UNIT-1 RETIREMENT OF A PARTNER

Learning Objectives:

The meaning of retirement of a partner; How calculate new profit sharing ratio and gaining ratio; Adjustment relating to goodwill, reserves and undistributed profits at the time of retirement; The need for revaluation of assets and reassessment of liabilities at the time of retirement The revaluation account relating to retirement, Difference between sacrificing ratio and gaining ratio.

Structure:

1.1 INTRODUCTION

When one or more partners leave the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Amit, Sunil and Ashu are partners in a firm. Due to some family problems, Ashu wants to leave the firm. The other partners decide to allow him to withdraw from the partnership. Thus, due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions. At the time of retirement the retiring partner's claim is settled. A partner retires either:

(i) With the consent of all partners, or
(ii) As per terms of the agreement; or
(iii) At his or her own will.

The terms and conditions of retirement of a partner are normally provided in the partnership deed. If not, they are agreed upon by the partners at the time of retirement. At the time of retirement the following accounting issues are dealt:

(a) New profit sharing ratio and gaining ratio.
(b) Goodwill

(c) Adjustment of changes in the value of Assets and liabilities
(d) Treatment of reserve and accumulated profits.
(e) Settlement of retiring partners dues,
(f) New capital of the continuing partners.

A retiring partner, however, continues to be liable to third parties even If the liability Is taken over by the remaining partners (s. 32) Therefore in a deed of retirement it is necessary to provide that In the event of the retiring partner being held liable by a third party, the remaining partners shall indemnify him to that extent, when the liabilities are taken over by the remaining partners.

Insolvency of a partner also causes compulsory retirement of an insolvent partner (s. 35). It is, therefore, generally provided in a deed of partnership when there are more than two partners that the insolvency of any partner will not dissolve the partnership. If a partner retires, unless there is contract to the contrary, the retiring partner cannot use the firm name, represent himself as carrying on the business of the firm or solicit the customers of the Firm. (s. 36).

Therefore, in a deed of retirement It is generally not necessary to make explicit that the retiring partner shall not do any of these things. But if he is to be restrained from carrying on similar business for a specified period or in a specified area, such condition can be provided in the deed of retirement and it is legal (s. 36(2).

1.2 CONCEPT OF RETIREMENT OF A PARTNER

A partner or partners may retire from the firm due to the various reasons like old age, better opportunity, ill health, conflict between the partners and so on. The retirement of partner can took place in any of the following grounds:

i. In accordance with the constant or consensus among all the members.
ii. In accordance with the partnership agreement which has already been signed.
iii. In accordance with the written notice, if the partnership is at will.

1.3 SACRIFICING RATIO

When there is a change in the profit sharing ratio due to any of the reason, one or more of the existing partners have to surrender some of their old share in favour of one or more of other partners. That surrender of profit in ratio is called **sacrificing ratio.** It is calculated as below:

Sacrificing Ratio = Old Ratio – New Ratio

The main purpose of calculating this is to determine the amount of compensation to be paid by the Gaining partner to the sacrificing partner (usually paid on the basis of proportionate amount of Goodwill).

1.4 GAINING RATIO

When profit sharing ratio changes between the partners, then one or more existing partners gain some portion of other partners' share of profit. This ratio of gain of profit is known as **gaining ratio**. It can be calculated as follows:

Gaining Ratio = New Ratio – Old Ratio

Example: A and B were partners in a firm sharing profits in the ratio of 5:3. With effect from 1st April, 2012 they agreed to share profits equally. Calculate the individual partner's gain or sacrifice due to change in ratio.

Solution:
Old Ratio of A and B = 5 : 3
New Ratio of A and B = 1: 1
Sacrifice or Gain:
A = 5 / 8 – 1 / 2 = 10 – 8 / 16 = 2 / 16 = 1 / 8 (Sacrifice)
B = 3 / 8 – 1 / 2 = 6 – 8 / 16 = 2 /16 = 1 / 8 (Gain)
A has sacrificed 1 / 8th share whereas B has gained 1 / 8th share.

1.5 SACRIFICING RATIO vs. GAINING RATIO

1. Meaning
   It is the ratio in which old partners agree to sacrifice their share of profit in favour of new partners/partner
   It is the ratio in which continuing partner acquires the share of profit from outgoing partner/partner

2. Calculation
   Sacrificing Ratio = Old Ratio – New Ratio
   Gaining Ratio = New Ratio – Old Ratio

3. Time
   It is calculated at the time of admission of new partner/partners.
   It is calculated at the time of retirement/death of old partner/partners.

4. Objective

   It is calculated to ascertain the share of profit and loss given up by the existing partners in favour of new partners/partner.

   It is calculated to ascertain the share of profit and loss acquired by the remaining partners (of the new firm in case of retirement) from the retiring or deceased partner.

5. Effect

   It reduces the profit share of the existing partners.

   It increases the profit share of the remaining partners.

   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.

Steps are:

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

1.6 ADJUSTMENTS AT THE TIME OF RETIREMENT:

The adjustments that need to be done at the time of retirement of a partner are as follows:

1. Calculation of new profit sharing ratio
2. Revaluation of assets and liabilities
3. Adjustment regarding undistributed profits and losses
4. Adjustment regarding goodwill
5. Adjustment of capital
6. Ascertainment of due amount to retiring partner
7. Mode of payment to the outgoing partners.

1. Calculation Of New Profit Sharing Ratio

When somebody left the firm, his share which left to the firm is gain to remaining partners. After retirement of someone, if the new profit sharing ratio is not given, then it has to be understand that they will continue old ratio. The new profit sharing ratio of the remaining partners is determined in the following way:

Suppose, three partners A,B and C are sharing profits and losses in the ratio of 2:3:1, as there is no fresh or new agreement between A and B, the new profit sharing ratio between A and B will be 2:3 by eliminating the share of C.

In the above calculation, gaining ratio of A and B will be:
A= 2/5-2/6 = 1/15
B = 3/5-3/6 = 1/10
Thus, gaining ratio is calculated by deducting old ratio from new ratio i.e.

Gaining ratio = New profit sharing ratio - Old profit sharing ratio
In the case of new ratio between the remaining partners are given, the gaining ratio calculation will be the same. However, it should not be confused with the sacrificing ratio which is calculated at the time of admission of a new partner and change in profit sharing ratio. Sacrificing ratio is calculated by deducting new ratio from old one. On the other hand, gaining ratio is computed by subtracting old ratio from new one.

2. Revaluation Of Assets And Liabilities

The retiring partner has the right to share the increase or decrease in value of assets and liabilities of the firm during the retirement period. To find out the profit or loss, a revaluation account is opened as in the case of admission of a partner. If there is an increase in the value of any assets then concerned asset account will be debited and revaluation account will be credited. In the same way, if there is decrease in the value of any asset then concerned asset will be credited and revaluation account will be debited. Similarly, if there is an increase in the value of liabilities, revaluation account is debited and concerned liability account is credited and vice versa.

The profit or loss on revaluation is to be divided among all the remaining and outgoing partners in their old profit sharing ratio. After the revaluation, the assets and liabilities will appear in the balance sheet either at original value (book value) or at revised value. If assets and liabilities are to be recorded at unchanged value then a memorandum revaluation account will have to prepare.

3. Adjustment Regarding undistributed Profits and Losses

At the time of retirement of a partner, there may be some accumulated profits or losses in the forms of any reserve or credit balance of profit and loss account or debit balance of profit and loss account etc. All such amount should be distributed among all the partners, outgoing or remaining, in their old profit sharing ratio. Sometimes, only the share of outgoing partners may transfer to his capital account and balance is shown in the balance sheet. Such can be done only when the remaining partners agreed for it.

4. Adjustment Regarding Goodwill

The valuation of goodwill has been discussed in admission of a partner. The same process should be followed here too. But during the time of retirement, the retiring partner has the right to get his share of goodwill of the firm. Therefore, to give effect to the same, the following adjustment must be carried out.

A. Goodwill already appears in the books

i) *if old value of goodwill is equal to new valuation of goodwill:*
- Adjustment entry is not needed

ii) *If the existing value of goodwill is less than the new valuation:*
Goodwill A/C.........Dr.(excess value)
To all partners' capital A/C

Note: The excess amount of goodwill is transferred to remaining and outgoing partners according to old profit sharing ratio.

iii) *If the existing value of goodwill is greater than new valuation:*
All partners' capital A/C..........Dr.(less value)
To Goodwill A/C

B. Goodwill not already appeared in the book

i) Goodwill raised at its full value:
Goodwill A/C.............Dr.
To All partners' capital A/C

ii) Goodwill raised at its full value and written off immediately:
Goodwill A/C ....Dr.
To all partners' capital A/C (old profit sharing ratio)

iii) Goodwill raised at only retired partner's capital account and immediately written off:
Goodwill A/C............Dr.
To retired partner's capital A\C

5. Adjustment Of Capital

When a partner retires from the business and if he is to be paid off his due amount immediately, the total capital of the firm is reduced. In such case, the retiring partner may be requested to keep the amount due to him as loan to the firm, so as to be paid gradually in the future. On the other hand, the remaining partner may bring necessary amount in new profit sharing ratio or in same agreed ratio to make payment to the retiring partner. Then afterwards, if agreed, the capitals of remaining partners may be required to be adjusted in new profit sharing ratio in any one of the following three ways:

A. *When the total capital is not given:*
   Step 1: Calculation of the total capital of the new firm as:
   Total capital of the new firm = Aggregate of adjusted old capitals of remaining partners.
   Step 2: Calculations of new capitals of remaining or continuing partners:
   New capital of a continuing partner= Total capital X New ratio
   Step 3: Any excess of new capital of a remaining partner, is to be paid off in cash and for the deficiency, the continuing partner has to bring in cash.

B. *When the total capital is given:*
   Step 1: Calculation of continuing partners' new capital
   New capital of continuing partner= Total capital given X New ratio
   Step 2: Any excess capital to be paid to and any deficiency is to be brought by the continuing partners.

C. When the retiring partner is to be paid through cash brought by the remaining partners so that their capitals would be in accordance with new ratio*:*
   Step 1: Calculation of total capital of new firm
   Total capital = Aggregate of old capitals after all adjustment + Shortage of cash to make payment to retiring partner
   Step 2: Calculation of new capital of continuing partners
   = Total capital of new firm X New ratio
   Step 3: Deficiency to be brought in by the remaining or continuing partners.

6. Ascertainment Of Due Amount To The Outgoing Partners

The total amount to be given to the retiring partners includes the following:

i. The balance shown by retired partnering capital account.
ii. The balance shown by retired partnering current account.
iii. Any interest or commission due to retiring partners.
iv. Any salary due to retiring partners.
v. Any share of profit or loss till the date of retirement.
vi. Share in the goodwill of the firm.
vii. Gain or loss on revaluation of assets and liabilities.
viii. Any share in the accumulated profits or funds as well as losses appearing in the balance sheet till the date of retirement.
ix. Share of joint life policy.
x. With drawing and interest on with drawing till the time of retirement.

The net amount due to the retiring partner is determined after the necessary addition and deduction of the above items.

7. Mode Of Payment To The Outgoing Partners

There are different ways of treating the due amount to the outgoing partner. Some of them are as follows:

A. If the due amount is paid off immediately*:*
Outgoing partner's capital A/C...............Dr.
To bank/cash A/C

B. Payment is made privately (if the remaining partners purchase the share of retiring partner in some agreed ratio or in the profit sharing ratio):
Retiring partner's capital A/C.............Dr.
To remaining partners' capital A/C

C. If payment is not made privately (remaining partners bring cash in the business and there after the retiring partner is paid off):
***** When cash brought in by the old partners:
Cash/Bank A/C..............Dr.
To remaining partners' capital A/C
***** When outgoing partner is paid off:
Outgoing partner's capital A/C.............Dr.
To Cash/Bank A/C

D. With due agreement the amount due to the outgoing partner may be transferred to a loan account to be paid gradually with or without interest:
* While due amount is transferred to loan account:
Retiring partner's capital A/C...........Dr.
To Retiring partner's loan A/C
* If interest has to be paid and due:
Interest A/C................Dr.
To retiring partner's loan A/c
* Paying of the instalment:
Retiring partner's loan A/C.............Dr.
To Bank A/C

1.7 REVALUATION ACCOUNT

It is prepared to record the changes in the value of assets & liabilities at time of admission, retirement, death and change in profit ratio of existing partners. Balance of this account represents the net profit and loss on revaluation. The profit and loss on revaluation is transferred to old partner's capital account in the profit sharing ratio.

Adjustment for Revaluation of Assets and Liabilities: 2 Ways

When a new partner is admitted, the existing assets and liabilities are to be revalued. To avoid any undue gain or loss to the incoming partner, the existing partners sometimes revalue the assets and liabilities.

The revaluation can be done in two ways:

(1) When assets and liabilities are revalued, the revised values are shown in the books of accounts.

(2) When the assets and liabilities are revalued, revised values are not to be shown in the books of accounts.

1. When Assets and Liabilities Revalued and the Revised Values are Shown in the Books of Accounts:

When a new partner takes admission in a firm, it is desirable for him as well as the existing partners to verily the correctness as to the values of assets and liabilities in order to satisfy them. It is also proper from the point of view of both. There may be depreciations (decrease) or appreciations (increase) in the values of assets and liabilities. For this purpose, the assets and liabilities are valued and the decrease and increase are brought into a separate account known as Profit and Loss Adjustment Account (also known as Revaluation Account) which is a nominal account.

Any profit or loss that arises out of revaluation account should be credited or debited to the old partners' capital account in their old profit sharing ratio.

2. When the Assets and Liabilities Revalued But not to be Shown in the Books of Accounts:

Sometimes the existing partners and the new partner decide that the revaluation of assets and liabilities should not be shown in the books of the new firm. In a circumstance, all journal entries passed through Revaluation Account are reversed. For instance, if earlier, the Revaluation Account is debited and the Building Account is credited, the reverse entry is that Building Account is debited and the Revaluation Account is credited.

That is, there is another Revaluation Account for the purpose of restoring the assets and liabilities at their original values. As said earlier that what is done, is reversed by passing reversal entries. Thus, two Revaluation Accounts are prepared, one to revalue the assets and liabilities and the other to restore them at original values. The combination of two such accounts, known as Memorandum Revaluation Account.

In the first section, the Revaluation Account is debited or credited with the difference in the book figures in respect of all changes in the assets and liabilities; and is balanced and the balance is transferred to the old partners' capital account in their Old Profit Sharing Ratio.

By this, the first section of the Memorandum Revaluation Account is closed. In the second section, reversal entries (of the changes made in the first section) are recorded. That is the effect of the first section of Memorandum Revaluation is nullified by the second revaluation, making the final result zero. Hence the Memorandum Revaluation Account.

