CHAPTER:1 FUNDAMENTALS

Special Aspects of Final Accounts of Partnership

1. Fixed and Fluctuating Capital Accounts

The partners of a firm have the option to decide whether their capital accounts may remain fixed or fluctuating. This aspect is not much relevant in a sole trading business, where the capital account is usually fluctuating. Stability in capital balances is important in a firm, because the capital investment is usually one of the major aspects of partner's business relationship. When the capital accounts are said to be 'fixed' it implies that the capital accounts will remain steady for a reasonably long time. In other words the daily items of credit and debit to partners will not be recorded in the capital accounts. They will open current accounts in each partner's name. These current accounts are regarded as subsidiary capital accounts. Daily transactions related to a partner are recorded in his current account, instead of capital account. Thus the current account keeps on changing as the transactions are posted into it, while the capital balance stays the same. However, if there is any additional capital investment by a partner or capital withdrawal, other than minor routine drawings, it will be recorded in the capital account, not in the current account. In the event of rescheduling of capitals transfers can be made from current accounts to capital or vice versa to adjust the capital balances.

When the capital accounts are fluctuating there will not be a current account in the name of partner. All transactions related to a partner, such as salary to a partner, interest on capital, additional capital investment and similar items are directly credited to the capital accounts of partner. Drawings, interest on drawings capital withdrawal etc. are debited to the capital accounts. Thus the balance in the capital account keeps on changing with every transaction posted into it.

The following comparative table shows the difference between fixed and fluctuating capital accounts:

Fixed Capital	Fluctuating Capital
1. **O**pening and Closing balances in the capital account will remain the same.	**O**pening and closing balances rarely remain the same.
2. **C**urrent Accounts will be opened in the name of partners when capitals are fixed.	**C**urrent accounts are not required.
3. **R**egular transactions related to partners are not entered in the capital accounts.	**A**ll regular transactions related to partners are recorded in their capital accounts.
4. **F**ixed capital accounts always have credit balance	**F**luctuating capital accounts can sometimes have debit balance

The following accounts with imaginary figures show the difference between Fixed and Fluctuating Capital Accounts.

a. Fixed Capital

Illustration 1.01

Abraham's Capital Account

Date	Particulars	Amount	Date	Particulars	Amount
2002			2002	By Balance b/d	30,000
Dec 31	To Balance c/d	30,000	Jan1		
		30,000			30,000

Abraham's Current Account

Date	Particulars	Amount	Date	Particulars	Amount
2002			2002		
Dec 31	To Drawings A/c	18,100	Jan 01	By Balance b/d	2,000
Dec 31	To interest on drawings	200			
			Dec 31	By Salary	6,000
			Dec 31	By Commission	1,500
Dec 31	To balance c/d	5,000	Dec 31	By Interest on capital	1,800
			Dec 31	By Net divisible profit	12,000
		23,300			23,300

b. Fluctuating Capital

Abraham's Capital Account

Date	Particulars	Amount	Date	Particulars	Amount
2002			2002	By Balance b/d *	32,000
Dec 31	To Drawings	18,100	Jan 01		
	To Interest on Capital	200	Dec 31	By Salary	6,000
	To Balance c/d	35,000	Dec 31	By Commission	1,500
			Dec 31	By Interest on capital	1,800
				By Net divisible profit	12,000
		53,300			53,300

* Note: Opening balance of capital account in part (b) includes current account balance also.

2. Division of Profit among Partners

Profit making and profit sharing are the main objectives of partnership business. When the partners do not have any special conditions regarding the profit distribution the task of profit sharing is a simple, one-step operation of dividing the profit in the given ratio. But in actual practice the partners are compelled to include many conditions such as interest on capital, interest on drawings, salaries, commission on profit etc. The purpose of these special conditions is to fairly compensate extra capital, extra effort or similar additional factors contributing to the profitability of the firm.

Thus the profit distribution becomes little more complex. A profit and loss appropriation account is prepared with full details of profit distribution. This is prepared as a supplementary account to the profit and loss account, prior to preparing the balance sheet.

Illustration 1.02

A & B are equal partners in a firm with capitals of Rs.75,000 and Rs.50,000 on 1st January 2002. A is entitled to a salary of Rs.24,000 per annum and B is entitled to a salary of Rs.18,000 per annum. They have withdrawn 50% of their salaries during the year. A and B are entitled to commissions at the rate of 5% and 3% respectively on the net profit after salary.

Net profit during the year 2002 before partner's salary amounted to Rs.84,000. Prepare:

a. Profit and Loss Appropriation Account

b. Capital Accounts of partners (assuming capitals are fluctuating)

c. Capital Accounts and Current Accounts of partners (assuming capitals are fixed)

Profit & Loss Appropriation A/c

Particulars	Amount	Particulars	Amount
To Salary – A	*24,000*	*By P & L Account-profit*	*84,000*
To Salary – B	*18,000*		
Commission to A (42,000x5/100)	*2,100*		
Commission to B (42,000x3/100)	*1,260*		
Net Divisible Profit A	*19,320*		
B	*19,320*		
	84,000		*84,000*

Note: when profit sharing ratio is not given in the question; it should be shared equally.

a. When capital accounts are fluctuating.

Capital Accounts

Particulars	**A**	**B**	**Particulars**	**A**	**B**
To Cash	*12,000*	*9,000*	*By Balance b/d*	*75,000*	*50,000*
			By Salary	*24,000*	*18,000*
To Balance c/d	*108,420*	*79,580*	*By Commission*	*2,100*	*1,260*
			By Net Divisible Profit	*19,320*	*19,320*
	120,420	*88,580*		*120,420*	*88,580*

b. When capital accounts are fixed

Capital Accounts					
Particulars	**A**	**B**	**Particulars**	**A**	**B**
			By Balance b/d	*75,000*	*50,000*
To Balance c/d	*75,000*	*50,000*			
	75,000	*75,000*		*75,000*	*50,000*

Current Accounts					
Particulars	**A**	**B**	**Particulars**	**A**	**B**
To Cash	*12,000*	*9,000*	*By Salary*	*24,000*	*18,000*
			By Commission	*2,100*	*1,260*
To Balance c/d	*33,420*	*29,580*	*By Net Divisible*	*19,320*	*19,320*
	45,420	*38,580*	*Profit*	*45,420*	*38,580*

Illustration 1.03

A & B started business on 1st January 2001 with capitals of Rs.75,000 and Rs. 50,000 respectively. On 31st December 2001, the drawings account of A showed a debit balance of Rs.8,000 and that of B showed a debit balance of Rs.5,000. The partnership deed provided for interest on capital @6%. Interest on drawings is to be charged @3% on the closing balance of the year irrespective of the date of drawing.

Their firm earned a profit of Rs.22,110 for the year 2001. Prepare profit and loss appropriation account and capital accounts of the partners.

Profit & Loss Appropriation A/c			
Particulars	Amount	Particulars	Amount
To Interest on Cap A	*4,500*	*By P&L account*	*22,110*
B	*3,000*	*By Interest on Drawings A*	*240*
		B	*150*
To Net Divisible Prof. A	*7,500*		
B	*7,500*		
	22,500		*22,500*

Capital Accounts					
Particulars	**A**	**B**	**Particulars**	**A**	**B**
To Drawings	*8,000*	*5,000*	*By Cash - Op Capital*	*75,000*	*50,000*
To Int. on drawings	*240*	*150*	*By Interest on capital*	*4,500*	*3,000*
To balance c/d	*78,760*	*55,350*	*By Net Divisible Profit*	*7,500*	*7,500*
	87,000	*60,500*		*87,000*	*60,500*

Illustration 1.04

A & B started business with Rs.15,000 each on 1st January, 2001. A made monthly drawings of Rs.750 and B made monthly drawings of Rs.500 from the business. Their profit for the year 2001 amounted to Rs.18,000. The partners are entitled to interest on capitals @6% p.a. No interest is charged on drawings. Prepare profit and loss appropriation account and the capital accounts of partners.

Profit & Loss Appropriation A/c			
Particulars	**Amount**	**Particulars**	**Amount**
To Interest on capital A	*900*	*By Profit & Loss A/c*	*18,000*
B	*900*		
To Net Profit A	*8,100*		
B	*8,100*		
	18,000		*18,000*

A's Capital Account			
Particulars	**Amount**	**Particulars**	**Amount**
To Drawings	*9,000*	*By Cash - Op Capital*	*15,000*
		By Interest on capital	*900*
To balance c/d	*15,000*	*By Net profit*	*8,100*
	24,000		*24,000*

B's Capital Account			
Particulars	**Amount**	**Particulars**	**Amount**
To drawings	*6,000*	*By Cash - Op Capital*	*15,000*
		By Interest on capital	*900*
To balance c/d	*18,000*	*By Net profit*	*8,100*
	24,000		*24,000*

Illustration 1.05

A & B started business with capitals of Rs.75,000 and Rs.50,000 respectively. They have agreed to share profits and losses in the ratio 3:2. A is entitled to salary of Rs.12,000 p.a. and B is entitled to Rs.18,000 p.a. Interest at a flat rate of 5% would be charged on the drawings exceeding the amount of salary allowed. Interest on capital is allowed @ 12%.

The total drawings of A amounted to Rs.20,000 and B Rs.23,000. Profit prior to partner's salary amounted to Rs.44,000.

Prepare profit and loss appropriation account and the capital accounts of partners.

Profit & Loss Appropriation A/c

Particulars	Amount	Particulars	Amount
To Salary – A	*12,000*	*By P&L Account*	*44,000*
- B	*18,000*	*By int on drawings - A*	*400*
To Int. on Capital – A	*9,000*	*- B*	*250*
- B	*6,000*	*By Net loss transferred*	
		A - 210	
		B - 140	*350*
	45,000		*45,000*

A's Capital Account

Particulars	Amount	Particulars	Amount
To Drawings	*20,000*	*By Cash - Op Capital*	*75,000*
To Int on drawings	*400*	*By Salary*	*12,000*
To Net loss	*210*	*By Interest on capital*	*9,000*
To balance c/d	*75,390*		
	96,000		*96,000*

B's Capital Account

Particulars	Amount	Particulars	Amount
To Drawings	*23,000*	*By Cash - Op Capital*	*50,000*
To Int on drawings	*250*	*By Salary*	*18,000*
To Net loss	*140*	*By Interest on capital*	*6,000*
To balance c/d	*50,610*		
	74,000		*74,000*

3. Past Adjustments

3.1. Omission of Interest on Capital / Interest on Drawings

This step is almost like rectification of errors that you studied last year. Let us first consider omission of interest on capital. Interest on capital is taken out of the available net profit and distributed to partners.

Thereafter the balance of net profit is distributed in the profit sharing ratio. So, when the interest on capital is omitted in the first place it means that the entire net profit is distributed.

Now how do we correct it?

Simple, take out the total amount required for paying interest on capital from the capital accounts of partners in the profit sharing ratio, and give it back to them as interest.

What is the use of taking out from partners and give them back the same?

We usually do not give back exactly what we take out. The profit sharing ratio plays a very important role here. See the next illustration. We take out the total interest divided equally from the three partners, and redistribute them as interest according to capital balance. The point to notice here is, that there is no definite relationship between profit sharing ratio and capital balance. In the illustration the partners are sharing profits and losses equally even though their capitals are not equal.

Illustration 1.06

A, B and C who are equal partners in a firm have capitals of Rs.30,000; Rs.30,000 and Rs.15,000 respectively. The profit for the year 2001 was distributed equally. However, interest on capital @10% was omitted. Pass a journal entry to rectify the error.

Details	**A**	**B**	**C**	**Total**
Interest to be credited	3,000	3,000	1,500	7,500
The amount to be debited (7500/3)	2,500	2,500	2,500	7,500
Net adjustment	**500(Cr.)**	**500 (Cr.)**	**1,000(Dr)**	**0**

Journal Entry

C's Capital account Dr. 1,000

To A's Capital account 500

To B's Capital account 500

(Capital adjustment for rectification of omission)

Illustration 1.07

A, B and C sharing profits and losses in the ratio 2:2:1 had capitals of Rs.50,000 each.. The profit for the year 2001 was distributed without providing for interest on capital @10% as agreed in the Partnership Deed. Pass a journal entry to rectify the error.

Details	A	B	C	Total
Interest to be credited	5,000	5,000	5,000	15,000
The amount to be debited (15000 at 2:2:1	6,000	6,000	3,000	15,000
Net adjustment	**1,000(Dr.)**	**1,000(Dr.)**	**2,000(Cr)**	**0**

Journal Entry
A's Capital Account Dr.1,000

B's Capital Account Dr.1,000

To C's Capital Account 2,000

(Capital adjustment for rectification of omission)

Illustration 1.08

A, B and C have distributed their profit for the year 2001 in the ratio 2:1:1. However they left out the interest @10% on their fixed capitals of Rs.40,000, Rs,40,000 and Rs. 20,000 respectively. Pass a journal entry to rectify the omission.

Details	A	B	C	Total
Interest to be credited	4,000	4,000	2,000	10,000
The amount to be debited (10,000 at 2:1:1	5,000	2,500	2,500	10,000
Net adjustment	1,000(Dr.)	1,500(Cr.)	500(Dr)	0

Journal Entry

A's Current Account Dr. 1,000

C's Current Account Dr. 500

To B's Current Account 1,500

(Adjustment for rectification of omission

Note: When capitals are fixed, all adjustment should be done through current account.

Illustration 1.09

A, B and C have distributed their profit for the year 2001 in their profit sharing ratio 2:1:1 after crediting interest on capitals @10% instead of 8% on their fixed capitals of Rs.40,000, Rs.40,000 and Rs.20,000 respectively. Pass journal entry to rectify the error.

Details	**A**	**B**	**C**	**Total**
Excess interest to debit (2%)	800	800	400	2,000
The total amount to credit (2000 at 2:2:1	1,000	500	500	2,000
Net adjustment	**200(Cr.)**	**300(Dr.)**	**100(Cr)**	**0**

Journal Entry

B's Current Account Dr.300

To A's Current Account 200

To C's Current Account 100

(Adjustment for rectification of omission)

<u>Illustration 1.10</u>

A, B and C started business with capitals of Rs.100,000 Rs.80,000 and Rs.60,000 respectively. They agreed to share profits and losses equally. Their partnership deed provided for interest on capital @ 10%. Interest on drawings have been estimated to be Rs.250 on A, Rs.200 on B and Rs.150 on C. Interest on capital had been credited to partners at 8% instead on 10%. Interest on drawings had been completely omitted. Pass a journal entry to rectify the above errors.

Details	A	B	C	Total
Interest to credited @2%	+2,000	+1,600	+1,200	4,800
Interest on Drawings	-250	-200	-150	-600
Total amount reversed (in profit sharing ratio)	-1400	-1,400	-1,400	-4,200
Net adjustment	**350(Cr.)**		**350(Dr)**	**0**

Journal Entry

C's Capital Account Dr. 350

A's Capital Account 350

(Capital adjustment for rectification)

3.2 Redistribution of Profit in a Different Ratio

Illustration 1.11

A B and C have distributed their profits and losses in the ratio 3:2:1. They have decided to share profits and losses equally with effect from the last three years. The previous three years' profits have been Rs.21,000, Rs.18,000 and Rs. 24,000. You are required to pass a journal entry to give effect to the above arrangement.

Details	A	B	C	Total
Profit for the 3 years reversed **Dr**.	31,500	21,000	10,500	63,000
The redistributed equally **Cr.**	21,000	21,000	21,000	63,000
Net Adjustment	10,500(Dr.)	0	10,500(Cr)	0

Journal Entry

A's Capital Account Dr.10,500

To C's Capital Account 10,500

(Adjustment to effect redistribution of profit)

3.3 Omission of Outstanding Expenses and Incomes

Outstanding expenses and outstanding incomes have direct effect on the net profit. Outstanding expense is an expense in the first place and a liability as well. When it is omitted it means a higher profit is distributed to partners and a liability is not provided in the books. Outstanding income has the opposite effect. Rectification of these errors is a simple procedure.

i) If the number of items is less, correct it by passing simple rectification entry, by debiting outstanding income, crediting outstanding expense and passing the difference into capital account. This way you are creating asset account in the books for the outstanding income, creating liability account for the outstanding expense, and transferring the net loss or gain into capital accounts.

ii) When the number of items involved is more or when it is specifically asked in the question, you should open a **profit and loss adjustment account**.

iii) P&L adjustment account can be safely assumed as a combined capital account of partners. When you want debit partner's capital account you can debit P&L adjustment account instead.

iv) When there is an outstanding expense, we usually debit capital accounts and credit outstanding expense account. Now you debit P&L adjustment account for any outstanding expense and credit it for the outstanding income.

v) The net balance of profit and loss adjustment account is transferred to the capital accounts of partners in the profit sharing ratio.

