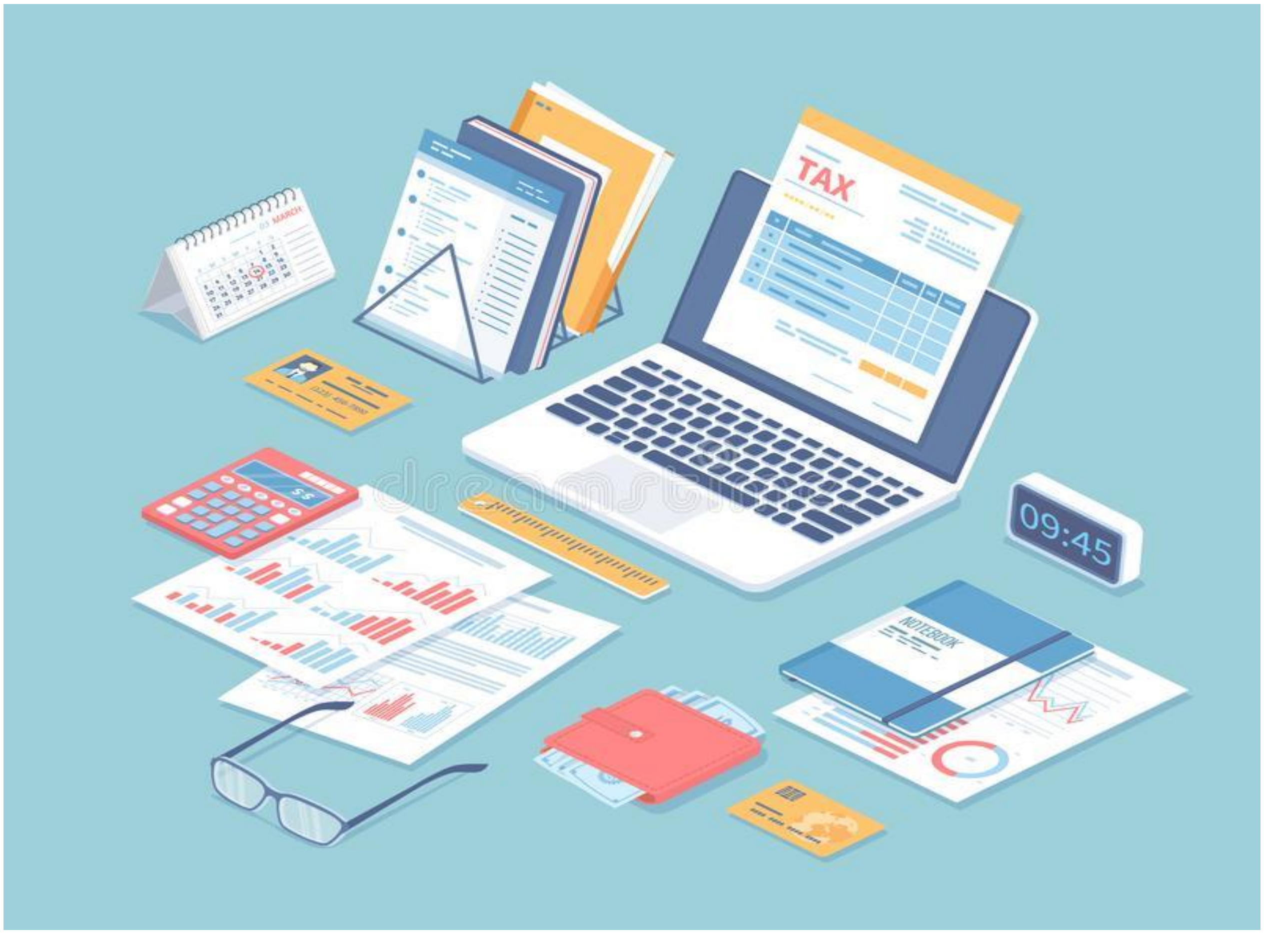
ACCOUNTANCY

PART-1

Chapter 3: Reconstitution of a Partnership Firm – Retirement and Death of a Partner



Reconstitution of a Partnership Firm – Retirement and Death of a Partner

According to section 32(1) of the Indian Partnership Act, 1932:

A partner may retire in any of the following ways:

1. With the consent of all the partners.
2. In accordance with an express agreement by the partners.
3. Where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

Retirement means one or more partners may leave the firm and it is the end of an existing agreement between the partners (one of the ways of reconstitution of partnership firm) but it does not mean the end of the business.