It is important to note:

1. The profit or loss of the first section is transferred to the old partners' capital account in the old profit and loss sharing ratio.
2. The profit or loss of the second section is transferred to all the partners' capital account including the new partner, in the new profit and loss sharing ratio.
3. If the first section shows a gain, then the second section shows a loss and vice versa.
4. When Balance Sheet is drawn, all assets and liabilities appear at the original values.
5. There will be certain changes in the Capital Accounts of all the partners due to such Memorandum Revaluation Account.

The steps are:

1. Open the relevant T-accounts.
2. Identify the relevant entries to the increase or decrease in the T-account.
3. Post the double entry of item 2 in Revaluation account.
4. Compute the profit or loss in the Revaluation account.
5. Apportion the profit or loss of revaluation according to the partners' profit and loss sharing ratio.

The first step is to open up a T-account for every item identified to be revalued. Most of the items that will be revalued are all fixed and current assets.

As for the second step, you will need to know whether it increases or decreases the account. See below for a sample T-Account and some of its explanation.

The third step is to open up a Revaluation Account. This is the double entry for the T-account that you have opened in the first step. Revaluation account will be the reverse of any increase and decrease to the T-account. In the example above, the increase amount will be posted into the credit side of a Revaluation account At the end of the revaluation account, you will need to arrive at profit or loss on revaluation.

The fourth step is to calculate whether or not you are making a profit or loss from the revaluation exercise. If there is more debit than credit, then it’s a revaluation loss, otherwise, it’s a revaluation gain.

1.8 ILLUSTRATIONS

Illustration: 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: A, B and C are three partners sharing profits in the ratio of 5 : 4 : 3 respectively. C retires and the goodwill of the firm is valued at Rs 60,000. Assuming that A and B agree to share future profits in the ratio of 7 : 5 respectively, pass an adjustment entry to credit retiring partner with his share of goodwill. Show calculations clearly.

Journal

Dr Cr

Date	Particulars	L.F.	Amount	Amount
	A`s Capital Account ------- Dr B`s Capital Account ------- Dr To C`s Capital Account ------ (Being retiring partners share of goodwill credited to his account and the same is debited to remaining partners capital account as per the ratio --		10000 5000	 15000

Working Ratio: value of firm`s goodwill = Rs 60000
C’s share of goodwill =Rs 60000* 3/12 = Rs 15000
A’s gain on C`s retirement 7/12—5/12= 2/12
B’s gain on C`s retirement 5/12---4/12= 1/12
Gaining Ratio A:B = 2: 1.
Hence A’s Capital account will be debited with Rs 15000* 2/3=Rs 10000
B’s capital account will be debited with Rs 15000* 1/3 = Rs 5000.

The Balance Sheet of A, B and C on 31st March, 2011 was as follows:

Liabilities	Rs	Assets	Rs
Capital Accounts		Sundry Assets	1,35,000
A	60,000		
B	40,000		
C	10,000		
Sundry Creditor	25,000		
	1,35,000		1,35,000

On March 31, 2011 A retired. Under the terms of the partnership deed, he was entitled to receive for the year succeeding his retirement one-half of the share of profits which he was receiving at the time of his retirement as a consideration for leaving his capital in the firm as a loan.

On 1st April, 2011 D was admitted a partner and he paid into the firm Rs 30,000 of which Rs 10,000 was for goodwill to be retained in the firm. D was to receive one-fourth share of net profits remaining after charging A’s proportion as stated above. All the partners were entitled to interest at the rate of 10% per annum.

The profit for the year ended 31st March, 2012 was Rs 49,000. Prepare the Profit and Loss Appropriation Account showing the distribution of the profit.

Profit and loss appropriation account

Dr For the year ended 31st march ,2012 Cr

Date	Particulars	Rs	Date	Particulars	Rs
	To interest on A's loan	6,000		By Net Profit	49,000
	To, interest on Capital B 4,500 C 1,500 D 2,000	8,000			
	To. A's loan A/c 1/7th of 35000 (Rs49,000—6,000—8,000)	5,000			
	To share of profit B 11,250 C 11,250 D 7,500	30,000			
		49,000			49,000

Notes:

(1) Since the problem is silent regarding the profit-sharing ratio, A. B and C must have been equal partners. After retirement, therefore. A is entitled to half of 1/3 or 1/6 share of profits.

(2) It is assumed that /is share is a charge against profits. Hence, his share is 1/7 of profits after charging interest but before charging A's share.

(3) D gets 1/4 share leaving 3/4 for B and C who are equal partners. Hence, both B and C get 3/8 share of profits each.

Note:

If A's share is to be treated as an appropriation of profits, he will get 1/6 of Rs 35,000 or Rs 5,833.

Illustration:

A, B and C sharing profits and losses equally, had been trading for many years. C decided to retire on 31st Dec. 02 on which date the balance sheet of the firm was as follows:

Liabilities	Rs.	Assets	Rs.
Capital account			
A	50,000	Cash	15,000
B	40,000	Debtors	30,000
C	30,000	Stock	25,000
Creditors	40,000	Plant and machinery	50,000
		Land and building	40,000
	1,60,000		1,60,000

The value of the goodwill was agreed at Rs. 40,500. The land and building had increased in value, the value being agreed at Rs. 55,000. Plant and machinery was re-valued at Rs. 44,000 and it was also agreed to provide 5% in respect of debtors. Prepare memorandum revaluation account, Capital account and balance sheet.

[When it desired not to alter the values of assets and liabilities in the books, then a Memorandum Revolution account will be prepared. The first part of this account will be exactly the same as in case of Revolution account but in the second part entries shall be reversed and the profit or loss of this part shall be divided among the continuing partners in their new profit sharing ratio.]

Solution:

Memorandum revolution a/c

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To plant machinery	6,000	By land and building	15,000
To provision for bad and Doubtful debts	1,500		
Profit A 2,500 B 2,500 C 2,500	7,500		
	15,000		15,000
Reversal of entries on the credit side	15,000	Reversal of entries on the debit side	7,500
		Loss transferred to A 3,750 B 3,750	7,500
	15,000		15,000

Capital Account

Particulars	A Rs.	B Rs.	C Rs.	Particulars	A Rs.	B Rs.	C Rs.
To goodwill	20,250	20,250	--	By balance b/d	50,000	40,000	30,000
To C's Loan	--	--	46,000	By memorandum revaluation a/c	2,500	2,500	2,500
To memorandum Revaluation	3,750	3,750	--	By goodwill	13,500	13,500	13,500
To balance c/d	42,000	32,000	--				
	66,000	56,000	46,000		66,000	56,000	46,000

Balance sheet

Liabilities		Rs.	Assets	Rs.
Creditor		40,000	Cash	15,000
C's loan		46,000	Debtors	30,000
Capitals			Stock	25,000
A	42,000		Plant and Machinery	50,000
B	32,000	74,000	Land and building	40,000
		1,60,000		1,60,000

Illustration:

A, B and C are partners in a firm sharing profit and loss in the ratio of 1/3 : 1/2 : 1/6 respectively. Their balance sheet as on 31st Dec. 03 was as follows

Liabilities		Rs.	Liabilities		Rs.
Sundry creditor		25,000	Building		50,000
Loans payable		15,000	Machinery		40,000
Reserve fund		16,000	Furniture		10,000
Capital	A	30,000	Stock		25,000
	B	40,000	Debtors		
	C	25,000		18,000	17,500
			Provision		8,500
		1,51,000	500		1,51,000
			Cash		

C Retires on 31.12.03 subject to the following conditions

(a) A goodwill is created in the book for Rs. 24,000
(b) Machinery to be depreciated by 10%
(c) Furniture to be depreciated by 5%
(d) Stock to be appreciated by 15% and building to be appreciated by 10%
(e) Reserve for doubtful debts to be raised to Rs. 2,000. Prepare necessary ledger accounts and show the Balance sheet of the new firm.

Solution:

Revaluation a/c

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To machinery	4,000	By stock	3,750
To furniture	500	By buildings	5,000
To provision for bad debts	1,500		
To profit (transferred)			
A's capital (2,750 × 1/3)	917		
B;s capital (2,750 ×1/2)	1,375		
C;s capital (2,750 × 1/6)	458		

	8,750		8,750

Capital a/c

Particulars	A Rs.	B Rs.	C Rs.	Particulars	A Rs.	B Rs.	C Rs.
To C's loan a/c To balance a/c	-- 44,250	-- 61,375	32,125 --	By balance b/d By reserve fund By goodwill By revaluation (Profit) By balance b/d	30,000 5,333 8,000 917	40,000 8,000 12,000 1,375	25,000 2,667 4,000 458
	44,250	61,375	32,125		44,250	61,375	32,125
					44,250	61,375	--

Balance sheet of A and B as on 31.12.03

Liabilities	Rs.	Assets	Rs.
Capital Accounts A B C's loan Sundry creditor Loan Payable	 44,250 61,375 32,125 25,000 15,000	Goodwill Building 50,000 Add: 10% appropriation 5,000 Machinery 40,000 Less: 10% Depreciation 4,000 Furniture 10,000 Less: 5% Depreciation 500 Stock 25,000 Add: 15% Appreciation 3,700 Debtors 18,000 Less: Provision 2,000 Cash	24,000 55,000 36,000 9,500 28,750 16,000 8.500
	1,77,750		1,77,750

Calculation of total amount due to a retiring partner:

The total amount due to a retiring partner may include

(i) Capital on the date of last balance sheet

(ii) Interest on salary if any payable to him.

(iii) Share of profit or loss to the date of retirement
(iv) Share in the goodwill of the firm
(v) Share in the profit or loss on revaluation of assets and liabilities
(vi) Share in the general reserve or profit and loss account appearing in the balance sheet.

The total amount calculated will be transferred to the retiring partner's loan account. The entry will be:

Retiring partner's capital a/c ....Dr.
To retiring partner's loan a/c

Sum up: A retiring partner, however, continues to be liable to third parties even If the liability Is taken over by the remaining partners .Therefore in a deed of retirement it is necessary to provide that In the event of the retiring partner being held liable by a third party, the remaining partners shall indemnify him to that extent, when the liabilities are taken over by the remaining partners.

Insolvency of a partner also causes compulsory retirement of an insolvent partner. It is, therefore, generally provided in a deed of partnership when there are more than two partners that the insolvency of any partner will not dissolve the partnership. If a partner retires, unless there is contract to the contrary, the retiring partner cannot use the firm name, represent himself as carrying on the business of the firm or solicit the customers of the Firm.

Keywords:

Sacrificing ratio: The existing partners sacrifice a share of their profit in favour of the new partner. Hence, the calculation of new profit sharing ratio becomes necessary. The ratio in which the existing partners agree to sacrifice their share of profits in favour of the incoming partner is called the sacrificing ratio.

Gaining ratio: Gaining Ratio is calculated at the time of retirement or death of partner. It is the excess of new ratio over old ratio of old partners except retire or dead partner. We can understand this ratio as the share of profit which is given by retired partner to the partners who still exist in the firm.

New profit sharing ratio: The ratio in which all partners including new partner will share the future profits and losses is called the new profit sharing ratio. The determination of the new profit sharing ratio depends upon the agreed ratio in which the incoming partner acquires his share from the old partners. The following cases arise in this regard.

Insolvency: Insolvency is when an organization, or individual, can no longer meet its financial obligations with its lender or lenders as debts become due. Before an insolvent company, or person, gets involved in insolvency proceedings, it will likely be involved in informal arrangements with creditors, such as making alternative payment arrangements. Insolvency can arise from poor cash management, a reduction in cash inflow forecasts or from an increase in expenses.

Retirement of a partner: A partner may retire-with the consent of all the other partners, in accordance with an express agreement by the partners, or where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

Self assessment questions:

Q1. MM, KK and PP are partners in a firm. PP retired from the firm. After making adjustments for Reserves and Revaluation of Assets and Liabilities the balance in PP's capital account was Rs.1, 20,000. MM and KK paid Rs.1, 80,000 in full settlement to PP. Identify the item for which MM and KK paid Rs.60, 000 more to PP and pass the entry for the same.

Q2. X, Y and Z are partners in a firm sharing profits in the ratio of 3: 2: 1. X retires from the firm. Y and Z agree that the capital of the new firm shall be fixed at Rs. 2, 10,000 in the profit-sharing ratio. The capital accounts of Y and Z after all adjustments on the date of retirement showed balances of Rs. 1, 45,000 and Rs. 63,000 respectively. State the amount of actual cash to be brought in or to be paid to the partners. Pass the necessary journal entries.

Q3. A, B, C and D were partners sharing profits in the ratio of 3: 3: 2: 2 respectively. On 1st April, 2014, D retired owing to ill health. It was decided by A, Band C that in future their profit-sharing ratio would be 3: 2: 1. Goodwill of the firm is valued at Rs. 6, 00,000. Goodwill already appeared in the Balance Sheet at Rs. 50,000. Pass the necessary journal entries

Q4 what is retirement of partner? In which conditions a partner is retired from the partnership?

Q5 what is revaluation account? How is it prepared?

Model questions:

1. **What are the adjustment needed at the time of retirement of a partner?**

Adjustments at the time of retirement:

The adjustments that need to be done at the time of retirement of a partner are as follows:

1. Calculation of new profit sharing ratio
2. Revaluation of assets and liabilities
3. Adjustment regarding undistributed profits and losses
4. Adjustment regarding goodwill
5. Adjustment of capital
6. Ascertainment of due amount to retiring partner
7. Mode of payment to the outgoing partners.

1. Calculation Of New Profit Sharing Ratio

When somebody left the firm, his share which left to the firm is gain to remaining partners. After retirement of someone, if the new profit sharing ratio is not given, then it has to be understand that they will continue old ratio. The new profit sharing ratio of the remaining partners is determined in the following way:

Suppose, three partners A, B and C are sharing profits and losses in the ratio of 2:3:1, as there is no fresh or new agreement between A and B, the new profit sharing ratio between A and B will be 2:3 by eliminating the share of C.

In the above calculation, gaining ratio of A and B will be:

A= 2/5-2/6 = 1/15

B = 3/5-3/6 = 1/10

Thus, gaining ratio is calculated by deducting old ratio from new ratio i.e.

Gaining ratio = New profit sharing ratio - Old profit sharing ratio

In the case of new ratio between the remaining partners are given, the gaining ratio calculation will be the same. However, it should not be confused with the sacrificing ratio which is calculated at the time of admission of a new partner and change in profit sharing ratio. Sacrificing ratio is calculated by deducting new ratio from old one. On the other hand, gaining ratio is computed by subtracting old ratio from new one.