Illustration 1.12

A, B and C have distributed their profit for the year ended 31st December, 2001 in their profit sharing ratio of 2:1:1. However it was found out in January, 2002 that outstanding expenses of Rs.3,500; and prepaid expenses Rs.1,500 have been left out while preparing the profit and loss account for the year 2001.

You are required to rectify this error by:

a) Passing Journal Entry (without Profit and Loss Adjustment Account)

b) Through Profit and Loss Adjustment Account.

a. Rectification without opening P&L Adjustment Account

Details	A	B	C
Credit Outstanding Exp (Rs.3500) and **Dr.>**	1,750	875	875
Debit Prepaid Exp (Rs.1,500) and **Cr.>**	750	375	375
	1,000(Dr)	500(Dr.)	500(Dr.)

Rectification Entry:

Prepaid Expenses Account Dr. 1,500

A's Capital Account Dr. 1,000

B's Capital Account Dr. 500

C's Capital Account Dr. 500

To Outstanding Expenses 3500

(Rectification of omission)

b. Rectification through P&L Adjustment Account

Journal Entries

Profit and loss adjustment account Dr. 3,500

To Outstanding Expenses 3,500

(Outstanding expenses brought into books)

Prepaid expenses account Dr.1,500

To Profit and Loss Adjustment Account 1,500

(Omission of prepaid expenses brought into books)

A's Capital Account Dr. 1,000

B's Capital Account Dr. .500

C's Capital Account Dr. 500

To Profit and Loss Adjustment Account 2,000

(Net balance in account transferred)

Profit and Loss Adjustment Account

Particulars	Amount	Particulars	Amount
To Outstanding expense	*3,500*	*By Prepaid expense*	*1,500*
		By Net adjustment	
		A 1,000	
		B 500	
		C 500	*2,000*
	3,500		*3,500*

Illustration 1.13

A, B and C have distributed their profit for the year ended 31st December, 2001 equally as provided in the partnership deed. However it was subsequently found out that commission received and credited in P& L account included Rs. 6,000 received in advance and interest accrued on investment Rs.4,500 are unaccounted.

Pass a journal entry to give effect to the above items in the books and prepare profit and loss adjustment account.

Journal Entries

P&L Adjustment account Dr. 6,000

To Commission Rec'd in Advance 6,000

(Omission of advance income rectified)

Accrued Interest Account Dr. 4,500

To P& L Adjustment Account 4,500

(Omission of accrued income rectified)

A's Capital Account Dr. 500

B's Capital Account Dr.500

C's Capital Account Dr.500

To P&L Adjustment Account 1,500

(Net difference transferred)

Profit and Loss Adjustment Account

Particulars	Amount	Particulars	Amount
To Commission Advance	*6,000*	*By Acc. Interest*	*4,500*
		By Net adjustment	
		A 500	
		B 500	
		C 500	*1,500*
	6,000		***6,000***

4. Guarantee of Profits

Sometimes partners agree to guarantee minimum profit to a partner as a special privilege. There can be many reasons for granting such a privilege. Attracting a reputed individual, who is unwilling to bear the risk of income fluctuations to become a partner, is one of such reasons. If the share of profit for such a partner falls short of the minimum amount guaranteed, the other partners will adjust that shortage form their share of profit according to the agreed conditions. If the share of profit of the partner holding guarantee privilege comes equal or more than the guaranteed sum, that actual share will be given without any adjustments.

Illustration 1.14

A, B and C have agreed to share their profits and losses in the ratio 3:3:2 in which C is guaranteed a minimum profit of Rs.12,000. The divisible profit for the year 2001 amounted to Rs.42,000. Show distribution of profit.

Profit & Loss Appropriation A/c

Particulars	Amount	Particulars	Amount
To A's Capital 15,750		*By P & L Account*	*42,000*
less adjusted to C 750	*15,000*		
To B's Capital 15,750			
less adjusted to C 750	*15,000*		
To C's Capital 10,500			
add share adjusted 1,500	*12,000*		
from A & B			
	42,000		*42,000*

If the entries of deduction and subtraction seem confusing, you can directly put C's share of 12,000 in his name and divide the balance amount of 30,000 in the ratio 3:3 (equally). The next illustration is done that way. But remember when you do this way in the examination don't forget to show the steps/workings to convince the examiner that you know the concept clear.

Illustration 1.15

A, B and C sharing profits and losses in the ratio of 3:2:1 in with C having a minimum guarantee of Rs.8,000. The profit available for distribution at the end of the year was found to be Rs.42,000. Show distribution of profit.

Profit & Loss Appropriation A/c

Particulars	Amount	Particulars	Amount
To A's Capital	*20,400*	*By P & L Account*	*42,000*
(34,000x3/5)			
To B's Capital	*13,600*		
(34,000x2/5)			
To C's Capital	*8,000*		
	42,000		*42,000*

You can divide 42,000 in the ratio 3:2:1 and then rearrange the amount. But here we are directly crediting C's share and dividing the balance of Rs.34,000 in the ratio 3:2.

Illustration 1.16

A, B and C are partners sharing profits and losses in the ratio 2:1:1, with capitals of Rs.40,000, Rs.30,000 and Rs.20,000 respectively. C's minimum profit after interest on capitals @6% has been guaranteed to be not less than Rs.10,000. A & B have agreed that if C's profit falls below the guaranteed sum such deficiency would be shared by them equally. The net profit before interest on capitals is estimated to be Rs.38,400. Prepare profit and loss appropriation account.

Here you cannot adopt direct distribution as in the previous case since the partners will bear the loss equally. When you distribute balance of profit after paying the partner with guarantee, the loss is automatically gets distributed in the profit sharing ratio. If any other ratio is to be applied for sharing the loss, you must adopt 'subtraction and addition' method.

Profit & Los Appropriation A/c

Particulars	Amount	Particulars	Amount
To Interest on Capitals: A	*2,400*	*By P&L Account*	*38,400*
B	*1,800*		
C	*1,200*		
Profit to A 16,500			
Less: C's Share Adj. 875	*15,625*		
Profit share to B 8,250			
Less: C's Share Adj. 875	*7,375*		
Profit Share to C 8,250			
Add: Share Adj A+B 1,750	*10,000*		
	38,400		*38,400*

Illustration 1.17

A, B and C are partners sharing profits and losses in the ratio 2:1:1, with capitals of Rs.40,000, Rs.30,000 and Rs.20,000 respectively. C's minimum profit after interest on capitals @6% has been guaranteed to be not less than Rs.10,000. A & B have agreed that if C's profit falls below the guaranteed sum such deficiency would be shared by them in the ratio 3:2. The net profit before interest on capitals is estimated to be Rs.38,400. Prepare profit and loss appropriation account.

Profit & Los Appropriation A/c

Particulars	Amount	Particulars	Amount
To Interest on Capitals: A	*2,400*	*By P&L Account*	*38,400*
B	*1,800*		
C	*1,200*		
Profit to A 16,500			
Less: C's Share Adj. 1,050	*15,450*		
Profit share to B 8,250			
Less: C's Share Adj. 700	*7,550*		
0Profit Share to C 8,250			
Add: Share Adj A+B 1,750	*10,000*		
	38,400		*38,400*

Illustration 1.18

A, B and C are partners sharing profits and losses in the ratio 2:1:1, with capitals of Rs.40,000, Rs.30,000 and Rs.20,000 respectively. A has personally guaranteed that he shall bear the deficiency if C's share of profit after interest on capitals of partners @6% falls below Rs.10,000. The net profit before interest on capitals is estimated to be Rs.38,400. Prepare profit and loss appropriation account.

Profit & Los Appropriation A/c			
Particulars	**Amount**	**Particulars**	**Amount**
To Interest on Capitals: A	*2,400*	*By P&L Account*	*38,400*
B	*1,800*		
C	*1,200*		
Profit to A 16,500			
Less: C's Share Adj. 1,750	*14,750*		
Profit share to B	*8,250*		
0Profit Share to C 8,250			
Add: Share Adj A 1,750	*10,000*		
	38,400		*38,400*

5. Accounting for Joint Life Policy

A partner ceases to be a partner either by retirement or death. At the time of retirement or death of a partner the continuing partners, have to settle his dues. Since retirement is a pre-planned event proper arrangement for this settlement can be made. Death comes unexpectedly. The firm suffers the loss of an experienced partner and it has the added burden of settling a huge amount of capital and other dues to the deceased partner. Unlike retirement, death of a partner results in a financial emergency, as the amount due cannot be delayed for long time. Unless adequate precautions are made, this emergency can turn into deep financial crisis.

(Please refer Chapter 4 – Retirement of Partners for details on Joint Life Policy)

Interest on Capital

Interest is allowed on partner's capitals only if there is a specific agreement in the partnership deed. When interest is allowed on partner's capital it should be calculated on the basis of period of capital investment. Suppose a partner makes additional investment after three months from the starting of a year, interest on this additional capital is allowed for nine months only, not for the full year.

<u>Illustration - 1.19</u>

A & B started business on 1st January 2001, with capitals of Rs.50,000 each. A introduced additional capital of Rs.25,000 on 1st July 2001 and B introduced the same amount on 1st October 2001.

Calculate interest on capital @12%, payable to A and B at the end of the year.

Interest on capital - A

Opening capital for 12 months (50,000 x 12%)	=	6,000
On Additional Capital 6 months (25,000x 12%x6/12)	=	1,500
Total interest payable to A		7,500

Interest on capital - B

On opening capital for 12 months (50,000 x 12%)	6,000
On additional capital for 3 months (25,000x12%x3/12)	750
	6,750

Illustration 1.20

On 1st January 2001 the capital accounts of A & B showed balances of Rs.70,000 and Rs.50,000 respectively. A introduced additional capital of Rs.50,000 on 31st March 2001 and B introduced additional capital of Rs.30,000 on 1st September, 2001. Interest on capital is allowed @ 12% p.a.

Calculate interest on capital payable at the end of 2001.

When interest is allowed on the net monthly balance of capital account, interest on drawings will not be charged,

because the drawings becomes deduction from capital, and the interest on capital is automatically reduced.

Interest on A's Capital

On Opening capital for 12 months (70,000 x 12%)	=	8,400
On Additional Capital 9 months (50,000x 12%x9/12)	=	4,500
Total interest payable to A		12,900

Interest on B's Capital

On opening capital for 12 months (50,000 x 12%)	=	6,000
On additional capital for 4 months (30,000x12%x 4/12)	=	1,200
		7,200

Illustration 1.21: A & B started business with Rs.100,000 each on 1st January, 2001. A introduced additional capital of Rs.50,000 on 1st July and B introduced Rs.50,000 on 1st September. A withdrew Rs.12,000, drawn in 4 installments of Rs.3000 each at the end of each quarter. B withdrew Rs.1,000 per month, at the end of each month.

Interest on capital is allowed on the net monthly balance of capital account @12% p.a. Calculate interest payable to A & B.

In this question interest is allowed on the net monthly balance of capital. But what is this monthly balance? Is it opening balance or closing balance? The idea behind interest on net balance is to give interest on the exact amount of capital used in the business. Suppose A added 10,000 at the **end** of January, he is not entitled to interest on this amount in the month of January, simply because it was not used in January. We cannot frame a that interest is allowed on the opening balance or closing balance. The main point to remember here is that the interest is allowed only on the capital used.

Net Monthly Balances in Capital accounts of A & B

Month	Interest On		Month	Interest on
January	100,000		January	100,000
February	100,000		February	99,000
March	100,000		March	98,000
April	**97,000**		April	97,000
May	97,000		May	96,000
June	97,000		June	95,000
July	**144,000**		July	94,000
August	144,000		August	93,000
September	144,000		**September**	**142,000**
October	**141,000**		October	141,000
November	141,000		November	140,000
December	**141,000**		December	139,000
Total	**1,446,000**		**Total**	**1,334,000**

A's Capital Account

April *= 100,000-3,000 on 31st March*

July *= Rs.97,000-3,000 on 30th June + 50,000 on 1st July*

October *= 144,000 – 3000*

December *31st –3,000 has no effect on this year's interest*

B's Capital Account

September *= 93,000 – 1,000 + 50,000*

Interest Allowed to 1446000 x 12 %, for 1 month Rs. 14,460
A

Interest Allowed to1334,000 x 12 %, for 1 month Rs.13,340
B

Illustration 1.22. The closing balances in the capital accounts of A & B On 31st Dec. 2001 were Rs.78,000 and Rs.65,000 respectively. During the year A introduced Rs.15000 on 1st July 2001 and withdrew @ Rs.1,000 at the end of each month. B introduced additional capital of Rs.25,000 on 31st March, 2001 and withdrew Rs.7,000 on 30th June and Rs.3,000 on 30th September. Calculate interest on capital @ 6% p.a. to be credited to each partner on 31st December, 2001 based on the net monthly capitals.

Read the question carefully. The capital balances given here are not the opening balances, but the closing balances of 2001, and you have the details of withdrawals during 2001. Now you must ***reverse*** *to the beginning of the year and calculate the monthly balances to arrive at the correct interest on capital.*

Opening Capital = Closing Capital + drawings – additional capital.

Opening Capital of A = 78,000 + 12,000 - 15,000 = 75,000

Opening Capital of B = 65,000 + 10,000 – 25,000 = 50,000

Net Monthly Balances in Capital Accounts of A & B

A's Capital **B's Capital**

Month	Interest On		Month	Interest On
January	75,000		January	50,000
February	74,000		February	50,000
March	73,000		March	50,000
April	72,000		April	75,000
May	71,000		May	75,000
June	70,000		June	75,000
July	84,000		July	68,000
August	83,000		August	68,000
September	82,000		September	68,000
October	81,000		October	65,000
November	80,000		November	65,000
December	79,000		December	65,000

Total	924,000		Total	774,000

Interest allowed to A = 924,000 x 6% x 1/12 = Rs. 4,620

Interest allowed to B = 774,000 x 6% x 1/12 = Rs. 3,870

Interest on Drawings

Illustration 1.23 Following is the details of drawings made by A & B from their firm during the year 2001. Calculate interest on drawings @ 6% p.a. to be debited to their accounts at the end of the year.

A's Drawings	Rs.	B's Drawings	Rs.
31-1-2001	1,500	28-2-2001	1,000
31-3-2001	500	1-4-2001	1,500
1-5-2001	2,000	1-7-2001	1,000
30-9-2001	1,000	1-10-2001	1,500
31-12-2001	1,000	1-12-2001	1,000
	6,000		6,000

This question clearly shows the effect of period of drawing on the amount of interest charged.

See that both these partners have withdrawn the same amount during the year 2001. But the interests charged are different, because of difference in period of drawing.

Interest on A's drawings **Interest on B's drawings**

Amount	Period	Equivalent		Amount	Period	Equivalent
Withdrawn	**till end**	**1 month**		**Withdrawn**	**till end**	**1 month**
1,500	11	16,500		1,000	10	10,000
500	9	4,500		1,500	9	13,500
2,000	8	16,000		1,000	6	6,000
1,000	3	3,000		1,500	3	4,500
1,000	0	0		1,000	1	1,000

6,000		40,000		6,000		35,000

Interest on A's drawings = 40,000 x 6% x 1/12 = Rs. 200

Interest on B's drawings = 35,000 x 6% x 1/12 = Rs. 175

Illustration 1.24

The closing balances in the drawings accounts of A, B and C show Rs.12,000 each on 31st December, 2001. They withdrew this amount in monthly installments of Rs.1,000. A's drawings were made at the beginning of each month, B on 15th and C at the end of each month.

Calculate interest on drawings @6% p.a. to be debited to them on 31st December 2001.

Interest on A's Drawings = 12,000 x 6% x 6.5/12 = Rs.390

Interest on B's Drawings = 12,000 x 6% x 6/12 = Rs.360

Interest on C's Drawings = 12,000 x 6% x 5.5 /12 = Rs.330

Commission to Partners

Commission is allowed to a partner for his service if all partners agree to such a payment. Again, in the absence of a specific condition in the partnership deed, a partner is not entitled to any salary or commission for his service rendered to the firm.

When commission is allowed it may be stated as 'payable on the profit **before** charging commission' or 'payable on the profit **after** charging commission'. If commission is payable on the profit before charging commission, it simply means that the commission is to be calculated at the given percent on the given amount of profit. But if it is a certain percentage after charging such commission, the amount of commission should be exactly the percentage specified on the balance of profit after deducting such commission, not the total amount. The following illustration will clarify the point.