Accounting treatment/ Adjustments to be made at the time of Retirement of a partner:

1. Calculation of New Profit-Sharing Ratio and Gaining Ratio.
2. Treatment of Goodwil.
3. Treatment of Accumulated Profit/ Losses and Reserves.
4. Revaluation of Assets and Reassessment of Liabilities.
5. Preparation of Balance Sheet.

Calculation of New Profit Sharing Ratio:

The ratio of remaining partners is known as New Profit Sharing Ratio, in which they will share the future profits. When a partner retires from the firm, the remaining partners acquired share of retiring partner either in their old ratio or in specified ratio.

New Profit Sharing Ratio = Old Ratio + Gaining Ratio

Calculation of Gaining Ratio: It is the ratio in which retiring partner’s share is acquired by the remaining partner.

Gaining Ratio = New Ratio – Old Ratio

Case:-1 When New profit sharing ratio of continuing partners is not given, in such a situation, it is assumed that they will share profits in their old ratio.

Example: A, B and C are partners sharing profit in the ratio of 3 : 2 : 1. If A retires from the firm.

Calculate New and Gaining Ratio.

The New and Gaining ratio between B and C will be 2:1.

Solution:

Total share of profits = 1

Remaining share after A's retirement = 1- 3/6 = 3/6

New Profit sharing Ratio:

B = 2/6 × 6/3(reciprocal of the remaining share) = 2/3

C = 1/6 × 6/3(reciprocal of the remaining share) = 1/3

Therefore New Profit sharing Ratio = 2 : 1

Gaining Ratio = New Ratio – Old Ratio

B's gaining share = 2/3 – 2/6 = (4-2)/6 = 2/6

C's gaining share = 1/3 - 1/6 = (2-1)/6 = 1/6

Therefore gaining ratio = 2 : 1

Case:- 2 When new profit sharing ratio of continuing partner is given.

Example: A, B and C are partners sharing profit in the ratio of 3 : 2 : 1. If A retires from the firm.

The New ratio between B and C will be 3 : 2.

Calculate gaining ratio.

Solution:

Gaining Ratio = (New Ratio – Old Ratio)

B's Gaining share = 3/5 – 2/6 = (18- 10)/30 = 8/30

C's gaining share = 2/5 – 1/6 = (12- 5)/30 = 7/30

Gaining Ratio between B and C = 8 : 7

Case:- 3 When continuing partners acquire retiring partner's share in some specified proportion.

Example: A, B and C are partners sharing profits in the ratio of 15 : 12 : 3. A gets retirement from the firm and his share is taken by remaining partners equally. Calculate New and Gaining Ratio.

Solution: A retire and his share = 15/30

This share of A is taken by B and C equally

B's gaining share = 15/30 × 1/2 = 15/60

C's gaining share = 15/30 × 1/2 = 15/60

Gaining Ratio = 1:1

New Profit sharing ratio = Old share + gaining share

B's new share = 12/30 + 15/60 = (24+ 15)/60 = 39/60

C's new share = 3/30 + 15/60 = (6+ 15)/60 = 21/60

Therefore New Profit sharing Ratio = 39:21 = 13:7

Case:- 4 When Retiring Partner sells his share to the Continuing partners.

Example: X, Y and Z are partners sharing profits in the ratio of 5 : 3 : 2. Y retires and sells his share of goodwill to X for ₹ 12,000 and to Z for ₹ 8,000. Calculate gaining ratio and new ratio of X and Z.