2. Revaluation Of Assets And Liabilities

The retiring partner has the right to share the increase or decrease in value of assets and liabilities of the firm during the retirement period. To find out the profit or loss, a revaluation account is opened as in the case of admission of a partner. If there is an increase in the value of any assets then concerned asset account will be debited and revaluation account will be credited. In the same way, if there is decrease in the value of any asset then concerned asset will be credited and revaluation account will be debited. Similarly, if there is an increase in the value of liabilities, revaluation account is debited and concerned liability account is credited and vice versa.

The profit or loss on revaluation is to be divided among all the remaining and outgoing partners in their old profit sharing ratio. After the revaluation, the assets and liabilities will appear in the balance sheet either at original value (book value) or at revised value. If assets and liabilities are to be recorded at unchanged value then a memorandum revaluation account will have to prepare.

3. Adjustment Regarding undistributed Profits and Losses

At the time of retirement of a partner, there may be some accumulated profits or losses in the forms of any reserve or credit balance of profit and loss account or debit balance of profit and loss account etc. All such amount should be distributed among all the partners, outgoing or remaining, in their old profit sharing ratio. Sometimes, only the share of outgoing partners may transfer to his capital account and balance is shown in the balance sheet. Such can be done only when the remaining partners agreed for it.

4. Adjustment Regarding Goodwill

The valuation of goodwill has been discussed in admission of a partner. The same process should be followed here too. But during the time of retirement, the retiring partner has the right to get his share of goodwill of the firm. Therefore, to give effect to the same, the following adjustment must be carried out.

5. Adjustment Of Capital

When a partner retires from the business and if he is to be paid off his due amount immediately, the total capital of the firm is reduced. In such case, the retiring partner may be requested to keep the amount due to him as loan to the firm, so as to be paid gradually in the future. On the other hand, the remaining partner may bring necessary amount in new profit sharing ratio or in same agreed ratio to make payment to the retiring partner. Then afterwards, if agreed, the capitals of remaining partners may be required to be adjusted in new profit sharing ratio in any one of the following three ways:

6. Ascertainment Of Due Amount To The Outgoing Partners

The total amount to be given to the retiring partners includes the following:

i. The balance shown by retired partnering capital account.
ii. The balance shown by retired partnering current account.
iii. Any interest or commission due to retiring partners.
iv. Any salary due to retiring partners.
v. Any share of profit or loss till the date of retirement.
vi. Share in the goodwill of the firm.

vii. Gain or loss on revaluation of assets and liabilities.
viii. Any share in the accumulated profits or funds as well as losses appearing in the balance sheet till the date of retirement.
ix. Share of joint life policy.
x. With drawing and interest on with drawing till the time of retirement.

The net amount due to the retiring partner is determined after the necessary addition and deduction of the above items.

7. Mode Of Payment To The Outgoing Partners

There are different ways of treating the due amount to the outgoing partner. Some of them are as follows:

A. If the due amount is paid off immediately*:*
Outgoing partner's capital A/C...............Dr.
To bank/cash A/C

B. Payment is made privately (if the remaining partners purchase the share of retiring partner in some agreed ratio or in the profit sharing ratio):
Retiring partner's capital A/C.............Dr.
To remaining partners' capital A/C

C. If payment is not made privately (remaining partners bring cash in the business and there after the retiring partner is paid off):
***** When cash brought in by the old partners:
Cash/Bank A/C..............Dr.
To remaining partners' capital A/C
***** When outgoing partner is paid off:
Outgoing partner's capital A/C.............Dr.
To Cash/Bank A/C

D. With due agreement the amount due to the outgoing partner may be transferred to a loan account to be paid gradually with or without interest:
* While due amount is transferred to loan account:
Retiring partner's capital A/C...........Dr.
To Retiring partner's loan A/C
* If interest has to be paid and due:
Interest A/C................Dr.
To retiring partner's loan A/c
* Paying of the instalment:
Retiring partner's loan A/C.............Dr.
To Bank A/C

2. What is sacrificing ratio? How it is calculated at the time of retirement?

Sacrificing ratio

When there is a change in the profit sharing ratio due to any of the reason, one or more of the existing partners have to surrender some of their old share in favour of one or more of other partners. That surrender of profit in ratio is called **sacrificing ratio.** It is calculated as below:

Sacrificing Ratio = Old Ratio – New Ratio

The main purpose of calculating this is to determine the amount of compensation to be paid by the Gaining partner to the sacrificing partner (usually paid on the basis of proportionate amount of Goodwill).

3. What is gaining ratio? How it is calculated at the time of retirement?

Gaining ratio

When profit sharing ratio changes between the partners, then one or more existing partners gain some portion of other partners' share of profit. This ratio of gain of profit is known as **gaining ratio**. It can be calculated as follows:

Gaining Ratio = New Ratio – Old Ratio

<u>Example:</u> A and B were partners in a firm sharing profits in the ratio of 5:3. With effect from 1^{st} April, 2012 they agreed to share profits equally. Calculate the individual partner's gain or sacrifice due to change in ratio.

Solution:

Old Ratio of A and B = 5 : 3

New Ratio of A and B = 1: 1

Sacrifice or Gain:

A = 5 / 8 – 1 / 2 = 10 – 8 / 16 = 2 / 16 = 1 / 8 (Sacrifice)

B = 3 / 8 – 1 / 2 = 6 – 8 / 16 = 2 /16 = 1 / 8 (Gain)

A has sacrificed 1 / 8^{th} share whereas B has gained 1 / 8^{th} share.

4. What is the difference between sacrificing ratio and gaining ratio?

Sacrificing Ratio vs Gaining Ratio

1. Meaning

   It is the ratio in which old partners agree to sacrifice their share of profit in favour of new partners/partner

It is the ratio in which continuing partner acquires the share of profit from outgoing partner/partner

2. Calculation
   Sacrificing Ratio = Old Ratio – New Ratio
   Gaining Ratio = New Ratio – Old Ratio

3. Time
   It is calculated at the time of admission of new partner/partners.
   It is calculated at the time of retirement/death of old partner/partners.

4. Objective
   It is calculated to ascertain the share of profit and loss given up by the existing partners in favour of new partners/partner.
   It is calculated to ascertain the share of profit and loss acquired by the remaining partners (of the new firm in case of retirement) from the retiring or deceased partner.

5. Effect
   It reduces the profit share of the existing partners.
   It increases the profit share of the remaining partners.
   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.

Steps are:

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

Further reading:

1. Modern Accountancy: Hanif and Mukherjee, volume –I, Tata McGrawhill.
2. Higher secondary Accounting: Biswal and Sharma.
3. Financial Accounting: P.C. Tulsian, Pearson.
4. An Introduction to Accountancy: S.N. Maheshwari, S.K. Maheshwari. Vikas.

UNIT 2 DEATH OF A PARTNER

Learning objectives:

After studying this lesson, you will be able to know: what happens after the death of a partner in partnership firm, representative of the deceased partner is entitlement for which items. How do you calculate the share of profit for deceased partner? How deceased executor account is settled.

Structure:

2.1 Introduction

2.2 Calculation of share of profit up to the date of death

2.3 Deceased partner`s share of goodwill

2.4 Accounting treatment at the time of death of a partner

2.5 Settlement of deceased executor account

2.6 Problem & solution

2.1 INTRODUCTION

When a partner dies, subject to any contract to the contrary, partnership is dissolved. Section 42 of the Indian Partnership Act, 1932 Provides for dissolution of partnership on occurrence of certain contingencies which includes ‘death of the partner’ as one of those contingencies. Death of a partner dissolves the partnership and the rights of the representatives of the deceased partner would depend on the provisions of the partnership deed. Usually, the surviving partners carry on the business, purchasing the share of the deceased partner after determining the amount due to him and then treating it as a loan to the firm. The executors of the deceased partner would be entitled to the decreased partner’s share of profits arising after the last closing up of accounts to the date of accounts death.

When an informal partnership exists without formal documentation, the partnership dissolves upon the death of a partner. The partnership itself may not die, but changes into a different partnership. When a partnership agreement exists, the agreement generally supersedes the default state statutes. The agreement may have provisions allowing for the continuation of the general partnership after the death of a general partner. If it does, it must specify what happens to the partnership interests of the deceased partner and if the partner or his heir can sell his interests to someone else. The agreement must also include procedures on how to pay out the deceased partner’s capital, remove his name from all partnership materials and contracts, and how to pay out the deceased partner's share.

On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner, When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings :

(a) The amount standing to the credit to the capital account of the deceased partner
(b) Interest on capital, if provided in the partnership deed upto the date of death:
(c) Share of goodwill of the firm;
(d) Share of undistributed profit or reserves;
(e) Share of profit on the revaluation of assets and liabilities;
(f) Share of profit upto the date of death;
(g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner's legal representatives:

i) Drawings
ii) Interest on drawings
iii) Share of loss on the revaluation of assets and liabilities;
iv) Share of loss that have occurred till the date of his/her death.

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor. The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment U/S 37.

2.2 CALCULATION OF SHARE OF PROFIT UPTO THE DATE OF DEATH

A retirement is usually arranged to be taken place at the end of an accounting year whereas, death may take place on a date some time after the date of which the last balance sheet and accounts were made up. Hence, the representatives of the deceased partner will be entitled to his share of profits accrued upto the date of death. To avoid the necessity of preparing final accounts till the date of death, it is frequently provided in the partnership deed that in the event of the death of a partner his share of the accruing profits upto the date of death is to be arrived at on the basis of either profits of the last year/ last few years or on the basis of turnover. In some cases, it is agreed to wait until the next annual accounts are prepared.

We have seen that the deceased partner's share of profit earned till the date of his death has to be given to his executors. The correct amount of profit earned can be calculated only if the books are closed till the date of death. This may be inconvenient. Profit may, therefore, be calculated by any of the following two methods.

1. On the basis of time.
2. On the basis of turnover

1. **On the basis of time :** If the time basis is used, the profit will be assumed to accrue evenly over the year. According to this method, profit may be estimated by any of the following two methods :

   a. On the basis of last year's profit : The proportionate profit of the firm is computed from the last accounting period to the date of death on the basis of profit earned during last year. Thereafter, share of profit of deceased partner is computed.

      Illustration : 1. R dies on 31st March, 2002 in partnership of P, Q and R sharing in the ratio of 2 : 2 : 1. The profit for the year ending 31st March, 2016 was Rs.36,000. Calculate R's share of profit.

      Solution :

      i) Last year's Profit = Rs.36,000
      ii) Period Between last final accounts to the date of C's death = January 1, 2002 to March 31, 2002 = 3 months.
      iii) 3 months' profit of the firm on the basis of last year's profit.
      iv) C's Share of Profit =

   b. On the basis of average profit : In certain cases, partners may agree to calculate deceased partner's share of profit on the basis of average profit. This is worked out as under :

      i) Take the total profits of the required number of past years;
      ii) Calculate the average profit (i.e., Total profit + No. of years)
      iii) Reduce average profit for the period upto date of death,
      iv) Find out the share of the deceased partner.

      Illustration 2. Sachin, Sourav and Rahul were partners in a firm. Sourav died on 28th February, 2002. Sourav's share of profit from the closure of the last accounting year till the date of death was to be calculated on the basis of the average of three completed years profits before death. Profits for 2008, 2009 and 2010 were Rs.70,000, Rs.80,000 and Rs.90,000 respectively. The firm closes its books on 31st March every year.

Calculate Sourav's share of profit till the date of her death.

Solution :

i) Total Profits = Rs.70,000 + Rs.80,000 + Rs.90,000 = Rs.2,40,000

ii) Average Profit =

iii) Two months' profit (1st Jan. 2002 to 28th Feb. 2002)

iv) Sourav's share of profit till the date of her death

Note : In the absence of an agreement, partners will share profits equally.

2. **On the basis of turnover (or sales)** : If profits till the date of death is to be calculated on the basis of turnover, on such arrangement last year's profit and sales are given together with the sale of the current year upto the date of death of the partner. The profit is ascertained proportionately and the share of deceased partner is calculated.

   Illustration 3.M, N and S are partners in the ratio of 4 : 3 : 3. N dies on 20th Sept., 2012. The sales and profit during the year 2000 Rs.1,20,000/- and Rs.20,000 respectively. The sale upto 20ths EPT. 2012 during current year amounted to rs.30,000. Calculate N’s share of profit.

Solution

If sales is worth Rs.1,20,000, the profit = Rs.20,000

If sale sis worth Rs. 1, the profit =

If sales is worth Rs. 30,000, the profit =

x 30,000 = Rs.5,000

N’s share of profit = Rs.5,000 x

Accounting Treatment of outgoing Partner's Share in Profits

The outgoing partner's share in the profits may be readjusted in either of the following ways :-

i.	In case of profit	Profit & Loss Suspense A/c Dr. (Share of Profit) To Outgoing Partner's Capital A/c
ii.	In case of Loss	Outgoing Partner's Capital A/c Dr. (Share of Profit) To Profit & Loss Suspense A/c

Illustration 4. A, B and C are partners in a firm sharing profits as 4 : 3 : 2 C died on 31.03.2002. Estimated profit upto date of death is Rs.18,000. C's share in the firm is purchased by A and B in their profit sharing ratio. Give the necessary journal entry to record the C's share of profit to the date of death.

Solution

Journal

Profit & Loss Suspense A/c To C'sDr. (For deceased partner's share of profit transferred to his capital (A/c)	Rs.4,000	Rs.4,000

Note : (1) C's share of profit = Rs.18,000 x 2/9 = Rs.4,000

(2) This entry is appropriate only when the new profit sharing ration of continuing partners does not differ from their old profit sharing ratio.

2. **Through capital transfer :** This method is used only, when the new profit sharing ration of continuing partners differ from their old profit sharing ratio. In this case, the following entries will be passed :

(i)	In case of Profit	Gaining Partner's Capital A/c	Dr. (Gaining Ratio)
		To Outgoing Partner's Capital A/c	(Share of Profit)
(ii)	In case of Loss	Outgoing Partner's /Capital A/c	Dr. (Share of loss)
			(Gaining Ratio)

Note : If a partner is retired during the year, the above same rules will be applicable for calculating his share of profit.

Illustration 5. (Accounting treatment of deceased partner's share of profit) A, B and C are partners sharing profits and losses in the ratio of 3 : 2 : 1 respectively. B died on 31st March, 2002. The profits from 01.01.2002 to 31.03.2002 amounted Rs.45,000. A and C decided to share the future profits the B's share of profit to the date of death.

