are: ₹ 3,29,000; ₹ 3,46,000 and ₹ 4,05,000.
- (a) ₹ 2,16,000 & ₹ 1,42,000.
(b) ₹ 2,44,000 & ₹ 2,16,000.

(c) ₹ 2,16,000 & ₹ 1,44,000.

Theory Questions

1. Explain distinction between retirement and death of a partner as relating to finalisation of amount payable.
2. What amount is payable to legal representatives of dead partner?

Practical Questions

1. The Balance Sheet of Seed, Plant and Flower as at 31st December, 2021 was as under :

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

The profit sharing ratio was: Seed 5/10, Plant 3/10 and Flower 2/10. On 1st May, 2022 Plant died. It was agreed that:

- (a) Goodwill should be valued at 3 years purchase of the average profits for 4 years. The profits were:

2018	₹ 10,000	2020	₹ 12,000
2019	₹ 13,000	2021	₹ 15,000
- (b) The deceased partner to be given share of profits upto the date of death on the basis of the previous year.
- (c) Fixed Assets were to be depreciated by 10%. A bill for ₹ 1,000 was found to be worthless. These are not to affect goodwill.
- (d) A sum of ₹ 7,750 was to be paid immediately, the balance was to remain as a loan with the firm at 9% p.a. as interest.

Seed and Flower agreed to share profits and losses in future in the ratio of 3: 2.

Give necessary journal entries.

2. Peter, Paul and Prince were partners sharing profits and losses in the ratio 2:1:1. It was provided in the partnership deed that in the event of retirement /death of a partner he/his legal representatives would be paid:
- (i) The balance in the capital Account
 - (ii) His share of goodwill of the firm valued at two years purchase of normal average profits (after charging interest on fixed capital) for the last three years to 31st December preceding the retirement or death.
 - (iii) His share of profits from the beginning of the accounting year to the date of retirement or death, which shall be taken on proportionate basis of profits of the previous year as increased by 25%
 - (iv) Interest on fixed capital at 10% p.a. though payable to the partners will not be payable in the year of death or retirement.
 - (v) All the asset are to be revalued on the date of retirement or death and the profit and loss be debited/credited to the Capital Accounts in the profit sharing ratio.

Peter died on 30th September, 2022. The books of Account are closed on calendar year basis from 1st January to 31st December.

The balance in the Fixed Capital Accounts as on 1st January, 2022 were Peter ₹ 10,000, Paul ₹ 5,000 and Prince ₹ 5,000. The balance in the Current Account as on 1st January, 2022 were Peter ₹ 20,000, Paul ₹ 10,000 and Prince ₹ 7,000. Drawings of Peter till 30th September, 2022 were ₹ 10,000. The profits of the firm before charging interest on capital for the calendar years 2019, 2020 and 2021 were ₹ 1,00,000, ₹ 1,20,000 and ₹ 1,50,000 respectively. The profits include the following abnormal items of credit:

	2019 ₹	2020 ₹	2021 ₹
Profit on sale of assets	5,000	7,000	10,000
Insurance claim received	3,000	-	12,000

The firm has taken out a Joint Life Policy for ₹ 1,00,000. Besides the partners had severally insured their lives for ₹ 50,000 each, the premium in respect thereof being charged to the Profit and Loss account. The surrender value of the Policies were 30% of the face value. On 30th June, 2022 the firm received notice from the insurance company that the insurance premium in respect of fire policy had been undercharged to the extent of ₹ 6,000 in the year 2021 and the firm has to pay immediately. The revaluation of the assets indicates an upward revision in value of assets to the extent of ₹ 20,000. Prepare an account showing the amount due to Peter's Legal representatives as on 30th September, 2022 along with necessary workings.

ANSWERS/HINTS

True and False

1. False: Surviving partners continue to carry on the business.
2. False: Legal heirs of deceased partners are entitled to dues of the deceased partner.
3. True: To find out the actual values of the assets and liabilities, revaluation account is prepared.
4. True: reserves belong to the partners in the same manner the capital contributed by them. Hence it is distributed to them through the capital account.
5. False: Legal heirs of a deceased partner are entitled to all the dues of deceased partner.
6. False: It is very much necessary to adjust goodwill on death of a partner.
7. True: Yes, it can be continued in the earlier share or in new share- in either case it leads to computing a new profit sharing ratio
8. False: On death of a partner the firm gets full value of sum assured of the joint life policy.
9. False: All the partners are entitled to amount received from joint life policy.

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(a)	4.	(b)	5.	(c)	6.	(c)
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Theoretical Questions

1. The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although, revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death
2. When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings :
 - (a) The amount standing to the credit to the capital account of the deceased partner;
 - (b) Interest on capital, if provided in the partnership deed upto the date of death;
 - (c) Share of goodwill of the firm;
 - (d) Share of undistributed profit or reserves;

- (e) Share of profit on the revaluation of assets and liabilities;
- (f) Share of profit upto the date of death;
- (g) Share of Joint Life Policy.

Practical Questions

1. Journal Entries

2022			₹	₹
May 1	General Reserve Account	Dr.	5,000	
	To Seed's Capital Account			2,500
	To Plant's Capital Account			1,500
	To Flower's Capital Account			1,000
	(General Reserve transferred to Capital Account on the death of Plant)			
	Seed's Capital Account	Dr.	3,750	
Flower's Capital Account	Dr.	7,500		
To Plant's Capital Account			11,250	
(Adjustment for goodwill on the death of Plant on the basis of gaining ratio) (Value = $3 \times (10,000 + 13,000 + 12,000 + 15,000)/4$)				
Revaluation Account	Dr.	5,000		
To Fixed Assets Account			4,000	
To Bills Receivable Account			1,000	
(Depreciation of fixed assets @ 10% and writing off of one bill for ₹1,000 on Plant's death)				
Seed's Capital Account	Dr.	2,500		
Plant's Capital Account	Dr.	1,500		
Flower's Capital Account	Dr.	1,000		
To Revaluation Account			5,000	
(Loss on Revaluation transferred to capital accounts)				
Profit and Loss Suspense Account	Dr.	1,500		
To Plant's Capital Account			1,500	
(Plant's share of four month's profit based on the previous year)				

Plant's Capital Account To Plant's Executor's Account (Amount standing to the credit of Plant's Capital Account transferred to the credit of his Executor's Account)	Dr.	27,750	27,750
Plant's Executor's Account To Bank Account (Amount paid to Plant's Executors)	Dr.	7,750	7,750

**2. In the books of M/s Paul and Prince
Executors of Peter Account**

	₹		₹
To Balance c/d	2,91,125	By Peter's capital A/c (W.N.6)	20,000
		By Peter's Current A/c (W.N.7)	2,71,125
	2,91,125		2,91,125

Working Notes:

	2019 ₹	2020 ₹	2021 ₹
1. Valuation of Goodwill:			
Profit as per Profit and loss A/c	1,00,000	1,20,000	1,50,000
Less: Interest on capital @ 10%	2,000	2,000	2,000
Abnormal Items:			
Profit on sale of asset	5,000	7,000	10,000
Insurance claim received	3,000	-	12,000
Insurance premium undercharged	-	-	6,000
	90,000	1,11,000	1,20,000
Total profit of three years		3,21,000	
Average profit		1,07,000	
Goodwill (2 x Average profit)		2,14,000	
Peter's share of goodwill (2/4)		1,07,000	

2. Peter's share of profit:	₹
Profit for the year 2021	1,50,000
Less: Insurance premium undercharged	6,000
	1,44,000
Add: 25% increase thereof	36,000
Estimated profit for 2022	1,80,000
Less: Interest on capital *	1,000
Estimated profit for 2022	1,79,000
Estimated profit upto 30.9.22	1,34,250
Peter's Share (2/4)	67,125

*Since Peter was not entitled to interest on capital in the year of death, interest is payable only to the remaining two partners.

3. Profit on revaluation of assets:

	₹
Upward revision in the value of assets	20,000
Peter's share (2/4)	10,000

4. Peter's share in insurance premium undercharged:

Insurance premium undercharged in 2021	6,000
Peter's share	3,000

5. Share of life policy:

Joint life policy	1,00,000
Maturity value of Peter's individual life policy	50,000
Surrender value of individual life policies of Paul & Prince (30 % of face value)	30,000
	1,80,000
Peter's share (2/4)	90,000

6.

Peter's Capital Account

		₹			₹
30.9.22	To Executors of Peter A/c (Transfer)	20,000	1.1.22	By Balance b/d	10,000
			30.9.22	By Profit on revaluation of assets	10,000*
		20,000			20,000

* This is generally transferred to Peter's current account. But as per the requirement of adjustment No. (v) of question, it is transferred to capital account.

7.

Peter's Current Account

		₹			₹
30.9.22	To Drawings	10,000	1.1.22	By Balance b/d	20,000
	To Insurance premium undercharged	3,000	30.9.22	By Share of goodwill	1,07,000
	To Executor's of Peter's Account (balance transferred)	2,71,125		By share of profit	67,125
				By Share of life policy	75,000
				By Paul & Prince	15,000
		2,84,125			2,84,125

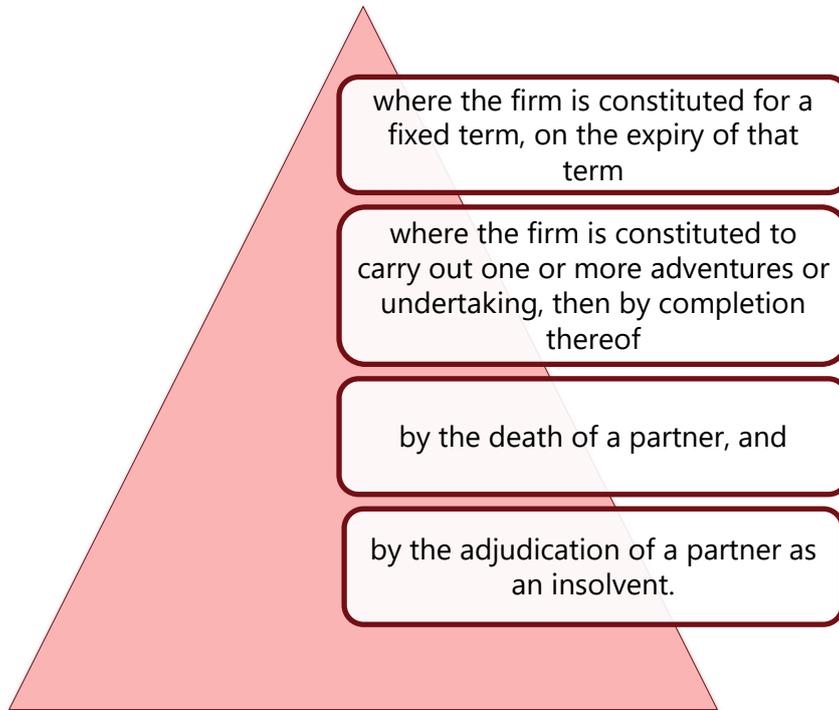
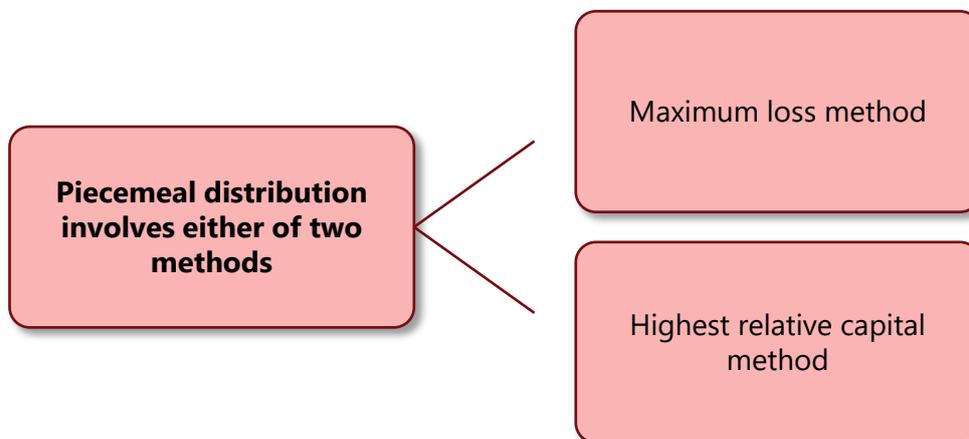
Note: The share of goodwill given to peter would be borne by remaining partners in their gaining ratio, so that goodwill account does not appear in the balance sheet.