*The idea of commission on the net profit '**before** charging such commission' and '**after** charging commission' sounds confusing 'Butler English'. But read it very carefully. This 'before charging' condition is exactly what we all normally understand. If the profit is 100 and 10% commission is allowed it simply means the commission is Rs.10 and the balance of profit available is Rs.90. The trouble hare is to take out 10% of the profit left after taking out such commission. Does this sound confusing again? In the above example Rs.10 is not 10% of the balance of profit of Rs.90. This is the problem. Now how to solve it? Remember that the commission is 10% of the balance of profit, which means if the balance is 100 then commission is 10. In other words it is not to be calculated as 10 out of 100 but as 10 out of 110.*

Study carefully how B's commission is calculated in illustration 1.25

Illustration 1.25

A & B are equal partners in a firm. Their partnership deed provided for commission to A @5% of the net profit before charging any commission. B is entitled to 5% commission on the profit after charging all commissions. Net profit before any such commission was Rs.42,000. Calculate commissions and profit share of each partner.

Commission payable of to A = 5% of 42,000 ie. Rs.2,100.

Commission payable to B = 5% of the N/P after all commissions.

Net profit available after charging A's commission = Rs.39,900 (42,000 – 2,100)
Which is B's commission + 'N/P after all commissions'

Now B's commission is to be 5% of the balance after deducting B's commission.

If B's commission is Rs.5, the balance available should be Rs.100

Which means the total should be 105.

Again, if the total available is 105, B will get a commission of 5 and the balance of Rs.100 will remain. ie. for every 105, B will get a commission of Rs.5.

Therefore B's commission is Rs.39,900 x 5/105 = Rs.1,900

Notice that the balance available is Rs.38,000 and B's commission of Rs.1,900 is exactly 5% of Rs.38,000.

Calculation of Capital Ratio

Capital ratio should be understood as investment ratio. Money is considered an important working factor in the business. When the capital contribution of a partner is higher, it also means that his money worked more in making the profit. In calculating the capital ratio the amount and the period of investment are to be considered. Suppose A contributes 10,000 in January and B contributes the same amount on 1st July, A's capital has worked double that of B due to earlier investment, even though both the amounts are the same at the end of the year. Therefore, capital ratio should be based on the amount of capital multiplied by the number of months the investment remained with the firm.

Illustration 1.26

A started business on 1st January 2001, with a capital investment of Rs.50,000. B joined on 1st May with a capital contribution of Rs.75,000 and C joined with 1st July with Rs.50,000 as capital.

They made a profit of Rs.25,000 in the first year. Distribute profit in the capital ratio.

Date & Amount	Months for which money was used	Effective Amount

A on 1st Jan Rs.50,000	12	600,000
B on 1st may Rs.75,000	8	600,000
C on Ist July Rs.50,000	6	300,000

Capital Ratio between A, B & C = 600000:600000:300000 ie. **2:2:1**

Illustration 1.27

A & B started business on 1st January 2001. They have decided to share profits and losses in the capital ratio. Calculate their capital ratio form the following details

A's Capital Account

Particulars		Amount	Particulars		Amount
Mar 1	*To Cash – Drawing..*	*9,000*	*Jan 1*	*By Cash*	65,000
Oct 1	*To Cash – Drawing.*	*10,000*	*Jul 1*	*By Cash..addl. Cap.*	40,000
Dec 31	*To bal c/d*	*86,000*			
		105,000			105,000

B's Capital Account

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
			Jan 1	*By Cash*	50,000
Apr 1	*To Cash – Drwng.*	*19,500*			
Oct 1	*To Cash – Drwng.*	*5,500*	*Jul 1*	*By Cash.. addl. Cap.*	25,000
			Sept 1	*By Cash – addl. Cap.*	10,500
Dec 31	*To bal c/d*	*60,500*			
		85,500			85,500

This question is worked out twice. The first answer is based on the capital balances multiplied by the number of months for which such balances are maintained. Even though this method looks very simple, you may make mistake in calculating the number of months for which the capital balances are maintained as there are no definite sequence or order followed in the question.

Most of the books follow the first method. I suggest the second; because there is very little chance of mistake this way.

Remember that the date of introduction or withdrawal is important. Capital for a month means capital available for use in that month. If capital is withdrawn at the beginning of a month, it means that the remaining balance only is available for that month. But if the capital is withdrawn at the end of the month that withdrawal has no effect on the capital for that month.

Answer (i) for Q.1.27

A's Capital

Date & Amount		Actual Balance	Months	Effective Amount
Jan 1	Op Cpital + 65,000	65,000	2	130,000
Mar 1	Drawing - 9,000	56,000	4	224,000
Jul 1	Addl Cap + 40,000	96,000	3	288,000
Nov 1	Drawings - 10,000	86,000	3	258,000
				900,000

B's Capital

Date & Amount		Actual Balance	Months	Effective Amount
Jan 1	Op Cpital + 50,000	50,000	3	150,000
Apr 1	Drawing - 19,500	30,500	3	91,500
Jul 1	Addl Cap + 25,000	55,500	2	111,000
Sept1	Addl Cap + 10,500	66,000	1	66,000
Nov 1	Drawings - 5,500	60,500	3	181,500
				600,000

Capital Ratio = 900:600

= 3:2

Answer (ii) for Q.1.27

Month	**Bal.- A**	**Bal – B**
Jan	65,000	50,000
Feb	65,000	50,000
Mar	56,000	50,000
Apr	56,000	30,500
May	56,000	30,500
Jun	56,000	30,500
Jul	96,000	55,500
Aug	96,000	55,500
Sep	96,000	66,000
Oct	86,000	60,500
Nov	86,000	60,500
Dec	86,000	60,500
Total	**900,000**	**600,000**

Illustration 1.28 The capital accounts of A & B on 31 December 2007 show balances of Rs.48,750 and Rs.56,000. The capital accounts for the year 2007 are given below. Calculate capital ratio (ratio in which their money was used in business).

Particulars		**A**	**B**	**Particulars**		**A**	**B**
Feb 1	To Cash	12,500	---	Jan 1	- By Cash	50,000	25,000
Mar 1	To Cash	---	14,000	Apr 1	By Cash	-	30,000
Jul 1	To Cash	8,750	---	Sept 1	By Cash	30,000	25,000
Oct 1	To Cash	10,000	10,000				

		80,000	**80,000**			**80,000**	**80,000**

Month	Bal.- A	Bal – B
Jan	50,000	25,000
Feb	37,500	25,000
Mar	37,500	11,000
Apr	37,500	41,000
May	37,500	41,000
Jun	37,500	41,000
Jul	28,750	41,000
Aug	28,750	41,000
Sep	58,750	66,000
Oct	48,750	56,000
Nov	48,750	56,000
Dec	48,750	56,000
Total	500,000	500,000

Capital Ratio = 1:1

Manager Admitted as a Partner

Illustration 1.29

A & B sharing profits and losses equally have decided to admit their manager C as a new partner. They have agreed to give him 1/5th share in future profits as well as the profits for the previous three years. His salary for the last three years is to be adjusted against his profit share. The profits for the last three years were Rs.76,000; Rs.83,000 and Rs.81,000 and his salary was Rs.1,500 p.m.

Recalculate the profit distribution and pass a journal entry to adjust the same in accounts.

Total Profit for the last three	240,000

years Salary to Manager for three years	54,000
Total Profit for redistribution	294,000

Details	A	B	C
Profit distributed taken back (Dr.)	120,000	120,000	
Salary paid to C taken back (Dr.)			54,000
Profit redistribution in new ratio (Cr.) (294,000 in 2:2:1)	117,600	117,600	58,800
Amount to readjust	2,400(Dr)	2,400(Dr)	4,800 (Cr).

Journal entry

A's Capital Account Dr .2 400

B's Capital Account Dr. 2,400

To C's Capital Account 4,800

(Profit readjustment)

Illustration 1.30

A & B sharing profits and losses in the ratio 2:1, have decided to admit their manager C as a partner, giving him 1/4th share in profits with retrospective effect for the past three years. His salary during this period is to be adjusted against his profit share. The profit for the last three years have been Rs.48,000; Rs.43,000 and Rs.44,000. His salary was Rs.1,200 p.m.

Recalculate the profit distribution and pass a journal entry to give effect to the same in accounts.

Total Profit for the last three years	135,000
Salary to Manager for three years	43,200
Total Profit for redistribution	178,200

Details	A	B	C
Profit distributed taken out Dr	90,000	45,000	0
Salary Paid to C Dr.			43,200
Total Amount Redistributed in the Cr. (178,200 at 2:2:1)	89,100	44,550	44,550
Net Adjustment	**900 (Dr.)**	**450 (Dr.)**	**1,350(Cr.)**

Journal entry

A's Capital Account Dr .900

B's Capital Account Dr. 450

To C's Capital Account 1,350

(Profit readjustment)

Illustration 1.31 A & B are partners sharing profits and losses in the ratio 2:1. On 31st December,2001 they have decided to take C, their manager as partner for 1/4th share with retrospective effect from 1st January 1999. As manager he had been paid annual salary of Rs.18,000, which is reduced to annual salary of Rs.6,000 as partner. He had advanced a loan of Rs.50,000 to the firm at 10% interest which is converted as his capital carrying interest @6% per annum. Profits and losses for the last three years are as follows:

1999	Rs. 54,000

2000	Rs.19,000
2001	Rs.47,000

Recalculate the profit distribution and pass adjustment entry to give effect to the same.

Total Profit for the last three years Excess Salary to Manager (12000x3) Excess interest paid to C	120,000 36,000 6,000
Total Profit for redistribution	162,000

Details

A

B

C

Profit redistribution in new ratio (Cr.)

(162000 at 2:1:1)

Profit already distributed (120000at 2:1) (Dr.)

Excess Salary given to C (12000x3) (Dr.)

Excess Interest given to C (Dr.)

+81,000

-80,000

-

+40,500

-40,000

-

+40,500

-

-36,000

- 6,000

Amount to readjust
1,000(Cr)
500(Cr)
1,500 (Dr)

Journal Entry

C's Capital Account Dr.1,500

To A's Capital Account 1,000

To B's Capital Account 500

(Profit readjustment)

Calculation of Capital Contribution

Illustration 1.32

A & B sharing profits and losses equally have agreed to admit C as a partner for 1/4th share from 1st January, 2002 who agreed to pay proportionate share of the total capital of the firm after necessary adjustments and appropriations at the end of the year 2001. The capital accounts of A & B on 1st January 2001 stood at Rs.40,000 and Rs.30,000 respectively. Drawings during the year 2001 amounted to Rs.3,000 by A and Rs.4,000 by B.

Calculate the capital to be invested by C.

C's Share is ¼ of the total Capital of the firm.

Therefore, combined capital of A& B is 3/4th of the total capital.

Net Capital of A (40,000-3000)	37,000
Net Capital of B (30,000-4000)	26,000
Total capital of A & B	63,000

Ie. 3/4th of the total capital = 63,000

*Total capital = 63000 *4/3 = 84,000*

C's Capital = 21,000

Chapter:2 Reconstitution Of Partnership

(Changing Ratio or Admission of a New Partner)

A partnership business may undergo several structural changes during its lifetime. New partners may join or existing ones may leave the business. While making such major changes in the structure of business, partners carefully evaluate their accounts. They have to reset the system on a correct starting point. They check the values of assets and liabilities appearing in the books. If there are discrepancies they have to be rectified before introducing a major change. Reconstitution of a partnership business can take place under the following situations:

- Admission of a new partner
- Changing profit sharing ratio among existing partners
- Retirement / death of a partner
- Amalgamation of two partnership firms

The most important accounting adjustment is resetting of old accounts. It is a common adjustment in all cases of reconstitution. In this chapter you will find reconstitution by admission and reconstitution by changing ratios. Reconstitution by admission is more important on examination point of view. The following are the common adjustments at the time of reconstitution of a partnership business.

1. Revaluation of assets and liabilities

2. Distribution of reserves and accumulated profits

3. Calculation of new ratio, sacrificing ratio and gaining ratio

4. Treatment of goodwill

5. Readjustment of capital accounts

1. Revaluation of Assets and Liabilities

Assets and liabilities are often shown in the accounts at their historical value rather than realisable value. Due to conservatism the partners usually do not revise the values of assets even when their actual market values are much higher than book values. Similarly inadequate depreciation, change in technology etc. make the book values of certain assets more than their realisable value. It is not practical for the partners to keep on changing the book values of their assets every time there is a change in their market values. The difference between book value and market value is not a problem as long as the partnership business goes on normally. But when they change the structure of the partnership in the form of revision in profit sharing ratio, admission of a new partner, retirement or death of a partner, amalgamation of two partnership firms or absorption of a firm by another, the values of assets and liabilities are to be reassessed and difference if any, should be accounted.

What is the purpose of revaluation?

When the realisable value of asset or liability is different from the book value there is a profit or loss hidden in the difference in value. The partners should distribute all the profits and losses in the existing profit sharing ratio before changing the ratio. If the ratio remains unchanged there is practically no use in estimating the hidden profit or loss. However, if this profit or loss is not distributed prior to changing profit sharing ratio some partners will lose and others gain due to the change in ratio.

For example: A&B, who were equal partners purchased land for Rs.10,000 in Jan 1975. They decided to share profits and losses in the ratio 2:1 from 1st January 2001. The actual market value of land on 1st January was Rs.70,000; whereas the book value remains at the purchase price of Rs.10,000. There is a hidden profit of Rs.60,000 in the value of land which A & B are entitled to share equally. Suppose they just ignored this factor and changed the profit sharing ratio to 2:1 and sold the land for Rs.70,000 next day, the profit on sale of land Rs.60,000 will go to A and B in the new ratio 2:1, which means A will get 40,000 and B will get only 20,000. In other words Rs.10,000 belonging to B will go to A. Vice versa can happen in case of a hidden loss. To prevent such problems the partners revalue the assets and liabilities and transfer the profit or loss into their capital accounts in the existing ratio before making a change.

Revaluation Account

When the value of one asset is to be increased in the books it can be easily done by debiting the asset and crediting the profit to partners' capital accounts in the profit sharing ratio. But when there is a major shake up, values of almost every asset and liability have to be revised. Distributing each change to the partners would be a lengthily process. For the sake of convenience, all those profits and losses on change in values of assets and liabilities are brought into a temporary account called 'revaluation account'. The revaluation account summarises the effect of revaluation of assets and liabilities.

Revaluation account is a special profit & loss account representing the combined capital accounts of partners. Any gain on revaluation of asset or liability, to be credited to partners, will be credited in the revaluation account. Similarly any loss on revaluation will be debited in revaluation account instead of debiting the capital accounts. The final balance in revaluation account indicates the profit or loss on the entire revaluation process. The revaluation account is closed by transferring this profit or loss to partner's capital accounts in the ratio before revision (old profit sharing ratio). All assets and liabilities will appear at their revised values in the books and in all future balance sheets.

When the partners want to adjust the profit or loss on revaluation process without actually changing the values of assets and liabilities in the books they can do so by opening a **memorandum revaluation account**. This revaluation account has two parts. The first part is a normal revaluation account and the profit or loss on this part is transferred in the old profit sharing ratio. The second part of memorandum revaluation account is almost a mirror image of the first part. Whatever debited in the first section is credited in the second and whatever credited is debited. Naturally if there was profit in the first section, there will be loss in the second and vice versa. The profit or loss in the first part is transferred to capital accounts in the old ratio, and that at the second part will be transferred to capital accounts new profit sharing ratio. As a result of this exercise the effect of profit or loss on revaluation will be fairly embedded in the capital accounts of partners.

2. Distribution of Reserves and Accumulated Profits

Distribution of reserves and accumulated profits is the first step in any reorganisation process. They include general reserves, credit balance in P & L accounts or any other fund that are retained in the business. These are profits earned in the past, but not taken out by the partners, or profits kept aside. Therefore, when the partners decide to change their future profit sharing ratio, the past profits retained in the above accounts should be distributed to partners in the old ratio as a first step.

3. Calculating new ratio, sacrificing ratio and gaining ratio

When a new partner comes into the business, old partners have to give him his profit share from their portion. Thus change in profit sharing ratio is an important aspect to be considered on reconstitution by admission. In academic accounting, change in profit sharing ratio can be presented in various ways. The existing partners may decide to change their profit sharing ratio for various reasons. When the profit sharing ratio is revised among existing partners, there ought to be a partial sacrifice of profit share by some partners in favour of others. The sacrifice of one or a group of partners becomes the gain of the remaining partners. Following is the formula for calculating sacrificing ratio:

Sacrificing ratio = Old ratio – new ratio

When the profit sharing ratio is revised it is important to calculate the sacrificing ratio and gaining ratio. These ratios are required to adjust the value of goodwill of a firm without raising goodwill account in the books.

Gaining ratio is the opposite of sacrificing ratio. This is the ratio gain to the existing partners of a firm when they revise the profit sharing ratio, or when the profit share of the deceased or retired partner is shared by the other partners. This ratio is calculated by deducting the old ratio from the new ratio. The new share will be higher than the old when there is a gain.

Gaining ratio = New ratio – old ratio

Examples of ratio calculations on reconstitution by admission

a. **The new partner's share is mentioned without specifying the old partner's profit sharing arrangement**.