Solution

Journal Dr Cr

	A's Capital A/c	Dr.		Rs.4,500	Rs.15,000
				Rs.10,500	
	C's Capital A/c	Dr.			
	To B's Capital A/c				
	(For B's share of profit to the date of death adjusted in the capital accounts of A & C in their gaining ration 3 :7)				

Note : (1) B's share of profit = 45,000 x 2/6 = Rs.15,000

(2) Gaining Ratio = New Ratio – Old Ratio

$$A = \frac{3}{5} - \frac{3}{6} = \frac{18 - 15}{30} = \frac{3}{30}$$

$$C = \frac{2}{5} - \frac{1}{6} = \frac{12 - 5}{30} = \frac{7}{30}$$

Gaining ratio between A and C = 3 : 7

(3) In case the new profit sharing ratio of continuing partners differ from their old sharing ratio, outgoing partner's share of profit must be adjusted through the capital transfer.

2.3 DECEASED PARTNER'S SHARE OF GOODWILL

The executors of the deceased partners are also entitled to receive the share of goodwill the firm. Goodwill for this purpose will be valued according to the provisions of partnership deed. The amount of deceased partner's share of good will ascertained will be credited to his capital account and will be debited to gaining partner's capital account in the gaining ratio.

Illustration 6. Ram Mohan an Sohan were partners in a firm sharing profits in the ratio of 2 : 2 : 1. On 28.02.2002, Mohan die and the new profit sharing profits in the ratio of Ram and Sohan was equal. On Mohan's death, the goodwill on Mohan's death for the treatment of goodwill without opening goodwill account.

Solution

(i) Calculation of Gaining Ratio :

Gaining Ratio = New Ratio – Old Ratio

$$\text{Ram} = \frac{1}{2} - \frac{2}{5} = \frac{5 - 4}{10} = \frac{1}{10}$$

$$\text{Sohan} = \frac{1}{2} - \frac{1}{5} = \frac{5 - 2}{10} = \frac{3}{10}$$

Gaining ratio between Ram &Sohan = 1 : 3

(ii) Mohan's Share of Goodwill = Rs. 1,50,000 x

(iii) Journals

Proforma of Capital Account

	Ram's Capital A/c (1/4 of Rs.60,000) Sohan;s Capital A/c (3/4 of Rs.60,000) To Mohan's Capital A/c		Rs.15,000 Rs.45,000	Rs.15,000 Rs.60,000
	[For Mohan's share of goodwill adjusted to continuing partners' capital accounts in their gaining ratio 1:3].			

Let us now see how deceased partner's capital will appear :

Deceased Partner's Capital Account

Dr. Cr.

To Accumulated Losses (Share in such losses)	Rs.	By Balance b/d	Rs.
To Revaluation A/c (Share of loss)	---	By Interest on Capital A/c	----
To Good will A/c (Share of deceased partner in goodwill written off)	---	By Salary and Commission A/c	-----
	---	By Accumulated Profit (Share in such profit)	----
To Drawings A/c	----	By Gaining Partner's Capital A/c (Share of goodwill)	----
To Interest of Drawings A/c	----	By Joint Life Policy A/c (Share of J.L.P)	----
To P/L Suspense A/c (Share of loss)	----	By Profit and Loss Suspense A/c (Share of Profit)	----
To P/L Suspense A/c (Share of Loss)	----	By Gaining Parnter's Capital A/c (Share of Profit)	----
To Gaining Partner Capital A/c (Share of Loss)	----	(Share in profits till death)	----
To Deceased Partner	----		

Executor's A/c (Balancing Figure)			
Total	**----**	**Total**	**----**

2.4 ACCOUNTING TREATMENT AT THE TIME OF DEATH OF A PARTNER

As discussed earlier on the death of a partner, the account of deceased partner is maintained in the same way as is maintained on the retirement of a partner. But the only difference is that the amount due to a deceased partner as revealed by his capital account is transferred to his executor's account. The journal entry will be :

Deceased Partner's Capital A/c ----------------------Dr
To Deceased partner`s executors Account --------
(For amount due to deceased partner transferred to his executor's a/c)

Illustration 7: A, B and C were partners in a firm sharing profits in the ratio of 3 :2 :1. The balance, sheet as on 31.03.2003 was as follows :-

Liabilities	Rs.	Assets	Rs.
Creditors	4,000	Building	20,000
Reserve	6,000	Plant & Machinery	16,000
A's Capital	24,000	Stock	5,100
B's Capital	12,000	Debtors	6,000
C's Capital	8,000	Cash of Bank	6,900
	54,000		**54,000**

A died on 30.09.2003. Under the Partnership agreement, the executors of a deceased partner were entitled to :-

(a) Amount standing to the credit of partner's capital account.
(b) Interest on capital at 12% p.a.
(c) Share of goodwill on the basis of four years purchase of last three years average profit.
(d) Share of profit from the closing of the last financial year to the date of death on the basis of last year's profit. Profits for the year 2001, 2002 and 2003 were Rs.8,000, 12,000 and Rs.7,000 respectively.

Prepare A's capital account to be rendered to his executors.

Solution

A's Capital Account

To A's Executor's A/c	Rs.48,190	By Balance b/d	24,000
		By General Reserve A/c	3,000
		By Interest on Capital A/c	1,440
		By B's Capital A/c (Good will)	12,000
		By Profit & Loss Suspense A/c	6,000
			1,750
	48,190		48,190

Note : (1) General Reserve = $Rs.6,000 \times \frac{3}{6} = Rs.3,000$

(2) Interest on Capital = $Rs.\ 24,000 \times \frac{12}{100} \times \frac{6}{12} = Rs.1,440$

(3) A's share of Goodwill = $\frac{Rs.27,000}{3} \times 4 \times \frac{3}{6} = Rs.18,000$ will be adjusted between B and C in the gaining ratio of 2 : 1.

(4) A's share of profit = $Rs.\ 7,000 \times \frac{6}{12} \times \frac{3}{6} = Rs.1,750$

2.5 SETTLEMENT OF DECEASED EXECUTORS ACCOUNT

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

(a) When full amount is paid in cash/ cheque, the following entry is recorded :
Deceased Partner's Executor's A/c : Dr.
To Cash / Bank A/c.

(b) When the settlement is made in instalments the following entries are recorded:
(i) For interest due to Deceased Partner Executor's A/c
Interest on Deceased Partner Executor's A/c
To Deceased Partner's Executor's A/c
(ii) When payment is made in instalment :
Deceased Partner's Executor's A/c Dr.
To Cash/ Bank A/c

To amount due to executor's of deceased partner is paid off immediately or is paid instalments with or without interest as per agreement. In the absence of an agreement in the paid off or a share of the profit which has been earned by the firm using the amount due to the as per Section 37 of the partnership Act.

Illustration 8. A, B and C were Partners sharing profits in the ratio of 2 : 1 : 1 individual policies of Rs.20,000, Rs.10,000 on the lives of A, B and C respectively were taken and premium paid was charged Profit & Loss A/c which is prepared on 31st March each year.

C died on 31st March, 2009. On this date surrender values are 20% of the amount of police. Under the partnership deed, the executors of deceased partner were entitled to:

i) His capital according to the last balance sheet ;
ii) Interest on the above capital @9% p.a. till the date of death ;
iii) His share of profit to the date of death, calculated on the basis of last year's profit;
iv) His share of life insurance policies;
v) Interest on drawings is to be charged at an average rate of 3%

C's capital as per balance sheet on 31st march, 2008 was Rs.60,000. During the year withdrew Rs.8,000 till his death. Last year's profit was Rs.40,000.
Prepare C's Capital Account.

Solution

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

To Drawings A/c	Rs. 8,000	By Balance b/d (1.1.99)	60,000
To Interest on Drawings A/c (8000 x 3/100)	Rs.240.00	By Interest on Capital A/c (60,000 x 9/100 x 3/12)	1,350.00
To C's Executor's A/c (Amount Payable)	59,610.00	By P/L Suspense A/c (40,000 x 3/12 x ¼)	2,500.00
		By Joint Life Police A/c	4,000.00
	67,850.00		**67,850.00**

Note : (1) Calculation of C's share in life policies.

Surrender value of A's policy = Rs.20,000 x 20/100 = 4,000.00
Surrender value of B's policy = Rs.10,000 x 20/100 = 2,000.00
Full sum assured of C's policy received due to his death = 10,000.00
Total valuation of life policies = 16,000.00
C's share in life policies = Rs.16,000 x ¼ = Rs. 4,000

LET'S SUM UP:

A partner or partners may retire from the firm due to the various reasons like old age, better opportunity, ill health, conflict between the partners and so on. The retirement of a partner extinguishes his interest in the Partnership firm and this leads to dissolution of the firm or reconstitution of the Partnership. A partner, who goes out of a firm, is called retiring partner or outgoing partner. Causes for the retirement may be that a retiring partner may be too old or he may have better opportunity in a different line or he may dislike the co-partners' attitude or any other reasons

Keyword:

Deceased Partner: Deceased partner means the partner who died. Surviving partner: means the partner of the deceased partner.

Executor: someone who makes sure that things are done according to the wishes in a dead person's will

Goodwill: The value of a partnership's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology represent goodwill.

New ratio: The ratio in which all partners including the incoming partner will share the profit and losses in future is known as new profit sharing ratio.

Old ratio: The ratio in which old partners use to share the profit and losses of the partnership firm is known as old profit sharing ratio.

Gaining ratio: It is the ratio in which continuing partner acquires the share of profit from outgoing partner/partner

Sacrificing ratio: It is the ratio in which old partners agree to sacrifice their share of profit in favour of new partners/partner

SELF- ASSESSMENT QUESTIONS:

Question No1: Rajesh, Ravi and Sujit are is partnership sharing profits 8 : 6 : 2 respectively. It is provided under the partnership deed that on the death of a partner, his share of goodwill is to be valued at one half of the net profits credited to his account during the last 4 completed years (books of accounts are closed on 31st December).

Ravi died on 1st January 2017. The firm's profits for the last 4 years were as follows

2013	Profits	Rs.1,20,000.00
2014	Profits	Rs.60,000.00
2015	Losses	Rs.20,000.00
2016	Profits	Rs.80,000.00

i) Determine the amount that should be credited to Ravi in respect of his share of goodwill.

ii) Pass a journal entry for adjustment of goodwill assuming that profits sharing ratio between Rajesh and Sujit in future will be 3:2. Show your working clearly.

[**Ans: gaining ratio between Rajesh and Sujit are 4:11, Ravi's share of goodwill is Rs 45000**]

Question No 2: P, Q are R were partners sharing profits in the ratio of 5 : 3 : 2 respectively.

On 31st March, 2010 their balance sheet stood as follows:

Balance Sheet as at 31st March 2016

Liabilities	Rs	Assets	Rs
A`s Capital	5,00,000	Machinery	6,30,000
B`s Capital	3,00,000	Furniture	2,60,000
C`S Capital	2,00,000	Stock	4,00,000
Creditors	4,50,000	Debtors	1,80,000
Bank overdraft	20,000		
	14,70,000		14,70,000

Q retired as on the abovementioned date. It was agreed that:

i) The firm's goodwill was worth Rs 250 thousand and Q was entitled to the credit for his share of goodwill

ii) P and R would continue to be partners but would share profits in future in the ratio of 7 : 3 respectively, and

iii) The amount due to Q would be paid immediately and for this purpose P and R would bring in cash in such a manner that the total capital of the reconstituted firm was Rs 1,000 thousand and the capital accounts of the partners were in their new profit sharing ratio.

Assuming that all the above-mentioned conditions were fulfilled pass journal entries in the boobs of the firm for all the transactions. Also, prepare the capital accounts of all the partners

[Ans: Q share of goodwill Rs 75,000, amount due to Q Rs 3,75,000. to be borne by P and R Rs 2,50,000 and 1,25,000 respectively]

Question No 3 : L, M and N were partners sharing profits and losses in the ratio of 2 : 2 : 1 respectively. On 1st April, 2012 L retired when his capital account showed a credit balance of Rs 8,00,000. In the ledger, goodwill account appeared at Rs 1,00,000 but the partners agreed that the fair value of firm's goodwill on the abovementioned date was Rs 4,75,000.

Apart from capital of Rs 8,00,000, the retiring partner's share of goodwill was also to be paid. Assuming that M and N continue to share profits in ratio of 2 : 1 respectively and L's capital account is immediately settled in cash, pass journal entries for all the transactions relating to partner's retirement.

[**Ans : settlement of L's capital account by payment of cash Rs 9,50,000]**

Question No 4 :C, D and E were partners sharing profits in the proportions of $^1/_2$: $^1/_3$:$^1/_6$ respectively.

The Balance sheet of the firm on 31st March, 2012 was as follows:

Liabilities	Rs	Assets	Rs
Capital Accounts		**Building**	**4,50,000**

C	**4,00,000**	**Machinery**	**3,50,000**
D	**3,00,000**	**Furniture**	**80,000**
E	**2,50,000**	**Stock**	**2,50,000**
Creditors	**1,90,000**	**Debtors**	
Bills Payble	**50,000**	**1,60,000**	**1,55,000**
Reserve	**1,20,000**	**Less provision**	**25,000**
	13,10,000	**5000**	**13,10,000**
		Bank	

D retired on that date subject to the following conditions:

(1) The goodwill of the firm to be valued at Rs 180 thousand and d be given credit for his share of goodwill.
(2) Plant to be depreciated by 10% and furniture by 15%.
(3) Stock to be appreciated by 20% and Buildings by 10%.
(4) The Provision for Bad Debts to be increased by Rs 20 thousand; and
(5) Liability for workmen's compensation to the extent of Rs 16 thousand to be brought into account. It was agreed that c and e will share profits in future in the ratio of C 3/5 and e 2/5.

Pass journal entries, prepare revaluation account, capital accounts and balance sheet

(1) When the change in the values is to be recorded in the books, and (2) when the assets and liabilities are to continue to appear at their old figures.

[Ans: profit on revaluation 12,000,D's share of goodwill 60,000]

Model questions and answers:

1. State the treatment of goodwill on retirement of a partner.

A retirement is usually arranged to be taken place at the end of an accounting year whereas, death may take place on a date some time after the date of which the last balance sheet and accounts were made up. Hence, the representatives of the deceased partner will be entitled to his share of profits accrued upto the date of death. To avoid the necessity of preparing final accounts till the date of death, it is frequently provided in the partnership deed that in the event of the death of a partner his share of the accruing profits upto the date of death is to be arrived at on the basis of either profits of the last year/ last few years or on the basis of turnover. In some cases, it is agreed to wait until the next annual accounts are prepared.

We have seen that the deceased partner's share of profit earned till the date of his death has to be given to his executors. The correct amount of profit earned can be calculated only if the books are closed till the date of death. This may be inconvenient. Profit may, therefore, be calculated by any of the following two methods.