UNIT - 6: DISSOLUTION OF PARTNERSHIP FIRMS AND LLP

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Go through the circumstances in which a partnership is dissolved.
- ◆ Understand that on the dissolution of a partnership all assets are sold out and all liabilities are discharged. Learn the accounting technique relating to the disposal of assets and payment of liabilities.
- ◆ Learn how to settle the partner's claims in case of surplus and how to raise money from partners in case of a deficit.
- ◆ Deal with piecemeal distribution to partners of the amount realized from assets net of liabilities.
- ◆ Winding up of a Limited Liability Partnership (LLP)

UNIT OVERVIEW **Circumstances leading to Dissolution of Partnership****Methods of piecemeal distribution**



6.1 INTRODUCTION

Apart from the readjustment of rights of partners in the share of profit by way of change in the profit-sharing ratio and admission of a new partner or for retirement/death of a partner, another important aspect of partnership accounts is how to close books of accounts in case of dissolution. In this Unit, we will discuss the circumstances leading to the dissolution of a partnership firm and accounting treatment necessary to close its books of accounts. Also, we will discuss the special problems relating to the insolvency of partners and the settlement of the partnership's liabilities.



6.2 CIRCUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP

A partnership is dissolved or comes to an end on:



(a) the expiry of the term for which it was formed;



(b) completion of the venture for which it was entered into;



(c) death of a partner;



(d) insolvency of a partner.

However, the partners or remaining partners (in case of death or insolvency) may continue to do the business. In such a case there will be a new partnership but the firm will continue. When the business comes to an end then only it will be said that the firm has been dissolved.

A firm stands dissolved in the following cases:

A firm stands dissolved in the following cases:

(i) The partners agree that the firm should be dissolved;

(ii) All partners except one become insolvent;

(iii) The business becomes illegal;

(iv) In case of partnership at will, a partner gives notice of dissolution; and

(v) The court orders dissolution.

The court has the option to order dissolution of a firm in the following circumstances :

- (a) Where a partner has become of unsound mind;
- (b) Where a partner suffers from permanent incapacity;
- (c) Where a partner is guilty of misconduct of the business;
- (d) Where a partner persistently disregards the partnership agreement;
- (e) Where a partner transfers his interest or share to a third party;
- (f) Where the business cannot be carried on except at a loss; and
- (g) Where it appears to be just and equitable.



6.3 CONSEQUENCES OF DISSOLUTION

On the dissolution of a partnership, firstly, the assets of the firm, including goodwill, are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards, the capital contributed by partners is repaid and, if there is still a surplus, it is distributed among the partners in their profit-sharing ratio.

Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm leftover are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratio.

According to the provisions contained in section 48 of the Partnership Act, upon dissolution of the partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner:

- (a) Losses including deficiencies of capital are paid, first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits.
- (b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital have to be applied in the following manner and order:
 - (i) in paying the debts of the firm to third parties;
 - (ii) in paying to each partner rateably what is due to him from the firm in respect of advances as distinguished from capital;
 - (iii) in paying to each partner what is due to him on account of capital; and

- (iv) the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits.

Distinction between Dissolution of Partnership and Dissolution of Partnership Firm

Dissolution of Partnership	Dissolution of Partnership Firm
Dissolution of a partnership refers to the discontinuance of the relation between the partners of the firm.	Dissolution of the firm implies that the entire firm ceases to exist, including the relation among all the partners.
There can be change in profit sharing ratio or admission/death/retirement of a partner.	Dissolution of partnership firm occurs.
In event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.	In event of the dissolution of the firm, the business ceases to end.
There is no intervention by the court.	Court has the inherent power to intervene. By its order, a firm can be dissolved.
Economic relationships among partners may remain same or change.	Economic relationship among partners comes to an end.
Assets and liabilities are revalued. New balance sheet is prepared.	Assets are sold and realized. Liabilities are paid off.
Revaluation account is prepared.	Realization account is prepared.
Assets and liabilities are revalued after winding up of the existing partnership.	Assets and liabilities are settled on winding up of a firm.
Books of accounts are not closed.	Books of accounts are closed.

6.3.1 Dissolution before the expiry of a fixed term

A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund of premium or of such part as may be reasonable, if the firm is dissolved before the term has expired.

No claim in this respect will arise if:

- (1) the firm is dissolved due to the death of a partner;
- (2) the dissolution is mainly due to the partner's (claiming refund) own misconduct; and
- (3) the dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

The amount to be repaid will be such as is reasonable having regard to the terms upon which the admission was made and to the length of the period agreed upon and that already expired. Any amount that becomes due will be borne by other partners in their profit-sharing ratio.



6.4 CLOSING OF PARTNERSHIP BOOKS ON DISSOLUTION

To close books of accounts of Partnership Firm. We need to transfer all the assets and liabilities to Realization Account. Given below is the specimen of the Realization Account.

Specimen of Realization Account

Particulars	₹	Particulars	₹
To Sundry Assets (Excluding Cash/Bank, Debit Balance of P&L A/c, Partners' Current, Capital, and Loan A/cs)		By Sundry Liabilities (Excluding Credit Balance of P&L A/c, Partners' Current, Capital, and Loan A/c)	
To Bank/Cash (expenses for realization)		By Provision on Assets	
To Bank/Cash A/c (Amount paid for liabilities and unrecorded liabilities)		By Bank/Cash A/c (Amount realized from assets and unrecorded assets)	
To Partners' Capital A/cs (Expenses or Liabilities paid by partners)		By Partners' Capital A/cs (Assets taken over by partners)	
To Partners' Capital A/cs (Profit on realization distributed among partners in profit sharing ratio)		By Partners' Capital A/cs (Loss on realization distributed among partners in profit sharing ratio)	

6.4.1 Treatment of Goodwill at the time of dissolution of Firm

Treatment of Goodwill

- If Goodwill appears in the Balance Sheet, it is considered as purchased Goodwill and is treated like any other asset and is transferred to realization account.
- If Goodwill does not appear in the balance sheet, no entry is required 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.

We will understand how to close the books of accounts through illustration the required journal entries to be made for closing the books of a firm with the example given below:

Balance Sheet of Fast and Quick as at Dec. 31, 2021

Liabilities		₹	Assets		₹
Sundry Creditors		20,000	Plant and Machinery		40,000
Fast's Loan		10,000	Patents		6,000
General Reserve		10,000	Stock		25,000
Capitals:			Sundry Debtors	19,000	
Fast	30,000		Less: Prov. for doubtful debts	(1,000)	18,000
Quick	25,000	55,000	Cash		6,000
		95,000			95,000

Fast and Quick share profits in the ratio of 3:2. On 1st January, 2022 the firm was dissolved. Fast took over the patents at a valuation of ₹ 5,000. The other assets realized as under:

Particulars	₹
Plant and Machinery	45,000
Stock	22,000
Sundry Debtors	<u>18,500</u>
Total	<u>85,500</u>

The Sundry Creditors were paid off at a discount of 5%. The expense amounted to ₹ 3,500. The steps to close the books are given below:

- I. Open a **Realization Account** and **transfer all assets** except cash in hand or at a bank at book values. Realization Account is debited and the various assets are credited and thus closed. It should be remembered that Sundry Debtors and Provisions for Bad Debts Accounts are two separate accounts and the gross amount of debtors should be transferred. In the above example the entry will be:

Particulars		₹	₹
Realization Account	Dr.	90,000	
To Plant and Machinery Account			40,000
To Patents Account			6,000
To Stock Account			25,000
To Sundry Debtors			19,000
(Transfer of various assets to the debit side of Realization Account)			

- II. **Transfer of liabilities** to outsiders and provisions and reserves against assets (e.g., Provision for Doubtful Debts) to the credit side of Realization account. The accounts of the liabilities and provisions will be debited and thus closed. The entry should be at book figures. The entry will be:

Particulars		₹	₹
Sundry Creditors Account	Dr.	20,000	
Provision for Doubtful Debts Account	Dr.	1,000	
To Realization Account			21,000
(Transfer of liabilities to outsiders and provision against debtors to Realization Account)			

Note: Accounts denoting accumulated losses or profits should not be transferred to the Realization Account.

- III. (i) The Realization Account should be **credited with the actual amount realized by the sale of assets**. This should take no note of the book figures. of course, Cash (or Bank) Account will be debited. Thus:

Particulars		₹	₹
Cash Account	Dr.	85,500	
To Realization Account			85,500
(Amount realized by the sale of various assets)			

- (ii) If a **partner takes over an asset**, his Capital Account should be debited and Realization Account credited with the value agreed upon, Thus:

Particulars		₹	₹
Fast's Capital Account	Dr.	5,000	
To Realization Account			5,000
(Patents taken over by Fast at ₹ 5,000)			

- IV. **Expenses of dissolution** or realization of assets are debited to the Realization Account and credited to Cash Account. Thus

Particulars		₹	₹
Realization Account	Dr.	3,500	
To Cash Account			3,500
(Payment of Expenses)			

- V. (i) The actual amount **paid to creditors** should be debited to the Realization Account and Cash Account is credited:

Particulars		₹	₹
Realization Account	Dr.	19,000	
To Cash Account			19,000
(Payment of Sundry Creditors ₹ 20,000 less 5%)			

- (ii) If any **liability is taken over by a partner**, his Capital Account should be credited and Realization Account debited with the amount agreed upon.

- VI. At this stage, the Realization Account will show **profit or loss**. If the debit side is bigger, there is a loss; if the credit side is bigger, there is a profit. Profit or loss is transferred to the Capital Accounts of partners in the profit-sharing ratio. In the case of profit, Realization Account is debited and Capital Accounts are credited. The entry for loss is, naturally, reverse of this entry. The Realization Account in the example given above shows a loss of ₹ 1,000 (see account below).

