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Year – II
Semester – IV
Paper - III

Advanced Accountancy - II



Centre for Distance and Online Education

श्रीचन्द्रशेखरेन्द्रसरस्वतीविश्वमहाविद्यालयः

Sri Chandrasekharendra Saraswathi Viswa Mahavidyalaya

Deemed to be University u/s 3 of UGC Act 1956 - Accredited with 'A' grade by NAAC

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BC413 Advanced Accountancy - II

Course Objectives

1. To understand the accounting principles and procedures for partnership firms, including partnership deeds and profit-sharing.
2. To analyze accounting treatment for admission, retirement, and death of a partner, including goodwill adjustments.
3. To learn the procedures for dissolution of partnership firms, including insolvency of partners and settlement of accounts.
4. To understand individual insolvency accounting under relevant Acts and preparation of statements of affairs.
5. To study consignment and joint venture accounts, including normal and abnormal losses, valuation, and accounting methods.

Unit – I

Partnership Accounts: Introduction – Partnership Deed – Rules applicable in the absence of an agreement – Profit and Loss appropriation account – Fixed capital account – Fluctuating capital account – Interest on capital and interest on drawings (excluding past adjustments and guarantees). Admission of a partner: New profit- sharing ratio – sacrificing ratio – revaluation of assets and liabilities – memorandum revaluation account– methods of valuation of goodwill – treatment of goodwill- adjustment of capital in proportion to profit sharing ratio- Balance sheet of the new firm.

Unit – II

Retirement of a partner: Retirement – treatment of goodwill –gaining ratio – settlement of amount due to the retiring partner - Admission cum Retirement – Calculation of capital of the new firm – balance sheet of the new firm- Death of a partner – Settlement of deceased partner's account – executors account- Joint life policy

Unit- III

Dissolution Accounting: Simple dissolution - settlement of accounts on dissolution – firms' debts Vs private debts – entries on dissolution – insolvency of a partner – Garner Vs Murray

rule – fixed and fluctuating capital – insolvency of all partners. Piece-meal Distribution: Proportionate capital method and Maximum loss method.

Unit –IV

Insolvency Accounts: Meaning – Insolvency Acts - Preferential creditors under the two Acts – Insolvency of individual – Preparation of statement of affairs and deficiency account (excluding firm insolvency)

Unit-V

Consignment Accounts: Meaning – Consignment Vs Sale – Journal and Ledger in the books of consignor and the consignee – Treatment of Normal loss and abnormal loss - Valuation of Closing stock - Invoice price method. Joint venture: Meaning – Joint venture Vs Partnership – Consignment Vs Joint Venture – Accounting for joint ventures – separate set of books – no separate set of books – memorandum joint venture method

Course Outcomes

1. Students will be able to prepare partnership accounts, including profit and loss appropriation, fixed/fluctuating capital, and interest on capital/drawings.
2. Students will be able to handle accounting for admission, retirement, and death of partners, including goodwill calculation and capital adjustments.
3. Students will be able to account for dissolution of firms, proportionate distribution of assets, and insolvency of partners.
4. Students will be able to prepare statements of affairs and deficiency accounts for individual insolvency cases.
5. Students will be able to maintain consignment and joint venture accounts using different methods, including memorandum and separate books methods.

Text Book

1. Advanced Accountancy - T. S. Reddy & A. Murthy Revised Edition - 2017, Margham Publications, 24, Rameshwaram Road, T. Nagar, Chennai - 17.
2. Shukla Grewal and Gupta, “Advanced Accounts”, volume 1, S.Chand and Sons, New Delhi.

3. Advanced Accountancy – R. L. Gupta & M. Radaswamy, Revised Edition– 2008 S. Chand & Company Ltd., Ram Nagar, New Delhi – 110 055.
4. R.L. Gupta and V.K. Gupta, “Financial Accounting”, Sultan Chand, New Delhi.
5. Grewal, T. S. (2023). Financial accounting. New Delhi: S. Chand Publishing.

Reference Books

1. **Partnership and Joint Venture Accounts** – B. Banerjee
2. **Advanced Accountancy** – R.L. Gupta
3. **Accounting Theory and Practice** – Tulsian P.C.
4. **Practical Accountancy** – B.S. Raman
5. **Advanced Accounting** – Ashok Sehgal & Deepak Sehgal

Web Resources

1. ICAI – Accounting Standards & Partnership Guidance
2. AccountingTools.com – Partnership & Joint Venture Accounts
3. Investopedia – Partnership Accounting
4. Swayam – Online Accountancy Courses
5. Corporate Finance Institute – Accounting Resources

BC413 – Advanced Accountancy II

Unit I: Partnership Accounts

1. Overview and Objectives

Overview:

Unit I focuses on partnership accounting, including the preparation of accounts based on partnership deeds, rules in the absence of an agreement, profit and loss appropriation, capital accounts (fixed and fluctuating), and adjustments on admission of a partner. It also covers goodwill treatment and balance sheet preparation for a new firm.

This unit introduces the concepts of partnership, types of partnership accounts, treatment of profit and loss, capital accounts (fixed and fluctuating), and the financial implications of admitting a new partner. Students will learn to handle partnership accounting practically, including goodwill valuation, revaluation of assets and liabilities, capital adjustments, and preparation of balance sheet of the reconstituted firm.

Objectives:

After completing this unit, students will be able to:

Understand partnership and partnership deed

Learn rules in the absence of an agreement

Prepare Profit & Loss Appropriation Account

Understand Fixed and Fluctuating capital accounts

Handle admission of a partner including goodwill and capital adjustments

Prepare balance sheet after reconstitution

2. Partnership Accounts – Introduction

Definition:

A partnership is defined under the **Partnership Act 1932** as:

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

Partnership Deed: Written agreement defining rights, duties, and profit-sharing ratio.

Rules in Absence of Deed:

- Equal sharing of profits
- No interest on capital
- No salary to partners
- Losses shared in capital ratio

Profit and Loss Appropriation Account

- Records distribution of **profits among partners**, including:
 - Interest on capital
 - Salary to partners
 - Interest on drawings
 - Profit share

Key Features:

- Mutual agency among partners
- Sharing of profits and losses
- No separate legal entity (except LLP under LLP Act)

Partnership Deed:

- The written agreement among partners, specifying:
 - Capital contribution
 - Profit sharing ratio
 - Interest on capital and drawings
 - Admission, retirement, or death of partners

Rules in the Absence of Deed (Section 11-17):

- Profits and losses shared equally
- No interest on capital or drawings
- Salaries or commissions not allowed unless agreed

Fixed Capital vs Fluctuating Capital Accounts

- **Fixed Capital:** Separate capital account; only drawings, additional capital, or revaluation adjustments recorded in current account.
- **Fluctuating Capital:** All transactions including drawings, interest, profit share, and capital adjustments recorded in single capital account.
- **Rules in Absence of Deed:**
 - Equal sharing of profits
 - No interest on capital
 - No salary to partners
 - Losses shared in capital ratio

2.2 Profit and Loss Appropriation Account

- Records distribution of **profits among partners**, including:
 - Interest on capital
 - Salary to partners
 - Interest on drawings
 - Profit share

2.3 Fixed Capital vs Fluctuating Capital Accounts

- **Fixed Capital:** Separate capital account; only drawings, additional capital, or revaluation adjustments recorded in current account.
- **Fluctuating Capital:** All transactions including drawings, interest, profit share, and capital adjustments recorded in single capital account.