1. On the basis of time.

2. On the basis of turnover

1. On the basis of time : If the time basis is used, the profit will be assumed to accrue evenly over the year. According to this method, profit may be estimated by any of the following two methods :

a) **On the basis of last year's profit :** The proportionate profit of the firm is computed from the last accounting period to the date of death on the basis of profit earned during last year. Thereafter, share of profit of deceased partner is computed.

b) **On the basis of average profit :** In certain cases, partners may agree to calculate deceased partner's share of profit on the basis of average profit. This is worked out as under :

i) Take the total profits of the required number of past years;
ii) Calculate the average profit (i.e., Total profit + No. of years)
iii) Reduce average profit for the period upto date of death,
iv) Find out the share of the deceased partner.

2. On the basis of turnover (or sales) : If profits till the date of death is to be calculated on the basis of turnover, on such arrangement last year's profit and sales are given together with the sale of the current year upto the date of death of the partner. The profit is ascertained proportionately and the share of deceased partner is calculated.

Accounting Treatment of outgoing Partner's Share in Profits

The outgoing partner's share in the profits may be readjusted in either of the following ways:-

	In case of profit	Profit & Loss Suspense A/c Dr. To Outgoing Partner's Capital A/c

	In case of Loss	Outgoing Partner's Capital A/c Dr. To Profit & Loss Suspense A/c

2. Distinguish between sacrificing ratio and gearing ratio.
Sacrificing Ratio vs Gaining Ratio

1. Meaning
   It is the ratio in which old partners agree to sacrifice their share of profit in favour of new partners/partner
   It is the ratio in which continuing partner acquires the share of profit from outgoing partner/partner

2. Calculation
   Sacrificing Ratio = Old Ratio – New Ratio
   Gaining Ratio = New Ratio – Old Ratio

3. Time
   It is calculated at the time of admission of new partner/partners.
   It is calculated at the time of retirement/death of old partner/partners.

4. Objective
   It is calculated to ascertain the share of profit and loss given up by the existing partners in favour of new partners/partner.
   It is calculated to ascertain the share of profit and loss acquired by the remaining partners (of the new firm in case of retirement) from the retiring or deceased partner.

5. Effect
   It reduces the profit share of the existing partners.
   It increases the profit share of the remaining partners.

3. What is the treatment of deceased partner`s share of goodwill.

The executors of the deceased partners are also entitled to receive the share of goodwill the firm. Goodwill for this purpose will be valued according to the provisions of partnership deed. The amount of deceased partner's share of good will ascertained will be credited to his capital account and will be debited to gaining partner's capital account in the gaining ratio.

4. What is the accounting treatment at the time of death of a partner?

As discussed earlier on the death of a partner, the account of deceased partner is maintained in the same way as is maintained on the retirement of a partner. But the only difference is that the amount due to a deceased partner as revealed by his capital account is transferred to his executor's account.

The journal entry will be :

Deceased Partner's Capital A/c ----------------------Dr

To Deceased partner`s executors Account --------

(For amount due to deceased partner transferred to his executor's a/c)

5. What are the procedures for settlement of deceased executors account?

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

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

Deceased Partner's Executor's A/c : Dr.

To Cash / Bank A/c.

(b) When the settlement is made in instalments the following entries are recorded:

(i) For interest due to Deceased Partner Executor's A/c

Interest on Deceased Partner Executor's A/c

To Deceased Partner's Executor's A/c

(ii) When payment is made in instalment :

Deceased Partner's Executor's A/c Dr.

To Cash/ Bank A/c

To amount due to executor's of deceased partner is paid off immediately or is paid instalments with or without interest as per agreement. In the absence of an agreement in the paid off or a share of the profit which has been earned by the firm using the amount due to the as per Section 37 of the partnership Act.

FURTHER READINGS:

1. Modern Accountancy: Hanif and Mukherjee, volume –I, Tata McGrawhill.
2. Higher secondary Accounting: Biswal and Sharma.
3. Financial Accounting: P.C. Tulsian, Pearson.
4. An Introduction to Accountancy: S.N. Maheshwari, S.K. Maheshwari. Vikas.

UNIT 3 DISSOLUTION Of PARTNERSHIP FIRM

Learning Objectives:

After studying this lesson, you will be able to know:

- Meaning of Dissolution,
- settlement of accounts between partners after dissolution,
- golden rule for dealing with the problem of dissolution,
- insolvency of a partner,
- Rule of Garnarvs Murray applicability of this rule in India and piecemeal distribution.

Structure:

3.1 INTRODUCTION

The dissolution of partnership among all the partners of a firm is called the Dissolution of the Firm (Sec. 39 of the Partnership Act, 1932). Dissolution of firm means complete breakdown of the relation of partnership among all the partners. When all the partners resolve to dissolve the partnership, the dissolution of firm occurs, i.e. the firm is wound up. If the business comes to an end, it is said that the firm has been dissolved. Dissolution of firm means the closing down of the business. Firm's dissolution implies partnership dissolution but not vice versa.

3.2 MEANING AND DEFINITION OF DISSOLUTION

The dissolution of a partnership is the end of the relationship that exists among the partners as a result of any partner discontinuing his or her involvement in the partnership, as distinguished from the winding up of the outstanding obligations of the business.

Partnerships may be dissolved when:

1. The term of the partnership has expired.
2. One partner has given notice to the other partner(s)

3. The partnership is now illegal e.g. one partner can no longer legally own a business.
4. There is a court order.
5. There is a death of a partner or the business has gone bankrupt.

Tests for insolvent partnerships:

The tests for an insolvent partnership are similar to the two generally accepted tests for an insolvent company. If a partnership is:

- unable to pay its debts as they fall due; or
- its assets, when realized in cash, would be insufficient to pay off its debts and other liabilities then the partnership is insolvent for the purposes of UK law.

A partnership will not be insolvent solely on the basis of one of its members being individually insolvent if it is itself able to pay its debts as they fall due or its assets are greater than its liabilities.

3.3 CAUSES OF GENERAL DISSOLUTION

The general dissolution of a partnership will usually be instigated as a result one of the following events:

- The mutual agreement of the partners – which may be an ad hoc agreement, or an agreement enshrined in the partnership agreement, for example, it was agreed that the partnership would be dissolved after a particular date or after a certain event. Such an agreement may be implied rather than actual.
- By the serving of a notice by a partner where such an action provided for in partnership agreement.
- The exercise of a specific power in the partnership agreement – where, for example, the partnership agreement allowed a majority of the partners to seek dissolution.
- The exercise of a power in the legislation.
- One of the events provided for in the legislation e.g., the death or bankruptcy of a partner – subject to contrary agreement.
- Fraud, misrepresentation, rescission or illegal activity.
- By an order of court, for example, the mental incapacity or other ill-health of a partner.
- Where the business may only be carried on at a loss.

3.4 DISSOLUTION OF PARTNERSHIP VS. DISSOLUTION OF FIRM

Dissolution of a partnership firm merely involves a change in the relation of partners; whereas the dissolution of firm amounts to a complete closure of the business. When any of the partners dies, retires or become insolvent but if the remaining partners still agree to continue the business of the partnership firm, then it is dissolution of partnership not the dissolution of firm. Dissolution of partnership changes the mutual relations of the partners. But in case of dissolution of firm, all the relations and the business of the firm comes to an end. On dissolution of the firm, the business of the firm ceases to exist since its affairs are would up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

Dissolution of a Firm:

A firm may be dissolved in the following manner

(A) Dissolution by Agreement (Sec. 40): A firm may be dissolved at any time with the consent of all partners. For instance, when a firm does not expect good prospects in the future, a firm can be dissolved by mutual consent of all partners.

(B) Compulsory Dissolution (Sec. 41): A firm is compulsorily dissolved by operation of law when all the partners except one become insolvent or when all the partners become insolvent or when business becomes illegal or when the number of partners exceeds twenty in case of ordinary business or ten in case of banking.

(C) Dissolution on the Happening of Certain Contingencies (Sec. 42): A firm is dissolved, in the event of any of the following circumstances:

- i) The expiry of the term for which it was formed.
- ii) The completion of the venture for which the partnership was constituted.
- iii) The death of a partner.
- iv) The adjudication of a partner as an insolvent.

(D) Dissolution by Notice of Partnership at Will (Sec. 43): Where a partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

(E) Dissolution by the Court (Sec. 44): The court is empowered to order the dissolution of a firm consequent on a suit by a partner in the following cases:

- i) When a partner becomes insane or unsound of mind.
- ii) When a partner becomes permanently incapable of performing his duties, be it mental or physical.

iii) When a partner is proved guilty of misconduct which is likely to affect adversely the business of the firm.
iv) When a partner conduct himself in such a way that it is not possible for the other partners to carry on partnership with him.
v) When a partner transfers his interest or share to third party.
vi) When the business cannot be carried out except at a loss. (It must be remembered that the object of partnership is to earn profits and if that object is not fulfilled, the firm can be dissolved).
vii) When it appears to be just and equitable. For instance, continued quarrelling, deadlock in the management, refusal to attend matters of business, absence of cooperation etc. among the partners. (The court has wide discretionary powers).

Settlement of Accounts (Sec. 48):

As soon as a firm is dissolved, it ceases to transact normal business. The mode of settlement of accounts between partners after the dissolution of a firm is determined by the partnership agreement. In the absence of any specific agreement as to the mode of settlement of accounts after the dissolution of the firm, the Partnership Act laid down the following provisions (Sec. 48) for settlement of accounts.

(a) Losses, including deficiencies of capital, shall be paid first out of profit, next out of capital, and lastly, if necessary, by the partners individually in their profit-sharing ratio.
(b) The assets of the firm including any sums contributed by the partners to make up deficiencies of capital shall be applied in the following manner and order:
    i) In paying the debts of the firm to third parties.
    ii) In paying each partner rateably what is due to him from the firm for advances.
    iii) In paying to each partner rateably what is due to him on account of capital, and
    iv) The surplus, if any, will be divided among the partners in their profit sharing ratio.

Firm's Debt and Personal Debts:

Where debts owe both the firm and the partners individually, the rule under section 49 is:
i) To apply the firm's assets first in paying off the firm's debts and out of the surplus left, if any, each partner's share thereof is applied in meeting his personal debts, and

ii) To apply the private property of each partner first in paying off his personal debts and the residue, if any, is applied to pay off the firm's debts.

Dissolution Accounts:

When a business is discontinued, the firm is said to be dissolved. As a result, all the accounts be closed. It is, therefore, necessary to open Realization Account, Cash or Bank Account and Partners Capital Accounts.

i) Realisation Accounts is opened for all transactions relating to realisation of assets and payment of liabilities. That is, on dissolution, it is essential to make sale of assets of the firm, realize cash and paying off the liabilities.

Realisation of assets and settlement of liabilities are centered round the Realisation Account. It is a nominal Account. The difference, being gain or loss will be transferred to Capital Accounts.

ii) Cash/Bank Account is opened to record all cash transactions. When the purpose is over the Cash Account shows a balance, which is equal to the amounts due to partners.

iii) Capital Accounts are opened to make all entries connected with the partners' accounts. Current Accounts, if any, are transferred to Capital Accounts. Finally the Capital Accounts are closed by receiving or paying cash.

The Six Golden Rules:

There are six golden rules about dealing with the problem of dissolution of firm:

i) If a balance sheet on the date of dissolution is not given in the question first of all, the balance sheet should be prepared in proper form.
ii) At the time of dissolution of firm, balances of accounts given in the Balance Sheet are once shown in Realisation account or Partner's Loan Account or Partners' Capital Accounts of Cash/ Bank Account but the transactions given outside the balance sheet are shown twice in said mentioned accounts.
iii) All the assets must be sold or otherwise disposed off.
iv) All of the creditors must be paid. Partners, who have contributed beyond their capital i.e. partner's loan must also be included in this category.
v) The amount due to each partner must be paid.
vi) The total of both the sides of cash/ bank account must be equal.

Illustration 1. The Balance Sheet of R and S as on 31st December, 1998 was as under :

Balance Sheet

Liabilities	Rs.		Assets	Rs.
Creditors	20,000		Good Will	18,000
R's Loan	10,000		Building	60,000
R's Brother's Loan	30,000		Stock	45,000
Capital Accounts			Debtors	18,000
Rs.			Cash in Hand	6,000
R 30,000	90,000		Cash at Bank	3,000
S 60,000	1,50,000			1,50,000

The firm was dissolved on 1st January, 1999. Rs.1, 500 became bad out of debtors and nothing could be realized of good will. Stock was sold at 10% less than book value and Building realized at Rs.90, 000. Creditors were paid off at discount of 3%. Dissolution expenses amounted to Rs.1, 500.00

Pass journal entries and prepare necessary accounts to close the books of the firm.

Solution

Journal

	Realisation A/c	Dr.	Rs. 1,41,000	Rs. 18,000
	To good will A/c			Rs. 60,000
	To Building A/c			Rs. 45,000
	To Stock A/c			Rs. 18,000
	To Debtors A/c			
	For transfer of various assets to reliation a/c at their book value)			
	Cash A/c		Rs. 300	Rs.3,000
	To Bank A/c			Rs.3,000
	For cash withdrew from bank)			
	Creditors A/c Dr.			
	To Realisation A/c			50,000
	(For transfer of outside liabilities to realization a/c at their book value)			
	Cash A/c Dr.		1,47,000	
	To Realisation A/c			1,47,000
	(For assets realized in cash)			
	Realisation A/c Dr.			
	To Cash A/c			
	(For payment of dissolution expenses)			
	Realisation A/c Dr.		1,500	
	To Cash A/c			1,500
	(For payment of dissolution expenses)			
	Realisation A/c Dr.		49,400	
	To Cash A/c			49,400
	(for payment of outside liabilities)			

	R's Loan A/c Dr.	10,000	
	To Cash A/c		10,000
	(For partner R's loan paid off)		
	Realisation A/c Dr.	5,100	
	To R's Capital A/c		2,550
	To S's Capital A/c		2,550
	(For profit on realization transferred to partners' capital a/cs in their profit sharing ratio)		
	R's Capital A/c Dr.	32,550	
	S's Capital A/c Dr.	62,550	
	To Cash A/c		95,100
	(For final payment made to the partners)		

Accounting Treatment of Provision or Undistributed Profits/ Losses

(1) Transfer of provision to realization account : Provision means it is created for a specific purpose and can be utilized for that purpose e.g. provision for bad debts, joint life policy fund, investment fluctuation fund etc.

(a) If there exists a provision against any assets should be transferred to the credit side of realization account and the foll9owing entry will be passed :

Provision for Bad Debts A/c Dr.
Provision for Discount on Debtors A/c Dr.
Investment Fluctuation Fund A/c Dr.
Joint Life Policy Fund A/c Dr.
Provision for Depreciation A/c Dr.
To Realization A/c

(For transfer of specific reserve to realization a/c)

Note: Provision is not to be paid as these are not the liabilities.