Particulars		₹	₹
Fast's Capital Account	Dr.	600	
Quick's Capital Account	Dr.	400	
To Realization Account			1,000
(Transfer of loss to Capital Account in the ratio of 3:2)			

- VII. **Partner's Loans** if any, should now be paid. The entry is to debit the Loan Account and credit Cash Account. Thus:

Particulars		₹	₹
Fast's Loan Account	Dr.	10,000	
To Cash Account			10,000
(Repayment of Fast's Loan)			

- VIII. Any reserve of accumulated profit or loss lying in the books (as shown by the Balance Sheet) should be transferred to the Capital Account in the profit-sharing ratio. Thus:

Particulars		₹	₹
General Reserve	Dr.	10,000	
To Fast's Capital Account			6,000
To Quick's Capital Account			4,000
(General Reserve transferred to Capital Account in the ratio of 3:2)			

- IX. At this stage the Capital Accounts of partners will show how much amount is due to them or from them. The partner owing money to the firm will pay; Cash Account will be debited and his Capital Account credited and thus closed. Money owing to a partner will be paid to him; his Capital Account will be debited and the Cash Account credited. This will close the Capital Accounts' as well as the Cash Account. The entry in the above example is seen in the Capital Accounts below:

Particulars		₹	₹
Fast's Capital Account	Dr.	30,400	
Quick's Capital Account	Dr.	28,600	
To Cash Account			59,000
(Amount paid to partners on Capital Account)			

Ledger Accounts Plant and Machinery Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	40,000	Jan. 1	By Realization A/c – Transfer	40,000

Patents Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realization A/c – Transfer	6,000

Stock Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	25,000	Jan. 1	By Realization A/c – Transfer	25,000

Sundry Debtors Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	19,000	Jan. 1	By Realization A/c – Transfer	19,000

Provision for Doubtful Debts Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c Transfer	1,000	Jan. 1	By Balance b/d	1,000

Sundry Creditors Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c -Transfer	20,000	Jan. 1	By Balance b/d	20,000

Fast's Loan Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Cash Account	10,000	Jan. 1	By Balance b/d	10,000

General Reserve Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Capital Accounts		Jan. 1	By Balance b/d	10,000
	Fast	6,000			
	Quick	4,000			
		10,000			
					10,000

Realization Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Sundry Assets		Jan. 1	By Sundry Creditors	20,000
	Plant and Machinery	40,000		By Provision for Doubtful Debts	1,000
	Patents	6,000		By Cash Account-	
	Stock	25,000		assets realized	85,500

Sundry Debtors	19,000	By Fast's Capital Account- patents taken over	5,000
To Cash Account-Exp.	3,500		
To Cash Account- Creditors paid	19,000	By Loss to:	
		Fast	600
		Quick	400
	1,12,500		1,12,500

Cash Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realization A/c-Expenses	3,500
	To Realization b/d	85,500	Jan. 1	By Realization A/c-Creditors	19,000
			Jan. 1	By Fast's Loan Account	10,000
			Jan. 1	By Fast's Capital A/c	30,400
			Jan. 1	By Quick's Capital A/c	28,600
		91,500			91,500

Fast's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c-Patents	5,000	Jan. 1	By Balance b/d	30,000
	To Realization A/c-Loss	600	Jan. 1	By General Reserve	6,000
	To Cash Account	30,400			
		36,000			36,000

Quick's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c-loss	400	Jan. 1	By Balance b/d	25,000
	To Cash Account	<u>28,600</u>		By General Reserve	<u>4,000</u>
		29,000			29,000

Note:

- (1) If any of the assets are taken over by a partner at a value mutually agreed to by the partners, debit the Partner's Capital Account and credit Realization Account with the price of asset taken over.

- (2) Pay off the liabilities, crediting cash, and debiting the liability accounts, the difference between the book figure and the amount paid being transferred to the Realization Account.
- (3) Liabilities to outsiders may also be transferred to the Realization Account. In that case, the amount paid in respect of the liabilities in cash should be debited to the Realization Account, Cash Account being credited. If liability is taken over by a partner, Realization Account should be debited and the Partners' Capital A/cs credited at the figure agreed upon.
- (4) The balance of the Realization Account will represent either the profit or loss on realization. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realization Account and debit various partners' Capital Accounts; follow the opposite course in the case of a profit.
- (5) Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.
- (6) The balance of the cash account at the end will be exactly equal to the balance of capital account, provided they are in credit; credit cash, and debit the partners' capital account with the amount payable to them to close their accounts.

ILLUSTRATION 1

X, Y, and Z are partners of the firm XYZ and Co., sharing Profits and Losses in the ratio of 4: 3: 2. Following is the Balance Sheet of the firm as on 31st March, 2022:

Balance Sheet as on 31st March, 2022

Liabilities	₹	Assets	₹
Partners' Capitals:		Fixed Assets	5,00,000
X	4,00,000	Stock in trade	3,00,000
Y	3,00,000	Sundry debtors	5,00,000
Z	2,00,000	Cash in hand	10,000
General Reserve	90,000		
Sundry Creditors	3,20,000		
	13,10,000		13,10,000

Partners of the firm decided to dissolve the firm on the above-said date.

Fixed assets realized ₹5,20,000 and book debts ₹4,40,000.

Stocks were valued at ₹2,50,000 and it was taken over by partner Y.

Creditors allowed discount of 5% and the expenses of realization amounted to ₹6,000.

You are required to prepare:

- (i) Realization account;
- (ii) Partners capital account; and
- (iii) Cash account.

SOLUTION

(i) Realization Account

Particulars	₹	Particulars	₹
To Fixed assets	5,00,000	By Creditors	3,20,000
To Stock in trade	3,00,000	By Cash (5,20,000+4,40,000)	9,60,000
To Debtors	5,00,000	By Y (Stock taken over)	2,50,000
To Cash – Expenses	6,000	By Loss transferred to partners' capital accounts	
To Cash -Creditors (3,20,000 x 95%)	3,04,000	X	35,555
		Y	26,667
		Z	17,778
	16,10,000		16,10,000

(ii) Partners' Capital Accounts

Particulars	X	Y	Z	Particulars	X	Y	Z
	₹	₹	₹		₹	₹	₹
To Realization Account	35,555	26,667	17,778	By Balance b/d	4,00,000	3,00,000	2,00,000
To Realization Account	-	2,50,000	-	By General reserve	40,000	30,000	20,000
To Cash	<u>4,04,445</u>	<u>53,333</u>	<u>2,02,222</u>				
	4,40,000	3,30,000	2,20,000		4,40,000	3,30,000	2,20,000

(iii) Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	10,000	By Realization A/c (Expenses)	6,000
To Realization A/c (Fixed assets and book debts realized)	9,60,000	By Realization A/c (Creditors)	3,04,000
		By X	4,04,445

		By Y	53,333
	_____	By Z	<u>2,02,222</u>
	9,70,000		9,70,000



6.5 CONSEQUENCES OF INSOLVENCY OF A PARTNER

If the capital account of a partner is in debit, after his share of loss or profit has been adjusted therein, the firm will not have sufficient cash or assets to pay off the amounts due to the other partners, until the amount is repaid by the partner whose account is in debit. If however, the partner is insolvent, the amount will not be realized. In such a case, the deficiency may be borne by the solvent partners in their profit-sharing ratio or according to the principle settled in the well-known case of *Garner vs. Murray*. In the latter case, the deficiency would be borne by the solvent partners in proportion to their capitals and not in the proportion in which they share profits and losses.

If a partner goes insolvent then the following are the consequences:

1. The partner adjudicated as insolvent ceases to be a partner on the date on which the order of adjudication is made.	2. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.	3. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication, and	4. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.
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6.6 LOSS ARISING FROM INSOLVENCY OF A PARTNER

When a partner is unable to pay his debt due to the firm, he is said to be insolvent and the share of loss is to be borne by other solvent partners following the decision in the English case of *Garner vs. Murray*.

According to this decision, solvent partners have to bear the loss due to insolvency of a partner and have to categorically put that the normal loss on realization of assets to be borne by all partners (including insolvent partner) in the profit-sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.

The determination of capital ratio for this has been explained below. The provisions of the Indian Partnership Act are not contrary to *Garner vs. Murray* rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per the deed should be applied.

Capital Ratio on Insolvency

- The partners are free to have either fixed or fluctuating capitals in the firm.
- If they are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary, etc. are done through Current Accounts, which may have debit or credit balances, and insolvency loss is distributed in the ratio of fixed capitals.
- But if capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then Balance Sheet of the business should not exhibit Current Accounts of the partners and capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and drawings to the date of dissolution but before adjusting profit or loss on Realization Account.
- If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear the loss on account of the insolvency of other partner.

Insolvency of all Partners

- When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances, it is better not to transfer the amount of creditors to Realization Account. The balance of the creditors' accounts is transferred to Deficiency Account.
- Creditors may be paid the amount available including the amount contributed by the partners.
- The unsatisfied portion of the creditor account is transferred to the Capital Accounts of the partners in the profit-sharing ratio. Then Capital Accounts are closed. In doing so first close the Partners' Capital Account which is having the worst position. The last account will be automatically closed.

ILLUSTRATION 2

P, Q, and R were partners sharing profits and losses in the ratio of 3: 2: 1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 2022 is as follows:

Liabilities		₹	Assets		₹
Fixed Capital			Fixed Assets:		
P	20,000		Trademark		40,000
Q	20,000		Freehold Property		8,000

R	<u>10,000</u>	50,000	Plant and Equipment	12,800
Current Accounts:			Motor Vehicle	700
P	500		Current Assets	
Q	<u>9,000</u>	9,500	Stock	3,900
Loan from P		8,000	Trade Debtors	2,000
Trade Creditors		12,400	Less: Provision	<u>(100)</u>
			Cash at Bank	200
			Miscellaneous losses	
			R's Current Account	400
			Profit and Loss Account	<u>12,000</u>
		<u>79,900</u>		<u>79,900</u>

On 1st July, 2022 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of ₹ 500 but no cash passed specifically in respect of this transaction. Sale of other assets realized the following amounts:

	₹
Trademark	Nil
Freehold Property	7,000
Plant and Equipment	5,000
Stock	3,000
Trade Debtors	1,600

Trade Creditors were paid ₹ 11,700 in full settlement of their debts. The costs of dissolution amounted to ₹ 1,500. The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to bring 1/3 of the amount due.

Required

- Cash and Bank Account,
- Realization Account, and
- Partners Fixed Capital Accounts (after transferring Current Accounts' balances).

SOLUTION

Cash / Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	200	By Realization A/c- Creditors	11,700
To Realization A/c-		By Realization A/c- Expenses	1,500
Freehold property	7,000	By P's Loan A/c	8,000

Plant and Equipment	5,000	By P's Capital A/c	14,200
Stock	3,000	By Q's Capital A/c	24,200
Trade Debtors	1,600		
To Capital Accounts:			
P	25,500		
Q	17,000		
R	300	42,800	
		59,600	59,600

Realization Account

Particulars	₹	Particulars	₹
To Trademark	40,000	By Trade Creditors	12,400
To Freehold Property	8,000	By Provision for Bad Debts	100
To Plant and Equipment	12,800	By Bank:	
To Motor Vehicle	700	Freehold Property	7,000
To Stock	3,900	Plant and Equip.	5,000
To Sundry Debtors	2,000	Stock	3,000
To Bank (Creditors)	11,700	Debtors	<u>1,600</u>
To Bank (Expenses)	1,500	By Q (Car)	500
		By Capital Accounts: (Loss)	
		P	25,500
		Q	17,000
		R	8,500
	80,600		51,000
			80,600

Partners' Capital Accounts

Particulars	P ₹	Q ₹	R ₹	Particulars	P ₹	Q ₹	R ₹
To Current A/c (Transfer) (WN)	5,500	—	2,400	By Balance b/d	20,000	20,000	10,000
To Realization A/c (Loss)	25,500	17,000	8,500	By Current A/c (Transfer) (WN)	—	5,000	—
To Realization A/c (Car)	—	500	—	By Bank	—	—	300
To R's Capital A/c (Deficiency)	300	300	—	By Bank (realization loss)	25,500	17,000	—

To Bank	14,200	24,200	—	By P & Q (Deficiency)	—	—	600
	45,500	42,000	10,900		45,500	42,000	10,900

Working Note

Particulars	P	Q	R
Current Account Balance	500 (Cr)	9000 (Cr)	400 (Dr)
Less: share of Profit & Loss A/c (debit balance)	6000 (Dr)	4000 (Dr)	2000 (Dr)
Adjusted Current Account Balance	5500 (Dr)	5000 (Cr)	2400 (Dr)

Note:

- P, Q, and R will bring cash to make good their share of the loss on realization. In actual practice they will not be bringing any cash; only a notional entry will be made.
- On following Garner Vs. Murray rule, solvent partners P and Q have to bear the loss due to insolvency of a partner R in their fixed capital ratio.