Solution:

Gaining share of X and Z is ₹ 12,000 and ₹ 8,000 = 3 : 2

It means X and Z has acquired Y's share in 3:2.

X's gaining share = 3/10 × 3/5 = 9/50

Z's gaining share = 3/10 × 2/5 = 6/50

New profit sharing ratio:

X's new share = 5/10 + 9/50 = (25+ 9)/ 50 = 34/50

Z's new share = 2/10 + 6/50 = (10+ 6)/50 = 16/50

New Ratio = 34:16 = 17 : 8

Treatment of Goodwill:

- At the time of retirement of a partner, he/she will get his/her capital, profit, reserves etc. and also goodwill.
- The goodwill of retiring partner will be calculated and will be adjusted among remaining partners in gaining ratio.
- Retiring Partner's share of goodwill = Total Goodwill of the firm × Retiring Partner's share

Journal Entries for Goodwill:

Gaining Partner's Capital A/c Dr.
    To Retiring Partner's Capital A/c/ Sacrificing Partner's Capital A/c

(Being retiring partners share of goodwill is adjusted in the gaining ratio through the Capital accounts of the partners)

Note: Goodwill given in the Balance Sheet of the firm should be debited all old partners in their old ratio. (Same treatment as in case of change in profit sharing ratio and admission of a partner)

Hidden Goodwill:

When goodwill is not given (in adjustment), in such a case following steps to be used to calculate the Hidden Goodwill.

Step 1. Calculation of actual amount due to the retiring partner.
Step 2. Calculation of total amount to be paid to retiring partner.
Step 3. Hidden Goodwill = Step 2 – Step 1
Note: Amount of hidden goodwill is equal to the goodwill of retiring partner. The treatment of hidden goodwill is same like the treatment of goodwill discussed above.

Treatment of Accumulated Profits/Losses and Reserves:

At the time of retirement of a partner, all the accumulated profits/Losses and Reserves are to be distributed to the old partners in their old profit-sharing Ratio.

Note: Treatment of Accumulated profits/losses and Reserves at the time of retirement is similar to that at the time of Admission of a Partner.

Treatment: All free reserves and profits given in the liabilities side should be credited to Partner's Capital Accounts or Current Account (If Capitals are fixed) and all fictitious assets/ accumulated losses should be debited to the Partner's Capital Account or Current Account (If Capitals are fixed) in their old ratios.

Treatment of Revaluation of Assets and Reassessment of Liabilities:

Note: Treatment of Revaluation of Assets and Re-assessment of liabilities and Preparation of Revaluation Account is same as we have done in case of Admission of a partner.
In case of Retirement also we will distribute Revaluation Profits/Losses to all the partners in their old ratios.

Amount Payable to Retiring Partner:

Amount to be credited to the Retiring Partner's Capital Account/Amount to be paid

- Balance of his/her capital account
- Balance of his/her current account
- Share of goodwill
- Share in Revaluation profits
- Share in Accumulated profits and Reserves
- Interest on Capital
- Salary/Commission etc.
- Share in the profit of current year.

Amount to be debited to the Retiring Partner's Capital Account/Amount to be recovered

- Drawings
- Interest on drawings
- Share in Revaluation Loss
- Written off portion of goodwill appearing in the books
- Written off of fictitious assets

Death of a Partner:

In case of death of the partner, partnership will come to an end immediately. In such a case remaining partners may continue the business. All amounts due to the deceased partner will be paid to his legal representative/Executor.
Executor is the person named in a Will or appointed by a court to wind up the deceased partner's financial affairs after death. He is entitled to all the amounts due to the deceased partner.

Calculation of deceased Partner's share of Profit till the date of death:

If a partner dies on any date after the date of the Balance Sheet, then his share of profits is calculated from the beginning of the year to the date of death on the following basis:

1. **On the Basis of Time:** When share of profit is calculated on the basis of time, it may be on the basis of previous years' profit or average profit of the last year.