(b) Provision which has a debit balance should be transferred to the debit side of realization account and entry will be:

Realization A/c
To Provision for Discount on Creditors A/c

(For transfer of specific reserve to realization a/c)

(2) Transfer of undistributed profits / losses to partners' capital accounts:

(a) Undistributed profits such as General Reserve, Reserve Fund, and Credit balance of Profit & Loss Account etc. are not to be transferred to Realization Account. These accounts are transferred to partners' capitals are transferred to partners' capital accounts in their profit sharing ratio. The following entry will be passed:

General Reserve A/c	Dr.
Reserve Fund A/c	Dr.
Profit & Loss A/c	Dr.
Workmen's' Compensation Fund	Dr.
To Partners' Capital A/cs	

(For the transfer of undistributed profits to partners' capital accounts in their profit sharing ratio)

(b) If undistributed loss i.e. Dr. Balance of Profit & Loss Account, advertisement expenses etc. is given in the assets side of balance sheet, the following entry will be passed :

Partners' Capital A/cs	Dr.
To Profit & Loss A/c	
To Advertisement Expenses A/c	

(For the transfer of undistributed loss to partners' capital accounts in their profit sharing ratio)

Illustration. A, B and C are sharing profits and losses in the ratio of 5: 3: 2. On 31st March, 1999 their balance sheet was as under:

Creditors	Rs.15,000	Cash at Bank 25,000	Rs.13,000
General Reserve	Rs.10,000	Debtors 25,000	
A's Loan	Rs.16,000	Less: Provision for Bad Debts. (1,000)	24,000
Joint Life Policy Fund	Rs. 8,000	Stock	36,000
Investment Fluctuation Fund	2,000	Investments	8,000
Capital Accounts	Rs.	Joint Life Policy	15,000
A	60,000	Plant	8,000
B	40,000		
C	25,000		
	1,76,000		1,76,000

The firm was dissolved on the above date. The joint life policy is surrendered for Rs.10, 000. The investments are taken over by B at Rs.7, 5000. C takes over the debtors amounting to Rs.12, 000 at Rs.10, 000. Plant is sold for Rs.63, 600 and the Stock for Rs.42, 000. The remaining debtors realized 60% of the book value. A agreed to accept Rs.15, 100 in full settlement of his loan. The expenses of realization amounted to Rs.800. Give journals entries and draw up the necessary ledger to close the books of the firm.

Solution

Journal

	Realisation A/c	Dr.		Rs.1,64,000	Rs.
	To Debtors A/c				25,000
	To Stock A/c				36,000
	To Investment A/c				8,000
	To Joint Life Policy A/c				15,000
	To Plant A/c				80,000
	(For transfer of various assets to realization a/c at their book value)				
	Creditors A/c	Dr.		15,000	
	To Realization A/c				15,000
	(For transfer of liabilities to realization a/c at book value)				
	Provision for Bad Debts A/c	Dr.		1,000	
	Joint Life Police Fund A/c	Dr.		8,000	
	Investment Fluctuation Fund A/c	Dr.		2,000	
	To Realization A/c				11,000
	(For transfer of special reserve to realization a/c)				
	General Reserve A/c	Dr.		10,000	
	To A's Capital A/c				5,000
	To B's Capital A/c				3,000
	To C's Capital A/c				2,000
(For transfer of general reserve to partners' capital a/c in their profit sharing ratio 5 : 3 :2)					
	Bank A/c	Dr.		1,23,400	
	To Realisation A/c				1,23,400
	(For assets realized)				
	B's Capital A/c	Dr.		7,500	

	C's Capital A/c	Dr.		10,000	
	To Realisation A/c	Dr.			17,500
	(For assets taken over by the partners)				
	Realisat on A/c			800	
	To Bank A/c				800
(For payment of realization expenses)					
Realization A/c		Dr.		15,000	
	To Bank A/c				15,000
(For payment of outside liability)					
A's Loan A/c				16,000	
To Bank A/c		Dr.			15,100
To Realisation A/c					900
(For A's loan paid off under discount Rs.900)					
A's Capital A/c		Dr.		6,000	
B's Capital A/c		Dr.		3,600	
C's Capital A/c		Dr.		2,400	
To Realisation A/c					12,000
(For loss on realisation transferred to capital a/cs)					
A's Capital A/c		Dr.		59,000	
B's Capital A/c		Dr.		31,900	
C's Capital A/c		Dr.		14,600	
To Bank A/c					1,05,500
(For final payment of partner's capital)					

Ledger Accounts
Realization Account

	Rs.		Rs.
To Debtors	25,000	By Creditors A/c	15,000
To Stock	36,000	By Provision for Bad Debts A/c	1,000
To Investments	8,000	By Life Policy Fund A/c	8,000
To Joint Life Policy	15,000	By Bank A/c (asserts realized i.e. 10,000 + 63,600 + 42,000 + 7,800)	2,000
To Plant	80,000	By Bank A/c (assets realized	1,23,400

		i.e. 10,000+ 63,600 + 42,000 + 7,800	
To Bank A/c (expenses)	800	By B's Capital A/c (assets taken)	7,500
To Bank A/c (liability paid)	15,000	By C's Capital A/c (assets taken)	10,000
		By A's Loan A/c (discount)	900
Total (Dr.)	1,79.800	Total (Cr.)	1,67,800
		By Loss Transferred to Capital A/cs.	
		A 5/10 6,000	
		B 3/10 3,600	
		C 2/10 2,400	12,000
	1,79,800		**1,79.800**

A/s Loan Account

	Rs.	By Balance b/d	Rs.
To Bank A/c	15,100		16,000
To Reliation A/c	900		
	16,000		16,000

Partner's Capital Account

Particulars	**A**	**B**	**C**	**Particular**	**A**		**C**
	Rs.	Rs.	Rs.		Rs.		Rs.
To Realisation A/c (assets taken)				By Balance b/d	60,000		25,000
		7,500	10,000	By General Reserve A/c	5,000		2,000
To Realisation A/c (loss)	6,000						
To Bank A/c							
(final payment)	59,000	31,900	14,600				
	65,000	43,000	27,000		65,000		27,000

Bank Account

	Rs.		Rs

			.
To Bank b/d	13,000	By Realisation A/c (expenses)	800
To Realisation (assets realized)	1,23,400	By Realisation A/c (liability)	15,00
		By A's Loan A/c	15,100
		By A's Capital A/c	59,000
		By B's Capital A/c	31,900
		By C's Capital A/c	14,600
	1,36,400		**1,36,400**

Note:

(1) Since nothing is mentioned about creditors, it is assumed that this is paid in full.

(2) Provision for Bad debts, Joint Life Policy Fund, Investment Fluctuation Fund being special reserve has been transferred to the credit side of Realization Accounts. At they are not outside liabilities, hence their payment will not be made.

(3) Sundry Debtors and Provision for Bad debts account are two separate accounts and these accounts should be transferred separately to realization a/c.

Accounting Treatment for Unrecorded Assets and Unrecorded Liabilities

i) Unrecorded assets: Sometimes it may happen at the time of dissolution of the firm that there are some assets in the business which do not appear in the books. These assets are known as unrecorded assets. For example, at the time of dissolution, firm had a scooter which was not shown in the books. It can be sold for Rs. 4,500. In this case accounting entries will be passed as follows :

(a) If cash realization fro unrecorded assets :

Cash/Bank A/c	Dr.	4,500
To Realisation A/c		4,500

(b) If unrecorded assets taken over by a partner:

Partner's Capital A/c	Dr.	4,500
To Realisation A/c		4,500

ii) Unrecorded liabilities: It may sometimes happen at the time of dissolution of the firm that there are certain liabilities which do not appear in the books. These liabilities are known as unrecorded liabilities. For example at the time of dissolution of firm compensation to employees paid by the firm amounted to Rs. 10,000. This liability was not provided in the books. For this purpose, the following accounting entries will be passed:

(a) If cash payment is made for unrecorded liability:

Realisation A/c	Dr.	10,000
To Cash/Bank A/c		10,000

(b) If unrecorded liability taken over by a partner:

Realisation A/c	Dr.	10,000
To Partner's Capital A/c		10,000

Note: Both unrecorded assets and unrecorded liabilities are not transferred to realization
Account because they have no account in the books.
Accounting Treatment of Good will

In the case of dissolution of a firm, goodwill should be treated just like other assets. If nothing is mentioned about the realization of goodwill, it can be assumed that the goodwill is valueless and as such, nothing is received or realised for it.

Illustration: (Unrecorded assets and unrecorded liabilities) A, B and C are partners sharing profits and losses equally. Their Balance Sheet as on June 30, 1999 is as follows:

Liabilities	**Rs.**	**Assets**	**Rs.**
Creditors	25,000	Cash at Bank	2,000
Bills Payable	10,000	Debtors	18,000
Rs.	5,000	Stock	25,200
Mrs. A's Loan B	1,00,000	Bills Receivable	8,000
60,000		Machinery	60,000
Capital : C		Goodwill	6,000
40,000		Profit & Loss A/c	10,800
		C's Capital	10,000
	1,40,000		**1,40,000**

(1) Assets were realised as follows: Stock Rs. 27,200, Debtors Rs. 15,000 and machinery at Rs. 60,000.
(2) B took away all the Bills Receivable at Rs. 7,000 and also agreed to make the payment of Bills Payable.
(3) There was an unrecorded asset of Rs.4, 000 which was taken over by C at Rs. 1,200.
(4) A bills receivable for Rs. 2,000 was received from a customer Sanjay which was discounted from bank. Sanjay became insolvent and 60 paise per rupee have been received from his estate.
(5) A agreed to pay off his wife's loan.
(6) Creditors were settled at 10% discount.
(7) Realisation expenses amounted to Rs. 900 are met by B.

Pass journal entries and prepare necessary ledger accounts to close the books of the firm.

Partner's Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
To Balance b/d	Rs.	Rs.	Rs.	By Balance b/d	Rs.	Rs.	Rs.
To Profit & Loss A/c	___	___	10,000	By Realisation A/c	60,000	40,000	___
To Realisation A/c	3,600	3,600	3,600	(expenses)			
(assets taken)	___			By Realisation A/c	___	900	___
To Realisation A/c		7,000	1,200	(liabilities taken)			
(loss)	2,000			By Bank A/c		10,000	___
To Bank A/c		2,000	2,000	(deficit	5,000	___	16,800
(final payment)					___		
	59,400	38,300	___				
	65,0000	50,900	16,800		65,000	50,900	16,800

Bank Account

Receipts	Rs.	Payments	Rs.
To Balance b/d	2,000	By Realisation A/c (liabilities	24,500
To Realisation A/c	1,03,400	paid)	
(sale proceeds)		By A's Capital A/c	59,400
To C's Capital A/c	16,800	By B's Capital A/c	38,300
	1,22,200		1,22,200

Note :

(1) Goodwill being intangible assets has been treated as valueless.

(2) There is deficit in the capital account of C. If it is not mentioned in the question that partner is insolvent, it is assumed that he will bring required cash.

Illustration:. A, B and C are three partners sharing profits in the ratio 3 : 1: 1. On 31st March, 1999, they decided to dissolve their firm. On that date, their balance sheet was as under :

Receipts	Rs.	Payments	Rs.
Creditors	6,000	Cash	3,200
Loan	1,500	Debtors 24,200	
Capital A/cs :Rs.		Less : Provision for Bad Debts	23,000
A 27,500		1,200	
B 10,000		Stock-in-Trade	7,800
C 7,000	44,500	Furniture	1,000
		Sundry Assets	17,000
	52,000		52,000

It is agreed that:

i) A is to take over Furniture at Rs. 800 and Debtors amounting to Rs. 20,000 at Rs. 17,200; the Creditors of Rs. 6,000 to be paid by him at this figure.
ii) B is to take over all the Stock-in-Trade at Rs. 7,000 and some of the Sundry Assets at Rs.7, 200 being 10% less than book value.
iii) C is to take over the remaining Sundry Assets at 90% of the book value, less Rs. 100 as discount and assume the responsibility for the discharge of the loan together with accrued interest of Rs. 30 which has not been recorded in the books.
iv) The expenses of dissolution were Rs. 270 the remaining debtors were sold to a debt collecting agency for 50% of the book value.

Prepare necessary accounts to close the books of the firm.

(ix)	Realisation A/c Dr. To Cash A/c (For compensation to employees paid)		9,000	9,000
(x)	Realisation A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (For profit on dissolution credited to partner's capital a/cs)		13,500	 5,400 4,050 4,050

INSOLVENCY OF A PARTNER:

The Capital Account of a partner may show a debit balance because of excess drawals or losses on account of realisation or some other reasons. Such a debit balance is called Capital Deficiency. If the Capital Account of a partner shows a debit balance as a result of various entries passed on account of dissolution of the firm, it is expected that he will pay the money from his estate. If this is done, the other partners will be able to get in full what is due to them.

If the partner is solvent, he will have to make good such capital deficiency by bringing cash. But if the partner is unable, he may not be able to pay off even his own private liabilities. In some cases, after paying the private liabilities, a small sum which is lesser than the amount due to the firm, may be given by the partner, whose capital account shows a debit balance.

When a partner is insolvent, then such a capital deficiency will be a loss to other solvent partners. For example, if there are two partners in a firm and if one of them is insolvent, then the capital deficiency will be borne by the other partner, who is solvent. But, when there are more than 2 partners, there arise problems as to the ratio in which the capital deficiency be borne by the remaining partners.

In such a case, the deficiency shown by the insolvent partner's capital account should be divided among the solvent partners in the ratio which has already been agreed upon by them for the purpose.

Prior to the decision in the leading case of Garner vs. Murray, this loss was borne by the solvent partners in the profit sharing ratio just like trading losses. No distinction was observed between trading loss and capital loss. The rule was laid down by Justice Joyce, in November 1903, in Garner vs. Murray.

Garner vs. Murray Decision:

Garner, Murray and Wilkins were partners, in a firm, sharing profits and losses equally. Their capi¬tals were not equal. There was no partnership deed. The firm dissolved on 30th June 1900.
The position was as follows, after dissolution:

Balance Sheet as on 30th June 1900

Liabilities	Amount	Assets	Amount
Garner capital Account	2,500	Cash	1,916
Murray capital Account	314	Wilkin's Capital	263
		Loss on realisation	635
	2814		2814

Mr. Wilkins became insolvent and could not pay anything against the capital deficiency. When the loss on realization is distributed, Garner Capital account would be reduced of £2,288 (£ 2,500 – 212), Murray's capital would be reduced to £ 102 (314-212) and Wilkins' capital deficiency would be increased to £ 474 (£ 263 + 211).
Such a loss which is due to capital deficiency, prior to Garner vs. Murray decision, was to be borne by the solvent partners in profit sharing ratio. But, here, Murray had raised an objection and claimed that the loss is a capital loss and not a business loss. Therefore, such loss due to capital deficiency of a partner to be borne in capital ratio and not in profit sharing ratio. Murray got the decision in his favour.