2.4 Admission of a Partner

- **Effect on Profit Sharing:**
 - **New Profit Sharing Ratio:** Agreed between old and new partners
 - **Sacrificing Ratio:** Portion of profit sacrificed by existing partners for new partner
- **Revaluation of Assets and Liabilities:**
 - Adjusts for changes in asset values or liabilities
 - Revaluation account prepared
- **Goodwill:**
 - Methods: Average profit, Super profit, Capitalization
 - Treatment: Cash payment, adjustment through capital accounts
- **Adjustment of Capital:** Partners' capital accounts adjusted in proportion to profit-sharing ratio

2.5 Balance Sheet of Reconstituted Firm

- Updated with:
 - Adjusted capital
 - Goodwill treatment
 - Revalued assets and liabilities

3. Profit and Loss Appropriation Account

Purpose:

- To **distribute net profit** among partners according to agreed ratio.

Format:

Particulars	Amount	Particulars	Amount
To Partner A's Capital/Current A/c XXXX		By Net Profit b/d XXXX	
To Partner B's Capital/Current A/c XXXX			

Adjustments:

- Interest on capital
- Interest on drawings
- Salaries or commissions

Example:

Profit ₹60,000 shared by A and B in 3:2. Interest on capital ₹2,000 each.
Net profit after adjustments is shared in **3:2 ratio**.

4. Capital Accounts

A. Fixed Capital Account

- Partners' capital is **fixed**; transactions unrelated to capital (like drawings) are recorded in **current accounts**.

B. Fluctuating Capital Account

- All transactions, including drawings and profit share, are recorded in **one capital account**.

Example:

Partner A contributes ₹50,000. Profit share ₹20,000. Drawings ₹5,000. Closing balance ₹65,000.

5. Admission of a Partner**Effects:**

1. New Profit Sharing Ratio – may differ from old ratio.
2. Sacrificing Ratio – portion of old partners' share given to new partner.
3. Revaluation of Assets and Liabilities – adjusted in Revaluation Account.
4. Goodwill Treatment – methods:
 - Average Profit Method
 - Super Profit Method
 - Capitalization Method
5. Adjustment of Capitals – in proportion to new profit-sharing ratio.
6. Balance Sheet of New Firm – updated with new capital, revalued assets, and goodwill treatment.

Formulae:

- Sacrificing Ratio = Old Ratio – New Ratio
- New Partner's Capital Contribution = Agreed Share of Capital

Example:

A and B share profits 3:2. C admitted for 1/5 share. C brings ₹40,000 as capital and ₹10,000 goodwill.

6. Illustrative Example**Problem:**

A and B share profits 3:2. Capital of A ₹50,000, B ₹30,000. Profit ₹40,000. Interest on capital 5% p.a. Drawings: A ₹5,000, B ₹3,000.

Prepare:

1. P&L Appropriation A/c
2. Current/Capital A/c

Solution:

1. Interest on capital: A ₹2,500, B ₹1,500 → Total ₹4,000
2. Net profit after interest: ₹40,000 – ₹4,000 = ₹36,000
3. Share in profit: A ₹21,600 (3/5), B ₹14,400 (2/5)

Current Account Balances:

Partner Opening Balance Add: Profit Share Less: Drawings Closing Balance

A	0	21,600	5,000	16,600
B	0	14,400	3,000	11,400

7. Solved Problems (5)

Problem 1: Fixed Capital, interest on capital, drawings adjustment

Problem 2: Fluctuating Capital and Profit Appropriation

Problem 3: Admission of partner with revaluation of assets

Problem 4: Calculation of goodwill using Super Profit Method

Problem 5: Adjustment of capital accounts in new profit-sharing ratio

*(Each problem includes **stepwise solution** and **final balance sheet**.)*

1.1 Introduction to Accounting as an Information System

Accounting standards are formal written guidelines issued by a professional accounting authority, the government, or another regulatory institution. They address various aspects of identifying, measuring, presenting, and disclosing financial transactions in financial reports. These standards act as a foundational structure that allows for the preparation of

reliable and consistent financial statements. They are developed to bring uniformity to diverse accounting methods and policies. The main purpose of these standards is to limit the variety of accounting choices available when preparing financial statements, while still maintaining logical and reasonable options. This ensures that the financial reports of different organizations can be compared effectively, offering valuable insights to a wide range of users. Accounting standards outline the fundamental accounting concepts and how to apply them during the preparation and presentation of financial data, ensuring that the statements reflect a true and fair representation. This in turn promotes transparency and strengthens financial discipline in the market. Furthermore, they assist regulatory bodies in assessing the accuracy and reliability of financial reporting.

1.2 Meaning of Accounting Standards:

As defined by the Institute of Chartered Accountants of India (ICAI), Accounting Standards are formal documents that include rules, methods, and procedures issued by a recognized accounting authority, government body, or regulatory institution. These standards cover aspects such as the identification, valuation, processing, presentation, and disclosure of accounting transactions in financial reports.

In essence, an accounting standard can be viewed as a form of regulatory guideline—a framework for action, a settled foundation for accounting practices and behavior.

Accounting Standards primarily address the following areas:

- a. The recognition of financial events and transactions in the accounts;
- b. The valuation or quantification of these transactions and events;
- c. The format and clarity with which these transactions are reported in the financial statements so that users can understand them easily; and
- d. The necessary disclosures that should be included, allowing the general public, stakeholders, and especially potential investors to gain clarity on what the financial statements are conveying. This helps them to make well-informed and sound business decisions.

1.3. Need for Accounting Standards:

- a) To eliminate discrepancies that may arise between accounting theories and actual practices, and to establish uniformity across diverse accounting principles used by different entities.
- b) A meaningful comparison between two companies is only possible when they follow consistent accounting policies. For instance, if Company A applies the FIFO method for inventory valuation and Company B uses the LIFO method, comparing their financial outcomes would be inaccurate. Such a comparison becomes valid only when both companies use the same method for valuing inventory.
- c) The objective is to create standardized accounting practices when preparing financial statements, ensuring consistency and accurate comparison of the financial data provided to users of accounting information.
- d) To uphold fairness, consistency, and transparency in accounting methods, which enhances trust and satisfies the expectations of various users of financial reports.
- e) To address and resolve potential conflicts of interest among the various external parties—such as investors, creditors, and analysts—who depend on the financial statements for decision-making.
- f) Accounting standards help limit the range of accounting choices available during the preparation of financial statements, within reasonable boundaries. This enhances the comparability of financial reports across different organizations. Therefore, accounting standards serve as an essential tool to minimize financial disputes among key stakeholders in the economy.
- g) To bring about alignment in accounting policies and procedures used by various businesses, enabling the standardization of diverse accounting treatments applied to different elements of financial reporting.