   In this case it is to be assumed that the profit available after paying the new partner's share is to be divided by the old partners in their old profit sharing ratio. In other words the even though the overall profit sharing ratio changes, the old ratio is still maintained between the old partners, within the new ratio.

Illustration 2.1

Calculate new profit sharing ratio in the following cases:

i) **A & B sharing profits and losses equally admit C for 1/5th share in future profits**

C's Share of profit = 1/5th of the profit of the firm.
Balance of profit available for A & B = 4/5th of the profit, which is shared by them equally.
A's New share = 4/5 x 1/2 = 4/10
B's New share = 4/5 x ½ = 4/10
Ratio between ABC = 4/10:4/10:1/5
= **2:2:1**

ii) **A & B sharing profits and losses in the ratio 3:1 admit C for 1/5th share in future profits.**

C's share of profit = 1/5
Balance available for A & B = 1-1/5 = 4/5 of the profit which is shared by them in the ratio 3:1
A's New share = 4/5 x 3/4 = 3/5
B's New share = 4/5 x ¼ = 1/5
New Ratio = 3/5 : 1/5 : 1/5
= **3:1:1**

iii) **A &B sharing profits and losses in the ratio 3:2 admit C for 1/5th share in future profits.**

C's Share = 1/5
Balance available for A & B = 4/5 which is shared by them in the ratio 3:2
A's new share = 4/5 x 3/5 = 12/25
B's new share = 4/5 x 2/5 = 8/25
C's share = 1/5
New profit sharing ratio = 12/25 : 8/25 : 1/5
12:8:5

iv) **A & B sharing profits and losses in the ratio 2/3 and 1/3 admit C into partnership giving him 1/4th share in future profits**

C's share of profit = 1/4
Balance available for A & B = 3/4
A's new share = 3/4 x 2/3 = 2/4
B's new share = 3/4 x 1/3 = 1/4
New profit sharing ratio = 2/4:1/4:1/4 ie. **2:1:1**

v) **A & B who are equal partners admit C for 1/6th share in future profits**

C's share of profits = 1/6
Balance available to A & B = 5/6
A's new share = 5/6 x 1/2 = 5/12
B's new share = 5/6 x 1/2 = 5/12
New profit sharing ratio = 5/12: 5/12: 1/6
= **5:5:2**

The old partners give part of their share to the new partner (focus on the old partner)

Illustration .2.2

Calculate profit sharing ratio and sacrificing ratios in the following cases:

i) A & B who are equal partners admit C for which A surrenders ½ of his share and B surrenders 1/4th of his share in favour of C

a. A's Old share = 1/2

b. Portion surrendered for C 1/2 of 1/2

i.e. 1/2x1/2 = 1/4

c. Balance available for A = 1/4 (a-b)

d. B's old share = 1/2

e. Portion surrendered for C = 1/4th of 1/2

i.e. 1/2x1/ 4 = 1/8

f. Balance available for B = 3/8 (1/2-1/8)

g. C's share = A's contribution + B's contribution

i.e. 1/4 +1/8 = 3/8

g. New profit sharing ratio = 1/4:3/8:3/8

i.e. **2:3:3**

ii) A & B sharing profits and losses in the ration 3:2 admit C for which each partner surrenders ½ of his respective share.

a. A's Old share = 3/5

b. Portion surrendered for C 1/2 of 3/5

i.e. 3/5x1/2 = 3/10

c. Balance available for A = 3/10(a-b)

d. B's old share = 2/5

e. Portion surrendered for C = 1/2 of 2/5

ie. 2/5x1/2 = 2/10

f. Balance available for B = 2/10(d-e)

g. C's share = A's contribution + B's contribution

i.e. 3/10+2/10= 5/10

h. New profit sharing ratio = 3/10:2/10:5/10 i.e. **3:2:5**

iii) A & b sharing profits and losses in the ratio 3:2 admit C into partnership for which A surrenders 1/4th of his share and B surrenders 1/2 of his share.

a. A's Old share = 3/5

b. Portion surrendered for C 1/4th of 3/5

i.e. 3/5x1/4 = 3/20

c. Balance available for A = 9/20(a-b)

d. B's old share = 2/5

e. Portion surrendered for C = 1/2 of 2/5

i.e. 2/5x1/2 = 2/10

f. Balance available for B = 2/10(d-e)

g. C's share = A's contribution + B's contribution

i.e. 3/20+2/10= 7/20

h. New profit sharing ratio =9/20:2/10:7/20 i.e. **9:4:7**

iv) A & B sharing profits and losses in the ratio 4:1 have admitted C by surrendering 1/2 of their respective shares.

a. A's Old share = 4/5

b. Portion surrendered for C 1/2 of 4/5

i.e. 4/5x1/2 = 4/10

c. Balance available for A = 4/10(a-b)

d. B's old share = 1/5

e. Portion surrendered for C = 1/2 of 1/5

i.e. 1/5x1/2 = 1/10

f. Balance available for B = 1/10(d-e)

g. C's share = A's contribution + B's contribution

i.e. 4/10+1/10= 5/10

h. New profit sharing ratio = 4/10:1/10:5/10 i.e. **4:1:5**

The new partner acquires his share from old partners (focus on the new partner's share)

Illustration.2.3

Calculate sacrificing ratio and new profit sharing ratio in the following cases:

i) A & B sharing profits and losses equally admit C into partnership for 1/3rd share in future profits, which 2/3rd is acquired from A and 1/3rd is acquired from B

a. C's share = 1/3rd of future profits
b. A's contribution (sacrifice) = 2/3rd of 1/3rd
i.e. 2/3 x 1/3 = 2/9
c. Balance available for A = A's old share – A's sacrifice
i.e. 1/2 – 2/9 = 5/18
d. B's contribution =1/3rd of 1/3rd
i.e. 1/3 x 1/3 = 1/9
e. Balance available for B = B's old share – B's Contribution
i.e. 1/2 – 1/9 = 7/18
C's share = 2/9 +1/9 = 3/9
f. New profit sharing ratio = 5/18 : 7/18 : 6/18
i.e. 5:7:6
g. Sacrificing Ratio = 2/9 : 1/9 **ie.2:1**

ii) A & B sharing profits and losses in the ratio 2:1 admit C as a new partner. C acquired 1/18th from and 1/9 from B

a. A's contribution (sacrifice) to C = 1/18 of the total profit
b. Balance available for A = A's old share – A's contribution / sacrifice
i.e. 2/3 – 1/18 = 11/18
c. B's contribution =1/9
d. Balance available for B = B's old share – B's Contribution
i.e. 1/3 – 1/9 = 2/9
e. C's share = 1/18 +1/9 = 3/18
f. New profit sharing ratio = 5/18 : 7/18 : 6/18
i.e. 11:4:3
g. Sacrificing ratio = **1/18:1/9 i.e.1:2**

iii) A & B sharing profits and losses in the ratio 3:2 admit C for 1/4th share which is acquired equally A and B

A's Contribution (sacrifice) to C = ½ of ¼ =1/8
B's Contribution (sacrifice) to C = ½ of ¼ = 1/8
A's new share = 3/5 –1/8 = 19/40
B's new share = 2/5 –1/8 = 11/40
New ratio = 19/40:11/40:10/40
Sacrificing ratio = 1/8 :1/8 ie. 1:1

iv) A & B sharing profits in the ratio 3:1 admit C for 1/5th share in future profits. C acquires 7/8th of share from a and 1/8th from B

A's contribution to C = 7/8th of 1/5
ie. 7/40

B's Contribution to C = 1/8th of 1/5
ie. 1/40
A's new share = 3/4-7/40 = 23/40
B's new share = 1/4 – 1/40 = 9/40
C's share = 7/40+1/40 =8/40
New ratio = 23:9:8
Sacrificing ratio 7:1

v) A & B who are equal partners admit C for 1/3rd share in future profits. C acquired 1/3rd of his share from A and 2/3rd of his share form B.
A's sacrifice 1/3rd of 1/3rd = 1/9
B's sacrifice 2/3rd of 1/3rd = 2/9
A's new share = 1/2 – 1/9 = 7/18
B's new share = 1/2 – 2/9 = 5/18
C's share = 1/9+2/9 = 6/18
New ratio = 7:5:6

The entire sacrifice is made by one partner

Illustration.2.4
Calculate new profit sharing ratio in the following cases:

i) A & B sharing profits and losses equally admit C for 1/4th share. B has made the entire sacrifice for C's share of profit.
B's new share = 1/2 – 1/4 = 1/4
New profit sharing ratio = 1/2:1/4:1/4

ii) A & B sharing profits and losses in the ratio 3:2 admit C for 1/5th share in future profit which is fully contributed by A.
A's contribution = 1/5
A's new share = 3/5 –1/5 = 2/5
New profit sharing ratio = 2/5:2/5:1/5

iii) A & B who are equal partners admit C into partnership. B has contributed ½ of his share in favour of C
New profit sharing ratio = 2:1:1

iv) A & B who are sharing profits and losses in the ratio 3:1 admit c by contributing ½ of A's share in favour of C.
A's contribution for C = ½ of ¾ = 3/8
New profit sharing ratio = 3/8 : 1/4: 3/8 = 3:2:3

v) A & B sharing profits and losses in the ratio 2:1 admit C by contributing 1/3rd portion of A's share of profits.
A's contribution (C's share) = 1/3rd of 2/3rd = 2/9
A's new share = 2/3 – 2/9 = 4/9
New profit sharing ratio = 4:3:2

c. An entirely new profit sharing ratio is given

Illustration.2.5:

Calculate sacrificing ratio in the following cases

i) A & B sharing profits and losses equally admit C into partnership and decide to share future profits and losses in the ratio 3:2:2

A's sacrifice = 1/2 – 3/7 =7/14 - 6/14 = 1/14

B's sacrifice = 1/2 –2/7 = 7/14 – 4/14 = 3/14

Sacrificing ratio = 1:3

ii) A & B sharing profits and losses in the ratio 3:1 admit C and decide to share future profits and losses in the ratio 3:2:4

A's sacrifice = 3/4 - 3/9 = 27/36 – 12/36 = 15/36

B's sacrifice = 1/4 – 2/9 = 9/36 – 8/36 = 1/36

Sacrificing ratio = 15:1

iii) A & B sharing profits and losses in the ratio 3:2 admit C and change their profit sharing as 3:2:3.

A's sacrifice = 3/5-3/8 = 24/40-15/40 = 9/40

B's sacrifice = 2/5 – 2/8 = 16/40 – 10/40 = 6/40

Sacrificing ratio = 9:6 ie.3:2

iv) A &B having equal partnership admit C and change their profit sharing as 4:3:2

A's sacrifice = 1/2 - 4/9 = 9/18 – 8/18 = 1/18

B's sacrifice = 1/2 – 3/9 = 9/18 – 6/18 = 3/18

Sacrificing ratio = 1:3

v) A & B sharing profits and losses in the ratio 4:3 admit C and decide to share future profits and losses equally.

A's sacrifice = 4/7 – 1/3 = 12/21 – 7/21 = 5/21

B's sacrifice = 3/7 – 1/3 = 9/21 – 7/21 = 2/21

Sacrificing ratio = 5:2

At the time of reconstitution by admission, the old partners generally sacrifice for the new partner. In other words, new partner is the gaining partner and the old partners are the sacrificing partners. However when the partners restructure the entire profit sharing arrangement even some of the old partners could turn out to be gaining partners. *When reconstitution takes place by changing ratio among existing partners (without any admission or retirement) sacrifice by one or more partners will match with the gain of other partners.*

Calculation of sacrifice and gain are significant for several other adjustments on reconstitution.

What about a situation where there is sacrifice as well as gain. If you simply apply the formula without knowing what exactly is sacrifice or gain there will be lot of confusion while working out the problems. In many cases your common sense is more useful than the text book principles. For example if you find the new share of a partner is less than his old share for whatever reason, it is called SACRIFICE and if the new share is higher than the old it is called GAIN. Now you decide how to find out sacrificing ratio or gaining ratio.

Shortcut to calculate sacrificing ratio and gaining ratio

When there is a revision of profit sharing ratio by existing partners, there will be sacrifice as well as gain within the same partnership. Therefore it is easier to stick to one formula. Take the result of new ratio minus old ratio. If the result is negative it is sacrifice; and positive it is gain.

Notice the steps once again:

a. Write the new ratio in the first line (because I like to see sacrifice as negative and gain as positive number)
b. Write the old ratio in the second line (remember to adjust the ratios to add up to the a convenient total)
c. Deduct the old from new
d. Negatives result indicates sacrifice; positive result indicates gain

a. Old and new ratios are given

Illustration 2.06

A,B,C and D sharing profits and losses in the ratio 4:3:2:1 have decided to share future profits and losses in the ratio 2:1:1:1. Find out the sacrifice or gain in the arrangement.

(Note: When you have to compare two different ratios, it will be easier if both add up to the same total)

	A	B	C	D	Total
New Ratio(adjusted out of 10)	4	2	2	2	10
Old Ratio	4	3	2	1	10
(Sac) /Gain	0	-1	0	1	

B's Sacrifice 1/10; A's Gain 1/10

Illustration 2.07

A, B, C and D sharing profits and losses in the ratio 3:3:2:2 have decided to share future profits and losses in the ratio 4:3:2:1. Find out the sacrifice or gain in the arrangement.

	A	B	C	D	Total
New Ratio(revised to add up to 10)	4	3	2	1	10
Old Ratio	3	3	2	2	10
Sac /Gain	1	0	0	-1	

A's Gain 1/10; D's Sacrifice 1/10

Illustration 2.08

A, B, C and D sharing profits and losses in the ratio 2:1:1:1 have decided to share future profits and losses in the ratio 3:3:3:1. Find out the sacrifice or gain in the arrangement.

	A	B	C	D	Total
New Ratio	3	3	3	1	10
Old Ratio(converted to add up to 10)	3	3	2	2	10
Sac /Gain	0	0	1	-1	

C's gain 1/10; D's sacrifice 1/10

Illustration 2.09

A, B, C and D sharing profits and losses in the ratio 2:1:2:1 have decided to share future profits and losses in the ratio 2:2:1:1. Find out the sacrifice or gain in the arrangement.

	A	B	C	D	Total
New Ratio	2	2	1	1	6
Old Ratio	2	1	2	1	6
Sac /Gain	0	1	-1	0	

B's Gain 1/6; C's sacrifice 1/6

Illustration 2.10

A, B, C and D sharing profits and losses in the ratio 4:3:2:1 have decided to share future profits and losses equally. Find out the sacrifice or gain in this arrangement.

	A	B	C	D	Total
New Ratio	5	5	5	5	20
Old Ratio	8	6	4	2	20
Sac /Gain	-3	-1	1	3	

A's Sacrifice 3/20; B's Sacrifice 1/20; C's Gain 1/20; D's Gain 3/20

Illustration 2.11

A, B, C and D sharing profits and losses equally have decided to share future profits and losses in the ratio 2:2:1:1. Find out the sacrifice or gain in the arrangement.

	A	B	C	D	Total
New Ratio	4	4	2	2	12
Old Ratio	3	3	3	3	12
Sac /Gain	1	1	-1	-1	

A's Gain 1/12; B's gain 1/12; C's sacrifice 1/12; D's sacrifice 1/12

Illustration 2.12

A, B and C sharing profits and losses in the ratio 4:3:3 have decided to share future profits and losses in the ratio 2:2:1. Find out the sacrifice or gain in the arrangement.

	A	B	C	Total
New Ratio	4	4	2	10
Old Ratio	4	3	3	10
Sac /Gain	0	1	-1	

B's gain 1/10; C's sacrifice 1/10

Partners' sacrifice is specified

Illustration 2.13

A, B and C sharing profits and losses in the ratio 3:2:1 have decided to change their ratios, to give more profit share to C who has agreed to work as managing partner. Both A and B have agreed to sacrifice 1/4th of their respective share in favour of C. work out the new ratio and the sacrificing ratio.

A's old share 3/6
A's sacrifice = 1/4th of 3/6
= 3/6 x 1/4 = **1/8**
A's new ratio = 3/6 – 1/8 = 3/8

B's old share = 2/6
B's sacrifice = 1/4th of 2/6
= 2/6 x 1/4 = **1/12**
B's new share= 2/6 – 1/12 = 3/12

C's new share = 1/6 +1/8 +1/12
= 4/24 + 3/24 + 2/24
= 9/24
New profit sharing ratio of AB and C = 3/8 : 3/12 : 9/24
= 9 : 6 : 9

Sacrificing ratio of A & B = 1/8 : 1/12 = 3/24 : 2 / 24 = 3:2

C's Gain = 3/24 + 2/24 = 5/24

Illustration 2.14

A, B and C sharing profits and losses in the ratio 3:2:1 have decided to rearrange their profit sharing ratio. A & B have agreed to contribute 1/5th of their respective shares in favour of C. Find out the sacrifice or gain the arrangement.