In Garner vs. Murray, a historic decision was given by Justice Joyce, upholding the contention of Murray i.e. capital deficiency of insolvent partner is a capital loss and is to be shared by the solvent partners, in capital ratio, just before dissolution.

Main Points of Garner vs. Murray Decision:

1. Loss due to insolvency is a capital loss.
2. Such loss, due to insolvency, is to be shared by solvent partners in their capital ratio just before dissolution.
3. All solvent partners should bring in their share or realization loss in cash.
4. If a partner's capital account shows a debit balance, he need not share the capital loss of the insolvent partner.

It is noteworthy that the decision in Garner versus Murray violates the principles of 'natural justice' and 'equity'. For instance, if a partner is having a debit balance of his capital account on the relevant date (just prior to dissolution) he will not bear the loss on account of insolvency of partner's even though he may be financially more sounded as compared to other solvent partners.

Application of this Rule in India

Indian Partnership Act, 1932 has no objection regarding the decision given in the case of 'Garner Versus Murray'. Thus in the absence of any rule or instruction, this rule should be followed while attempting the question. But the solvent partners may not be required to bring the loss on realization in cash because this amount is paid back to the solvent partners. It is against the principle of accountancy. Hence,

i) Debit balance of insolvent partner's capital account (deficiency) should be divided amongst the solvent partners in the ratio of their capitals.
ii) Where in examination question specifies that the rule in 'Garner vs. Murray' is to be applied, the solvent partners should be required to bring the loss on realization in cash otherwise not.

Application of Garner vs. Murray Rule in India:

The rule of Garner vs. Murray is applicable in India only if:

(a) There is no agreement to the contrary.'
(b) The capitals of partners are not in profit sharing ratio.
(c) There must be capital deficiency in a partner's capital account.

Illustration:. Taking facts of the case Garner versus Murray, you are required to give ledger accounts so as to show the final distribution among partner as per decision of case.

Solution

Realisation Account

To Balance b/d		By Loss transferred to	ε

(Loss)	636	Capital A/cs : ε Garner 1/3 212 Murray 1/3 212 Wilkins 1/3 212	636
	636		636

Partner's Capital Accounts:-

Particulars	**Garner**	**Murray**	**Wilkins**	**Particular**	**Gamer**	**Murray**	**Wilkins**
To Balance b/d To Realization A/c (Loss) To Wilkins Capital A/c2(Deficit) To Cash A/c (F. Payment)	ε ____ 212 422 2,078	ε ____ 212 53 261	ε 263 212	By Balance b/d By Cash A/c1 By Garner's Capital A/c By Murray's Capital A/c	ε 2,500 212 ____ ____	ε 314 212 ____ ____	ε _____ 422 53
	2,712	526	475.00[1]		2,712	526	475

Cash Account

To Balance b/d To Garner's A/c To Murray's	ε 1,915 212 212	By Garner's Capital A/c By Murray's Capital A/c	ε 2,078 261
	2,339		2,339

Note : (1) Garner and Murray being solvent partners have brought their share of realization loss in cash.

(2) Wilkins capital deficiency of 475 is borne by Garner and Murray in their capital ratio (before dissolution), i.e., 2,500 : 314 or 8 : 1

Garner : 475 x 8/9 = 422, Murray : 475 x 1/9 = Rs. 53

Illustration 6. (Capitals are fluctuating) A, B and C were in partnership sharing profits and losses in the ratio of 2 : 2 : 1. Their Balance Sheet on the date of dissolution was as follows :

Sundry Creditors General Reserve Capital Account :Rs. A 50,000 B	Rs. 7,400 10,000 82,000	Cash at Bank Sundry Debtors Less : Provision for Bad Debts Stock - in - Trade Furniture	Rs. 2,100 15,300 28,600 4,000

32,000		Buildings Capital A/c-C	40,000 9,400
	99,400		99,400

Assets realised : Debtors Rs. 12,500 : Stock Rs. 16,000; and Building Rs. 42,000. Furniture is taken over by A for Rs. 1,500. Discount of Rs. 400 are secured on payments due to creditors. Outstanding creditors not provided for amounting to Rs. 1,700 were also paid. The expenses of realization amounted to Rs. 625.

C was declared insolvent but Rs. 965 were recovered from his private estate. Write up the necessary accounts to close the books of the firm. Make final payment to the partners according to the decision in Garner versus Murray.

Solution.

Realisation Account

To Debtors a/c	Rs.	By Provision for Bad Debts A/c	Rs.
To Stock-in-Trade A/c	16,000	By Sundry Creditors A/c	700
To Furniture A/c	28,600	By Bank A/c (Assets realised)	7,400
To Building A/c	4,000	By A's Capital A/c (Asset taken)	70,500
To Bank A/c (Expenses)	40,000	By Loss transferred to Capital A/cs :Rs.	1,500
To Bank A/c (Liabilities paid)	625	A 2/5 7,130	
	8,700	B 2/5 7,130	
		C 1/5 3,565	
			17,825
	97,925		97,925

Partners' Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Balance b/d	____	___	9,400	By Balance b/d	50,000	32,000	____
To Realisation	1,500	___	____	By Gen. Reserve	4,000	4,000	2,000
A/c (Loss)	7,130	7,130	3,565	A/c	7,130	7,130	____
To Balance c/d	52,500	36,000	____	By Bank A/c3	____	____	965
To Balance b/d				By Bank A/c	____	____	10,000
To C's Cap.				(Recovery)			
(Deficience)				By Balance c/d			
To Bank A/c							
(F. Payment							
	61,130	43,130	12,965		61,130	43,130	12,965
	____	____	10,000		52,500	36,000	____
	6,000	4,000	____	By Balance b/d	____	____	6,000[5]
	46,500	32,000	____	By A's Capital A/c	____	____	4,000[5]
				By B's Capital A/c			
	52,500	36,000	10,000		52,500	36,000	10,000

Bank Account

	Rs.		Rs.
To Balance b/d	2,100	By Realisation A/c (Expenses paid)	625
To Realisation A/c (Sale Proceeds)	70,500	By Realisaiton A/c (Liabilities Paid)	8,700
To A's Capital A/c	7,130	By A's Capital A/c	46,500
To B's Capital A/c	7,130	By B's Capital A/c	32,000
To C's Capital A/c (Recovery)	9654		
	87,825		87,825

Note :

(1) Total Amount realised from assets = Rs. 12,500 (debtors) + Rs. 16,000 (stock) + Rs. 42, 000 (building) = Rs. 70,500.

(2) Payment of total outside liabilities = Rs. 7,000 (creditors) + Rs. 1,700 (outstanding creditors) = Rs. 8,700.

(3) In above illustration, the rule in Garner vs. Murray is to be applied. Thus, solvent partners will bring in cash their share of loss on realization. The entry will be :

Bank A/c	Dr.	14,260
To A's Capital A/c		7,130
To B's Capital A/c		7,130

(4) On C's insolvency Rs. 965 are recovered from his private estate. The following entry will be made:

Bank A/c	Dr.	965
To A's Capital A/c		965

(5) C's Capital account shows a debit balance of Rs. 10,000 being capital loss will be borne by A and B in their capital, ratio. In case of fluctuating capital, capital ratio will be ascertained as follows:

	A	B
	Rs.	Rs.
Opening Capital	50,000	32,000
(+) Share of General Reserve	4,000	4,000
Adjusted Opening Capital	54,000	36,000

Thus, capital ratio = 54,000: 36,000 or 3 : 2.

Above - mentioned C's deficiency Rs. 10,000 should be borne by a and B in their capital ratio of 3 : 2 which will be recorded as follows :

A's Capital a/c	Dr.	6,000
B's Capital A/c	Dr.	4,000

To C’s Capital A/c 10,000

Illustration 20. (Capitals are fixed) X, Y, and Z are partners sharing profits and losses in the ratio of 3: 2: 1. On 30th June, 1999, they agreed to dissolve the partnership. They appointed Y to realize the assets and distribute the proceeds. Y is to receive 5% commission on the sale of asset except cash as his remuneration and is to bear all expenses of realization. Their Balance Sheet was as follows:

When all Partners become Insolvent or Insolvency of a firm

When the partners become insolvent; creditors will not be able to get their amounts in full In such a case, outside liabilities are not to be transferred to Realisation Account but it is to be shown separately in their respective account. At the time of accounting treatment, the following points should be taken into consideration:

i) Cash Account should be prepared after Realisation Account :
ii) After recording the amount realised from assets together with the amounts which at received from the estate of the partners in Cash Account, first realization expenses to the paid and then remaining balance will be paid ratably to the creditors. Thus, Cash Account shows a zero balance.
iii) After that, balance of Creditors Account which cannot be paid, should be transferred the credit side of Deficiency Account. Similarly, partner's loan will be treated.
iv) At the end, debit balance of partners' capital accounts should be transferred to the credit side of Deficiency Account and vice-versa. Both the sides of Deficiency Account must equal.

	Rs.	Cash	Rs.
Sundry Creditors	18,000	Stock	450
A's Loan	4,500	Debtors	10,000
A's Capital	2,250	Furniture	3,000
B's Capital	1,350	Buildings	1,350
		C's Capital	6,800
			4,500
	26,100		26,100

Due to the inability to pay the creditors, the firm is dissolved. B and cannot pay anything. Can contribute only Rs. 675 from his private estate. Stock, debtors, furniture and buildings realised Rs. 14,400. Realisation expenses amounted to Rs. 1,350.

Prepare accounts to close the books of the firm.

Solution :

Realisation Account

To Stock A/c	Rs.	By Cash A/c (assets realised)	Rs.
To Debtors A/c	10,000	By Loss transferred to Capital A/cs	14,400
To Furniture A/c	3,000	:Rs.	
To Buildings A/c	1,350	A1/3 2,700	
To cash A/c (Expenses)	6,800	B 1/3 2,700	
	1,350	C 1/3 2,700	8,100
	22,500		22,500

Cash Account

	Rs.		Rs.
To Balance b/d	450	By Realisation A/c (Expenses)	1,350
To Realisation A/c (assets realised)	14,400	By Sundry Creditors balancing figure being available cash paid to them	14,175
To A's Capital A/c (amount received) From private estate)	675		
	15,525		15,525

Sundry Creditors Account

To Cash A/c	Rs.		Rs.
To Deficiency A/c	14,175	By Balance b/d	18,000
(Balance transferred)	3,825		
	18,000		18,000

A's Loan Account

	Rs.		Rs.
To Deficiency A/c (Balance transferred)	4,500	By Balance b/d	4,500

Partners' Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Balance b/d	___	___	4,500	By Balance b/d	2,250	1,350	___
To Realisation A/c(Loss)	2,700	2,700	2,700	By Cash A/c	675	___	___
To Deficiency A/c (Transfer)	225	___	___	By Deficiency A/c (Transfer)	___	1,350	7,200
	2,925	2,700	7,200		2,925	2,700	7,200

Deficiency Account

To B's Capital A/c (amount not received) To C's Capital A/c (amount not received)	Rs. 1,350 7,200	By Sundry Creditors (amount unpaid) By A's Loan (amount unpaid) By A's Capital A/c (amount unpaid)	Rs. 3,825 4,500 525
	8,550		8,550

Note :

(1) Due to the Inability to pay the creditors means firm is insolvent.

(2) In deficiency account, loss to the firm is debited and profit to the firm is credited from the insolvency point of view.

Piece-Meal Distribution:

It has so far been presumed that the assets are disposed of on the same day of dissolution and liabilities are also simultaneously discharged. But in actual practice, the sale of assets realise gradually unless the business is sold to a buyer (vendee).

The dissolution process takes some time during which period assets are gradually realised. This is because assets are sold piece by piece and the realisation of assets will be slow and gradual.

Similarly the liabilities are paid gradually depending upon amount realized from the sale of assets. Therefore, the final results are known only when all assets are completely realized and all liabilities are completely discharged.

On realisation of assets, the cash realised is distributed in the following order:

1. Payment of realisation expenses.
2. Payment to outside liabilities i.e. Creditors, Overdraft, Bills Payable, Outstanding expenses etc.
3. Payment of Partner’s loans and advances.
4. Payment of Partners’ balance in Capital Accounts.

After making payments to outside liabilities and partner’s loan, the capitals of the partners are returned. Unless the profit or loss on realisation is known, the amount payable to partners cannot be ascertained.

If it is so, it means that the partners should not be paid till the realisation is complete. This creates a problem. This is because the profit or loss on account of realisation is to be credited or debited to Partners’ Capital Account.

It is also necessary to see that all partners have been paid and the unpaid balance of each partner being a loss must be in the ratio of profit and loss sharing ratio. It is, therefore, necessary to find out a method by which the partners are paid, as and when cash is received, without waiting till the realisation of all assets and at the same time to ensure that no partner is paid in excess and amounts left unpaid are in profit and loss sharing ratios.

Basis of Distribution:
When a firm decides to make distribution of cash as and when received, there arises a problem of determination of basis i.e. ratio in which the available cash is to be distributed, keeping share of loss to each partner in profit and loss sharing ratio. The capital contribution or balance in the Capital Account of the Partners may not be in their profit and loss sharing ratio.

The ultimate realisation loss cannot be ascertained when the distribution of cash is made on the interim basis. In such case, when the Capital is not in profit and loss sharing ratio, whichever ratio is followed, the loss shared by the partners will not be in profit and loss sharing ratio. See Illustration 17.

Out of the available cash (as mentioned above), distribution of cash may be done in the following manner:
1. First, outside liabilities are to be paid
2. Secondly, Partners Loans or Advances are to be paid
3. Thirdly and lastly, Partners' Capital are to be paid

Now the question arises how the available cash to be distributed to the partners. The balance in the Capital Accounts of Partners may not be in profit sharing ratio. It is necessary to see that after making payments to partners, the unpaid balance of each partner, being a loss must be in Profit Sharing Ratio.

Therefore, if the Capitals of the Partners are not in profit sharing ratio, then in order to make the Partners' Loss on realisation in their profit and loss sharing ratio and to make equitable distribution of cash, on piece-meal basis, without affecting the interest of Partners, either of the following two methods can be adopted:

1. Surplus capital Method (Proportionate Capital Method) (or)
2. Maximum Possible Loss

I. Surplus Capital Method (Proportionate Capital Method):
When the Capitals of the Partners are not in proportion to their profit and loss ratio, the partner who has contributed more than his proportionate share of capital is paid first, in priority to the other partners.