   Profit from the date of last balance sheet to the date of death = (Number of days or month from the date of last balance sheet to the date of death/ 365 or 12) × Previous years' profit or Average profits of given number of past years.

   Example: 1 A, B and C are partners sharing profits in the ratio of 3:2:1. They closed their books on 31st March, 2021. C died on 1st August 2021. Profit of the last year was ₹ 54,000. C's share of profit to be calculated on the basis of last year's profit.

   Solution: C's share of profit = 54,000 × 4/12(period) × 1/6(His share) = 3,000

   Example: 2 X, Y and Z are partners sharing profits in the ratio of 5:3:2. They closed their books on 31st March, 2021. Y died on 30th September, 2021. Y's share of profit of the interim period is to be calculated on Average profits of last 3 years The Profits of the last 3 years were ₹ 18,000; ₹ 20,000; ₹ 22,000.

   Solution: Y's share of profit = (18,000 + 20,000 + 22,000)/3 = 20,000; 20,000 × 6/12(period) × 3/10 (His share) = 3,000

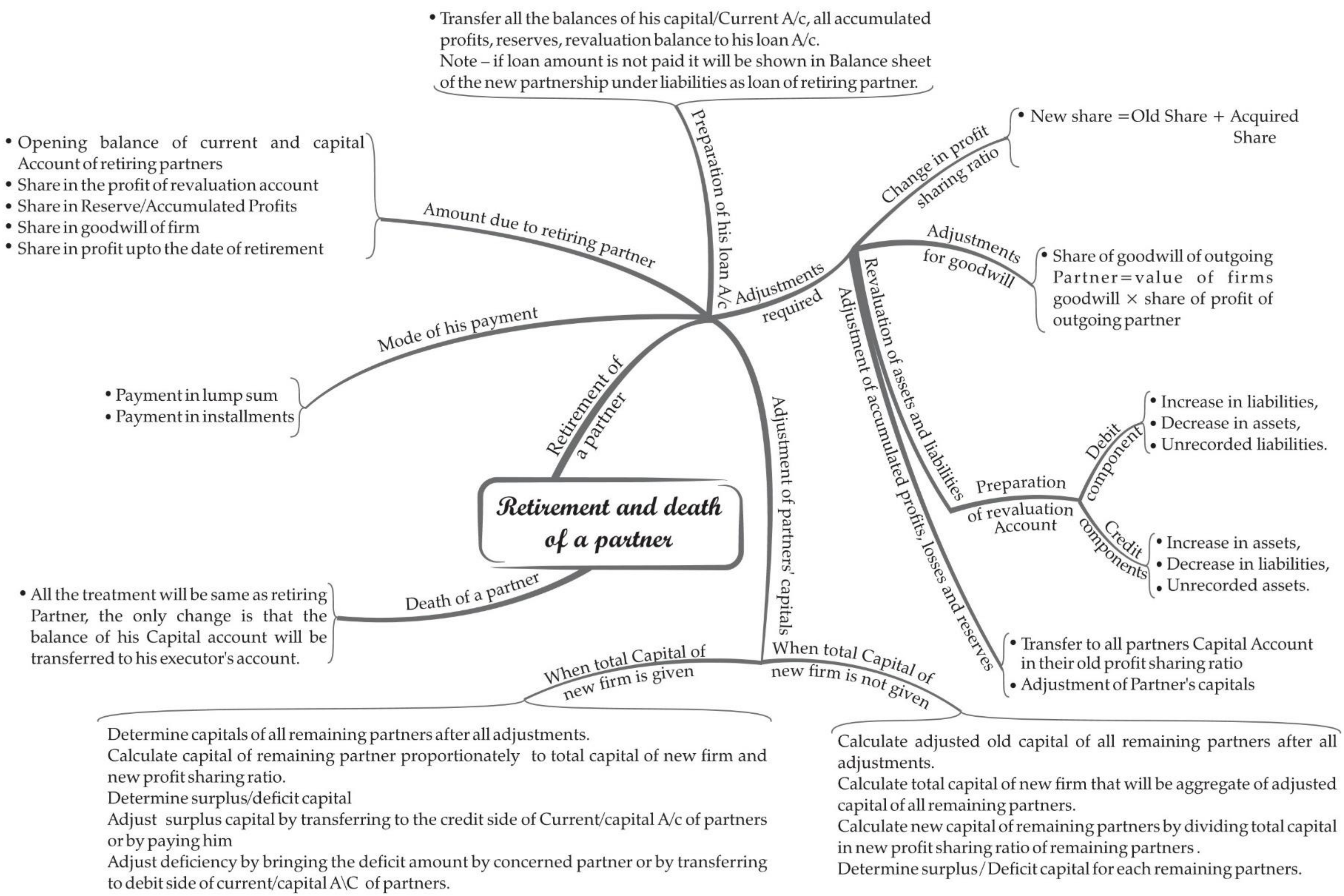
2. **On the basis of Sales/Turnover:** Profit from the date of last balance sheet to the date of death = (Sales from the date of the last Balance Sheet to date of death)/ (Previous year's sales or Average sales of given number of past years) × Previous years' Profits or Average Profits of given number of Past years.