ILLUSTRATION 3

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on 31st March, 2021 when the firm was dissolved:

Liabilities	₹	Assets	₹
Creditors A/c	4,800	Plant & Machinery	2,500
Amal's Capital A/c	750	Furniture	500
		Debtors	1,000
		Stock	800
		Cash	200
		Bimal's drawings	550
	5,550		5,550

The assets realized as under:

Particulars	₹
Plant & Machinery	1,250
Furniture	150
Debtors	400
Stock	500

The expenses of realization amounted to ₹ 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of ₹ 200 only.

Show necessary ledger accounts to close the books of the firm.

SOLUTION**In the books of M/s Amal and Bimal****Realization Account**

Particulars	₹	Particulars		₹
To Sundry Assets:		By Cash A/c:		
Plant & Machinery	2,500	Plant & Machinery	1,250	
Furniture	500	Furniture	150	
Debtors	1,000	Debtors	400	
Stock	800	Stock	<u>500</u>	2,300
Cash A/c-expenses	175	By Partners' Capital A/c		
		Loss on realization (Bal. fig.)		
		Amal	1,337	
		Bimal	1,338	2,675
	<u>4,975</u>			<u>4,975</u>

Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	200	By Realization A/c- expenses	175
To Realization A/c		By Sundry Creditors A/c (Bal. fig.)	2,525
- Sale of sundry assets	2,300		
To Bimal's Capital A/c	200		
	<u>2,700</u>		<u>2,700</u>

Sundry Creditors Account

Particulars	₹	Particulars	₹
To Cash A/c	2,525	By Balance b/d	4,800
To Deficiency A/c-transfer (bal. fig.)	2,275		
	<u>4,800</u>		<u>4,800</u>

Partners' Capital Accounts

Particulars	Amal (₹)	Bimal (₹)	Particulars	Amal (₹)	Bimal (₹)
To Balance b/f	—	550	By Balance b/f	750	—
To Realization A/c			By Cash A/c	—	200
- loss	1,337	1,338	By Deficiency A/c- transfer (bal. fig.)	587	1,688
	1,337	1,888		1,337	1,888

Deficiency Account

Particulars	₹	Particulars	₹
To Partners' Capital A/c		By Sundry Creditors A/c	2,275
Amal	587		
Bimal	<u>1,688</u>		
	2,275		<u>2,275</u>

ILLUSTRATION 4

A, B, C, and D sharing profits in the ratio of 4:3:2:1 decided to dissolve their partnership on 31st March 2022 when their balance sheet was as under:

Liabilities	₹	Assets	₹
Creditors	15,700	Bank	535
Employees Provident Fund	6,300	Debtors	15,850
Capital Accounts:		Stock	25,200
A 40,000		Prepaid Expenses	800
B <u>20,000</u>	60,000	Plant & Machinery	20,000
		Patents	8,000
		C's Capital A/c	3,200
		D's Capital A/c	8,415
	<u>82,000</u>		<u>82,000</u>

Following information is given to you: -

- One of the creditors took some of the patents whose book value was ₹ 5,000 at a valuation of ₹ 3,200. Balance of the creditors were paid at a discount of ₹ 400.
- There was a joint life policy of ₹ 20,000 (not mentioned in the balance sheet) and this was surrendered for ₹ 4,500.

- 3 The remaining assets were realized at the following values: - Debtors ₹ 10,800; Stock ₹ 15,600; Plant and Machinery ₹ 12,000; and Patents at 60% of their book-values. Expenses of realization amounted to ₹ 1,500.

D became insolvent and a dividend of 25 paise in a rupee was received in respect of the firm's claim against his estate. Prepare necessary ledger accounts.

SOLUTION**Realization Account**

Particulars		₹	Particulars		₹
To Sundry Assets: -			By Creditors		15,700
Debtors	15,850		By Employee's Provident Fund		6,300
Stock	25,200		By Bank A/c:		
Prepaid Expenses	800		Joint Life Policy	4,500	
Plant & Machinery	20,000		Debtors	10,800	
Patents	8,000	69,850	Stock	15,600	
To Bank-Creditors: (₹ 15,700 - ₹ 3,200 - ₹ 400)		12,100	Plant and Machinery	12,000	
To Bank A/c		6,300	Patents 60% of (₹ 8,000 - ₹ 5,000)	<u>1,800</u>	44,700
Employee's (P.F)			By Loss transferred to:		
To Bank A/c (expenses)		1,500	A's Capital A/c	9,220	
			B's Capital A/c	6,915	
			C's Capital A/c	4,610	
			D's Capital A/c	2,305	23,050
		89,750			89,750

Capital Accounts

Particulars	A (₹)	B (₹)	C (₹)	D (₹)	Particulars	A (₹)	B (₹)	C (₹)	D (₹)
To Bal. b/d	—	—	3,200	8,415	By Bal. b/d	40,000	20,000	—	—
To Realization A/c	9,220	6,915	4,610	2,305	By Bank (Realization loss)	9,220	6,915	4,610	—
To D's Capital (Deficiency)	5,360	2,680	—	—	By Bank (Recovery)	—	—	—	2,680
To Bank	34,640	17,320	—	—	By A's Capital (2/3)	—	—	—	5,360

					By B's Capital (1/3)	—	—	—	2,680
					By Bank A/c		—	3,200	—
	49,220	26,915	7,810	10,720		49,220	26,915	7,810	10,720

Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	535	By Realization A/c	12,100
To Realization A/c	44,700	By Realization A/c	6,300
To A's Capital A/c	9,220	By Realization A/c	1,500
To B's Capital A/c	6,915	By A's Capital A/c	34,640
To D's Capital A/c	2,680	By B's Capital A/c	17,320
To C's Capital A/c (4,610 + 3,200)	7,810		
	71,860		71,860

Working Note

D's loss will be borne by A and B only because only solvent partners having credit balance has to bear the loss on account of insolvency. C will bring his share of loss in cash.

ILLUSTRATION 5

M/s X, Y, and Z who were in partnership sharing profits and losses in the ratio of 2:2:1 respectively, had the following Balance Sheet as on December 31, 2022:

Liabilities	₹	₹	Assets	₹	₹
Capital: X	29,200		Fixed Assets		40,000
Y	10,800		Stock		25,000
Z	10,000	50,000	Book Debts	25,000	
Z's Loan		5,000	Less: Provision	(5,000)	20,000
Loan from Mrs. X		10,000	Cash		1,000
Sundry Trade Creditors		25,000	Advance to Y		4,000
		90,000			90,000

The firm was dissolved on the date mentioned above due to continued losses. After drawing up the balance sheet given above, it was discovered that goods amounting to ₹ 4,000 have been purchased in November, 2022 and had been received but the purchase was not recorded in books.

Fixed assets realized ₹ 20,000; Stock ₹ 21,000 and Book Debt ₹ 20,500. Similarly, the creditors allowed a discount of 2% on average. The expenses of realization come to ₹ 1,080. X agreed to take over the loan of Mrs. X. Y is insolvent, and his estate is unable to contribute anything.

Give accounts to close the books; work according to the decision in Garner vs. Murray.

SOLUTION**Realization Account**

Particulars	₹	Particulars	₹	₹
To Sundry		By Provision for Doubtful Debts		5,000
Fixed Assets (transfer)	40,000	By Cash (20,000+21,000+20,500)		61,500
Stock	25,000	By Sundry Trade Creditors		
Book Debts	25,000	(Discourt)		29,000
To Cash—Expenses	1,080	By Loss: X (2/5)	9,600	
- Creditors	28,420	Y (2/5)	9,600	
		Z (1/5)	4,800	24,000
	1,19,500			1,19,500

Sundry Trade Creditors

Particulars	₹	Particulars	₹
To Realization A/c	29,000	By Balance b/d	25,000
		By Partners Capital Accounts	
		(Purchase omitted)	4,000
	29,000		29,000

Z's Loan Account

Particulars	₹	Particulars	₹
To Cash Account	5,000	By Balance b/d	5,000

Mrs. X's Loan Account

Particulars	₹	Particulars	₹
To X's Capital A/c – transfer	10,000	By Balance b/d	10,000

Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	1,000	By Sundry Trade Creditors (after deducting discount of 2%)	28,420
To Realization A/c- assets realized	61,500	By Realization A/c – expenses	1,080
To X's Capital A/c*	9,600	By Z's Loan	5,000
To Z's Capital A/c*	<u>4,800</u>	By X's Capital A/c	34,300
	76,900	By Z's Capital A/c	<u>8,100</u>
			76,900

*X and Z bring these amounts to make good their share of the loss on realization. In actual practice they will not be bringing any cash; only a notional entry will be made.

Capital Accounts

Particulars	X (₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹)
To Sundry Trade Creditors-omission	1,600	1,600	800	By Balance b/d	29,200	10,800	10,000
To Balance c/d	27,600	9,200	9,200				
	29,200	10,800	10,000		29,200	10,800	10,000
To Advance	-	4,000	-	By Balance b/d	27,600	9,200	9,200
To Realization A/c-loss	9,600	9,600	4,800	By Mrs. X's Loan	10,000	-	-
To Y's Capital A/c	3,300	-	1,100	By Cash (Realization loss)	9,600	-	4,800
				By X's Capital A/c		3,300	
To Cash	34,300	-	8,100	By Z's Capital A/c	-	1,100	-
	47,200	13,600	14,000		47,200	13,600	14,000

Note: Y's deficiency comes to ₹ 4,400 (difference in the two sides of his Capital Account); this has been debited to X and Z in the ratio of 27,600: 9,200 *i.e.*, capital standing up just before dissolution but after correction of error committed while drawing up the accounts for 2022.



6.7 PIECEMEAL PAYMENTS

Generally, the assets sold upon dissolution of partnership are realized only in small instalments over a period of time. In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted. In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order in which the payment should be made.

6.7.1 Maximum Loss Method

Each installment realized is considered to be the final payment *i.e.*, outstanding assets and claims are considered worthless and partners' accounts are adjusted on that basis each time when a distribution is made, following either *Garner vs. Murray* Rule or the profit-sharing ratio rule.

ILLUSTRATION 6

A, B, and C are partners sharing profits and losses in the ratio of 5:3:2. Their capitals were ₹ 9,600, ₹ 6,000 and ₹ 8,400 respectively.

After paying creditors, the liabilities and assets of the firm were:

Liabilities	₹	Assets	₹
<i>Liability for interest on loans from:</i>		<i>Investments</i>	<i>1,000</i>
<i>Spouses of partners</i>	<i>2,000</i>	<i>Furniture</i>	<i>2,000</i>
<i>Partners</i>	<i>1,000</i>	<i>Machinery</i>	<i>1,200</i>
		<i>Stock</i>	<i>4,000</i>

The assets realized in full in the order in which they are listed above. B is insolvent.

You are required to prepare a statement showing the distribution of cash as and when available, applying the maximum possible loss procedure.

Statement of Distribution of Cash

SOLUTION

Realization	Interest on loans from partner's spouses	Interest on loans from partners	Partners Capitals			Total
			A	B	C	
			₹	₹	₹	₹
Balances due	(1)		9,600	6,000	8,400	24,000
(i) Sale of Investments	1,000					
(ii) Sale of furniture		1,000				
(iii) Sale of machinery						
Maximum possible loss ₹ 22,800 (total of capitals ₹ 24,000 less Cash available ₹ 1,200) allocated to partners in the profit sharing ratio i.e. 5:3: 2			(11,400)	(6,840)	(4,560)	(22,800)
Amounts at credit			(1,800)	(840)	3,840	1,200
Deficiency of A and B written off against C			1,800	840	(2,640)	

ILLUSTRATION 7

The following is the Balance Sheet of A, B, C on 31st December, 2022 when they decided to dissolve the partnership:

Liabilities	₹	Assets	₹
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts:			
A	15,000		
B	18,000		
C	<u>9,000</u>		
	49,000		<u>49,000</u>

The assets realized the following sums in installments:

I	1,000
II	3,000
III	3,900
IV	6,000
V	<u>20,100¹</u>
	<u>34,000</u>

The expenses of realization were expected to be ₹ 500 but ultimately amounted to ₹ 400 only. Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

SOLUTION

First of all, the following table will be constructed to show the amounts available for distribution among the various interests:

Statement showing Realization and Distribution of Cash Payments

Particulars	Realization	Creditors	Partners' Loan	Partners' Capitals
	₹	₹	₹	₹
1. After taking into account cash balance and amount set aside for expenses	1,000	1,000	-	-

¹ includes saving in expenses i.e. ₹ 100 (₹ 500 - ₹ 400).