1.4. Objectives of Accounting Standards:

To bring uniformity to varied accounting methods and procedures

To minimize, as far as possible, the lack of comparability in financial reports

To enhance the trustworthiness and dependability of financial statements

To improve the mathematical precision and correctness in financial reporting

To help users interpret the accounting treatments applied in financial statements

To offer a consistent set of accounting practices, valuation guidelines, and requirements for disclosure

1.5. Significance or advantages of Accounting Standards:

1. Investors can benefit from accounting standards as they assist in evaluating the returns and risks associated with various investment options across different companies and countries.
2. These standards offer authoritative guidelines for public accountants (such as Chartered Accountants in India) when preparing financial statements. This ensures that the reports are created in a truthful and fair manner, promoting professional commitment and ethical integrity in the accounting field.
3. Accounting standards also contribute to enhancing the quality of auditing, aiding auditors in their role of providing accurate reports on financial statements.
4. Government bodies, tax departments, and other regulatory agencies view financial reports prepared under recognized standards as credible and trustworthy.
5. Such standardized financial statements serve as dependable resources for analysts, researchers, and consultants, facilitating economic analysis, forecasting, and strategic planning.

1.6. Limitations of Accounting Standards:

1. For some accounting issues, multiple valid approaches may exist, each supported by logical reasoning. As a result, selecting the most appropriate method among these alternatives can be challenging.

2. The implementation of accounting standards might lead to inflexibility, reducing the ability to adapt to unique situations, as they may encourage a more rigid approach to financial reporting.
3. Accounting standards do not have the authority to override legal provisions. They must be designed within the framework of existing laws and regulations.

1.7. Accounting standards in Indian context:

In India, the Accounting Standards are formulated and issued by the Accounting Standards Board (ASB), which functions under the Institute of Chartered Accountants of India (ICAI), in collaboration with the National Advisory Committee on Accounting Standards (NACAS). Recognizing the importance of bringing uniformity to the varied accounting methods and policies being followed across the country, the ICAI established the Accounting Standards Board on April 21, 1977.

1.8. The scope and functions of Accounting Standards Board are:

- a. To develop Accounting Standards that can be officially issued by the Council of the Institute in India. While drafting these standards, the Accounting Standards Board (ASB) considers relevant laws, customs, business practices, and the economic environment of the country.
- b. To align with the goals of the International Accounting Standards Committee (IASC), as the Institute is a member of this international body. The ASB takes into account the International Accounting Standards, adapting them where appropriate to suit Indian conditions and practices.
- c. To promote awareness and encourage the adoption of these standards by stakeholders involved in the preparation and presentation of financial statements.
- d. To release guidance notes and offer clarifications regarding issues related to the Accounting Standards.
- e. To periodically review and update the Accounting Standards as necessary.

1.9. Conclusion

Accounting as an information system is the foundation for financial communication. Its role becomes effective when governed by robust standards that promote clarity and comparability. Despite challenges, India's move toward global convergence through Ind AS has enhanced its credibility in global markets.

Check Your Progress

1. What is meant by accounting as an information system?
2. Who are the primary users of accounting information?
3. Explain the concept and types of accounting standards.
4. List any three benefits of accounting standards.
5. What are the major challenges in setting accounting standards?
6. What are the scope and functions of Accounting Standards Board?

Let Us Sum Up

This unit explained how accounting functions as an information system, identified the users of such information, and detailed accounting standards' purpose and implementation. We explored the benefits and challenges of standardization and outlined the standard-setting mechanisms in India.

Glossary of Terms

- Accounting Standards: Rules for preparing financial statements
- GAAP: Generally Accepted Accounting Principles
- IFRS: International Financial Reporting Standards
- Ind AS: Indian Accounting Standards aligned with IFRS
- ICAI: Institute of Chartered Accountants of India
- NFRA: National Financial Reporting Authority

Answers to Check Your Progress

1. A structured process that collects, processes, and communicates financial information.
2. Management, investors, creditors, regulators, tax authorities, etc.
3. Standards that guide financial reporting; types include GAAP, IFRS, Ind AS.
4. Uniformity, comparability, transparency.
5. Diverse practices, political pressures, rapid economic changes.
6. ICAI, NFRA, and MCA.

Suggested Reading

1. T.S. Grewal, “Double Entry Book Keeping”
2. ICAI publications on Accounting Standards
3. Narayanaswamy, R. – Financial Accounting
4. ACCA and IFRS Foundation Learning Materials
5. Ministry of Corporate Affairs website – www.mca.gov.in

8. Summary

- Partnership accounting follows Partnership Deed; otherwise, default rules apply.
- Capital accounts may be fixed or fluctuating.
- P&L Appropriation account distributes profits after adjustments.
- Admission of a partner involves:
 - Sacrificing ratio
 - Revaluation of assets/liabilities
 - Goodwill adjustments
 - Capital adjustment
 - New balance sheet preparation

9. Question Bank

Objective Questions (MCQs):

1. In absence of partnership deed, profits are shared:
 - a) According to capital contribution
 - b) Equally
 - c) As decided by majority
 - d) None
2. Sacrificing ratio is:
 - a) Old ratio – New ratio
 - b) New ratio – Old ratio
 - c) Capital ratio
 - d) None

Short Answer Questions:

1. Explain fixed vs fluctuating capital accounts.
2. Define sacrificing ratio and its significance.
3. What are the methods of goodwill valuation?
- 4.

Long Answer Questions:

1. Prepare P&L Appropriation account with interest on capital and drawings.
2. Admission of a partner with revaluation of assets and goodwill adjustment – solution with balance sheet.

Unit II: Retirement and Death of a Partner

1. Overview and Objectives

Overview:

Unit II deals with accounting treatment when a partner retires or dies. It explains adjustments related to goodwill, revaluation of assets, capital adjustments, and settlement of amounts due to retiring or deceased partners. Special considerations such as gaining ratio, joint life policy, and combined admission-retirement are also covered.

Objectives:

After completing this unit, students will be able to:

1. Explain accounting treatment on retirement of a partner.
2. Calculate gaining ratio and adjust profits accordingly.
3. Prepare accounts for death of a partner and executors.
4. Understand settlement of capital and goodwill for retiring/deceased partners.
5. Prepare the balance sheet of the reconstituted firm.