For this purpose, the Surplus Capitals are to be found out on the basis of profit and loss sharing ratio. Thus, the initial payments are made in such a way that the capitals of all the partners are adjusted to their profit and loss sharing ratio. When this is done, the capitals will be in proportion to the profit and loss sharing ratio.

The steps are detailed below:
1. Divide undistributed profit, if any, among the Partners, in profit and loss sharing ratio.
2. Pay off realisation expenses or make a provision for it.
3. Pay off outside liabilities. If the amount is insufficient, then apportion the amount in the ratio of their claims.
4. After paying off the outside liabilities, pay off Partners' Loans when more than two partners are there and available cash is insufficient, then apportion the amount in the ratio of their claims.
5. Now partners' capitals are to be refunded. Find out the amount payable to Partners whose capitals are relatively in excess of their profit and loss sharing ratios. When the excess amounts have been paid off, the ratio of remaining balances in the Capital Account and profit and loss sharing ratio are one and the same.

To find out the excess capital, the following steps are needed:
(a) Partners' actual capitals are divided with their respective ratio figures.
(b) Take the relatively lowest capital as the base and find out notionally adjusted capital.
(c) Find out the excess of capital by comparing actual capital and notional capitals.
(d) Repeat these above steps till the number thereof reduced to one partner.
(e) Then, start paying off from the last ultimate excess first, then preceding excess till all the excesses are paid off.
(f) The balance i.e. the unpaid capitals (or losses) will be in profit and loss sharing ratio. Generally the unpaid balance would be loss on realisation.

II. Maximum Possible Loss:

Under this method, it is assumed that at every stage of realisation of assets; think that the remaining unrealised assets are worthless. Therefore, at every stage loss can be ascertained and this loss is distributed among the partners in profit and loss sharing ratio. The balance in the capital accounts and the cash available will be equal and the cash is paid.

The steps are:
1. Pay off Creditors first and then partners' loan account if any, out of the realised amounts.

2. Now the capitals are there to be paid. Whenever any cash is received, find out the difference between the available cash and the balance in the capital accounts. This difference is maximum loss.
3. The Maximum Loss is distributed to Capital Accounts in profit and loss sharing ratio, that is from the Capital Account, the share of losses are deducted.
4. Now distribute the available cash among the partners according to their Capital Accounts as adjusted above. Here the cash available equals the sum of the partners' adjusted credit balance.
5. If any partners' capital shows a debit balance, write it off according to Garner vs. Murray ruling.

As and when further realisations are made and cash is to be distributed, the above procedure is to be followed, in all subsequent payments among the partners.

LET'S SUM UP

Dissolution of firm means complete breakdown of the relation of partnership among all the partners. When all the partners resolve to dissolve the partnership, the dissolution of firm occurs, i.e. the firm is wound up. If the business comes to an end, it is said that the firm has been dissolved. Dissolution of firm means the closing down of the business. Firm's dissolution implies partnership dissolution but not vice versa. As soon as a firm is dissolved, it ceases to transact normal business. The mode of settlement of accounts between partners after the dissolution of a firm is determined by the partnership agreement. In paying each partner rateably what is due to him from the firm for advances

KEY WORDS:

Dissolution of a partnership: The dissolution of a partnership is the end of the relationship that exists among the partners as a result of any partner discontinuing his or her involvement in the partnership.

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.

Dissolution by Agreement (Sec. 40): A firm may be dissolved at any time with the consent of all partners. For instance, when a firm does not expect good prospects in the future, a firm can be dissolved by mutual consent of all partners.

Compulsory Dissolution (Sec. 41): A firm is compulsorily dissolved by operation of law when all the partners except one become insolvent or when all the partners become insolvent or when business becomes illegal or when the number of partners exceeds twenty in case of ordinary business or ten in case of banking.

Insolvency: Insolvency is essentially the state of being that prompts one to file for bankruptcy. An entity – a person, family, or company – becomes insolvent when it cannot pay its lenders back on time. In general, this occurs when the entity's cash flow in falls below its cash flow out.

Bankruptcy: Bankruptcy is a legal declaration of one's inability to pay off debts. When one files for bankruptcy, one obliges to pay off what is owed with help from the government.

Piecemeal distribution: The process followed to discharge the liabilities and claims of the partners as and when the assets are realized is called piecemeal distribution of cash.

Realization account: An account used to record the disposal of an asset or assets and to determine the profit or loss on the disposal

SELF-ASSESSMENT QUESTIONS:

Question 1: The following is the Balance Sheet of a firm as on 31st
December 2005:

Liabilities	Rs	Assets	Rs
Capital Account		Building	20,000
Raja 20,000		Machinery	20,000
Sonu 12,000	32,000	Debtors	10,000
Creditors	18,000	Cash	10,000
Bills payble	10,000	Profit& loss A/c	5,000
Bank overdraft	5,000		
	65,000		65,000

The firm was dissolved on 31st December 2005.
The assets were realized as follows:
Debtors Rs. 1,500; Machinery Rs. 3,000; Stock Rs. 1,200 and Factory Premises Rs, 10,000.

Bank overdraft and Bills Payable were paid in full. Creditors were settled in Rs 7,800. Realisation expenses amounted to Rs. 200.

Pass journal entries and prepare ledger accounts to close the books of the firm assuming that the profit sharing ratio between Raja and Sonu is 3: 2.

[Ans profit on realization Rs 20700]

Question 2:

A, B and C sharing profits in the ratio of 3: 2: 1, agreed upon dissolution of firm. A was appointed to realize the assets and pay off the liabilities for which he was entitled to a lump-sum amount of Rs. 1,000.

The Balance Sheet of the firm on 31st December 2005 was as under:

Liabilities	Rs	Assets	Rs
Capital:		Fixed assets	40,000
A	50,000	Inventory	20,000
B	20,000	Debtors	10,000
Creditors	30,000	C `s Capital account	30,000
Workman compensation fund	10,000	Cash	10,000
	1,10,000		1,10,000

The investments are taken over by A for Rs 18,000. B takes over all the stocks at Rs, 7,000 and debtors amounted to Rs 5,000 at Rs 4,500. Machinery is sold for Rs 55,000. The remaining debtors realize 50% of the book value. Prepare necessary ledger account on completion of the dissolution of the firm

[**Ans profit on realization Rs 46,000]**

Question 3:

Chopra, Shah and Patel were carrying on business as manufacturers of sports goods. The profit-sharing ratio was 3:2:1 respectively.

Their Balance Sheet on 30th June 2005 was as under:

Liabilities	Rs	Assets	Rs
Capital Account			
Chopra	1,50,000	Machinery	2,00,000
Shah	2,00,000	Closing stock	1,00,000
Patel	50,000	Debtors	1,50,000
Creditors	2,00,000	Marketable securities	1,50,000
Mr`s chopra loan	1,00,000	Cash	1,00,000
Reserve	20,000	Prepaid expenses	20,000
	7,20,000		7,20,000

On this date the firm was dissolved.

The assets realized as under:

Plant and Machinery – Rs. 1, 00,000

Stock – Rs. 1, 20,000

Sundry Debtors – Rs. 1, 60.000

The investments were taken over by Chopra at a value of Rs. 20,000. He also agreed to pay Mrs. Chopra’s loan. During the course of realisation it was found that a bill for Rs 50,000 previously discounted by the firm was dishonored and had to be paid. Expenses of realisation come to Rs 8,000.

Prepare Realisation Account, Partners’ Capital Account and Cash Account..

[**Ans profit on realization Rs 62,000]**

Problem4: Abinash, Barun and Chandan are in partnership sharing profits and losses in the ratio of 3:2:1.They decided to dissolve the business on 31.03.2014, on which date their balance sheet was as follows:

Liabilities	Rs	Assets	Rs
Capital : Abinash	38,700	Land &building	30,800
Barun	10,680	Motor car	5,160
Chandan	11,100	Investments	1,080
Loan Account	3,000	Stock	19,530
Creditors	10,320	Debtors	11,280
		Cash	5,940
	73,800		73,800

The assets were realized piece meal as follows and it was agreed that cash should be distributed as and when realized on 15 04 2014 Rs 10,380, on 20.5.14 Rs 27,900, on17.06.14 Rs 3,600; on the same date C took over investment at a value of Rs 1,260,0n 12.04.2014 19,200. Dissolution expenses were originally provided for an estimated amount of Rs 2,700 but actual spent on 19.3 2014 was Rs 1920.the creditors were settled for Rs 10,080.

You are required to prepare a statement showing distribution of cash amongst the partners.
[Ans: Loss on realization A- Rs 3,600; B-Rs 2,400;C- 1,200.]

Model question and answers:

1. What do you mean by dissolution of firm? How dissolution of partnership differs from dissolution of firm?

The dissolution of a partnership is the end of the relationship that exists among the partners as a result of any partner discontinuing his or her involvement in the partnership,

Dissolution of a partnership firm merely involves a change in the relation of partners; whereas the dissolution of firm amounts to a complete closure of the business. When any of the partners dies, retires or become insolvent but if the remaining partners still agree to continue the business of the partnership firm, then it is dissolution of partnership not the dissolution of firm. Dissolution of partnership changes the mutual relations of the partners. But in case of dissolution of firm, all the relations and the business of the firm comes to an end. On dissolution of the firm, the business of the firm ceases to exist since its affairs are would up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

2. How are accounts settled at the time of dissolution of firm?

As soon as a firm is dissolved, it ceases to transact normal business. The mode of settlement of accounts between partners after the dissolution of a firm is determined by the partnership agreement. In the absence of any specific agreement as to the mode of settlement of accounts after the dissolution of the firm, the Partnership Act laid down the following provisions (Sec. 48) for settlement of accounts.

(a) Losses, including deficiencies of capital, shall be paid first out of profit, next out of capital, and lastly, if necessary, by the partners individually in their profit-sharing ratio.
(b) The assets of the firm including any sums contributed by the partners to make up deficiencies of capital shall be applied in the following manner and order:
    i) In paying the debts of the firm to third parties.
    ii) In paying each partner rateably what is due to him from the firm for advances.
    iii) In paying to each partner rateably what is due to him on account of capital, and
    iv) The surplus, if any, will be divided among the partners in their profit sharing ratio.

3. What are the golden rules dealing with the problem of dissolution of firm?

There are six golden rules about dealing with the problem of dissolution of firm:

i) If a balance sheet on the date of dissolution is not given in the question first of all, the balance sheet should be prepared in proper form.

ii) At the time of dissolution of firm, balances of accounts given in the Balance Sheet are once shown in Realisation account or Partner's Loan Account or Partners' Capital Accounts of Cash/ Bank Account but the transactions given outside the balance sheet are shown twice in said mentioned accounts.
iii) All the assets must be sold or otherwise disposed off.
iv) All of the creditors must be paid. Partners, who have contributed beyond their capital i.e. partner's loan must also be included in this category.
v) The amount due to each partner must be paid.
vi) The total of both the sides of cash/ bank account must be equal.

4. What do you mean by insolvency of a partner what will be if all the partners become insolvent?

Insolvency and bankruptcy mean the same thing. The latter term is used in the United Kingdom, the former in India. It is “a proceeding by which, when a debtor cannot pay his debts or discharge his liabilities or the persons to whom he owes money or has incurred liabilities cannot obtain satisfaction of their claims, the State, in certain circumstances, takes possession of his property through an officer appointed for the purpose, and such property is realized and distributed in appropriate proportions among the persons to whom the debtor owes money or has incurred pecuniary liabilities.” The officer is called Official Receiver and is appointed by the Court.

When the partners become insolvent; creditors will not be able to get their amounts in full In such a case, outside liabilities are not to be transferred to Realisation Account but it is to be shown separately in their respective account. At the time of accounting treatment, the following points should be taken into consideration:

i) Cash Account should be prepared after Realisation Account :
ii) After recording the amount realised from assets together with the amounts which at received from the estate of the partners in Cash Account, first realization expenses to the paid and then remaining balance will be paid ratably to the creditors. Thus, Cash Account shows a zero balance.
iii) After that, balance of Creditors Account which cannot be paid, should be transferred the credit side of Deficiency Account. Similarly, partner's loan will be treated.
iv) At the end, debit balance of partners' capital accounts should be transferred to the credit side of Deficiency Account and vice-versa. Both the sides of Deficiency Account must equal.

5. What are the propositions of Garner vs Murray. Is this rule applicable in India?

Garner, Murray and Wilkins were partners, in a firm, sharing profits and losses equally. Their capitals were not equal. There was no partnership deed. The firm dissolved on 30th June 1900. In Garner vs. Murray, a historic decision was given by Justice Joyce, upholding the contention of Murray i.e. capital deficiency of insolvent partner is a capital loss and is to be shared by the solvent partners, in capital ratio, just before dissolution.

Main Points of Garner vs. Murray Decision:

1. Loss due to insolvency is a capital loss.
2. Such loss, due to insolvency, is to be shared by solvent partners in their capital ratio just before dissolution.
3. All solvent partners should bring in their share or realization loss in cash.
4. If a partner’s capital account shows a debit balance, he need not share the capital loss of the insolvent partner.

It is noteworthy that the decision in Garner versus Murray violates the principles of 'natural justice' and 'equity'. For instance, if a partner is having a debit balance of his capital account on the relevant date (just prior to dissolution) he will not bear the loss on account of insolvency of partner's even though he may be financially more sounded as compared to other solvent partners.

Application of this Rule in India

Indian Partnership Act, 1932 has no objection regarding the decision given in the case of ‘Garner Versus Murray'. Thus in the absence of any rule or instruction, this rule should be followed while attempting the question. But the solvent partners may not be required to bring the loss on realization in cash because this amount is paid back to the solvent partners. It is against the principle of accountancy. Hence,

i) Debit balance of insolvent partner's capital account (deficiency) should be divided amongst the solvent partners in the ratio of their capitals.
ii) Where in examination question specifies that the rule in 'Garner vs. Murray' is to be applied, the solvent partners should be required to bring the loss on realization in cash otherwise not.

Application of Garner vs. Murray Rule in India:
The rule of Garner vs. Murray is applicable in India only if:
(a) There is no agreement to the contrary.’
(b) The capitals of partners are not in profit sharing ratio.
(c) There must be capital deficiency in a partner’s capital account.

Further Readings:

1. Modern Accountancy: Hanif and Mukherjee, volume –I, Tata Mcgrewhill.
2. Higher secondary Accounting: Biswal and Sharma.
3. Financial Accounting: P.C. Tulsian, Pearson.
4. An Introduction to Accountancy: S.N. Maheshwari, S.K. Maheshwari. Vikas.