A's old share 3/6
A's sacrifice = 1/5th of 3/6
= 3/6 x 1/5 = 3**/30**
A's new ratio = 3/6 – 3/30 = 12/30

B's old share = 2/6
B's sacrifice = 1/5th of 2/6
= 2/6 x 1/5 = 2**/30**
B's new share= 2/6 – 2/30 = 8/30
C's new share = 1/6 +3/30 +2/30
= 5/30 + 3/30 + 2/30
= 10/30

New profit sharing ratio of AB and C = 12 : 8 : 10
= 6 : 4 : 5

Sacrificing ratio of A & B = 3 : 2

C's Gain = the total sacrifice made by A & B; ie. 3/30 + 2/30 = 5/30

Illustration 2.15

A, B and C sharing profits and losses in the ratio 3:2:1 have decided that C's future share of profit shall be doubled. A & B have agreed to sacrifice this portion equally. Work out the details of new profit sharing arrangement.

A's old share 3/6
A's sacrifice = 1/2 of 1/6 = 1/12
A's new ratio = 3/6 – 1/12 = 5/12

B's old share = 2/6
B's sacrifice = 1/2 of 1/6 = 1/12
B's new share= 2/6 – 1/12 = 3/12

C's new share = 1/6 +1/12 +1/12 = 2/6

New profit sharing ratio of AB and C = 5/12 : 3/12 : 2/6
= 5 : 3 : 4

Sacrificing ratio of A & B = 1/12 : 1/12

Illustration 2.16

A, B & C sharing profits and losses in the ratio 2:1:1 have decided to share future profits and losses equally. Their goodwill was estimated to be worth Rs.18,000. Pass adjustment entry for treating goodwill.

Answer i (using ratios)

Sacrifice / Gain

	A	**B**	**C**	**Total**
Old Ratio	6	3	3	12
New Ratio	4	4	4	12
Sac /Gain	**2**	1	1	

A has a sacrifice of 2/12 portion of goodwill or which is Rs.3,000 (18,000 x2/12)
This is becomes the gain of B and C equally.

Adjustment entry:
B's Capital Account Dr. 1,500
C's Capital Account Dr.1,500
To A's Capital Account 3,000.
(The gaining partner's margin of gain is adjusted to sacrificing partner)

Answer ii (using the value of goodwill directly, in place of ratios)

	A	**B**	**C**	**Total**
Goodwill in old ratio cr.	9000	4500	4500	18000

Goodwill in new ratio dr.	6000	6000	6000	18000
Dr./cr.	Cr. 3000.	Dr. 1500	Dr. 1500	0

I think the second method is easier. You need not worry about finding out the ratios and distributing them. But if the question wants you to write the ratios as part of answer, you have no choice other than the first. So learn both.

Illustration 2.17

A & B sharing profits and losses in the ratio 2:2:1 have decided to share future profits and losses equally. Their goodwill was estimated to be worth Rs.30,000 and which they do not want to remain in the books. Pass necessary Journal entries.

	A	B	C	Total
Old Ratio	6	6	3	15
New Ratio	5	5	5	15
Sac /Gain	**1**	**1**	2	

Adjustment entry:

C's Capital Account Dr.4,000

To A's Capital Account 2,000

To B's Capital Account 2,000

(The gaining partner's margin of gain is adjusted to sacrificing partners)

Illustration 2.18

A & B sharing profits and losses in the ratio equally have decided to share future profits and losses in the ratio 2:2:1. Their goodwill was estimated to be worth Rs.18,000. Pass necessary Journal entries.

	A	B	C	Total
Old Ratio	5	5	5	15
New Ratio	6	6	3	15
Sac /Gain	1	1	**2**	

Adjustment entry:

A's Capital Account Dr.1,200

B's Capital Account Dr 1,200

To C's Capital Account 2,400

(The gaining partner's margin of gain is adjusted to sacrificing partners)

4. Accounting for Goodwill

Meaning of Goodwill

Goodwill is the monetary value assigned to the advantages of a reputed business in comparison with a new one. It indicates the extra earning capacity of the business. Goodwill is an intangible asset. But it is not a fictitious asset. Goodwill has a realisable value. It is acquired in a gradual consistent process of good business. Ideal location, experience of staff, reputation of owners, faithful customers etc. contribute to the creation of goodwill.

Usually goodwill is not shown in books due to conservatism. However, it is essential to assess the value of goodwill and pass appropriate entries in the books prior to any change in profit sharing or ownership structure. If this step is ignored while making any rearrangement in profit sharing or ownership structure, some partners will lose and some others will make undue gain, since goodwill is a valuable hidden asset of the business.

Nature of Goodwill

1. Goodwill is an intangible asset
2. Goodwill is a valuable asset.
3. Goodwill generates extra income for the business
4. It is acquired in a gradual process

Following are the major situations in which the goodwill of the firm is to be estimated.

a. Change in profit sharing ratio

b. Admission of a new partner

c. Retirement or death of a partner

d. Amalgamation of two partnership firms

Factors Influencing Goodwill

There are several factors that influence the formation of goodwill. The following are some of the important factors helping the formation of goodwill in a business.

1. **Honest business dealings**

   A firm builds up its reputation over a long period by consistent good dealing with the customers. Once the customers start identifying a business for clean and honest dealings they would prefer to stay with the firm, which in turn help the firm to earn higher profits.

2. **Good quality of products**

   A manufacturing concern maintaining a very good quality in their production will gradually build up reputation, which will help them while launching new products. Similarly trading concerns dealing only in good quality products will gradually build up their reputation.

3. **Ideal Location**

Good location of the business is another favourable factor enhancing the profitability and thereby goodwill of the business. A business which is centrally located will naturally attract more business and more profit.

4. **Special skill or Technical Know-how**

The business builds up skill in dealing with their product line, dealing with the clients' specific requirements, problems associated with the geographical location of their business etc. through experience. The problems are wide and varied, and solutions are also equally diverse. Thus the actual experience help develop skill in dealing with similar situations in future, which is naturally promote efficiency and goodwill of the business.

5. **Monopoly of Business**

Some established business concerns manage to build up their monopoly simply by being the first one in the market. This enables them to establish its position in and to some extent, restrict future competition. Even though, monopolies are undesirable from the customer's point of view, they are unavoidable and harmless at a limited scale.

Methods of Valuation of Goodwill

Following are the most commonS methods adopted for valuation of Goodwill.

a. Average Profit Method

Average profit method, as the name suggests, is based on the average profit of the business. Under this method, average profits for the past three or four years as agreed by the partners will be taken. Goodwill is estimated as twice or thrice of this average profit.

<u>Illustration 2.19</u>

ABC earned profits of Rs.20, 000, Rs.15,000 and Rs.25,000 in the past three years. They have decided that the Goodwill to be estimated at twice the average profit for the past three years. Estimate Goodwill.

Average profits = 45000

Value of Goodwill being twice the average = 45000 x2 = <u>90,000</u>

b. Super Profit Method

The existence of Goodwill is recognised in a firm only when its profitability is beyond the level of a new firm. Such excess profit earned by the firm is termed as super profit. Goodwill under super profit method is calculated in one of the following ways:

i. Simple Super Profit

<u>Illustration 2.20</u>

The net profit earned by ABC in the previous year was Rs.50,000. The capital employed by the firm is Rs.400,000. The normal rate of return for similar business is 10% on capital. Goodwill is considered to be the value of 3 years purchase of Super Profit.

Calculate Goodwill.

Capital Employed = 400,000

Normal rate of return = 10%

Normal profit on the capital employed = 400,000 x 10% = Rs. 40,000

Actual profit = Rs.50,000

Super profit = 50000 – 40000 = 10,000

Goodwill being 3 years purchase of super profit = Rs.30,000

ii. Average Super Profit

Illustration 2.21

The firm ABC earned R.17,500, Rs.22,500 and Rs.20,000 in the last three years. The mount of capital employed by the firm was Rs.150,000 and the normal rate of return for similar business is 10%.

Goodwill is considered 5 times the value of average super profits.

Calculate goodwill.

Average profit for the last three years = Rs.20,000

Normal profit on the capital employed = Rs.15,000

Average super profit = Rs.5,000

Value of Goodwill = 5000 x 5 = Rs. 25, 000

iii. Capitalisation of Simple Super Profit

Illustration 2.22

ABC earned a profit of Rs.20,000 during the year 2001. The capital employed by the firm was Rs.120,000 and the normal rate of return on similar business is 10%. Calculate goodwill by capitalising super profit.

Actual Profit = Rs.20,000

Normal profit on capital investment = 120000 x 10% = Rs.12,000

Super profit = 20,000 –12,000 = Rs.8,000

Capitalised value of super profit =80000 x 100 / 10 = Rs.80,000

c. Capitalisation Method (Goodwill based on capital saved)

Capitalisation method considers goodwill as the value of capital saved due to higher profitability. Under this method the amount of effective capital is estimated on the basis of market condition. This effective capital is always higher than the actual capital due to better profitability. The excess of effective capital over the actual capital is regarded as capital saved which is considered the goodwill of the firm. Capitalisation of super profit and capitalisation of actual profit and estimation of capital saved as goodwill are practically the same.

Illustration 2.23

ABC earned a profit of Rs.20,000 on a capital investment of Rs.175,000. Normal rate of return is 10%. Goodwill is considered the value of capital saved based on normal rate of return.

Estimate the value of Goodwill.

(This sum is worked out in two ways to illustrate that both the methods are same)

Estimation of Capital Saved

Actual profit = Rs.20,000

Estimated capital for earning this profit = Rs.200,000

Actual capital employed = Rs.175,000

Capital saved = 200,000 – 175,000 = **Rs.25,000**

Capitalisation of Super Profit

Actual profit = Rs.20,000

Normal profit on capital employed = 175,000 x 10% = Rs. 17,500

Super profit = 20,000-17,500 = Rs.2,500

Capitalised value of super profit = **Rs.25,000**

Accounting Treatment of Goodwill on Admission

Once the value of goodwill is estimated it should be properly accounted prior to the admission of a new partner. There are basically three methods of treatment of goodwill on admission, which are:

Premium method

Margin Adjustment

Revaluation method

Memorandum revaluation method

Premium Method

Under premium method the new partner pays cash for his share goodwill along with his capital. Cash account is debited for both these payments. The total amount brought in by the new partner (Capital + Goodwill) is credited to his capital account. The goodwill part of this payment belongs to the old partners. This amount is transferred to their capital accounts IN THE **SACRIFICING RATIO.** Since goodwill account is not opened in the book of the firm it will not appear in the balance sheet.

If there is any goodwill partly appearing in the balance sheet of the firm and the new partner is willing to contribute for his share, there are two options available for its treatment.

First, the existing goodwill may be left intact, and collect the new partner's share of the remaining value of goodwill only.

Alternatively, write off the existing goodwill against the capital accounts of old partners in their old profit sharing ratio and collect the share for full value of goodwill from the new partner.

Margin Adjustment Method

This method is practically a variation of premium method. Here the new partner does not bring in money specifically for his share of goodwill. The best option in this situation is to raise goodwill. *For unreasonable reasons, raising goodwill is not allowed*. The last resort is margin adjustment. Here the goodwill is adjusted only through the capital accounts. This method will work fine for all cases of reconstitution. When profit sharing ratio is changed at reconstruction something is added or deducted from their old profit share. In other words the partners retain a major part of their old profit share for which no adjustment is required. Goodwill under this method is adjusted on the basis of marginal increase or decrease of profit share. The basic rule is that the gaining partner shall compensate the sacrificing partner.

Following are the steps involved in goodwill adjustment.

i) Find out the partner's sacrifice / gain

ii) Debit gaining partner and credit the sacrificing partner with the proportionate value of goodwill.

If you find the ratios bit difficult, you can arrive at the margin values by following memorandum revaluation in a different format in the workings. This is basically crediting full value of goodwill to partners' capital accounts in the old ratio and debiting it in the new ratio. The net result is premium being adjusted in the account. You are not allowed to show these entries in the capital account. But the examiner has no problem if you do it in the workings.

Revaluation Method

When the new partner does not pay cash for his share of goodwill the old partners will RAISE full value of goodwill in the books, by debiting goodwill account and crediting the capital accounts of old partners in the **OLD PROFIT SHARING** ratio. This method is termed as revaluation method. As a new goodwill account is opened in the books it will appear in the balance sheet of the firm.

If a part of the goodwill is already appearing in the books of the firm the old partners are allowed to raise the only the remaining balance of goodwill to bring it to the full value. In other words, the value of goodwill the books should not exceed its estimated full value. (This method is explained in the previous chapter also)

Difference between

Premium Method and Revaluation Method

Premium Method

1. The new partner pays for his share of goodwill

2. Only the share of goodwill not the full value taken for distribution

3. Cash account, not the good will account is debited upon receiving the goodwill payment

4. Sacrificing ratio is applied for distribution of goodwill money.

5. Goodwill will not appear in the balance sheet after admission.

Revaluation Method

1. The new partner does not pay for his share of goodwill

2. Full value of goodwill is taken for distribution to old partners

3. Goodwill account is debited for raising the goodwill. Cash is not affected by goodwill.

4. Old profit sharing ratio is applied of distribution of full value of goodwill
5. Full value goodwill will appear in the balance sheet after admission.

Memorandum Revaluation Method

Memorandum revaluation method is basically same as revaluation method with a minute variation. Under this method the goodwill is raised in the books of the firm by debiting goodwill account and crediting the old partner's capital accounts in the old profit sharing ratio same as the revaluation method. Thereafter the goodwill is written off against capital accounts of all partners (including the new partner), in the new profit sharing ratio. In this case goodwill will not appear in the balance sheet after admission.

Illustration 2.24

A, B & C sharing profits and losses in the ratio 2:1:1 have decided to share future profits equally from 1st January 2003. Their Balance Sheet on that date stood as follows:

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*14,000*	*Machinery*	*20,000*
Capital B	*10,000*	*Furniture*	*11,000*
Capital C	*10,000*	*Cash*	*9,000*
General reserve	*2,000*		

Creditors	*4,000*		
	40,000		*40,000*

The assets and liabilities have been revalued as follows:

Machinery 10% less; Furniture valued at Rs.13,000; Creditors include Rs.400 not to be paid. Pass necessary adjustment entries, make revaluation account and prepare new balance sheet of the firm.

Journal Entries:

General Reserve a/c Dr. 2000

A's Capital Account 1,000

B's Capital Account 500

C's Capital Account 500

(General reserve account transferred to partner's capital account in the old ratio)

Revaluation Account Dr. 2,000

To Machinery Account 2,000

(Value of machinery reduced)

Furniture Account Dr.2,000

To Revaluation 2,000

(Value of furniture raised)

Creditors Dr. 400

To Revaluation 400

(Value of Creditors reduced)

Revaluation Account

Particulars	Amount	Particulars	Amount
To machinery	*2,000*	*By Furniture*	*2,000*

To Profit		*Creditors*	*400*
A-200			
B-100			
C-100	*400*		
	2,400		*2,400*

Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
To balance c/d	*15,200*	*12,600*	*10,600*	*By Balance b/d*	*14,000*	*12,000*	*10,000*
				By General Res	*1,000*	*500*	*500*
				By Revaluation	*200*	*100*	*100*
	15,200	*12,600*	*10,600*		*15,200*	*12,600*	*10,600*

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*15,200*	*Machinery*	*18,000*
B	*12,600*	*Furniture*	*13,000*
C	*10,600*	*Cash*	*9,000*
Creditors	*3,600*		
	40,000		*40,000*

Illustration 2.25

The following is the balance sheet of A & B. They have decided to revalue the machinery 10% more and furniture Rs.1,000 less for the purpose of admitting C as a new partner. Revise the balance sheet prior to admission.

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	10,000	Machinery	15,000

Capital B	10,000	Furniture	6,000
Creditors	2,500	Cash	1,500
	22,500		**22,500**

Here we have to do three things.

1. Prepare a revaluation account to summarise the effect of revaluation.

ii. Prepare capital accounts

iii. Prepare new balance sheet.

Revaluation Account

Particulars	Amount	Particulars	Amount
To Furniture	*1,000*	*By Machinery*	*1,500*
To Revaluation Profit			
A 250			
B 250	*500*		
	1,500		***1,500***

A's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
		By Revaluation a/c	*250*
To balance c/d	*10,250*		
	10,250		***10,250***

B's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*

		By Revaluation a/c	*250*
To balance c/d	*10,250*		
	10,250		***10,250***

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*10,500*	*Machinery*	*16,500*
Capital B	*10,500*	*Furniture*	*5,000*
Creditors	*2,500*	*Cash*	*1,500*
	23,000		***23,000***

Notice that the values of the two assets have changed and the effect is transferred to the capital account in the form of revaluation profit]

Illustration 2.26

A, B & C sharing profits and losses in the ratio 2:2:1 have decided to share future profits equally 1st January 2003. Their Balance Sheet on that date stood as follows:

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*15,000*	*Machinery*	*20,000*
Capital B	*10,000*	*Furniture*	*15,000*
Capital C	*10,000*	*Cash*	*9,000*
General reserve	*5,000*		
Creditors	*4,000*		
	44,000		*44,000*

The assets and liabilities have been revalued as follows:

Machinery 10% less

Furniture valued at Rs.13,000

Creditors should include an additional bill for Rs.500.