2.	3,000	1,000	2,000	-
3.	3,900	-	3,000	900
4.	6,000	-	-	6,000
Including saving in expenses	20,100	-	-	20,100
	34,000	2,000	5,000	27,000

To ascertain the amount distributable out of each installment realized among the partners, the following table will be constructed:

Statement of Distribution on Capital Accounts

(1) Calculation to determine the mode of distribution of ₹ 900

Particulars	Total (₹)	A (₹)	B (₹)	C (₹)
Balance	42,000	15,000	18,000	9,000
Less: Possible loss, should remaining assets prove to be worthless (in their profit-sharing ratio)	(41,100)	(16,440)	(16,440)	(8,220)
	+ 900	- 1,440	+ 1,560	+ 780
Deficiency of A's capital written off against those of B and C in the ratio of their capital, 18,000:9,000 (<i>Garner vs. Murray</i>)			(960)	(480)
Manner in which the first ₹ 900 should be distributed			+ 600	+ 300

(2) Distribution of ₹ 6,000

Balance after making payment of amount shown in step (1)	41,100	15,000	17,400	8,700
Less: Possible Loss assuming remaining asset to be valueless (in their profit sharing ratio)	(35,100)	(14,040)	(14,040)	(7,020)
Balance available and to be distributed	6,000	960	3,360	1,680

(3) Distribution of ₹ 20,100

Balance after making payment of amount shown in step (2)	35,100	14,040	14,040	7,020
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Less: Possible loss, assuming remaining assets to be valueless (in their profit sharing ratio)	(15,000)	(6,000)	(6,000)	(3,000)
Manner of distribution of ₹ 20,100	20,100	8,040	8,040	4,020
<i>Summary:</i>				
Balance	42,000	15,000	18,000	9,000
Total amounts paid	27,000	9,000	12,000	6,000
Loss	15,000	6,000	6,000	3,000

6.7.2 Highest Relative Capital Method

According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off. This method is also called as proportionate capital method.

For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit-sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals. The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

The illustration given above is now worked out according to this method.

Particulars	A	B	C
Capital	₹ 15,000	18,000	9,000
Profit-sharing ratio	2	2	1
Capital divided by the profit-sharing ratio	7,500	9,000	9,000
Proportionate Capital of B and C, taking A's capital as the base	₹ 15,000	15,000	7,500
Excess of actual over proportionate capital	₹ nil	3,000	1,500

This indicates that A should not get anything till ₹ 3,000 is paid to B and ₹ 1,500 is paid to C. Since capital of B and C are already according to their mutual profit-sharing ratio (2:1), they will share the available cash in this ratio.

After paying off creditors and A's loan, the available amount will be distributed as below in this method:

Particulars	Total	A	B	C
		₹	₹	₹
Third Installment	900	-	600	300
Fourth Installment (i)	3,600	-	2,400	1,200
(ii)	2,400	960	960	480
Fifth Installment	<u>20,100</u>	<u>8,040</u>	<u>8,040</u>	<u>4,020</u>
Total	27,000	9,000	12,000	6,000

Total payment made to each partner will, of course be same under both the methods.

ILLUSTRATION 8

A partnership firm was dissolved on 30th June, 2022. Its Balance Sheet on the date of dissolution was as follows:

Liabilities	₹	₹	Assets	₹
Capitals:			Cash	10,800
A	76,000		Sundry Assets	1,89,200
B	48,000			
C	36,000	1,60,000		
Loan A/c – B		10,000		
Sundry Creditors		30,000		
		<u>2,00,000</u>		<u>2,00,000</u>

The assets were realized in instalments and the payments were made on the proportionate capital basis. Creditors were paid ₹ 29,000 in full settlement of their account. Expenses of realization were estimated to be ₹ 5,400 but actual amount spent was ₹ 4,000. This amount was paid on 15th September. Draw up a statement showing distribution of cash, which was realized as follows:

	₹
On 5 th July, 2022	25,200
On 30 th August, 2022	60,000
On 15 th September, 2022	80,000

The partners shared profits and losses in the ratio of 2 : 2 : 1. Prepare a statement showing distribution of cash amongst the partners by 'Highest Relative Capital' method.

SOLUTION**Statement showing distribution of cash amongst the partners**

	Creditors	B's Loan	A	B	C
2022	₹	₹	₹	₹	₹
June 30					
Balance b/d	30,000	10,000	76,000	48,000	36,000
Cash balance less Provision for expenses (₹ 10,800 – ₹ 5,400)	5,400	-	-	-	-
Balances unpaid	24,600	10,000	76,000	48,000	36,000
July 5					
1 st Instalment of ₹ 25,200	23,600	1,600	-	-	-
Discount received on full settlement	1,000	8,400	76,000	48,000	36,000
Less: Transferred to Realisation A/c	1,000				
	Nil				
August 30					
2 nd instalment of ₹ 60,000 (W.N. 2)		8,400	32,640	4,640	14,320
Balance unpaid		Nil	43,360	43,360	21,680
September 15					
Amount realised ₹ 80,000					
Add: Balance out of the Provision for Expenses A/c					
			1,400		
			<u>81,400</u>		
Amount unpaid being loss on Realisation in the ratio of 2 : 2 : 1			10,800	10,800	5,400

Working Notes:**1. Highest relative capital basis**

		A	B	C
		₹	₹	₹
1.	Present Capitals	76,000	48,000	36,000
2.	Profit-sharing ratio	<u>2</u>	<u>2</u>	<u>1</u>
3.	Capital per unit of Profit share (1 ÷ 2)	<u>38,000</u>	<u>24,000</u>	<u>36,000</u>
4.	Proportionate capitals taking B, whose capital is the least, as the basis	48,000	48,000	24,000
5.	Excess capital (1-4)	28,000	Nil	12,000
6.	Profit-sharing ratio	<u>2</u>	-	<u>1</u>
7.	Excess capital per unit of Profit share (5 ÷ 6)	14,000		12,000
8.	Proportionate capitals as between A and C taking C capital as the basis	24,000	-	12,000
9.	Excess of A's Capital over C's Excess capital (5-8)	4,000	-	-
10.	Balance of Excess capital (5-9)	24,000		12,000
11.	Distribution sequence:			
	First ₹ 4,000 (2 : 0 : 0)	4,000	-	-
	Next ₹ 36,000 (2 : 0 : 1)	24,000	-	12,000
	Over ₹ 40,000 (2 : 2 : 1)			

2. Distribution of Second instalment

		<i>Creditors</i>	A	B	C
First	₹ 8,400	8,400	-	-	-
Next	₹ 4,000 (2 : 0 : 0)		4,000	-	-
Next	₹ 36,000 (2 : 0 : 1)		24,000	-	12,000
Balance	<u>₹ 11,600</u> (2 : 2 : 1)		4,640	4,640	2,320
	60,000	8,400	32,640	4,640	14,320



6.8 WINDING UP OF A LIMITED LIABILITY PARTNERSHIP (LLP)

The winding up of a LLP may be either voluntary or by the Tribunal and LLP, so wound up may be dissolved.

Winding up of a LLP may be initiated by Tribunal if:

- The LLP wishes to wind up;
- The LLP has less than 2 partners for more than 6 months;
- The LLP is unable to pay its debts;
- The LLP has not acted in the interest of the sovereignty and the integrity of India;
- The LLP has failed to submit with the statements of accounts and solvency or the LLP annual returns for more than five consecutive financial years with the Registrar;
- The Tribunal thinks that it is Just and Equitable that the LLP should be wound up.

The Central Government may make rules for the provisions in relation to winding up and dissolution of LLP.

ILLUSTRATION 9

P and Q were partners sharing profits equally in LLP. Their Balance Sheet as on March 31, 2022 was as follows:

Balance Sheet as on 31st March, 2022

Equity and Liabilities	₹	Assets	₹
Capitals:		Bank	30,000
P	1,00,000	Debtors	25,000
Q	<u>50,000</u>	Stock	35,000
	1,50,000	Furniture	40,000
Creditors	20,000	Machinery	60,000
Q's current account	10,000	P's current account	10,000
Reserves	15,000		
Bank overdraft	5,000		
	<u>2,00,000</u>		<u>2,00,000</u>

The firm was dissolved on the above date:

P took over 50% of the stock at 10% less on its book value, and the remaining stock was sold at a gain of 15%. Furniture and Machinery realized for ₹ 30,000 and ₹ 50,000 respectively; There

was an unrecorded investment which was sold for ₹ 25,000; Debtors realized 90% only and ₹ 1,245 were recovered for bad debts written off last year. There was an outstanding bill for repairs which had to be paid for ₹ 2,000.

You are required to prepare Realization Account, Partners' capital accounts (including transfer of current account balances) and Bank Account in the books of the firm.

SOLUTION**Books of P & Q LLP.****Realization Account**

Particulars	₹	Particulars	₹
To Debtors	25,000	By Creditors	20,000
To Stock	35,000	By Bank overdraft	5,000
To Furniture	40,000	By Bank:	
To Machinery	<u>60,000</u>	Investment	25,000
To Bank:		Furniture	30,000
Creditors	20,000	Machinery	50,000
Bank overdraft	5,000	Debtors (90%)	22,500
Outstanding bill	<u>2,000</u>	Stock	20,125
To Profit transferred to:		Bad debts Recovered	<u>1,245</u>
P's capital	1,310	By P's capital	15,750
Q's capital	1,310	(stock taken over)	
	<u>1,89,620</u>		<u>1,89,620</u>

Partners' Capital Accounts

	P	Q		P	Q
To P's current Account	16,940		By Balance b/d	1,00,000	50,000
To Bank	83,060	68,810	By Q's current Account		18,810
	<u>1,00,000</u>	<u>68,810</u>		<u>1,00,000</u>	<u>68,810</u>

Bank Account

	₹		₹
To Balance b/d	30,000	By Realization	27,000
To Realization	1,48,870	By P's capital	83,060
		By Q's capital	68,810
	<u>1,78,870</u>		<u>1,78,870</u>

Working Note:**Partners' Current Accounts**

	P	Q		P	Q
To Balance b/d	10,000		By Balance b/d		10,000
To Realization	15,750		By Reserves	7,500	7,500
To Q's capital		18,810	By Realization (profit)	1,310	1,310
			By P's Capital	16,940	
	25,750	18,810		25,750	18,810

SUMMARY

- Reasons for which a partnership could be dissolved are
 - expiry of term for which it was formed
 - death of a partner
 - insolvency of a partner.
- Reasons when a firm stands dissolved
 - when partners mutually decide to dissolve
 - partners except one becomes insolvent
 - business becomes illegal
 - if partnership is at will any partner can give notice for dissolution
 - Court orders.
- The winding up of a LLP may be either voluntary or by the Tribunal and LLP, so wound up may be dissolved.
- On dissolution assets are realized and all liabilities are paid off.
(if any liability remains unpaid then it is to be realized from partners in their profit-sharing ratio).
- Piecemeal distribution involves either of two methods:
 - Maximum loss method
 - Highest relative capital method.