   Example: A, B and C are partners sharing profits equally. They closed their books on 31st March, 2021. A died on 30th June 2021. Sales for the last year was ₹ 5,00,000 and profit was ₹ 1,00,000. Sales for the period 1st April, 2021 to 3oth June 2021 was ₹ 3,00,000.
   Solution: Last year's Profit on sales = (1,00,000/ 5,00,000) × 100 = 20%
   Current year's profit up to the date of death = 3,00,000 × 20/100 = 60,000
   A's share of Profit = 60,000 × 1/3 = 20,000

   OR

   Profit from the date of last balance sheet to the date of death = (3,00,000/5,00,000) / 1,00,000 = 60,000
   A's share of Profit = 60,000 × 1/3 = 20,000
   Journal Entries -
   - In case of profit,
     Profit and Loss Suspense Account ……… Dr.
     To Deceased Partner's / Current Account
   - In case of Loss,
     Deceased Partner's / Current Account ……… Dr.
     To Profit and Loss Suspense Account

CHAPTER 4 - RETIREMENT AND DEATH OF A PARTNER



Important Questions

Multiple Choice questions-

Question 1. At what rate is interest payable on the amount remaining unpaid to the executor of deceased partner, in absence of any agreement among partners, when (s)he opts for interest and not share of profit.
(a) 12% p.a.
(b) 8%p.a.
(c) 6%p.a.
(d) 7.5%p.a.
Question 2. Partnership will be dissolved if
(a) profit sharing ratio changed
(b) admission of a new partner
(c) retirement of a partner
(d) All of these
Question 3. Gaining Ratio:
(a) Old Ratio – New Ratio
(b) New Ratio – Old Ratio
(c) Old Ratio + Old Ratio
(d) All of these.
Question 4. At the time retirement of a partner, ratio is calculated:
(a) old
(b) sacrifice
(c) gaining
(d) All of these.
Question 5. After the death of an existing partner, shares of remaining partner will
(a) increase
(b) decrease
(c) not change
(d) All of these.
Question 6. At the time of retirement of an existing partner, goodwill already shown in the books is written off in ratio.
(a) old
(b) new
(c) sacrifice
(d) gaining
Question 7. Goodwill of the deceased partner will be debited in remaining partners' capital Account in ratio.
(a) old
(b) new
(c) sacrifice
(d) gaining

Question 8. At the time of retirement of a partner, goodwill will be credited in partner's capital Account.
(a) old
(b) gaining
(c) retiring
(d) All of these.
Question 9. At the time of retirement of a partner, account is prepared.
(a) revaluation A/c
(b) profit and loss A/c
(c) balance sheet
(d) All of these.
Question 10. The retiring/deceased partner must be compensated in the form of premium (goodwill) for the share of profit in favour of continued partners. .
(a) sacrificed
(b) gained
(c) obtained
(d) None of these.