Pass necessary adjustment entries and prepare new balance sheet of the firm.

Journal Entries:

General Reserve a/c Dr. 5,000

A's Capital Account 2,000

B's Capital Account 2,000

C's Capital Account 1,000

(General reserve account transferred to partner's capital account in the old ratio)

Revaluation Account Dr. 2,000

To Machinery Account 2,000

(Value of machinery reduced and the loss debited to revaluation)

Revaluation Account Dr.2,000

To Furniture Account 2,000

(Value of furniture reduced and the loss debited to the revaluation account)

Revaluation Account Dr. 500

To Creditors 500

(Creditors raised and loss transferred)

A's Capital Account Dr.1,800

B's Capital Account Dr.1,800

C's Capital Account Dr. 900

To Revaluation Account 4,500

(Revaluation loss transferred to capital accounts)

Revaluation Account

Particulars	Amount	Particulars	Amount
To machinery	*2,000*	*By Loss transferred*	
To Furniture	*2,000*	*A 1,800*	
To Creditors	*500*	*B 1,800*	
		C 900	*4,500*
	4,500		*4,500*

Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
To Revaluation	*1,800*	*1,800*	*900*	*By Balance b/d*	*15,000*	*10,000*	*10,000*
				By General Res	*2,000*	*2,000*	*1,000*
Balance c/d	*15,200*	*10,200*	*10,100*				
	17,000	*12,000*	*11,000*		*17,000*	*12,000*	*11,000*

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*15,200*	*Machinery*	*18,000*
B	*10,200*	*Furniture*	*13,000*
C	*10,100*	*Cash*	*9,000*
Creditors	*4,500*		
	40,000		*40,000*

Illustration 2.27 *(Memorandum Revaluation)*

A, B & C sharing profits and losses in the ratio 2:2:1 have decided to share future profits equally 1st January 2003. Their Balance Sheet on that date stood as follows:

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*25,000*	*Buildings*	*40,000*
Capital B	*20,000*	*Machinery*	*25,000*
Capital C	*20,000*	*Debtors*	*14,000*
General reserve	*15,000*	*Stock*	*7,000*
Creditors	*14,000*	*Cash*	*8,000*
	94,000		*94,000*

The assets and liabilities have been revalued as follows:

Buildings appreciated to Rs.50,000

Machinery appreciated by Rs.4,000

Create provision for bad debts @10% on debtors.

Stock to be valued at Rs.9,400.

The partners want the values of assets and liabilities to remain the same.

Prepare Memorandum Revaluation Account; Capital Accounts of Partners and the Balance Sheet of the firm after the necessary adjustments are carried out.

Memorandum Revaluation Account

Particulars	Amount	Particulars	Amount
To Prov. For bad debts	*1,400*	*By Buildings*	*10,000*
To profit Transferred		*By Machinery*	*4,000*
A 6,000		*By Stock*	*2,400*
B 6,000			
C 3,000	*16,000*		
	16,400		*16,400*

			1,400
	10,000		
	4,000		
	2,400		
		By provision– reversed	15,000
	16,400	By Loss Transferred	16,400
To Buildings –reversed		A 5,000	

Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
				By Balance b/d	25,000	20,000	20,000
To Mem Reval.	5,000	5,000	5,000	By General Reserve	6,000	6,000	3,000
To balance c/d	32,000	27,000	21,000	ByMem. Revaluation	6,000	6,000	3,000
	37,000	32,000	26,000		37,000	32,000	26,000

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital Accounts A	32,000	Buildings	40,000
B	27,000	Machinery	25,000
C	21,000	Debtors	14,000
		Stock	7,000
Creditors	14,000	Cash	8,000
	94,000		94,000

5. Adjustment of Capital Accounts

When the partners change their profit sharing ratio, they may also change their capitals. Contribution of capital is not essentially the basis of profit sharing. But in most cases capital contribution is considered the most important factor in determining profit sharing ratio. Capital balances are usually adjusted by bringing in or taking out cash. However as a temporary measure capital balances can be adjusted by transferring the differences through current accounts.

Reconstitution by admission

The illustrations given below are carefully planned to explain each concept we discussed before. Work out each one of them. They will help you focus on each aspect of this chapter. They will also help you have a fresh look at the theory section.

Illustration 2.28

The following Balance Sheet shows the financial position of A & B sharing profits and losses equally before admission of C.

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	10,000	Machinery	15,000
Capital B	10,000	Furniture	6,000
Creditors	2,500	Cash	1,500
	22,500		**=SUM(ABOVE) 22,500**

C paid Rs.12,000 as his capital and Rs.3,500 as his share of goodwill for equal partnership in future.

Pass necessary journal entries; Prepare revaluation account, capital accounts of partners and the new balance sheet of the firm after C's admission.

Journal Entries

1.. Cash Account Dr. Rs.12,000

To C's Capital Account Rs.12,000

(C's share of capital credited to his account)

----

2. Cash Account Dr. Rs.3,500

To A's Capital Account Rs.1,750

B's Capital Account Rs.1,750

(C's goodwill contribution credited to old partners in the sacrificing ratio)

A's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
To balance c/d	*11,750*	*By Cash – G/w prem*	*1,750*
	11,750		***11,750***

B's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
To balance c/d	*11,750*	*By Cash – G/s prem*	*1,750*
	11,750		***11,750***

C's Capital Account

Particulars	Amount	Particulars	Amount
To balance c/d	*12,000*	*By Cash Account*	*12,000*
	12,000		***12,000***

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*11,750*	*Machinery*	*15,000*
Capital B	*11,750*	*Furniture*	*6,000*
Capital C	*12,000*	*Cash*	*17,000*

Creditors	2,500		
	38,000		***38,000***

Nothing is mentioned about the future profit sharing arrangement between A & B. Therefore it should be understood that they will continue to remain equal partners for the future as well.

Here C pays for his share of goodwill which has to be given to A & B in their sacrificing ratio. When the ratio between old partners remains the same for future; the old ratio itself will be the sacrificing ratio. (A's Sac 1/2 – 1/3; B's sacrifice is also the same. which means their sacrifice is equal]

Goodwill account will not appear in the books after admission.

Illustration 2.29

The following Balance Sheet shows the financial position of A and B sharing profits and losses in the ratio 2:1.

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	10,000	Machinery	16,000
Capital B	10,000	Furniture	5,000
Creditors	2,500	Cash	1,500
	22,500		**22,500**

They have decided to admit C and to share future profits and losses equally. C agreed to contribute Rs. 10,000 as his capital and Rs.2,500 as his share of goodwill. Pass necessary journal entries and prepare the new balance sheet after admission.

Here new partners' share of goodwill is given to the old partners in the sacrificing ratio. This aspect is repeated because of its importance. Here you have a new ratio. Whenever there is a new ratio given in the question you must check if the ratio between old partners is still the same. For example suppose the old ratio was equal (1:1) and the new ratio is 2:2:1 here the ratio between old partners remains the same, even though 2/5 is smaller than their old 1/2. If the old partners continue to remain in the same ratio as before you need not calculate the sacrificing ratio, See the previous illustration, There you find the old partners were equal, getting ½ each before admission and after admission they are getting 1/3rd each. Therefore we say their sacrifice also is same.

Here in this illustration you will really see the effect of sacrificing ratio. The old ratio was 2:1. This means A's share was 2/3 and B's share 1/3. The future profit sharing arrangement is agreed to be equal; which means all will get 1/3rd share. Now notice that A is the only loser in this arrangement. B continues to get his old 1/3rd. Therefore, goodwill is given only to A.

Journal Entries

1. Cash account Dr.12,500

To C's Capital Account 12,500

(Cash contribution for Capital and Goodwill by C)

----

2. C's Capital account Dr. 2,500

To A's Capital 2,500

(Goodwill contribution transferred to the sacrificing partner)

- You can credit the full contribution of the new partner to his capital and transfer it to the sacrificing partners afterwards.

A's Capital Account

Particulars

Amount

Particulars

Amount

By Balance b/d

10,000

To Balance C/d

12,500

By C's Capital – goodwill

2,500

12,500

12,500

B's Capital Account

Particulars

Amount

Particulars

Amount

By Balance b/d

10,000

To balance c/d

10,000

10,000

10,000

C's Capital Account

Particulars	Amount	Particulars	Amount
To A's Capital –Goodwill	*2,500*	*By Cash*	*12,500*
To balance c/d	*10,000*		
	12,500		***12,500***

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*12,500*	*Machinery*	*16,000*
Capital B	*10,000*	*Furniture*	*5,000*
Capital C	*10,000*	*Cash*	*14,000*
Creditors	2,500		
	35,000		***35,000***

Illustration 2.30

Following balance sheet shows the financial position of A & B sharing profits and losses in the ratio 3:2.

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	10,000	Machinery	15,000
Capital B	10,000	Furniture	6,000
Creditors	2,500	Cash	1,500
	22,500		**22,500**

They have decided to admit C for 1/6th share in the future profits for which C brings in Rs.10,000 as his capital and Rs.2,500 as his share of goodwill.

Pass necessary journal entries and present the balance sheet of the firm after C's admission.

You know this is also premium method of goodwill. The old partner's share after admission is not specifically mentioned. You must understand the portion of profit left after paying C's share will be divided in the old ratio. Here C's share is 1/6th. The balance available for A & B is 5/6th. This portion will be shared in the ratio 3:2 which makes the new ratio 3:2:1. As the ratio between old partners continues to be 3:2, the sacrificing ratio also will be the same. Study the small illustrations on ratios carefully.

Journal Entries

1. *Cash Account Dr.12,500*

   To C's Capital Account 12,500

(Capital and goodwill contribution by C is credited to his account)

---

2. *C's Capital account Dr. 2,500*

   To A's Capital Account 1,500

   To B's Capital Account 1,000

(Goodwill contribution is transferred to old partners in sacrificing ratio)

A's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
To balance c/d	*11,500*	*By C's Capital-Goodwill*	*1,500*
	11,500		***11,500***

B's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
To balance c/d	*11,000*	*By C's Capital – goodwill*	*1,000*
	11,000		***11,000***

C's Capital Account

Particulars	Amount	Particulars	Amount
To A's Capital	*1,500*	*By Cash*	*12,500*
To B's Capital	*1,000*		
To balance c/d	*10,000*		
	12,500		***12,500***

Balance Sheet

Particulars	Amount	Particulars	Amount
A's Capital	*11,500*	*Machinery*	*15,000*
B's Capital	*11,000*	*Furniture*	*6,000*
C's Capital	*10,000*	*Cash*	*14,000*
Creditors	*2,500*		
	35,000		***35,000***

Illustration 2.31

The following balance sheet shows the financial position of A & B sharing profits and losses in the ratio 3:2.

Balance Sheet

Liabilities

Amount

Assets

Amount

Capital A

10,000

Machinery

15,000

Capital B

10,000

Furniture

6,000

Creditors

2,500

Cash

1,500

22,500

22,500

They have decided to admit C into partnership, who agreed to pay Rs.15,000 as his share of capital for 1/4 share in future profits. He also paid premium for his share of goodwill Rs.2,500.

Pass necessary journal entries, open ledger accounts and prepare balance sheet after admission.

Journal Entries

1. *Cash Account Dr.15,000*

To C's Capital Account 15,000

(Capital contribution by the new partner)

----

2. *Cash Account Dr.2,500*

To A's Capital 1,500

To B's Capital 1,000

(Full value of goodwill raised in the books on admission)

A's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
To balance c/d	*11,500*	*By Cash –goodwill*	*1,500*
	11,500		***11,500***

B's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
To Balance c/d	*11,000*	*By Cash –goodwill*	*1,000*
	11,000		***11,000***

C's Capital Account

Particulars	Amount	Particulars	Amount
		By Cash a/c	*15,000*
To Balance c/d	*15,000*		
	15,000		***15,000***

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*11,500*	*Machinery*	*15,000*
Capital B	*11,000*	*Furniture*	*6,000*

Capital C	*15,000*	*Cash*	*19,000*
Creditors	2,500		
	40,000		***40,000***

Illustration 2.32

The following balance sheet shows the financial position of A & B.

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	10,000	Machinery	15,000
Capital B	10,000	Furniture	6,000
Creditors	2,500	Cash	1,500
	22,500		**22,500**

They have decided to admit C for 1/4th share in future profits. C pays Rs.15,000 as his capital. The goodwill of the firm is estimated to be worth Rs.12,000, C contributes for his share of goodwill.

Pass journal entries; prepare ledger and present balance sheet after admission.

Journal Entries

1. *Cash account Dr. 15,000* *To C's Capital Account 15,000* *(Being capital contribution of new partner credited to his account)*
2. *Cash Account Dr. 3,000* *To Premium Account 3,000* *(C's share of goodwill contribution)*

3. Premium account Dr. 3000

To A's Capital Account 1,500

To B's Capital Account 1,500

A's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
To Balance c/d	*11,500*	*By Premium g/w a/c*	*1,500*
	11,500		***11,500***

B's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*10,000*
To balance c/d	*11,500*	*By Prem G/w a/c*	*1,500*
	11,500		***11,500***

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*11,500*	*Machinery*	*15,000*
Capital B	*11,500*	*Furniture*	*6,000*
Capital C	*15,000*	*Cash*	*19,500*
Creditors	*2,500*		
	40,500		***40,500***

Illustration 2.33

The following balance sheet shows the financial position of A & B sharing profits and losses in the ratio 3:2. They have decided to admit C into partnership for 1/4th share in future profits.

A's Capital Account

Particulars	Amount	Particulars	Amount
Capital A	11,500	Machinery	15,000
Capital B	11,500	Furniture	6,000
Creditors	2,500	Equipment	3,000
		Cash	1,500
	25,500		25,500

C has agreed to pay Rs.15,000 as his share of capital. He also agreed to pay for his share of goodwill Rs.2000. A and B agreed that they will divide their portion of profit equally.

Show the ledger accounts and the balance sheet after admission.

Note: Here the old partners are not continuing in the old ratio. The old partners are sharing their portion equally, which means they will give ¼ to C and the remaining ¾ will be shared equally. Their new profit sharing ration will be 3/8:3/8:1/4 ie.3:3:2. The sacrificing ratio here is 9:1

A's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*11,500*
To Balance c/d	*13,300*	*By cash g/w*	*1,800*
	13,300		***13,300***

B's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*11,500*

To Balance c/d	*11,700*	*By Cash- Goodwill*	*200*
	11,700		***11,700***

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*13,300*	*Machinery*	*15,000*
Capital B	*11,700*	*Furniture*	*6,000*
Capital C	*15,000*	*Equipment*	*3,000*
Creditors	*2,500*	*Cash*	*18,500*
	42,500		***42,500***

Illustration 2.34

The following balance sheet shows the financial position of A & B sharing profits and losses equally.

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*11,500*	*Machinery*	*15,000*
Capital B	*11,500*	*Furniture*	*6,000*
Creditors	*2,500*	*Equipment*	*3,000*
		Cash	*1,500*
	25,500		**25,500**

They have decided to admit C as a partner and to share future profits and losses in the ratio 2:1:1. C agreed to pay Rs.15000 as his share of capital. The full value of goodwill is estimated to be worth Rs.8,000. C paid for his share of goodwill.

Pass journal entries and prepare capital accounts and the balance sheet of the firm after C’s admission.

Journal Entries

Cash Account Dr. 15,000

To C's Capital 15,000

(C's capital contribution)

----

2. Cash Account Dr.2,000

To B's Capital 2,000

(C's goodwill contribution credited to B)

Note: B is the only sacrificing partner

A's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*11,500*
To balance c/d	*11,500*		
	11,500		***`11,500***

B's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*11,500*
To Balance c/d	*13,500*	*By Cash– goodwill*	*2,000*
	13,500		***13,500***

C's Capital Account

Particulars	Amount	Particulars	Amount
		By Cash Account	*15,000*
To Balance c/d	*15,000*		

	15,000		***15,000***

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*11,500*	*Machinery*	*15,000*
Capital B	*13,500*	*Furniture*	*6,000*
Capital C	*15,000*	*Equipment*	*3,000*
Creditors	*2,500*	*Cash*	*18,500*
	42,500		***42,500***

<u>Illustration 2.35</u>

The balance sheet of A & B sharing profits and losses equally is given below.