2. Retirement of a Partner

Definition:

Retirement occurs when a partner ceases to be part of the firm with mutual consent, without the firm being dissolved.

Effects on Accounts:

1. Revaluation of Assets and Liabilities – recorded in Revaluation Account.
2. **Goodwill Treatment:**
 - Retiring partner is entitled to share of goodwill

- Payment can be in cash or via capital adjustment

3. Gaining Ratio:

- Remaining partners' share of profit after retirement
- Formula: **Gaining Ratio = New Ratio – Old Ratio**

Settlement of Amount Due:

- Debit retiring partner's capital/current account
- Credit cash/bank or remaining partners' current accounts (if adjustment through capital)

Example:

A, B, and C share profits 3:2:1. C retires. A and B gain in ratio 3:2. C's share of goodwill ₹12,000 paid by A and B in gaining ratio.

3. Admission-Cum-Retirement

- Occurs when a new partner is admitted **simultaneously with retirement** of an existing partner.
- Adjustments include:
 - Revaluation of assets and liabilities
 - Goodwill treatment (existing and new partners)
 - Adjustment of capitals based on new profit-sharing ratio
- Balance Sheet of new firm prepared after all adjustments

Example:

D retires and E is admitted for 1/5 share. Existing partners adjust C's share of goodwill, revalue assets, and calculate new capitals for A, B, and E.

4. Death of a Partner

Accounting Considerations:

1. Revaluation of Assets and Liabilities
2. **Share of Deceased Partner:**

- Capital balance
- Share of profit up to date of death
- Share of goodwill

3. Executors' Account:

- Amount due to deceased partner transferred to Executors' Account
- Payment may be immediate or in installments

Joint Life Policy:

- Insured amount used to pay deceased partner's share
- Policy amount credited to Executors' Account

Example:

Partner B dies. Capital ₹50,000, profit share up to date ₹5,000, share of goodwill ₹10,000. Executors' account credited ₹65,000.

5. Illustrative Example

Problem:

A, B, and C share profits 3:2:1. C retires. Goodwill of firm ₹18,000. Revaluation results in profit of ₹3,000. Prepare:

1. Revaluation Account
2. Capital accounts
3. Balance Sheet of new firm

Solution:

1. Revaluation Account: Debit assets decreased / liabilities increased, credit profit/loss to partners' capital in old ratio (3:2:1).

2. Goodwill adjustment: C's share = $\frac{1}{6}$ of ₹18,000 = ₹3,000. Paid by A and B in gaining ratio 3:2 → A pays ₹1,800, B pays ₹1,200.
3. Capital accounts updated accordingly.
4. New balance sheet prepared with adjusted capitals and balances.

6. Solved Problems (5)

Problem 1: Retirement of partner – calculation of gaining ratio, goodwill, revaluation, and balance sheet

Problem 2: Admission-cum-retirement – capital adjustment, goodwill treatment, new profit ratio

Problem 3: Retirement with payment in installments – calculation of present value of installments

Problem 4: Death of a partner – preparation of executors' account, joint life policy adjustment

Problem 5: Reconstitution of firm after retirement/death with multiple adjustments – final balance sheet

(Each problem includes stepwise solutions with journal entries, ledger postings, and final balances.)

7. Summary

- Retirement: Partner leaves; adjustments include revaluation, goodwill, gaining ratio, and capital settlement.
- Admission-Cum-Retirement: Combination of old partner leaving and new partner joining; adjustments for capital, goodwill, and profit-sharing ratio.
- Death: Share of deceased partner includes capital, profit, and goodwill; executors' account prepared; joint life policy may be used for payment.
- Balance sheet of reconstituted firm reflects updated capitals, adjusted goodwill, and revalued assets.

8. Question Bank

Objective Questions (MCQs):

1. Gaining ratio =
 - a) Old ratio – New ratio
 - b) New ratio – Old ratio
 - c) Capital ratio
 - d) None
2. Executors' account is credited with:
 - a) Only capital
 - b) Capital + Share of profit + Share of goodwill
 - c) Only goodwill
 - d) Only profit

Short Answer Questions:

1. Explain the accounting treatment for retirement of a partner.
2. Define gaining ratio and its significance.
3. Describe the role of joint life policy in accounting for deceased partner.

Long Answer Questions:

1. Prepare capital accounts and balance sheet after retirement of a partner.
2. Admission-cum-retirement: Explain adjustments for goodwill, revaluation, and capital.
3. Accounting for death of partner including executors' account and joint life policy.

Case Study Questions:

- Partner retires and payment of capital and goodwill is made in installments. Prepare ledger accounts.
- A partner dies; prepare executors' account and balance sheet considering revaluation of assets.

Unit III: Dissolution Accounting

1. Overview and Objectives

Overview:

Unit III deals with dissolution of a partnership firm, including simple dissolution, insolvency of partners, and piece-meal distribution. The unit explains accounting entries for settlement of firm's debts versus private debts, distribution of assets, and insolvency rules like Garner vs Murray.

Objectives:

After completing this unit, students will be able to:

1. Explain the meaning and procedure of dissolution of a partnership firm.
2. Distinguish between simple dissolution and dissolution due to insolvency.
3. Prepare realization accounts, partners' capital/current accounts, and bank/cash accounts during dissolution.
4. Apply Garner vs Murray rule for insolvency of partners.
5. Understand methods of piece-meal distribution of assets.

2. Dissolution of a Firm – Definition

Definition:

Dissolution means the winding up of a partnership firm, where:

- All assets are realized
- Liabilities settled
- Surplus distributed among partners
- Firm ceases to exist

Types of Dissolution:

1. Simple Dissolution – solvent firm; all partners pay debts and receive remaining assets.
2. Insolvency of a Partner – one or more partners cannot pay their share of losses.
3. Insolvency of All Partners – firm cannot meet debts; assets distributed to creditors first.

Causes of Dissolution:

- Expiration of partnership term
- Agreement among partners
- Death or insolvency of partner
- Court order for just and equitable grounds

3. Accounting for Simple Dissolution

Steps:

1. Realization of Assets – transferred to Realization Account
2. Settlement of Liabilities – creditors paid from bank/cash
3. Distribution of Profit or Loss on Realization – to partners' capital accounts in profit-sharing ratio

Journal Entries:

1. To transfer assets to Realization A/c:
2. Bank A/c / Assets A/c Dr
3. To Realization A/c
4. To pay creditors:
5. Realization A/c Dr
6. To Bank/Cash A/c
7. To transfer profit/loss on realization:
8. Realization A/c Dr / Cr
9. To Partners' Capital A/c

Example:

A, B, C share profits 3:2:1. Assets ₹60,000, Liabilities ₹20,000. Profit on realization ₹6,000.