Very Short Questions-

1. What is meant by 'Gaining Ratio' on retirement of a partner?
2. At the time of retirement how is the new profit sharing ratio among the remaining partners calculated?
3. In which ratio do the remaining partners acquire the share of profit of the retiring partner?
4. At the time of retirement of a partner, state the condition when there is no need to compute gaining ratio.
5. On the retirement of a partner, how is the profit sharing ratio of the remaining partners decided?
6. Why is gaining ratio of the remaining partners calculated at the time of retirement/death of a partner?
7. State the ratio in which share of goodwill of the retiring partner is debited to Capital Accounts of the remaining partners.

Short Questions-

1. What are the different ways in which a partner can retire from the firm?

2. Write the various matters that need adjustments at the time of retirement of partner/partners.

3. Distinguish between sacrificing ratio and gaining ratio.

4. Why do firm revaluate assets and reassess their liabilities on retirement or on the event of death of a partner?

5. Why a retiring/deceased partner is entitled to a share of goodwill of the firm?

Long Questions-

1. Explain the modes of payment to a retiring partner.

2. How will you compute the amount payable to a deceased partner?

3. Explain the treatment of goodwill at the time of retirement or on the event of death of a partner?

4. Discuss the various methods of computing the share in profits in the event of death of a partner.

MCQ Answers-

1. Answer: (c) 6%p.a.
2. Answer: (d) All of these
3. Answer: (b) New Ratio – Old Ratio
4. Answer: (c) gaining
5. Answer: (a) increase
6. Answer: (a) old
7. Answer: (d) gaining
8. Answer: (c) retiring
9. Answer: (a) revaluation A/c
10. Answer: (a) sacrificed

Very Short Answers-

1. Answer: The ratio in which retiring Partner's Share is distributed between remaining Partner is called gaining ratio.

2. Answer: The new share of each of the remaining partner is calculated as his/her own share in the firm plus the share acquired from the retiring partner.

3. Answer: Gaining ratio.

4. Answer: When the remaining partners share profits in old ratio.

5. Answer: On the basis of old profit sharing ratio.

6. Answer: Gaining ratio of the remaining partners is calculated to determine amount of goodwill payable by them to retired/deceased partner.

7. Answer: In their gaining ratio.

Short Answers-

1. Here are the different ways:
    i. For a partner to retire consent of firm's co-partners is required. A partner can retire if all partners agree with the decision to retire.
    ii. A partner can express his desire to retire by issuing a notice to the firm in case there is a written agreement.
    iii. A partner can retire by giving a written notice to all other partners in absence.
2. At the time of retirement of partner/partners, following matters needs adjustment:
    i. Determining new gaining ratio of the partners who are remaining in the firm.
    ii. Determine new ratio of firms remaining partners.
    iii. Determine goodwill of the firm and ensure its proper accounting treatment
    iv. Revaluating liabilities and assets of the new firm.
    v. Distributing among all the partners the accumulated profits and losses, along with reserves.
    vi. Retiring partner's settlement
    vii. Revised calculation of capital accounts of remaining partners and their new and updated profit sharing ratio.
    viii. Joint life policy treatment.
3.

Basis of Difference	Sacrificing ratio	Gaining Ratio

1. Meaning	The ratio where a partner of a firm agree to sacrifice the profit share and make it available for new partner.	That ratio in which a partner obtains the profit share from the partner who is leaving the firm.
2. Calculation	Calculated as difference between old and new ratio	Calculated as difference between new and old ratio
3. Time	Calculation done at the admission of a new partner	Calculation done at the retirement/death of a partner.
4. Objective	It is used to determine the profit and loss share that is sacrificed by the current partners at the time of joining of new partner.	It is used to determine profit and loss share that is obtained by the existing partners when a partner retires/becomes deceased
5. Effect	Existing partners profit share is reduced	Continuing partner profit share is increased.