TEST YOUR KNOWLEDGE

True and False

1. *Books of accounts are closed in dissolution of partnership.*
2. *On the dissolution of a partnership, firstly, the assets of the firm are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders.*
3. *In event of the dissolution of the firm, the business ceases to end. In event of dissolution of the partnership, the partnership is reconstituted and the business discontinues.*
4. *Expenses of dissolution on realization of assets are credited to the Realization Account.*
5. *Revaluation Account is prepared at the time of dissolution of partnership but Realization Account is prepared at the time of dissolution of partnership firm.*

Multiple Choice Questions

1. *Partnership could be dissolved because of*
 - (a) *Death of a partner.*
 - (b) *Insolvency of a partner.*
 - (c) *Either (a) or (b).*
2. *On the dissolution of partnership, profit or loss on realization of assets and liabilities should be divided among partners*
 - (a) *In the ratio of their capitals.*
 - (b) *In the same ratio in which they share profits.*
 - (c) *Equally.*
3. *An unrecorded asset realized at the time of dissolution is credited to*
 - (a) *Realization account.*
 - (b) *Revaluation account.*
 - (c) *Capital accounts.*
4. *A liability taken over by a partner at the time of dissolution is credited to*
 - (a) *Profit and loss account.*
 - (b) *Partners' capital accounts.*
 - (c) *Realization account.*

5. Realization account is a
- Nominal account.
 - Real account.
 - Personal account.
6. Which of the following method/methods is adopted to ensure that distribution of cash among partners is in proportion to their interest in partnership?
- Maximum loss method.
 - Highest relative capital method.
 - Either (a) or (b).

Theoretical Questions

- 1 State the circumstances when Garner V/S Murray rule not applicable.
- 2 W paid a premium to other partners of the firm at the time of his admission to the firm, with a condition that they will not be dissolved before the expiry of five years. The firm is dissolved after three years. W claims refund of premium.
- List the criteria for the calculation of the amount of refund.
 - Also list any two conditions when no claim in this respect will arise.

Practical Questions

1. P, Q, and R are partners sharing profits and losses as to 2:2:1. Their Balance Sheet as on 31st March, 2022 is as follows:

Liabilities		₹	Assets		₹
Capital accounts			Plant and Machinery		1,08,000
P	1,20,000		Fixtures		24,000
Q	48,000		Stock		60,000
R	24,000	1,92,000	Sundry debtors		48,000
Reserve Fund		60,000	Cash		60,000
Creditors		<u>48,000</u>			<u> </u>
		<u>3,00,000</u>			<u>3,00,000</u>

all three partners decide to dissolve the partnership with effect from 30th September, 2022. It then transpires that 'Fat' has no private assets whatsoever.

The premises are sold for ₹ 60,000 and the plant for ₹ 1,07,500. The fixtures realize ₹ 20,000 and the stock is acquired by another firm at a book value less 5%. Debtors realize ₹ 45,900. Realization expenses amount to ₹ 4,500.

The bank overdraft is discharged and the creditors are also paid in full.

You are required to write up the following ledger accounts in the partnership books following the rules in Garner vs. Murray:

- (i) Realization Account;
 - (ii) Partners' Current Accounts;
 - (iii) Partners' Capital Accounts showing the closing of the firm's books.
3. Amit, Sumit, and Kumar are partners sharing profit and losses in the ratio 2:2:1. The partners decided to dissolve the partnership on 31st March 2022 when their Balance Sheet was as under:

Liabilities	Amount	Assets	Amount
Capital Accounts:		Land & Building	1,35,000
Amit	55,200	Plant & Machinery	45,000
Sumit	55,200	Furniture	25,500
General Reserve	61,500	Investments	15,000
Kumar's Loan A/c	15,000	Book Debts	60,000
Loan from D	1,20,000	Less: Prov. for bad debts	(6,000)
Trade Creditors	30,000	Stock	36,000
Bills Payable	12,000	Bank	13,500
Outstanding Salary	7,500	Capital Withdrawn:	
		Kumar	32,400
	3,56,400		3,56,400

The following information is given to you:

- (i) Realization expenses amounted to ₹ 18,000 out of which ₹ 3,000 was borne by Amit.
- (ii) A creditor agreed to takeover furniture of book value ₹ 12,000 at ₹ 10,800. The rest of the creditors were paid off at a discount of 6.25%.

(iii) *The other assets realized as follows:*

Furniture - Remaining taken over by Kumar at 90% of book value

Stock - Realized 120% of book value

Book Debts - ₹ 12,000 of debts proved bad, remaining were fully realized

Land & Building - Realized ₹ 1,65,000

Investments - Taken over by Amit at 15% discount

(iv) *For half of his loan, D accepted Plant & Machinery and ₹ 7,500 cash. The remaining amount was paid at a discount of 10%.*

(v) *Bills payable were due on an average basis of one month after 31st March 2022, but they were paid immediately on 31st March @ 6% discount "per annum".*

Prepare the Realization Account, Bank Account and Partners' Capital Accounts in the books of Partnership firm.

ANSWERS/HINTS

True and False

1. False. Books of accounts are not closed in dissolution of partnership but are closed in case of dissolution of partnership firm.
2. True. On the dissolution of a partnership, firstly, the assets of the firm, are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards, the capital contributed by partners is repaid.
3. True. In event of the dissolution of the firm, the business ceases to end. However, in event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.
4. False. Expenses of dissolution on realization of assets are debited to the Realization Account.
5. True. Revaluation Account is prepared at the time of dissolution of partnership but Realization Account is prepared at the time of dissolution of partnership firm.

Multiple Choice Questions

1.	(c)	2.	(b)	3.	(a)	4.	(b)	5.	(a)	6.	(c)
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Theoretical Questions

1. Non-Applicability of Garner vs Murray rule:
 - (i) When the solvent partner has a debit balance in the capital account.
Only solvent partners will bear the loss of capital deficiency of insolvent partner in their capital ratio. If incidentally, a solvent partner has a debit balance in his capital account, he will escape the liability to bear the loss due to insolvency of another partner.
 - (ii) When the firm has only two partners.
 - (iii) When there is an agreement between the partners to share the deficiency in capital account of the insolvent partner.
 - (iv) When all the partners of the firm are insolvent.
2. If the firm is dissolved before the term expires, as is the case, W being a partner who has paid a premium on admission will have to be repaid/refunded
The criteria for calculation of refund amount are:
 - (i) Terms upon which admission was made,
 - (ii) The time period for which it was agreed that the firm will not be dissolved,
 - (iii) The time period for which the firm has already been in existence.
 No claim for refund will arise if:
 - (i) The firm is dissolved due to the death of a partner,
 - (ii) If the dissolution of the firm is basically because of misconduct of W,
 - (iii) If the dissolution is through an agreement and such an agreement does not have a stipulation for a refund of premium.

Practical Questions

1. Realization Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Debtors	48,000	By Creditors	48,000
To Stock	60,000	By Cash A/c (Assets realized):	
To Fixtures	24,000	Plant and Machinery	1,02,000
To Plant and machinery	1,08,000	Fixtures	18,000
To Cash A/c (Creditors)	45,600	Stock	84,000

To Cash A/c (GST)	4,200	Sundry Debtors	<u>44,400</u>	2,48,400
To Cash A/c (Realization expenses)	1,500	By Q (Unrecorded asset)*		4,800
To Profit on Realization				
P	3,960			
Q	3,960			
R	<u>1,980</u>			
	9,900			
	<u>3,01,200</u>			<u>3,01,200</u>

Partners' Capital Accounts

Particulars	P	Q	R	Particulars	P	Q	R
	₹	₹	₹		₹	₹	₹
To Realization A/c (unrecorded asset)		4,800		By Balance b/d	1,20,000	48,000	24,000
To Cash (Bal. Fig.)	1,47,960	71,160	37,980	By Reserve fund	24,000	24,000	12,000
				By Realization A/c (Profit)	3,960	3,960	1,980
	<u>1,47,960</u>	<u>75,960</u>	<u>37,980</u>		<u>1,47,960</u>	<u>75,960</u>	<u>37,980</u>

Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	60,000	By Realization A/c (Creditors)	45,600
To Realization A/c (Assets)	2,48,400	By Realization A/c (Expenses)	1,500
		By Realization A/c (GST)	4,200
		By P's Capital A/c	1,47,960
		By Q's Capital A/c	71,160
		By R's Capital A/c	37,980
	<u>3,08,400</u>		<u>3,08,400</u>

* An unrecorded asset is in the nature of gain hence realization account is credited. Since this asset has been taken over by Q, therefore, his account has been debited.

2. Realization Account

<i>Particulars</i>	₹	<i>Particulars</i>		₹
To Premises	50,000	By Sundry Creditors		84,650
To Plant	1,25,000	By Bank:		
To Fixtures	32,500	Premises	60,000	
To Stock	43,200	Plant	1,07,500	
To Debtors	54,780	Fixtures	20,000	
To Bank (Creditors)	84,650	Stock	41,040	
To Bank (Expenses)	4,500	Debtors	<u>45,900</u>	2,74,440
		By Loss on Realization transferred to Partners' Current A/cs		
		Thin	14,216	
		Short	14,216	
		Fat	<u>7,108</u>	35,540
	<u>3,94,630</u>			<u>3,94,630</u>

Partners' Current Accounts

<i>Particulars</i>	<i>Thin</i>	<i>Short</i>	<i>Fat</i>	<i>Particulars</i>	<i>Thin</i>	<i>Short</i>	<i>Fat</i>
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	14,500	By Balance b/d	29,700	11,300	–
To Realization	14,216	14,216	7,108	By Capital A/c Transfer	–	2,916	21,608
To Capital A/c transfer	15,484	–	–				
	<u>29,700</u>	<u>14,216</u>	<u>21,608</u>		<u>29,700</u>	<u>14,216</u>	<u>21,608</u>

Partners' Capital Accounts

<i>Particulars</i>	<i>Thin</i>	<i>Short</i>	<i>Fat</i>	<i>Particulars</i>	<i>Thin</i>	<i>Short</i>	<i>Fat</i>
	₹	₹	₹		₹	₹	₹
To Current A/c	–	2,916	21,608	By Balance b/d	80,000	50,000	20,000
To Fat's Capital A/c Deficiency in the ratio of 8:5	990	618	–	By Current A/c (transfer)	15,484	–	–
				By Bank (Realization loss)	14,216	14,216	

To Bank	1,08,710	60,682	–	By Thin & Short Capital A/cs			1,608
	1,09,700	64,216	21,608		1,09,700	64,216	21,608

Working Notes:

(i)

Bank Account

Particulars	₹	Particulars	₹
To Realization A/c	2,74,440	By Balance b/d	44,330
To Thin's Capital A/c	14,216	By Realization A/c (Creditors)	84,650
To Short's Capital A/c	14,216	By Realization A/c (Expenses)	4,500
		By Thin's Capital A/c	1,08,710
		By Short's Capital A/c	60,682
	3,02,872		3,02,872

(ii) Fat's deficiency has been borne Thin & Short in the ratio of their fixed capitals i.e., 8:5 following the rule in *Garner vs. Murray*.

3.