UNIT IV- PARTNERSHIP

PARTNERSHIP:

When two or more persons join hands to set up a business and share its profits and losses, they are said to be in partnership. Section 4 of the Indian Partnership Act 1932 defines partnership as the 'relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'.

FEATURES OF PARTNERSHIP

1. Two or More Persons:

In order to form partnership, there should be at least two persons coming together for a common goal. In other words, the minimum number of partners in a firm can be two. There is however, a limit on their maximum number. By virtue of Section 464 of the Companies Act 2013, the Central Government is empowered to prescribe maximum number of partners in a firm but the number of partners cannot be more than 100. The Central government has prescribed the maximum number of partners in a firm to be 50 under Rule 10 of the Companies (Miscellaneous) Rules, 2014, So, a partnership firm cannot have more than 50 partners.

2. Agreement:

Partnership is the result of an agreement between two or more persons to do business and share its profits and losses. The agreement becomes the basis of relationship between the partners. It is not necessary that such agreement is in written form. An oral agreement is equally valid. But in order to avoid disputes, it is preferred that the partners have a written agreement.

3. Business:

The agreement should be to carry on some business. Mere co-ownership of a property does not amount to partnership. For example, if Rohit and Sachin jointly purchase a plot of land, they become the joint owners of the property and not the partners. But if they are in the business of purchase and sale of land for the purpose of making profit, they will be called partners.

4. Mutual Agency:

The business of a partnership concern may be carried on by all the partners or any of them acting for all. This statement has two important implications. First, every partner is entitled to participate in the conduct of the affairs of its business. Second, that there exists a relationship of mutual agency between all the partners. Each partner carrying on the business is the principal as well as the agent for all the other partners. He can bind other partners by his acts and also is bound by the acts of other partners with regard to business of the firm. Relationship of mutual agency is so important that one can say that there would be no partnership, if the element of mutual agency is absent.

5. Sharing of Profit:

Another important element of partnership is that, the agreement between partners must be to share profits and losses of a business. Though the definition contained in the Partnership Act describes partnership as relation between people who agree to share the profits of a business, the sharing of loss is implied. Thus, sharing of profits and losses is important. If some persons join hands for the purpose of some charitable activity, it will not be termed as partnership.

6. Liability of Partnership:

Each partner is liable jointly with all the other partners and also severally to the third party for all the acts of the firm done while he is a partner. Not only that the liability of a partner for acts of the firm is also unlimited. This implies that his private assets can also be used for paying off the firm's debts.

PARTNERSHIP DEED

Partnership comes into existence as a result of agreement among the partners. The agreement can be either oral or written. The Partnership Act does not require that the agreement must be in writing. But wherever it is in writing, the document, which contains terms of the agreement is called 'Partnership Deed'.

Contents of the Partnership Deed

The Partnership Deed usually contains the following details:

- Names and Addresses of the firm and its main business;
- Names and Addresses of all partners;
- Amount of capital to be contributed by each partner;
- The accounting period of the firm;
- The date of commencement of partnership;
- Rules regarding operation of Bank Accounts;
- Profit and loss sharing ratio;

- Rate of interest on capital, loan, drawings, etc;
- Mode of auditor's appointment, if any;
- Salaries, commission, etc, if payable to any partner;
- The rights, duties and liabilities of each partner;
- Treatment of loss arising out of insolvency of one or more partners;
- Settlement of accounts on dissolution of the firm;
- Method of settlement of disputes among the partners;
- Rules to be followed in case of admission, retirement, death of a partner; and
- Any other matter relating to the conduct of business

PROVISIONS RELEVANT FOR ACCOUNTING

The important provisions affecting partnership accounts are as follows:

(a) Profit Sharing Ratio: If the partnership deed is silent about the profit-sharing ratio, the profits and losses of the firm are to be shared equally by partners, irrespective of their capital contribution in the firm.

(b) Interest on Capital: No partner is entitled to claim any interest on the amount of capital contributed by him in the firm as a matter of right. However, interest can be allowed when it is expressly agreed to by the partners. Thus, no interest on capital is payable if the partnership deed is silent on the issue. Further the interest is payable only out of the profits of the business and not if the firm incurs losses during the period.

(c) Interest on Drawings: No interest is to be charged on the drawings made by the partners, if there is no mention in the Deed.

(d) Interest on Advances: If any partner has advanced some money to the firm beyond the amount of his capital for the purpose of business, he shall be entitled to get an interest on the amount at the rate of 6 per cent per annum.

(e) Remuneration for Firm's Work: No partner is entitled to get salary or other remuneration for taking part in the conduct of the business of the firm unless there is a provision for the same in the Partnership Deed.

CAPITAL ACCOUNTS OF PARTNERS

All transactions relating to partners of the firm are recorded in the books of the firm through their capital accounts. This includes the amount of money brought in as capital, withdrawal of capital, share of profit, interest on capital, interest on drawings, partner's salary, commission to partners, etc.

There are two methods by which the capital accounts of partners can be maintained. These are:

- (i) Fixed capital method, and
- (ii) Fluctuating capital method.

i) Fixed Capital Method: Under the fixed capital method, the capitals of the partners shall remain fixed unless additional capital is introduced or a part of the capital is withdrawn as per the agreement among the partners

All items like share of profit or loss, interest on capital, drawings, interest on drawings, etc. are recorded in a separate account, called Partner's Current Account. The partners' capital accounts will always show a credit balance, which shall remain the same (fixed) year after year unless there is any addition or withdrawal of capital. The partners' current account on the other hand, may show a debit or a credit balance. Thus under this method, two accounts are maintained for each partner viz., capital account and current account, While the partners' capital accounts shall always appear on the liabilities side in the balance sheet, the partners' current account's balance shall be shown on the liabilities side, if they have credit balance and on the assets side, if they have debit balance

Dr				Partner's Capital Account				Cr			
Date	Particulars	JF	Amount (Rs.)	Date	Particulars	JF	Amount (Rs.)				
	Bank (permanent withdrawal of capital)		XXX		Balance c/d (Opening balance)		XXX				
	Balance c/d (closing balance)		XXX		Bank (fresh capital introduced)		XXX				
			XXX				XXX				

Dr				Partner's Current Account				Cr			
Date	Particulars	JF	Amount (Rs.)	Date	Particulars	JF	Amount (Rs.)				
	Balance b/d (in case of debit opening bal.)		XXX		Balance b/d (in case of credit opening balance)		XXX				
	Drawings		XXX		Salary		XXX				
	Interest on drawings		XXX		Commission		XXX				
	Profit & Loss a/c		XXX		Interest on capital		XXX				
	Balance c/d (in case of credit closing balance)		XXX		Profit & Loss Appropriation (share of profit)		XXX				
					Balance c/d (in case of debit)		XXX				

					closing bal.)		
			XXX				XXX

ii) **Fluctuating Capital Method:** Under the fluctuating capital method, only one account, i.e. capital account is maintained for each partner. All the adjustments such as share of profit and loss, interest on capital, drawings, interest on drawings, salary or commission to partners, etc are recorded directly in the capital accounts of the partners. This makes the balance in the capital account to fluctuate from time to time. That's the reason why this method is called fluctuating capital method. In the absence of any instruction, the capital account should be prepared by this method. The proforma of capital accounts prepared under the fluctuating capital method is given below:

Dr		Partner's Capital Account				Cr	
Date	Particulars	J F	Amount (Rs.)	Date	Particulars	J F	Amount (Rs.)
	Drawings		XXX		Balance b/d		XXX
	Interest on drawings		XXX		Bank (fresh capital introduced)		XXX
	Profit & Loss a/c (for share of loss)		XXX		Salaries		XXX
	Balance c/d		XXX		Interest on Capital		XXX
					Profit & Loss Appropriation (share of profit)		XXX
			XXX				XXX

Illustration : 1

Amit, Babu and Charu set up a partnership firm on April 1, 2015. They contributed Rs. 50,000, Rs. 40,000 and Rs. 30,000, respectively as their capitals and agreed to share profits and losses in the ratio of 3 : 2 :1. Amit is to be paid a salary of Rs. 1,000 per month and Babu, a Commission of Rs. 5,000. It is also provided that interest to be allowed on capital at 6% p.a. The drawings for the year were Amit Rs. 6,000, Babu Rs. 4,000 and Charu Rs. 2,000. Interest on drawings of Rs. 270 was charged on Amit's drawings, Rs. 180 on Babu's drawings and Rs. 90, on Charu's drawings. The net profit as per Profit and Loss Account for the year

ending March 31, 2015 was Rs. 35,660. Prepare the Profit and Loss Appropriation Account to show the distribution of profit among the partners.

Dr		Profit and Loss Appropriation Account		Cr	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)		
Amits' salary	12,000	Net profit	35,660		
Babus' commission	5,000	Interest on drawings:			
Interest on Capitals :		Amit 270			
Amit 3,000		Babu 180			
Babu 2,400		Charu 90	540		
Charu 1,800	7,200				
Share of profit transferred to Capital accounts					
Amit 6,000					
Babu 4,000					
Charu 2,000	12,000				
	36,200				36,200

Illustration :2

Mahesh and Dinesh share profits and losses in the ratio of 2:1. From January 01, 2014 they admit Rakesh into their firm who is to be given a share of 1/10 of the profits with a guaranteed minimum of Rs. 25,000. Mahesh and Dinesh continue to share profits as before but agree to bear any deficiency on account of guarantee to Rakesh in the ratio of 3:2 respectively. The profits of the firm for the year ending December 31, 2015 amounted to Rs. 1,20,000. Prepare Profit and Loss Appropriation Account.

Dr		Profit and Loss Appropriation Account		Cr	
Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Capital Accounts: (for share of profit)			Net profit		1,20,000
Mahesh ($6/10 \times 1,20,000$)	72,000				
Less: Deficiency share	7,800	64,200			
Dinesh ($3/10 \times 1,20,000$)	36,000				
Less: Deficiency share	5,200	30,800			
Rakesh	12,000				
Add: Share of Deficiency from					
Mahesh	7,800				
Dinesh	5,200	25,000			
		1,20,000			1,20,000

Working Notes:

New profit-sharing Ratio will be calculated as follows:

Rakesh to share 1/10 of the profits. The remaining profit 9/10 will be shared by Mahesh and Dinesh in the ratio of 2:1.

Mahesh's share in profit will be $\frac{2}{3} * \frac{9}{10} = \frac{3}{10}$

Dinesh's share will be $\frac{1}{3} * \frac{9}{10} = \frac{3}{10}$

The New ratio becomes $\frac{3}{5} : \frac{3}{10} : \frac{1}{10}$ or 6:3:1

Mahesh's share in profit = $1,20,000 \times \frac{6}{10} = \text{Rs. } 72,000$,

Dinesh's share in profit = Rs. 36,000,

Rakesh's share in profit = Rs. 12,000.

Deficiency of Rakesh (Rs. 13,000) will be shared by Mahesh and Dinesh in the ratio of 3:2.

Mahesh will bear $\frac{3}{5}$ of 13,000, i.e. Rs. 7,800 and Rakesh, $\frac{2}{5}$ of Rs. 13,000, i.e. Rs. 5,200.

Thus, the profits of the firm will be shared as follows.

Mahesh will get Rs. 72,000 – Rs. 7,800 = Rs. 64,200.

Dinesh will get Rs. 36,000 – Rs. 5,200 = Rs. 30,800

Rakesh will get Rs. 12,000 + Rs. 7,800 + Rs. 5,200 = Rs. 25,000.

Illustration :3

Final Accounts

Kapil and Vineet were partners sharing profits and losses in the ratio of 3:2. The following balances were extracted from the books of account for the year ended March 31, 2017

Particulars	Debit (Rs.)	Credit (Rs.)
Capitals Kapil	—	60,000
Capitals Vineet	—	50,000
Current accounts (on April 01, 2013)		2,800
Kapil	—	—
Vineet	—	1,600
Drawings:		—
Kapil	12,000	—
Vineet	8,000	—
Stock as on 1.4.2016	11,000	
Purchases and Sales	54,000	80,000
Returns	2,000	1,500
Wages	2,500	—
Salaries	4,000	—
Printing and Stationery	500	—
Bills receivables	12,000	—
Bills payables	—	2,000
Debtors and Creditors	36,000	8,000
Discounts	1,200	1,500
Rent and Rates	800	—
Bad debts	1,400	—
Insurance	400	—
Postage and Telegrams	300	—
Salesman's commission	3,400	—
Land and Building	24,000	—
Plant and Machinery	20,000	—
Furniture	13,500	—

Overdraft	—	2,000
Trade expenses	400	—
Cash in hand	500	—
Cash at bank	1,500	—
	2,09,400	2,09,400

Prepare the final accounts for the year ended March 31, 2017 firm taking into consideration the following:

- 1) Stock on March 31, 2017 was Rs. 18,000;
- 2) Provision for doubtful debts is to be provided at 5% on debtors;
- 3) Outstanding salaries were Rs. 1,000;
- 4) Goods worth Rs. 8,000 were destroyed by fire on December 10, 2016. The Insurance Company agreed to pay Rs. 7,000 in full settlement of the claim;
- 5) Interest on capitals is allowed at 6% per annum and interest on drawings is also charged at 6% per annum;
- 6) Kapil is entitled to a Salary of Rs. 1,200 per annum;
- 7) Write-off Land and buildings at 5%, Furniture at 10% and Plant and Machinery at 15%.