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*11,500*	*Machinery*	*15,000*
Capital B	*11,500*	*Furniture*	*6,000*
Creditors	*2,500*	*Goodwill*	*3,000*
		Cash	*1,500*
	25,500		**25,500**

They have decided to admit C for 1/4th share in the future profits. C has agreed to pay Rs.15,000 as his capital. The goodwill is valued at Rs.8000 and C pays Rs.2,000 for his share of goodwill. The old partners want the value of goodwill shown in the books shall remain unchanged.

Pass necessary journal entries, open ledger accounts and the new balance sheet after admission.

This is a complicated arrangement. C's 1/4th share of goodwill is estimated at Rs.2,000. The new partner pays for goodwill on condition that the old partners do not raise their goodwill in the books. In fact the new partner is buying his share of that hidden asset of goodwill. Here the goodwill is appearing at Rs.3000 which means the old partners have already added that portion into their capital accounts. The new partner is required to pay only for the portion *that is still hidden. If the new partner pays for his full share of goodwill, the old partners must remove the goodwill from accounts. If they insist on keeping it, the next option is to give them what is due for the hidden portion only. In this illustration, C's contribution of Rs2000 is credited to his capital account and from there Rs.1,250 representing Rs.5000 of the goodwill not raised is transferred to old partners in their sacrificing ratio.*

Is this explanation enough? Please read this slowly, carefully. Write down all the numbers above, and study the relation between them.

Journal Entries

1. *Cash account Dr. 17,000*

    To C's Capital account 17,000

(C's share of capital and goodwill contribution credited to his capital account)

---

3. *C's Capital account Dr.1,250*

    A's Capital Account 675

    B's Capital Account 675

(Proportionate amount for the hidden part of goodwill transferred in the sacrificing ratio)

A's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*11,500*
To balance c/d	*12,175*	*By C's Capital a/c*	*675*
	12,175		***12,175***

B's Capital Account

Particulars	Amount	Particulars	Amount
		By Balance b/d	*11,500*
To balance c/d	*12,175*	*By C's Capital a/c*	*675*
	12,175		***12,175***

C's Capital Account

Particulars	Amount	Particulars	Amount
To A's Capital	*675*	*By Cash a/c*	*15,000*
To B's Capital	*675*	*By Cash a/c*	*2,000*
To Balance c/d	*15,650*		
	17,000		***17,000***

Balance Sheet

Liabilities	Amount	Assets	Amount
Capital A	*12,175*	*Machinery*	*15,000*
Capital B	*12,175*	*Furniture*	*6,000*
Capital C	*15,650*	*Goodwill*	*3,000*
Creditors	*2,500*	*Cash*	*18,500*
	42,500		***42,500***

CHAPTER:3 RETIREMENT OR DEATH OF A PARTNER

1. Change in profit sharing ratio

2. Treatment of goodwill

3. Revaluation of assets and liabilities

4. Accumulated profits; reserves; losses etc.

5. Adjustment of Joint Life Policy

6. Adjustment of capital

1. Change in profit sharing ratio

Retirement or death reduces the number of partners to share future profits or losses. Naturally the share of profit for the continuing partners will increase by the retirement or death of a partner. Recalculation of ratios is the first step in for further accounting procedures. Revision in ratio may be indicated in any of the following ways in a question:

a. *Old ratio is given and nothing is mentioned about the new arrangement after retirement*.

This is practically the easiest way of presenting new profit sharing arrangement. The new ratio under this method is found out simply by canceling the outgoing partner's share of profit assuming that the ratio between the continuing partners does not change. When this method is followed the outgoing partner's share **merges into the continuing partners share in their profit sharing ratio**.

Example: A, B and C have been sharing profits and losses in the ratio 3:2:1. B has retired from the business. Find out new ratio between A & C.

Here B is retired and nothing is mentioned about the arrangement between A & C. The new ratio is found out by simply canceling the B's share of profit.

New ratio = 3:1

Here B's share of 2/3 of profit is merged in the shares of A and C in the ratio 3:1.

b. *The outgoing partner's share is taken over by the continuing partners in a certain ratio.*

A & B have been sharing profits and losses in the ratio 3:2:1. B retired from the firm. His share of profit is divided equally between A & C. Find out new ratio.

Here B's share of 2/6 is shared between A & C equally. The new share of A is his old share of 3/6 + 1/6 from B. Thus his new share is 4/6. C's new share is his old share of 1/6 + 1/6 from B. Thus his new share is 2/6. New profit sharing ratio is 4:2 that is 2:1.

c. *The new ratio is directly given*.

When the new ratio is directly given, the need for calculating it is taken away. But it is important to remember that new ratio is only a first step for further adjustments in accounts on retirement or death.

2. Accounting Treatment of goodwill

Accounting treatment of goodwill on retirement and death is very close to that in admission Following are the different methods followed:

1. The outgoing partner's share adjusted in the books **(Margin Adjustment)**

This method is similar to the premium method adopted in admission of partners. Under this method the outgoing partner's share of goodwill is credited to his capital account and the continuing partner's capital accounts are debited for the same in the "**gaining ratio**."

Gaining ratio

Gaining ratio is the ratio of gain. You have seen this in the earlier chapters. Retirement or death of partners is one situation where gaining ratio is applied for adjusting goodwill. When a partner leaves the firm the ratio is revised and the continuing partners will share the outgoing partner's portion of profit in addition to their old ratio. It is calculated by deducting the old ratio from the new.

Calculation of gaining ratio is important when the partners decide to adjust the outgoing partner's share of goodwill without raising the goodwill account in the firm.

[Notice that we use sacrificing ratio when the new partner brings in cash for the share of goodwill on admission. Compare the two situations carefully learn thoroughly the difference in accounting treatment.]

2. Goodwill raised in the books

This is the revaluation method of treatment of goodwill. Goodwill is raised in the books of the firm by debiting goodwill account and crediting "all partners' capital accounts" in the old ratio.

With this journal entry goodwill account is actually opened in the books and will appear in the future balance sheets at its full value. The outgoing partner gets his share of goodwill along with the continuing partners.

If the continuing partners decide to reduce the value of goodwill or to write it off completely they can do so by debiting their capital accounts in the new ratio and crediting the goodwill account with the amount to be reduced. The outgoing partners share or his position is in no way affected due to this step.

3. Revaluation of assets and liabilities

Revaluation of assets and liabilities are done exactly the same way it is done on admission of a partner. The reason behind revaluation in admission or retirement is to make the balance sheet reflect a true and fair view of the assets and liabilities of the firm, prior to making any other major changes in the ownership structure of the business. Any loss or gain in this rearrangement should go to those persons, only to those persons, who are responsible. In other words the incoming new partner in admission or the outgoing partner in retirement or death shall not lose or gain due to wrong valuation of assets and liabilities.

Revaluation is done in the books through a revaluation account. Profit or loss on revaluation is transferred to the capital accounts of **all partners (including the outgoing partner) in the old profit sharing ratio.**

Remember the rule we follow in admission; "old partners in old ratio". Here also we apply the same rule. We don't call them old partners just because we don't have any "new partner in retirement". Also notice that the expression "outgoing partner" is used in this book as a convenient term to refer the "retiring partner" as well as the "deceased partner". Again deceased partner means dead partner. The term deceased sounds less deadly.

4. Reserves and Accumulated profits losses etc.

Accumulated profits, reserves, losses etc. are treated on retirement or death exactly the way they were done in admission. The profits or reserves are transferred to the credit of capital accounts of all partners in the old profit sharing ratio. As a result these items will disappear from the books and from future balance sheets as well. Accumulated losses that are appearing on the asset side of the balance sheet are transferred to the debit side of all partners in the old profit sharing ratio.

5. Adjustment of Joint Life Policy

Joint life policy is a precautionary measure to protect the firm from financial crisis, on account of death of a partner. This is a life insurance policy by which more than one life is insured. In case of a partnership firm all partners are covered usually by a single life insurance policy. The firm, not the partner, pays the premium on this policy. In the **event of death of any one of the partners, the insurance company will pay the full amount assured sum to the firm.** This amount will be regarded as a special income to the firm and credited to capital accounts of all partners in the profit sharing ratio.

Does it sound little unfair on the part of the continuing partners to share the insurance amount in the profit sharing ratio? How can someone share the life insurance money on the death of another man? This doubt is quite natural.

A person is allowed to take any number of policies on his own life and pay from his private income. Nobody except the legal heirs will get the insurance amount. But the joint life policy discussed here is different. The main aim of this policy is not supporting the family of the partner, but to save the firm from landing into financial crisis due to death of a partner. However this indirectly helps the family of the deceased by quick settlement of dues. Here all the partners (including the deceased one) decided together to insure their lives jointly and pay the premium from the firm's funds. There is another aspect also to this problem. Suppose the entire insurance claim is credited only to the deceased partner. This will defeat the very purpose for which the policy is taken. The capital account or the amount payable to the executors will directly increase to the extent of the insurance claim. Now firm has to find out other sources of finance to settle original capital investment and reserves. Therefore it is perfectly logical to consider the insurance amount as a business income and share the amount in the normal profit sharing ratio.

Sometimes the partners insure their lives separately and pay the premium from the firm. This will help the continuing partners to keep their life insurance policy valid even after the death of a partner. When there are separate life insurance policies, the full amount due on the policy of deceased partner and the surrender values of the policies of the continuing partners will be credited to all partners in their profit sharing ratio. The surrender values will appear in the subsequent balance sheets.

The following are the three methods of accounting treatment of joint life policies:

i. The insurance premium treated as normal business expense

When insurance premium is treated as normal business expense, the premium paid will be initially debited to the premium account and later on transferred to the profit and loss account just like any other business expense.

Journal entries

a) **For payment of premium**:

Joint life insurance premium account Dr.

To Cash

b) **For Transfer of expense to P & L account**

P & L account Dr.

To Joint Life Premium Account

c) **At the time of maturity** (claim due to death)

Insurance Claim Account Dr. (full amount of insurance policy)

To All Partner's Capital Accounts (in the profit sharing ratio)

d) **For cash received**

Cash / Bank account Dr.

To Insurance Claim

Illustration 3.01

A, B, and C sharing profits and losses in the ratio 2:1:1 have taken a joint life policy for Rs.100,000 with an annual premium of Rs.1,000 on 1st January 2000. C died on 10th February 2002. The Insurance Company settled the claim on 15th Feb 2002..Pass necessary journal entries in the books of the firm and show the Joint Life Premium and Insurance Claim accounts.

First Year

Jan 1, 2000

JLP Premium account Dr.1,000

To Cash Account 1,000

(JLP premium paid)

Dec.31, 2000

Profit and Loss Account Dr.1,000

To JLP premium Account 1,000

(JLP Premium written off as expense)

Second Year

Jan1, 2001

JLP Premium Account Dr.1,000

To Cash 1,000

(JLP Premium paid)

Dec.31, 2001

Profit and Los Account Dr.1,000

To JLP Premium 1,000

(JLP Premium written off)

Third Year

Jan1st, 2002

JLP Premium Account Dr.1,000

To Cash 1,000

(JLP Premium paid)

Feb10, 2002

Insurance Claim Account Dr.100,00

To A's Capital Account 40,000

To B's Capital Account 40,000

To C's Capital Account 20,000

(Insurance claim/policy maturity due to C's death)

Feb 15, 2002

Bank Account Dr.100,000

To Insurance Claim 100,000

(Insurance claim settled)

JLP Premium Account

Date	Particulars	Amount	Date	Particulars	Amount
1Jan,2000	*To Cash*	*1,000*	*31 Dec2000*	*By P&L Account*	*1,000*
		1,000			***1,000***
1 Jan 2001	*To Cash*	*1,000*	*31 Dec, 2001*	*By P&L Account*	*1,000*
		1,000			***1,000***
1 Jan 2002	*To Cash*	*1,000*	*31 Dec 2002*	*By P &L Account*	*1,000*
		1,000			***1,000***

Insurance Claim Account

Date	Particulars	Amount	Date	Particulars	Amount
Feb 10,2002	*To A's Cap 40,000*		*Feb 10, 2002*	*By Bank*	*100,000*
	To B's Cap 40,000				
	To C's Cap 20,000	*100,000*			
		100,000			***100,000***

ii. The surrender value is retained as asset.

Surrender value of an insurance policy is the amount which the insurance company will pay back to the insured if he decides to cancel the policy before maturity. The insurance company usually would not pay anything if the policy is cancelled in the first year. But thereafter, they company will agree to refund a small portion of the premium paid if the customer decides to discontinue the policy. With each payment of premium some portion it is added to the surrender value of the policy. The portion thus added into the surrender value is not considered a capital expense. Only the remaining part is written off to Profit and Loss account as expense.

Journal entries:

a. For Payment of Premium

Joint life policy account Dr.

To cash

(Notice that the joint life policy (asset) account, not the premium (expense) account is debited)

---

b. For the premium above surrender value is transferred:

P & L account Dr.

To Joint Life Policy Account

---

c. At the time of maturity (claim due to death)

Insurance Claim Account Dr. (full value insured)

To Joint Life Policy

---

d. For the Claim Settlement

Bank/cash Account Dr.

To Insurance Claim

---

e. For Closing JLP account

JLP account Dr. (balance amount)

To All Partner's Capital Accounts (Profit sharing ratio)

Illustration 3.02

A,B, and C sharing profits and losses in the ratio 2:1:1 have taken a joint life policy for Rs.100,000 with an annual premium of Rs.1,000 on 1st January 2000.The surrender values for the policy were:
31st Dec. 2000-nil;
31st Dec. 2001-Rs.300;
31st Dec. 2002- Rs.750
31st Dec. 2003- Rs.1,250
C died on 10th February 2003. The Insurance Company settled the claim on 15th Feb, 2003. Pass necessary journal entries in the books of the firm and show the Joint Life Policy and Insurance Claim accounts.

The full amount of premium paid in the first year Rs. 1,000 would be regarded an expense in that year. The premium paid in the second year resulted in surrender value of Rs300, and therefore only Rs. 700 will be considered an expense in the second year. The third premium payment resulted in an ***addition*** *of Rs. 450 to the surrender value and therefore only Rs.550 is considered to be the expense.*

Journal Entries

First Year
Jan1, 2000
Joint life policy account Dr.1,000
To Cash 1,000
(Premium paid on the joint life policy)

---

31 Dec.,2000
P&L account Dr. Rs.1000
To Joint life policy account Rs.1,000
(Premium paid transferred to the P&L)
Note: There is no surrender value in the first year in the above example.

Second Year
Jan1, 2001
Joint Life Policy account Dr.1,000
To Cash 1,000
(Premium paid on the policy)

---

31 Dec. 2001
P&L account Dr.700
To Joint Life policy 700
(The premium payment above the surrender value transferred to P&L)
(Note: Here the premium payment is Rs.1,000 out of which only Rs.700 is considered expense surrender due to value of Rs.300. The joint life policy will appear as asset in the balance sheet.)

Third Year
Jan 1 2002
Joint Life Policy account Dr.1,000
To Cash 1,000
(Premium paid on the policy)

---

31 Dec.2002
P&L account Dr.550
To Joint Life policy 550
(The premium payment above the surrender value transferred to P&L)

Fourth Year
10 Feb 2003
Insurance Claim Account Dr.100,000
To Joint Life Policy 100,000
(Insurance Claim credited to policy account)

Joint Life Policy Account Dr. 98,250
To A's Capital 39,300
To B's Capital 39,300
To C's Capital 19,650
(Joint Life policy balance transferred to capital accounts)

15 Feb 2003

Bank Account Dr. 100,000
To Insurance Claim 100,000
(Insurance claim settled)

Joint Life Policy Account

Date	Particulars	Amount	Date	Particulars	Amount
1Jan,2000	To Cash	1,000	31 Dec2000	By P&L Account	1,000
		1,000			**1,000**
1 Jan 2001	To Cash	1,000	31 Dec, 2001	By P&L Account By Balance c/d	700 300
		1,000			**1,000**
1 Jan 2002	To balance b/d To Cash	300 1,000	31 Dec.2002	By P& L Account By Balance c/d	550 750
		1,300			**1,300**
1 Jan 2003 10 Feb 2003	To balance b/d To cash To A's Cap 39,300 To B's Cap 39,300 To C's Cap 19,650	750 1,000 98,250	10 Feb 2003	By Insurance Claim	100,000
		100,000			**100,000**

Insurance Claim Account

Date	Particulars	Amount	Date	Particulars	Amount
10 Feb 2003	*To Joint Life Policy*	*100,000*	*15 Feb 2003*	*ByBank*	*100,000*
		100,000			***100,000***

iii. Joint life policy reserve account is maintained.

Under this method surrender value of Joint life policy is shown as asset (same as the second method). A joint life policy reserve equivalent to the surrender value is maintained in the books. There are three steps involved in the accounting.