Realization Account

	Particulars	₹		Particulars	₹
To	Land and Building	1,35,000	By	Provision for bad debts	6,000
To	Plant and Machinery	45,000	By	Loan from D	1,20,000
To	Furniture	25,500	By	Trade creditors	30,000
To	Investments	15,000	By	Bills payable	12,000
To	Book debts	60,000	By	Outstanding salary	7,500
To	Stock	36,000	By	Kumar - Furniture taken over (13,500 x .9)	12,150
To	Bank (Realization expenses)	15,000	By	Bank A/c - Stock Realized	43,200
To	Amit- Realization expenses	3,000		Land & Building	1,65,000
				Debtors	<u>48,000</u>
To	Bank A/c - Bill payable	11,940	By	Amit (Investment taken over)	12,750
	D's Loan	61,500			
	Creditors	18,000			
	Salary	7,500			

To	Profit transferred to partners' capital Accounts			
	Amit	9,264		
	Sumit	9,264		
	Kumar	<u>4,632</u>	23,160	
			<u>4,56,600</u>	4,56,600

Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	13,500	By Realization A/c (payment of liabilities: 11,940+ 7,500 + 54,000 + 15,000 + 18,000 + 7,500)	1,13,940
To Realization A/c (assets realized)	2,56,200	By Amit	79,314
To Kumar	12,618	By Sumit	89,064
	<u>2,82,318</u>		<u>2,82,318</u>

Partners' Capital Accounts

Particulars	Amit ₹	Sumit ₹	Kumar ₹	Particulars	Amit ₹	Sumit ₹	Kumar ₹
To Balance b/d			32,400	By Balance b/d	55,200	55,200	
To Realization A/c (Investment taken over)	12,750			By Kumar's Loan			15,000
To Realization A/c (Furniture taken over)			12,150	By General Reserve	24,600	24,600	12,300
To Bank A/c	79,314	89,064		By Realization A/c (expense)	3,000		
				By Realization A/c (profit)	9,264	9,264	4,632
				By Bank A/c			12,618
	<u>92,064</u>	<u>89,064</u>	<u>44,550</u>		<u>92,064</u>	<u>89,064</u>	<u>44,550</u>

Working Notes:

1. Payment for Bills Payable

Particulars	Amount (₹)
Bills Payable as per Balance Sheet	12,000
Less: Discount for early payment {12,000 x 6% x (1/12)}	60
Amount Paid in Cash	11,940

2. **Payment to D's Loan**

Particulars	Amount (₹)
D's Loan as per Balance Sheet	120,000.00
50% of Loan adjusted as below:	
Plant & Machinery accepted at Book Value (₹ 45,000) and ₹ 7,500 in cash.	7,500
Balance 50% of Loan adjusted as below:	
In cash after allowing discount of 10% i.e. ₹ 60,000 – ₹ 6,000 = ₹ 54,000.	54,000

3. **Payment to Trade Creditors**

Particulars	Amount (₹)
Trade Creditors as per Balance Sheet	30,000
Less: Furniture of Book Value ₹ 12,000 accepted at value ₹ 10,800	10,800
	19,200
Less: Discount @ 6.25%	1,200
Amount paid in Cash	18,000

4. **Furniture taken over by Kumar**

Particulars	Amount (₹)
Furniture as per Balance Sheet	25,500
Less: Furniture of Book Value ₹ 12,000 accepted by trade creditors	12,000
	13,500
Less: 10% of Book Value	1,350
Value of Furniture taken over by Kumar	12,150

Annexure – II

FORMATS OF FINANCIAL STATEMENTS FOR LIMITED LIABILITY PARTNERSHIPS

PART I – Form of BALANCE SHEET

Name of the Limited Liability Partnership.....

Balance Sheet as at

(Rupees in.....)

	Particulars	Note No	Figures as at the end of (Current reporting period) (in ₹) _____ (DD/MM/YYYY)	Figures as at the end of (Previous reporting period) (in ₹) _____ (DD/MM/YYYY)
	1	2	3	4
I.	PARTNERS FUNDS AND LIABILITIES			
	(1) Partner's Fund			
	(a) Partners Capital Account (i) Partners' Contribution (ii) Partners' Current Account			
	(b) Reserves and surplus			
(2)	Non-current liabilities			
	(a) Long-term borrowings			
	(b) Deferred tax liabilities (Net)			
	(c) Other Long term liabilities			
	(d) Long-term provisions			
(3)	Current liabilities			
	(a) Short-term borrowings			

	(b) Trade payables			
	(c) Other current liabilities			
	(d) Short-term provisions			
	TOTAL			
II.	ASSETS			
(1)	Non-Current Assets			
	(a) Property, Plant and Equipment and Intangible assets			
	(i) Property, Plant and Equipment			
	(ii) Intangible assets			
	(iii) Capital work-in-progress			
	(iv) Intangible assets under development			
	(b) Non-current investment			
	(c) Deferred tax assets (net)			
	(d) Long-term loans and advances			
	(e) Other non-current assets			
(2)	Current assets			
	(a) Current investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash and bank balances			
	(e) Short-term loans and advances			
	(f) Other current assets			
	TOTAL			

See accompanying notes which form part of the financial statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is expected to be realized within twelve months after the reporting date; or
 - (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.
3. A liability shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be settled in the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is due to be settled within twelve months after the reporting date; or
 - (d) the Limited Liability Partnership does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A Limited Liability Partnership shall disclose the following in the Notes to Accounts:

A. Partners' Funds

For each partner's contribution account/current account following items for the year to be disclosed separately, as agreed in the LLP Agreement:

- (a) opening balance;

- (b) Introduced/Contributed during the year;
- (c) remuneration for the year;
- (d) interest for the year;
- (e) withdrawals during the year;
- (f) share of profit or loss for the year (share in % and amount);
- (g) closing balance.

For partner's contribution account, the agreed contribution shall also be disclosed.

B. Reserves and Surplus

- (i) Reserves and Surplus shall be classified as:
 - (a) Capital Reserves;
 - (b) Revaluation Reserve;
 - (c) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
 - (d) Undistributed Surplus i.e. balance in Statement of Profit and Loss.
- (ii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Undistributed Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

- (i) Long-term borrowings shall be classified as:
 - (a) Term loans
 - From banks
 - From other parties
 - (c) Deferred payment liabilities.
 - (d) Loans and advances from related parties.
 - (e) Long term maturities of finance lease obligations
 - (f) Other loans and advances (specify nature).

- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by partners/proprietor/owners or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Terms of repayment of term loans and other loans shall be stated.

D. Long-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

E. Short-term borrowings

- (i) Short-term borrowings shall be classified as:
 - (a) Loans repayable on demand
 - From banks
 - From other parties
 - (b) Loans and advances from related parties.
 - (b) Other loans and advances (specify nature).
- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by partners or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) current maturities of Long term borrowings may be disclosed separately.

F. Trade Payables

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:-

- (a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
- (b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along

with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

- (c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;
- (d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and
- (e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.-The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. Other current liabilities

The amounts shall be classified as:

- (a) Current maturities of finance lease obligations;
- (b) Interest accrued but not due on borrowings;
- (c) Interest accrued and due on borrowings;
- (d) Income received in advance;
- (e) Other payables (specify nature);

H. Short-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

I. Property, Plant and Equipment

- (i) Classification shall be given as:
 - (a) Land.
 - (b) Buildings.

- (c) Plant and Equipment.
 - (d) Furniture and Fixtures.
 - (e) Vehicles.
 - (f) Office equipment.
 - (g) Others (specify nature).
- (ii) Assets under lease shall be separately specified under each class of asset.
- (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

J. Intangible assets

- (i) Classification shall be given as:
- (a) Goodwill.
 - (b) Brands /trademarks.
 - (c) Computer software.
 - (d) Mastheads and publishing titles.
 - (e) Mining rights.
 - (f) Copyrights, and patents and other intellectual property rights, services and operating rights.
 - (g) Recipes, formulae, models, designs and prototypes.
 - (h) Licenses and franchise.
 - (i) Others (specify nature).
- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related amortisation and impairment losses or reversals shall be disclosed separately.

K. Non-current investments

- (i) Non-current investments shall be classified as trade investments and other investments and further classified as:
 - (a) Investment property;
 - (b) Investments in Equity Instruments;
 - (c) Investments in preference shares;
 - (d) Investments in Government or trust securities;
 - (e) Investments in debentures or bonds;
 - (f) Investments in Mutual Funds;
 - (g) Investments in partnership firms;
 - (h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
- (iii) The following shall also be disclosed:
 - (a) Aggregate amount of quoted investments and market value thereof;
 - (b) Aggregate amount of unquoted investments;
 - (c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

- (i) Long-term loans and advances shall be classified as:
 - (a) Capital Advances;
 - (b) Loans and advances to related parties (giving details thereof);
 - (c) Other loans and advances (specify nature).
- (ii) The above shall also be separately sub-classified as:

- (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed separately.

M. Other non-current assets

Other non-current assets shall be classified as:

- (i) Security Deposits;
- (ii) Bank deposits with more than 12 months maturity;
- (ii) Others (specify nature).

N. Current Investments

- (i) Current investments shall be classified as:
 - (a) Investments in Equity Instruments;
 - (b) Investment in Preference Shares;
 - (c) Investments in government or trust securities;
 - (d) Investments in debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investments in partnership firms;
 - (g) Other investments (specify nature).

Under each classification, details shall be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) The following shall also be disclosed:
 - (a) The basis of valuation of individual investments;
 - (b) Aggregate amount of quoted investments and market value thereof;

- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

O. Inventories

- (i) Inventories shall be classified as:
 - (a) Raw materials;
 - (b) Work-in-progress;
 - (c) Finished goods;
 - (d) Stock-in-trade (in respect of goods acquired for trading);
 - (e) Stores and spares;
 - (f) Loose tools;
 - (g) Others (specify nature).
- (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

P. Trade Receivables

- (i) Aggregate amount of trade receivables outstanding for a period exceeding six months from the date they are due for receipt shall be stated separately.
- (ii) Trade receivables shall be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed separately.

Q. Cash and bank balances

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature).

- (ii) Other bank balances shall be classified as
 - (a) Bank Deposits - Earmarked balances with banks.
 - (b) Margin money or deposits under lien shall be disclosed separately.
 - (c) Bank deposits with original maturity for more than 3 months but less than 12 months from reporting date.
 - (d) others (specify nature)

R. Short-term loans and advances

- (i) Short-term loans and advances shall be classified as:
 - (a) Loans and advances to related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above shall also be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities (to the extent not provided for)

- (i) Contingent liabilities shall be classified as:
 - (a) Claims against the limited liability partnership not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the limited liability partnership is contingently liable.

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the LLP.....

Statement of Profit and loss for the year ended

(Rupees in.....)

	Particulars	Note	Figures for the current reporting period (in) From _____ (DD/MM/YYYY) To _____ (DD/MM/YYYY)	Figures for the previous reporting period (in) From _____ (DD/MM/YYYY) To _____ (DD/MM/YYYY)
	1	2	3	4
I.	Revenue from operations			
II.	Other income			
III.	Total Income (I + II)			
IV.	Expenses			
	Cost of Material consumed			
	Purchases of Stock in Trade			
	Changes in inventories of finished goods			
	Work-in-progress and Stock-in-Trade			
	Employee benefits expense			
	Depreciation and amortization expense			
	Finance Cost			
	Other expenses			
	Total expenses			

V	Profit before exceptional and extraordinary items, partners' remuneration and tax (III – IV)			
VI	Exceptional items			
VII	Profit before extraordinary items, partners' remuneration and tax (V – VI)			
VIII	Extraordinary Items			
IX	Profit before partners' remuneration and tax (VII – VIII)			
X	Partners' remuneration			
XI	Profit before tax (IX – X)			
XII	Tax expense:			
	(i) Current tax			
	(ii) Deferred tax			
XIII	Profit (Loss) for the period from continuing operations (XI – XII)			
XIV	Profit/(loss) from discontinuing operations			
XV	Tax expense of discontinuing operations			
XVI	Profit/(loss) from Discontinuing operations (after tax) (XIV – XV)			
XVII	Profit/ (Loss) (XIII + XVI)			

See accompanying notes which form part of the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall be applied to the income and expenditure account in like manner as they apply to a statement of profit and loss.
2. (A) Revenue from operations shall disclose separately in the notes revenue from—
 - (a) Sale of products;
 - (b) Less: Excise duty
 - (c) Sale of services;
 - (d) Other operating revenues;(B) In respect of a finance Limited Liability Partnership, revenue from operations shall include revenue from—
 - (a) Interest; and
 - (b) Other financial services.
3. Finance Costs
Finance costs shall be classified as:
 - (a) Interest expense; (other than interest on partners' capital)
 - (b) Interest on partners' capital
 - (c) Other borrowing costs;
 - (d) Applicable net gain/loss on foreign currency transactions and translation.
4. Other income
Other income shall be classified as:
 - (a) Interest Income;
 - (b) Dividend Income;
 - (c) Net gain/loss on sale of investments;
 - (d) Other non-operating income (net of expenses directly attributable to such income).