4. As a partner retires or is taken away by death, it becomes critical to determine the liabilities and assets value on the current date to get a fair idea about its true worth. Revaluation becomes essential as liabilities and assets may increase or decrease in value as time passes. It may also happen that certain liabilities and assets had remained unrecorded the last time books are updated. As a partner retires/ death happens, it may have a positive/negative impact on the value of firm's liabilities and assets. Therefore, it is a good idea to revaluate the value so that the true profit/loss can be determined so that it can be share d among partners as per sharing ratio as determined at the time of setting up partnership.

5. A firm earns goodwill by the efforts of the partners and is regarded as one of the most important intangible asset. After a partner retires or is dead, the good work that was done by that partner should be acknowledged and hence a proper compensation should be provided to the partner in form of a part of goodwill of firm.

Long Answers-

1. The following are the modes of payment to a retiring partner.

   (i) If the amount due to the retiring partner is to be paid in lump sum on the day of his/her retirement then the following Journal entry need to be passed.

   Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

(Retiring partner paid in cash)

(ii) If the amount due to the retiring partner is to be paid in installments then the balancing figure of his/her capital account is transferred to his/her loan account. In this case, the retiring partner receives equal installments along with the interest on the amount outstanding. The following necessary Journal entry is to be passed.

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

(Retiring partner capital account transferred to the retiring partner's loan account @ -------- % p.a.).

(ii) If the amount due to the retiring partner is to be paid partly in cash and partly in equal installments then a certain amount is paid in cash to the retiring partner on the date of the retirement and the rest amount due to him/her is transferred to his/her loan account. The following necessary Journal entry is to be passed.

Retiring Partner's Capital A/c (with the total amount due to the retiring partner) Dr.

To Retiring Partner's Loan A/c (with the amount transferred to the partner's loan account)

To Cash A/c (with the amount paid in cash immediately on the date of the retirement)

(Retiring partner partly paid in cash and balance transferred to the partner's loan account)

2. The legal executer of the deceased partner is entitled for the balancing figure of the deceased partner's capital account. The balancing figure of the deceased partner's capital account is derived after posting the below mentioned items in Step 1 and Step 2.

Step 1: The following items are posted in the debit side of the deceased partner's capital account.

a) Credit balance of the deceased partner's capital account and/or current account.

b) Deceased partner’s share of profit up to the date of his/her death.

c) Deceased partner’s share of goodwill.

d) Deceased partner's share in accumulated reserves and profit account.

e) Deceased partner's share in gain on revaluation of assets and liabilities.

f) Deceased partner's share of Joint Life Policy.

g) Interest on capital, if any, up to the date of the death.

h) Salary or commission, if any, up to the date of the death.

Step 2: The following items are posted in the credit side of the deceased partner's capital account.

a) Debit balance of the deceased partner's capital account and/or current account.

b) Amount withdrawn in the form of drawings up to the date of death of the partner.

c) Interest on drawings, if any, up to the date of the death.

d) Deceased partner's share in loss on revaluation of assets and liabilities.

e) Deceased partner's share of loss up to the date of the death.

f) Deceased partner's share in the accumulated losses of the firm.

The legal executor is entitled for the balancing figure that is the excess of the credit side over the debit side of the deceased partner's capital account.

Deceased Partner's Capital Account

Dr. **Cr.**

Date	Particulars	J.F.	Amount Rs	Date	Particulars	J.F.	Amount Rs
	Revaluation A/c (Loss)				Balance b/d		
	Profit and Loss Suspense A/c				Profit and Loss Suspense A/c		
	(Share of loss up to the date of the death)				(Share of profit up to the date of the death)		
					Goodwill		
	Accumulated Losses A/c				Reserves and Profits		
	Goodwill A/c (Written off)				Revaluation A/c (gain)		
	Partner Executor's A/c				Joint Life Policy A/c		
	(Balancing Figure)				Interest on Capital A/c		
					Salary A/c		
					Commission A/c		

3. At the time of retirement or at the event of death of a partner, the goodwill is adjusted among the partners in gaining ratio with the share of goodwill of the retiring or the deceased partner. As per Para 16 of Accounting Standard 10, it is mandatory to record goodwill in the books only when consideration in money or money's worth has been paid for it.