Solution:

Trading and Profit & Loss Account for the year ending March 31, 2017

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Opening stock		11,000	Sales	80,000	
Purchases	54,000		Less: Returns	<u>2,000</u>	78,000
Less: Returns	<u>1,500</u>	52,500	Closing stock		18,000
Wages		2,500	Goods destroyed by fire		8,000
Gross Profit c/d		38,000			
		1,04,000			1,04,000
Salaries	4,000		Gross Profit b/d		38,000
Add: Outstanding	1,000	5,000	Discount received		1,500
Printing and Stationery		500			
Rent and Rates		800			
Insurance		400			
Discount allowed		1,200			
Trade expenses		400			
Postage and Telegrams		300			
Bad debts	1,400				
Add: Provision	1,800	3,200			
Salesman's commission		3,400			
Loss due to fire (Rs. 8000–Rs. 7000)		1,000			
Depreciation:					
Land and Buildings	1,200				
Furniture	1,350				
Plant and Machinery	3,000	5,550			

Net Profit transferred to Profit and Loss Appropriation		17,750			
		39,500			39,500

Dr			Cr		
Profit and Loss Appropriation Account					
Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Interest on capital:			Profit and Loss		17,750
Kapil	3,600		Interest on drawings:(for 6 months)		
Vineet	3,000	6,600	Kapil	360	
Salary to Kapil		1,200	Vineet	240	600
Net profit (transferred to capital accounts)					
Kapil	6,330				-
Vineet	4,220	10,550			-
		18,350			18,350

Dr					Cr				
Partner's Current Accounts									
Date	Particulars	J.F.	Kapil (Rs.)	Vineet (Rs.)	Date	Particulars	J.F.	Kapil (Rs.)	Vineet (Rs.)
	Drawings		12,000	8,000		Balance b/d		2,800	1,600
	Interest on drawings		360	240		Interest on capital		3,600	3,000
	Balance c/d		1,570	580		Salary		1,200	—
						Share of profit		6,330	4,220
			13,930	8,820				13,930	8,820
						Balance c/d		1,570	580

Balance Sheet as on March 31, 2017

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital:			Land and Building	24,000	
Kapil	60,000		Less: Depreciation	<u>1,200</u>	22,800
Vineet	50,000	1,10,000	Plant and Machinery	20,000	
Current Accounts			Less: Depreciation	3,000	17,000
Kapil	1,570		Furniture	13,500	
Vineet	580	2,150	Less: Depreciation	1,350	12,150
Overdraft		2,000	Stock		18,000
Bill payables		2,000	Debtors	36,000	
Creditors		8,000	Less: Provision for	<u>1,800</u>	34,200
Outstanding		1,000	discount on debtors		7,000

salaries			Insurance company		
			Bill receivables		12,000
			Cash at bank		1,500
			Cash in hand		500
		1,25,150			1,25,150

Admission of a New Partner

When firm requires additional capital or managerial help or both for the expansion of its business a new partner may be admitted to supplement its existing resources. According to the Partnership Act 1932, a new partner can be admitted into the firm only with the consent of all the existing partners unless

otherwise agreed upon. With the admission of a new partner, the partnership firm is reconstituted and a new agreement is entered into to carry on the business of the firm.

A newly admitted partner acquires two main rights in the firm—

1. Right to share the assets of the partnership firm; and
2. Right to share the profits of the partnership firm.

For the right to acquire share in the assets and profits of the partnership firm, the partner brings an agreed amount of capital either in cash or in kind. Moreover, in the case of an established firm which may be earning more profits than the normal rate of return on its capital the new partner is required to

contribute some additional amount known as premium or goodwill. This is done primarily to compensate the existing partners for loss of their share in super profits of the firm.

Following are the other important points which require attention at the time of admission of a new partner:

- New profit-sharing ratio;
- Sacrificing ratio;
- Valuation and adjustment of goodwill;
- Revaluation of assets and Reassessment of liabilities;
- Distribution of accumulated profits (reserves); and
- Adjustment of partners' capitals.

Illustration : 4

Anil and Vishal are partners sharing profits in the ratio of 3:2. They admitted Sumit as a new partner for 1/5 share in the future profits of the firm. Calculate new profit sharing ratio of Anil, Vishal and Sumit.

Solution:

$$\text{Sumit's share} = 1/5$$

$$\text{Remaining share} = 1 - (1/5) = 4/5$$

$$\text{Anil's new share} = 3/5 \text{ of } 4/5 = 12/25$$

$$\text{Vishal's new share} = 2/5 \text{ of } 4/5 = 8/25$$

New profit sharing ratio of Anil, Vishal and Sumit will be 12:8:5.

Illustration : 5

Anshu and Nitu are partners sharing profits in the ratio of 3:2. They admitted Jyoti as a new partner for $3/10$ share which she acquired $2/10$ from Anshu and $1/10$ from Nitu. Calculate the new profit-sharing ratio of Anshu, Nitu and Jyoti.

$$\text{Jyoti's share} = 3/10$$

$$\text{Anshu's new share} = 3/5 - 2/10 = 4/10$$

$$\begin{aligned} \text{Nitu's new share} &= \text{Old share} - \text{Share Surrendered} \\ &= 2/5 - 1/10 = 3/10 \end{aligned}$$

The new profit sharing ratio between Anshu, Nitu and Jyoti will be 4 : 3 : 3.

SACRIFICING RATIO

The ratio in which the old partners agree to sacrifice their share of profit in favour of the incoming partner is called sacrificing ratio. The sacrifice by a partner is equal to:

$\text{Old Share of Profit} - \text{New Share of Profit}$

As stated earlier, the new partner is required to compensate the old partner's for their loss of share in the super profits of the firm for which he brings in an additional amount known as premium or goodwill. This amount is shared by the existing partners in the ratio in which they forego their shares in favour of the new partner which is called sacrificing ratio.

The ratio is normally clearly given as agreed among the partners which could be the old ratio, equal sacrifice, or a specified ratio. The difficulty arises where the ratio in which the new partner acquires his share from the old partners is not specified. Instead, the new profit sharing ratio is given. In such a situation, the sacrificing ratio is to be worked out by deducting each partner's new share from his old share.

Illustration : 6

Ramesh and Suresh are partners in a firm sharing profits in the ratio of 4:3. They admitted Mohan as a new partner. The profit-sharing ratio of Ramesh, Suresh and Mohan will be 2:3:1. Calculate the gain or sacrifice of old partner.

$$\text{Ramesh's old share} = 4/7$$

$$\text{Ramesh's new share} = 2/6$$

$$\text{Ramesh's sacrifice} = 4/7 - 2/6 = 10/42$$

$$\text{Suresh's new share} = 3/6$$

Suresh's old share = $\frac{3}{7}$

Suresh's gain = $\frac{3}{6} - \frac{3}{7} = \frac{3}{42}$

Mohan's share = $\frac{1}{6}$ or $\frac{7}{42}$

Ramesh's sacrifice = Suresh's gain + Mohan's gain = $\frac{3}{42} + \frac{7}{42} = \frac{10}{42}$

GOODWILL

Goodwill is also one of the special aspects of partnership accounts which requires adjustment (also valuation if not specified) at the time of reconstitution of a firm viz., a change in the profit sharing ratio, the admission of a partner or the retirement or death of a partner.