5. Following shall be disclosed by way of notes regarding aggregate expenditure and income on the following items:—
- (i)
 - (a) Employee Benefits Expense showing separately (i) salaries and wages, (ii) Contribution to provident and other funds, (iii) staff welfare expenses;
 - (b) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000 whichever is higher;
 - (c) Adjustments to the carrying amount of investments;
 - (d) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
 - (e) Details of items of exceptional and extraordinary nature;
 - (f) Prior period items.
 - (ii) Expenditure incurred on each of the following items, separately for each item:—
 - (a) Consumption of stores and spare parts;
 - (b) Power and fuel;
 - (c) Rent;
 - (d) Repairs to buildings;
 - (e) Repairs to machinery;
 - (f) Insurance;
 - (g) Rates and taxes, excluding, taxes on income;
 - (h) Miscellaneous expenses.

Annexure – II

FORMATS OF FINANCIAL STATEMENTS FOR LIMITED LIABILITY PARTNERSHIPS

PART I – Form of BALANCE SHEET

Name of the Limited Liability Partnership.....

Balance Sheet as at

(Rupees in.....)

	Particulars	Note No	Figures as at the end of (Current reporting period) (in ₹) _____ (DD/MM/YYYY)	Figures as at the end of (Previous reporting period) (in ₹) _____ (DD/MM/YYYY)
	1	2	3	4
I.	PARTNERS FUNDS AND LIABILITIES			
	(1) Partner's Fund			
	(a) Partners Capital Account (i) Partners' Contribution (ii) Partners' Current Account			
	(b) Reserves and surplus			
(2)	Non-current liabilities			
	(a) Long-term borrowings			
	(b) Deferred tax liabilities (Net)			
	(c) Other Long term liabilities			
	(d) Long-term provisions			
(3)	Current liabilities			
	(a) Short-term borrowings			

	(b) Trade payables			
	(c) Other current liabilities			
	(d) Short-term provisions			
	TOTAL			
II.	ASSETS			
(1)	Non-Current Assets			
	(a) Property, Plant and Equipment and Intangible assets			
	(i) Property, Plant and Equipment			
	(ii) Intangible assets			
	(iii) Capital work-in-progress			
	(iv) Intangible assets under development			
	(b) Non-current investment			
	(c) Deferred tax assets (net)			
	(d) Long-term loans and advances			
	(e) Other non-current assets			
(2)	Current assets			
	(a) Current investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash and bank balances			
	(e) Short-term loans and advances			
	(f) Other current assets			
	TOTAL			

See accompanying notes which form part of the financial statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is expected to be realized within twelve months after the reporting date; or
 - (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.
3. A liability shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be settled in the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is due to be settled within twelve months after the reporting date; or
 - (d) the Limited Liability Partnership does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A Limited Liability Partnership shall disclose the following in the Notes to Accounts:

A. Partners' Funds

For each partner's contribution account/current account following items for the year to be disclosed separately, as agreed in the LLP Agreement:

- (a) opening balance;

- (b) Introduced/Contributed during the year;
- (c) remuneration for the year;
- (d) interest for the year;
- (e) withdrawals during the year;
- (f) share of profit or loss for the year (share in % and amount);
- (g) closing balance.

For partner's contribution account, the agreed contribution shall also be disclosed.

B. Reserves and Surplus

- (i) Reserves and Surplus shall be classified as:
 - (a) Capital Reserves;
 - (b) Revaluation Reserve;
 - (c) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
 - (d) Undistributed Surplus i.e. balance in Statement of Profit and Loss.
- (ii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Undistributed Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

- (i) Long-term borrowings shall be classified as:
 - (a) Term loans
 - From banks
 - From other parties
 - (c) Deferred payment liabilities.
 - (d) Loans and advances from related parties.
 - (e) Long term maturities of finance lease obligations
 - (f) Other loans and advances (specify nature).

- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by partners/proprietor/owners or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Terms of repayment of term loans and other loans shall be stated.

D. Long-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

E. Short-term borrowings

- (i) Short-term borrowings shall be classified as:
 - (a) Loans repayable on demand
 - From banks
 - From other parties
 - (b) Loans and advances from related parties.
 - (b) Other loans and advances (specify nature).
- (ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by partners or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) current maturities of Long term borrowings may be disclosed separately.

F. Trade Payables

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:-

- (a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
- (b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along

with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

- (c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;
- (d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and
- (e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.-The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. Other current liabilities

The amounts shall be classified as:

- (a) Current maturities of finance lease obligations;
- (b) Interest accrued but not due on borrowings;
- (c) Interest accrued and due on borrowings;
- (d) Income received in advance;
- (e) Other payables (specify nature);

H. Short-term provisions

The amounts shall be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

I. Property, Plant and Equipment

- (i) Classification shall be given as:
 - (a) Land.
 - (b) Buildings.

- (c) Plant and Equipment.
 - (d) Furniture and Fixtures.
 - (e) Vehicles.
 - (f) Office equipment.
 - (g) Others (specify nature).
- (ii) Assets under lease shall be separately specified under each class of asset.
- (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

J. Intangible assets

- (i) Classification shall be given as:
- (a) Goodwill.
 - (b) Brands /trademarks.
 - (c) Computer software.
 - (d) Mastheads and publishing titles.
 - (e) Mining rights.
 - (f) Copyrights, and patents and other intellectual property rights, services and operating rights.
 - (g) Recipes, formulae, models, designs and prototypes.
 - (h) Licenses and franchise.
 - (i) Others (specify nature).
- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related amortisation and impairment losses or reversals shall be disclosed separately.

K. Non-current investments

- (i) Non-current investments shall be classified as trade investments and other investments and further classified as:
 - (a) Investment property;
 - (b) Investments in Equity Instruments;
 - (c) Investments in preference shares;
 - (d) Investments in Government or trust securities;
 - (e) Investments in debentures or bonds;
 - (f) Investments in Mutual Funds;
 - (g) Investments in partnership firms;
 - (h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
- (iii) The following shall also be disclosed:
 - (a) Aggregate amount of quoted investments and market value thereof;
 - (b) Aggregate amount of unquoted investments;
 - (c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

- (i) Long-term loans and advances shall be classified as:
 - (a) Capital Advances;
 - (b) Loans and advances to related parties (giving details thereof);
 - (c) Other loans and advances (specify nature).
- (ii) The above shall also be separately sub-classified as:

- (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed separately.

M. Other non-current assets

Other non-current assets shall be classified as:

- (i) Security Deposits;
- (ii) Bank deposits with more than 12 months maturity;
- (ii) Others (specify nature).

N. Current Investments

- (i) Current investments shall be classified as:
 - (a) Investments in Equity Instruments;
 - (b) Investment in Preference Shares;
 - (c) Investments in government or trust securities;
 - (d) Investments in debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investments in partnership firms;
 - (g) Other investments (specify nature).

Under each classification, details shall be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

- (ii) The following shall also be disclosed:
 - (a) The basis of valuation of individual investments;
 - (b) Aggregate amount of quoted investments and market value thereof;

- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

O. Inventories

- (i) Inventories shall be classified as:
 - (a) Raw materials;
 - (b) Work-in-progress;
 - (c) Finished goods;
 - (d) Stock-in-trade (in respect of goods acquired for trading);
 - (e) Stores and spares;
 - (f) Loose tools;
 - (g) Others (specify nature).
- (ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

P. Trade Receivables

- (i) Aggregate amount of trade receivables outstanding for a period exceeding six months from the date they are due for receipt shall be stated separately.
- (ii) Trade receivables shall be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed separately.

Q. Cash and bank balances

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature).

- (ii) Other bank balances shall be classified as
 - (a) Bank Deposits - Earmarked balances with banks.
 - (b) Margin money or deposits under lien shall be disclosed separately.
 - (c) Bank deposits with original maturity for more than 3 months but less than 12 months from reporting date.
 - (d) others (specify nature)

R. Short-term loans and advances

- (i) Short-term loans and advances shall be classified as:
 - (a) Loans and advances to related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above shall also be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities (to the extent not provided for)

- (i) Contingent liabilities shall be classified as:
 - (a) Claims against the limited liability partnership not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the limited liability partnership is contingently liable.

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the LLP.....

Statement of Profit and loss for the year ended

(Rupees in.....)

	Particulars	Note	Figures for the current reporting period (in) From _____ (DD/MM/YYYY) To _____ (DD/MM/YYYY)	Figures for the previous reporting period (in) From _____ (DD/MM/YYYY) To _____ (DD/MM/YYYY)
	1	2	3	4
I.	Revenue from operations			
II.	Other income			
III.	Total Income (I + II)			
IV.	Expenses			
	Cost of Material consumed			
	Purchases of Stock in Trade			
	Changes in inventories of finished goods			
	Work-in-progress and Stock-in-Trade			
	Employee benefits expense			
	Depreciation and amortization expense			
	Finance Cost			
	Other expenses			
	Total expenses			

V	Profit before exceptional and extraordinary items, partners' remuneration and tax (III – IV)			
VI	Exceptional items			
VII	Profit before extraordinary items, partners' remuneration and tax (V – VI)			
VIII	Extraordinary Items			
IX	Profit before partners' remuneration and tax (VII – VIII)			
X	Partners' remuneration			
XI	Profit before tax (IX – X)			
XII	Tax expense:			
	(i) Current tax			
	(ii) Deferred tax			
XIII	Profit (Loss) for the period from continuing operations (XI – XII)			
XIV	Profit/(loss) from discontinuing operations			
XV	Tax expense of discontinuing operations			
XVI	Profit/(loss) from Discontinuing operations (after tax) (XIV – XV)			
XVII	Profit/ (Loss) (XIII + XVI)			

See accompanying notes which form part of the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall be applied to the income and expenditure account in like manner as they apply to a statement of profit and loss.
2. (A) Revenue from operations shall disclose separately in the notes revenue from—
 - (a) Sale of products;
 - (b) Less: Excise duty
 - (c) Sale of services;
 - (d) Other operating revenues;(B) In respect of a finance Limited Liability Partnership, revenue from operations shall include revenue from—
 - (a) Interest; and
 - (b) Other financial services.
3. Finance Costs
Finance costs shall be classified as:
 - (a) Interest expense; (other than interest on partners' capital)
 - (b) Interest on partners' capital
 - (c) Other borrowing costs;
 - (d) Applicable net gain/loss on foreign currency transactions and translation.
4. Other income
Other income shall be classified as:
 - (a) Interest Income;
 - (b) Dividend Income;
 - (c) Net gain/loss on sale of investments;
 - (d) Other non-operating income (net of expenses directly attributable to such income).

5. Following shall be disclosed by way of notes regarding aggregate expenditure and income on the following items:—
- (i)
 - (a) Employee Benefits Expense showing separately (i) salaries and wages, (ii) Contribution to provident and other funds, (iii) staff welfare expenses;
 - (b) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000 whichever is higher;
 - (c) Adjustments to the carrying amount of investments;
 - (d) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
 - (e) Details of items of exceptional and extraordinary nature;
 - (f) Prior period items.
 - (ii) Expenditure incurred on each of the following items, separately for each item:—
 - (a) Consumption of stores and spare parts;
 - (b) Power and fuel;
 - (c) Rent;
 - (d) Repairs to buildings;
 - (e) Repairs to machinery;
 - (f) Insurance;
 - (g) Rates and taxes, excluding, taxes on income;
 - (h) Miscellaneous expenses.