   In case of retirement and death of a partner, goodwill account cannot be raised. There are namely two probable situations on which the treatment of goodwill rests.

   1. If goodwill already appears in the books of the firm.

   2. If no goodwill appears in the books of the firm.

   Situation 1: If goodwill already appears in the books of the firm.

   Step 1: Write off the existing goodwill

   If goodwill already appears in the old balance sheet of the firm (if mentioned in the question), then first of all, this goodwill should be written off and should be distributed among all the partners of the firm including the retiring or the deceased partner in their old profit sharing ratio. The following Journal entry is passed to write off the old/existing goodwill.

   All Partners' Capital A/c Dr.

   To Goodwill A/c

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

   Step 2: Adjusting goodwill through partner's capital account.

   After writing off the old goodwill, the goodwill need to be adjusted through the partner's capital account with the share of the goodwill of the retiring or the deceased partner. The following Journal entry is passed.

   Remaining Partner's Capital A/c Dr.

   To Retiring/Deceased Partner's Capital A/c

   (Gaining Partner's Capital A/c is debited in their gaining share and retiring/deceased partner's capital account in credited for their share of goodwill)

   Situation 2: If no goodwill appears in the books of the firm.

   As no goodwill appears in the books of the firm, so the goodwill is adjusted through the partner's capital account with the share of the goodwill of the retiring or the deceased partner. The following Journal entry is passed.

Remaining Partner's Capital A/c Dr.

To Retiring/Deceased Partner's Capital A/c

(Gaining partner's capital account is debited in their gaining share and retiring/deceased partner's capital account in credited for their share of goodwill)

4. In case of death of a partner during the year, his/her executer is entitled for share of profit up to the date of death of the partner.

The share of profit can be calculated by one of the two methods.

1) On time basis: Under this method, profit up to the date of the death of the partner is calculated on the basis of the last year's/years' profit or average profit of last few years. In this approach, it is assumed that the profit will be uniform throughout the current year. The deceased partner will be entitled for the share of the profit proportionately up to the date of his/her death.

Share of Deceased Partner in Profit =

$$\text{Previous Year /Average Profit} \times \frac{\text{Time period from date of balance sheet till death}}{\text{12 months / 52 weeks / 365 days}} \times \text{Profit Share of deceased partner}$$

Example- A, B and C are equal partners. The profit of the firm for the years 2008, 2009 and 2010 are Rs 10,00,000, Rs 7,00,000 and Rs 13,00,000 respectively. C dies on April 30, 2011. The share of C in the firm's profit will be calculated on the basis of average profit of last three years. Firm closes its books every year on December 31.

In this case, C's share in the profits will be calculated for four months, i.e. from January 01, 2011 to April 30, 2011.

$$\text{Average Profit} = \frac{10,00,000 + 7,00,000 + 13,00,000}{3} = \text{Rs } 10,00,000$$

$$\text{C's share of profit} = 10,00,000 \times \frac{4}{12} \times \frac{1}{3} = \text{Rs } 1,11,111 \text{ approx.}$$

2) **On the sale basis:** Under this method, profit is calculated on the basis of last year's sale. In this situation, it is assumed that the net profit margin of the current year's sale is similar to that of the last year's.

Share of Deceased Partner's $= \frac{previous\ Year's Profit}{Previous\ Year's Sales} \times$ Sales from the beginning of the current year up to the date of death × Share of deceased partner.

Example- X Y and Z are equal partners. The last year's sales and profit were Rs 25,00,000 and Rs 2,50,000. Z died on the April 30, 2011. Sales of the current year till the date of Z's death amounts to Rs 12,00,000. Firm closes its books on December 31 every year.

$$\text{Z's share of profit} = \frac{2,50,000}{25,00,000} \times 12,00,000 \times \frac{1}{3} = \text{Rs } 40,000$$