Journal Entries

Step 1: Debit Join Life Policy and Credit Cash for payment of Premium

Joint Life Policy Account Dr.
To Cash

Step 2 Debit P&L Appropriation account and Credit Joint Life policy reserve to create reserve equivalent to that of policy.

P& L Appropriation Account Dr.
To Joint Life Policy Reserve Account

Step 3 Debit Joint life policy reserve and Credit Joint life policy account, to adjust the amounts in both the accounts to the actual surrender value.

Joint Life Policy Reserve Account Dr.
To Joint Life Policy Account

At the time of death of a partner the insurance related accounts are closed in the following way:

Journal Entries

1. Insurance Claim

Insurance Claim account Dr.
To Joint Life policy Account

----

2. Closing of Reserve

Joint Life Policy Reserve Account Dr.
To Joint Life Policy Account

(There is no strict rule that you must transfer the reserve into the policy account only. You can transfer this account directly to the capital accounts of partners)

----

3. Closing the Policy Account

Joint Life Policy Account Dr.
To All Partner's Capital Accounts

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4. Receiving Claim Amount
Bank/Cash Account Dr.
Insurance Claim

*Note: The above section may sound a complicated accounting treatment. More formal explanation will make more confusion. Just notice that you are creating a joint life policy account on the asset side (first entry), creating the same amount on the liability side as reserve (second entry), and trim down both the asset and liability by **mutual transfer / elimination** (third entry).*

Illustration 3.03

A,B, and C sharing profits and losses in the ratio 2:1:1 have taken a joint life policy for Rs.100,000 with an annual premium of Rs.1,000 on 1st January 2000.The surrender values estimated for the policy were:
31st Dec. 2000-nil;
31st Dec. 2001-Rs.300;
31st Dec. 2002- Rs.750
31st Dec. 2003- Rs.1,250
C died on on 10th February 2003. The Insurance Company settled the claim on 15th Feb, 2003. Pass necessary journal entries and related ledger accounts keeping treating the surrender value of the insurance policy as asset and maintaining a reserve against the policy.

First Year *Jan1, 2000* *Joint life policy account Dr.1,000* *To Cash 1,000* *(Premium paid on the joint life policy)*
31 Dec.,2000 *P&L Appropriation Account Dr. Rs.1000* *To Joint Life Policy Reserve Account Rs.1,000* *(Reserve created for the premium payment)*
31st Dec, 200 *Joint Life Policy Reserve Account Dr.1,000* *To Joint Life Policy Account 1,000* *(Balances in reserve and policy accounts eliminated by mutual transfer)* *Note: There is no surrender value in the first year in the above example.*

Second Year *Jan1, 2001* *Joint Life Policy account Dr.1,000* *To Cash 1,000* *(Premium paid on the policy)*

31 Dec. 2001
P&L Appropriation Account Dr 1,000
To Joint Life Policy Reserve Account 1,000
(Reserve created for the premium payment)

31st Dec.2001
Joint Life Policy Reserve Account Dr.700
Joint Life Policy Account 700
(Both JLP and Reserve reduced to the surrender value by mutual elimination)

(Note: Here the premium payment is Rs.1,000, but Joint life policy and JLP reserve accounts will appear at Rs.300 on the either side of the Balance Sheet.)

Third Year
Jan 1 2002
Joint Life Policy account Dr.1,000
To Cash 1,000
(Premium paid on the policy)

31 Dec. 2002
P&L Appropriation account Dr.1,000
To Joint Life policy Reserve Account 1,000
(The reserve created against premium payment)

31st Dec.2001
Joint Life Policy Reserve Account Dr.550
Joint Life Policy Account 550
(Both JLP and Reserve reduced to the surrender value by mutual elimination)

Fourth Year

1st January 2003
Joint Life Policy account Dr.1,000
To Cash 1,000
(Premium paid on the policy

10 Feb 2003
Insurance Claim Account Dr.100,000
To Joint Life Policy 100,000
(Insurance Claim credited to policy account)

10 Feb 2003

Joint Life Policy Reserve Account Dr. 750
To Joint Life Policy Account 750
(Reserve account closed by transfer to policy account)
Note: You can transfer the reserve directly to the capital accounts of partners.

10 Feb 2003
Joint Life Policy Account Dr.100,000
To A's Capital 39,600
To B's Capital 39,600
To C's Capital 19,800
(Joint Life policy closed by transfer to capital accounts)

15 Feb 2003
Bank Account Dr. 100,000
To Insurance Claim 100,000
(Insurance claim settled)

Joint Life Policy Account

Date	Particulars	Amount	Date	Particulars	Amount
1Jan,2000	To Cash	1,000	31 Dec2000	By JLP Reserve a/c	1,000
		1,000			1,000
1 Jan 2001	To Cash	1,000	31 Dec, 2001	By JLP Reserve a/c By Balance c/d	700 300
		1,000			1,000
1 Jan 2002 31 Dec 2002	To balance b/d To Cash	300 1,000	31 Dec, 2002	By JLP Reserve a/c By Balance c/d	550 750
		1,300			1,300
1 Jan 2003 10 Feb 2003	To balance b/d To Cash To A's Capital 39,600 To B's Capital 39,600 To C's Capital 19,800	750 1,000 99,000	10 Feb 2003	By JLP Reserve By Insurance Claim	750 100,000
		100,750			100,750

JLP Reserve Account

Date	Particulars	Amount	Date	Particulars	Amount
31 Dec 2000	To JLP Account	1,000	31 Dec2000	By P&L Appropriation	1,000
		1,000			1,000

31 Dec 2001	To JLP Account To Balance c/d	700 300	31 Dec, 2001	By P&L Appropriation	1,000
		1,000			1,000
31 Dec 2002	To JLP Account To Balance c/d	550 750	1 Jan, 2002 31 Dec, 2002	By Balance b/d By P&L Appropriation	300 1,000
		1,300			1,300
10 Feb 2003	To JLP Account	750	1 Jan, 2003	By Balance b/d	750
		750			750

6. Adjustment of Capital Accounts

Capital accounts of the continuing partners may be readjusted on the basis of new profit sharing ratio. Generally partners bring in or take out cash to adjust the capital balances. They can even do this adjustment by opening current accounts and passing the surplus or deficiency there, without bringing in or taking out cash.

CHAPTER:4 DISSOLUTION OF THE PARTNERSHIP

Meaning of Dissolution

Dissolution of a partnership firm is the process by which the existence of a partnership firm comes to an end. This involves the sale or disposal of assets, settlement of liabilities and closing of books of accounts. Once the outside liabilities of the firm are settled, the partners take away their capital investment. If there is any surplus or deficit in this process it will be shared by the partners in their profit sharing ratio.

Dissolution of a partnership firm can take place on account of any of the following reasons:

a. **Dissolution by Agreement:** When the partners themselves reach an agreement to discontinue their business for whatever reason, it is known as dissolution by agreement.

b. **Compulsory Dissolution:** Compulsory dissolution takes place when the business of the firm is declared illegal, or the partners become insolvent or the citizen of an enemy country happens to be partner of the firm.

c. **Dissolution by notice:** A partner can demand dissolution of a partnership at will, by serving a notice to the firm.

d. **Dissolution by Court:** Court may initiate dissolution of a firm under the following circumstances:

i) When one of the partners has become of unsound mind
ii) When a partner is guilty of misconduct which may affect the business
iii) When a partner commits wilful breach of contract
iv) Any other reason which the court may find adequate

e. **Dissolution by the expiry of a pre determined period or completion of event:** This dissolution takes place in case of particular partnerships which are formed for a specific period or the completion of a specific project. Such partnerships will be dissolved at the completion of the specific period of or the project as the case may be.

Dissolution of Partnership and Dissolution of Partnership Firm

The term dissolution, referred in relation to a partnership business generally denotes the winding up of the business. However, there is a difference between 'dissolution of partnership' and 'dissolution of the partnership firm'. The former indicates ending of agreement only to replace it with a new one, but the latter indicates the ending of partnership business altogether. The following points may be noted in comparison between the two:

Dissolution of Partnership	**Dissolution of Partnership Firm**
Only the agreement is dissolved, no physical disposal takes place.	The Firm is dissolved, by selling off assets and settling liabilities.
The partners will continue to run the business with a new agreement.	The partners will discontinue the business
Limited effect on employees or debtors and creditors of the business	Since the business is closed down it affects the workers, debtors and creditors of the firm
Many dissolutions of agreement can take place during the life of a partnership business.	Dissolution of firm can take place only once in the lifetime of a partnership business.
Admission, retirement and or death of a partner can result in compulsory dissolution of existing agreement.	None of these events can lead to a compulsory dissolution of the firm.

Settlement of Accounts on Dissolution

The first step in dissolution is the realisation of assets followed by the settlement of outside liabilities. All individual accounts for assets and liabilities, except cash, are closed by transferring their balances to a Realisation Account. Realisation account is the temporary account for accumulating all assets and liabilities for convenient accounting treatment. All ledger accounts except partner's capital accounts and cash account are closed prior to realisation procedure. Accumulated profits or losses are directly transferred into the capital accounts in the profit sharing ratio. The following is the order of priority in settlement of liabilities and capital upon dissolution:

i) Expense incurred on realisation of assets such as commission, cartage, brokerage etc.
ii) All outside creditors
iii) Partner's Loan accounts
iv) Balances in Capital Accounts of partners

Special Items in Accounting for Dissolution

1. **Realisation Account:** This is the most important account prepared to facilitate dissolution of firms. This is equal in importance to Revaluation Account in Reconstitution. There is no scope of revaluation of assets and liabilities of a firm under liquidation. Realisation account is used to accumulate all assets and liabilities in one place for convenient accounting steps for disposal and settlement of liabilities.

2. **Treatment of Goodwill:** Goodwill is the most prominent item in Reconstitution of partnership. But goodwill does not have any special treatment in dissolution. If it appears in the books it has to be transferred into Realisation Account. This will automatically gets transferred into the Capital Accounts of Partners, by way of realisation profit or loss. If goodwill does not appear in the books it is just ignored. There is no meaning in raising it or treating it in any way when the firm is being dissolved.

3. **Realisation Expenses:** Expenses of realisation such as commission paid to brokers for the disposal of assets, expenses on transportation of items, registration documentation charges for the assets sold etc. are debited to Realisation Account and credited to Cash Account. However if any partner agrees to bear the expense for a certain fees, the fees charged by the partner becomes the common expense which is debited in Realisation Account; whereas the actual realisation expense, if mentioned, should be treated as personal drawing of the partner concerned.

4. **Wife's Loan:** Loans from a partners' wife is to be treated as normal creditor. The basic aim of providing a loan in the name of partner's wife is to by-pass the legal restrictions on the Loan from a Partner to the firm.

5. **Provident Fund:** Provident fund should be understood as a liability payable to the employees. It should be paid off even when the question is silent about its treatment. Same rule applies to all other outside liabilities, such as creditors, bills payable etc.

6. **Specific Funds:** Specific funds such as Investment Fluctuation Funds are preferably credited to Realisation account along with the transfer of related asset, which will get transferred to capital accounts by way of profit of loss on Realisation. Provision for doubtful debts, accumulated depreciation etc. must be credited to Realisation Account along with the transfer of assets.

7. **Profits Kept Aside:** General Reserve; credit balance in P& L Account etc should be directly transferred into the Capital Accounts of Partners, in the profit sharing ratio.

8. **Unrecorded Assets:** Unrecorded assets or assets which are completely written off may fetch some cash at the time of dissolution. There is no need of bringing them into books and selling them afterwards. It can be directly treated by crediting realisation account and debiting cash account.

9. **Creditors Purchasing Some Assets in Part Settlement of Claim:** When creditors purchase some of the assets in part settlement, this is not specifically recorded by way of a journal entry, since the asset and liability are appearing in the same Realisation Account. The balance amount due to the creditors is aid in full satisfaction of the claim. If the value of asset taken over is more than the amount due, the creditors will pay the excess amount to the firm.

   Please note*: The treatment of creditors taking over part of the assets mentioned above is a questionable accounting treatment. What I mentioned above is only on 'examination point of view'. The correct account treatment is to debit the Creditors account in the Ledger by passing a journal entry and transferring the balance of creditors into Realisation Account*

Profit or loss on realization will be transferred to the Capital Accounts of partners in the profit sharing ratio. At the final stage of the realization process, only Cash Account and Capital Accounts will be left. The final balances of each other will match exactly, and the cash will be paid off to capital accounts to close both the accounts. This is the last transaction in the books of the firm.

The entire accounting steps in realization can be summarized as follows:

Step 1: Reduce the Number of Accounts into THREE: As you are aware each item in a detailed Balance Sheet represents an account in the Ledger. You have to reduce them into just **three** accounts, namely
i) Realisation Account
ii) Capital Accounts of Partners (considered one account)
iii) Cash Account

Step 2: Reduce the Number of Accounts into TWO: Major activities of realisation process take place at this stage. Sell assets one by one and add it to (debit) Cash and reduce it from (credit) Realisation Account. Take out cash and pay to liabilities placed in the Realisation Account. Now the Realisation Account is reduced to a residue, without any active accounts inside. This balance is transferred into capital accounts as realisation profit or loss. Now you have only two accounts, the Cash Account and the Capital Account.

Step 3: Reduce the Number of Accounts to NIL: This is the most interesting step. Here the cash balance has to be exactly equal to the credit balance in capital account. Take out cash (cr); Pay off Capital (Dr.), and there ends the Partnership Business.

Journal Entries in Dissolution

Accounting for dissolution begins with the closing of assets and liabilities accounts by transferring them to Realisation Account.

i) For transfer of assets
Realisation Account Dr.
To Asset Account

ii) For Transfer of liabilities
Liability Account Dr.
To Realisation Account

Accumulated profits such as General Reserves, Profit and Loss Account Credit Balance etc. are transferred to capital Accounts in the profit sharing ratio.

iii) For transfer of accumulated profits
Accumulated Profit Account (General Reserve; P&L etc.) Dr.
To Realisation Account

Note: Provision for doubtful debts; Investment fluctuation fund etc. are credited to realization account and ignored thereafter. These are internal provisions having no claim against the firm and therefore these amounts will merge into realization profit or loss and finally get transferred to Capital Accounts of partners.

iv) For assets realized
Cash/Bank account Dr
To Realisation Account
Note: We do not have separate asset account anymore. Realisation account is the common account representing all assets and liabilities transferred into it. Please check the next entry also.

v) For Liabilities paid off
Realisation Account Dr.
To Cash Account

vi) For asset taken over by a partner
Partner's Capital Account Dr.
To Realisation Account

vii) For Liability taken up by the partner
Realisation Account Dr.
To Partner's Capital Account

viii) For unrecorded asset taken over by a partner
Partner's Capital Account Dr.
To Realisation Account

ix) Unrecorded Liability settled by the firm
Realisation Account Dr.
To Cash account

x) Realisation expense
Realisation Account Dr.
To Cash

xi) Asset taken over by creditors

No entry; Only settlement of balance amount is shown in the books.

Author's Comment

This is the easiest chapter in Partnership accounts. You have 10 marks for this chapter under revised syllabus. Here you need not remember different methods of treatment of goodwill, no ratio calculations etc. Everything is plain and simple. Pay serious attention to this chapter to secure full 10 marks. Look at some of the important adjustments in the previous chapters becoming very simple here.

1. Goodwill

You must have spent maximum time in understanding various ways of treatment of goodwill in the earlier chapters. Here it is very simple; if there is goodwill given in the Balance Sheet, just debit it in the realisation account and forget it, yes, forget it. If it does not appear in the Balance Sheet, just ignore it; who cares about the goodwill of a firm under liquidation anyway? Simple, simple indeed!

2. Old Ratio, New Ratio, Sacrificing Ratio, Gaining Ratio, any other ratio? See the long list of ratios you need NOT apply here. You have just one profit sharing ratio, to transfer the profit or loss on realisation.

3. Revaluation: You need not struggle with the revaluation of assets and liabilities. There are no provisions to be kept. Here you just have a Realisation Account to move your ledger account items for the time being to help you transfer them to cash as and when realised.

4. Balance Sheet In dissolution you have to prepare NO Balance Sheet at all. Instead you have to destroy one Balance Sheet given in the question. Too good to be true, but it is very true. What you have to do here is to break up old Balance Sheet, extract cash out of it, pay to creditors and finally to owners. Remember how funny it looked when you played video cassettes in reverse mode, cars running backwards at full speed, food taken out of mouth and put back into plate and all those funny stuff. Dissolution is the action replay of partnership formation in the 'reverse mode'. The process of forming cash and other assets and liabilities in a business forming a Balance Sheet in the beginning of a business is now reversed to show how a Balance Sheet melts into cash, finally goes from the cash box to the owners' pockets as return of capital.