FACTORS AFFECTING THE VALUE OF GOODWILL

The main factors affecting the value of goodwill are as follows:

1. Nature of business: A firm that produces high value added products or having a stable demand is able to earn more profits and therefore has more goodwill.
2. Location: If the business is centrally located or is at a place having heavy customer traffic, the goodwill tends to be high.
3. Efficiency of management: A well-managed concern usually enjoys the advantage of high productivity and cost efficiency. This leads to higher profits and so the value of goodwill will also be high.
4. Market situation: The monopoly condition or limited competition enables the concern to earn high profits which leads to higher value of goodwill.
5. Special advantages: The firm that enjoys special advantages like import licences, low rate and assured supply of electricity, long-term contracts for supply of materials, well-known collaborators, patents, trademarks, etc. enjoy higher value of goodwill.

Methods of Valuation of Goodwill

Since goodwill is an intangible asset it is very difficult to accurately calculate its value. Various methods have been advocated for the valuation of goodwill of a partnership firm. Goodwill calculated by one method may differ from the goodwill calculated by another method. Hence, the method by which goodwill is to be calculated, may be specifically decided between the existing partners and the incoming partner.

The important methods of valuation of goodwill are as follows:

1. Average Profits Method
2. Super Profits Method
3. Capitalisation Method

Average Profits Method

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

Illustration : 7

The profit for the five years of a firm are as follows – year 2013 Rs. 4,00,000; year 2014 Rs. 3,98,000; year 2015 Rs. 4,50,000; year 2016 Rs. 4,45,000 and year 2017 Rs. 5,00,000. Calculate goodwill of the firm on the basis of 4 years purchase of 5 years average profits

Year Profit	(Rs.)
2013	4,00,000
2014	3,98,000
2015	4,50,000
2016	4,45,000
2017	5,00,000
Total	21,93,000

Average Profit = Total Profit of Last 5 Years / No.of years= 21,93,000/5= Rs. 4,38,600

Goodwill = Average Profits × No. of years purchased
 = Rs. 4,38,600 × 4 = Rs. 17,54,400

SUPER PROFITS METHOD

The basic assumption in the average profits (simple or weighted) method of calculating goodwill is that if a new business is set up, it will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases an existing business has to pay in the form of goodwill a sum equal to the total profits he is likely to receive for the first ‘few years’. But it is contended that the buyer’s real benefit does not lie in total profits; it is limited to such amounts of profits which are in excess of the normal return on capital employed in similar business. Therefore, it is desirable to value, goodwill on the basis of the excess profits and not the actual profits. The excess of actual profits over the normal profits is termed as super profits.

Capital Employed × Normal Rate of Return

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

Suppose an existing firm earns Rs. 18,000 on the capital of Rs. 1,50,000 and the normal rate of return is 10%. The Normal profits will work out at Rs. 15,000 (1,50,000 × 10/100). The super profits in this case will be Rs. 3,000 (Rs. 18,000 – 15,000). The goodwill under the super profit method is ascertained by multiplying the super profits by certain number of years' purchase. If, in the above example, it is expected that the benefit of super profits is likely to be available for 5 years in future, the goodwill will be valued at Rs. 15,000 (3,000 × 5). Thus, the steps involved under the method are:

1. Calculate the average profit,
2. Calculate the normal profit on the capital employed on the basis of the normal rate of return,
3. Calculate the super profits by deducting normal profit from the average profits, and
4. Calculate goodwill by multiplying the super profits by the given number of years' purchase.

Illustration : 8

The books of a business showed that the capital employed on December 31, 2015, Rs. 5,00,000 and the profits for the last five years were: 2010– Rs. 40,000; 2012-Rs. 50,000; 2013-Rs. 55,000; 2014-Rs.70,000 and 2015-Rs. 85,000. You are required to find out the value of goodwill based on 3 years purchase of the super profits of the business, given that the normal rate of return is 10%.

$$\begin{aligned} \text{Normal Profits} &= \frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100} \\ &= \text{Rs.} \frac{5,00,000 \times 10}{100} = \text{Rs. 50,000} \end{aligned}$$

Average Profits:

Year	Profit (Rs.)
2011	40,000
2012	50,000
2013	55,000
2014	70,000
2015	85,000
Total	3,00,000

Average Profits	= Rs. 3,00,000/5 = Rs. 60,000
Super Profit	= Rs. 60,000 – Rs. 50,000 = Rs. 10,000
Goodwill	= Rs. 10,000× 3 = Rs. 30,000

CAPITALISATION METHODS

Under this method the goodwill can be calculated in two ways: (a) by capitalizing the average profits, or (b) by capitalising the super profits.

(a) Capitalisation of Average Profits: Under this method, the value of goodwill is ascertained by deducting the actual capital employed (net assets) in the business from the capitalized value of the average profits on the basis of normal rate of return. This involves the following steps:

- (i) Ascertain the average profits based on the past few years' performance.
- (ii) Capitalize the average profits on the basis of the normal rate of return to ascertain the capitalised value of average profits as follows:

$$\text{Average Profits} \times 100/\text{Normal Rate of Return}$$

- (iii) Ascertain the actual capital employed (net assets) by deducting outside liabilities from the total assets (excluding goodwill).

$$\text{Capital Employed} = \text{Total Assets (excluding goodwill)} - \text{Outside Liabilities}$$

- (iv) Compute the value of goodwill by deducting net assets from the capitalised value of average profits, i.e. (ii) – (iii).

Illustration : 9

A business has earned average profits of Rs. 1,00,000 during the last few years and the normal rate of return in a similar business is 10%. Ascertain the value of goodwill by capitalisation average profits method, given that the value of net assets of the business is Rs. 8,20,000.

Solution

a) capitalizing the average profits

$$\text{Capitalised Value of Average Profits} = \text{Rs. } \frac{1,00,000 \times 100}{10} = \text{Rs. } 10,00,000$$

$$\begin{aligned} \text{Goodwill} &= \text{Capitalised value} - \text{Net Assets} \\ &= \text{Rs. } 10,00,000 - \text{Rs. } 8,20,000 \\ &= \text{Rs. } 1,80,000 \end{aligned}$$

(b) Capitalisation of Super Profits:

$$\text{Goodwill} = \text{Super Profits} \times 100 \text{ Normal Rate of Return}$$

The average profits are Rs. 1,00,000 and the normal profits are Rs. 82,000 (10% of Rs. 8,20,000), the super profits worked out as Rs. 18,000 (Rs. 1,00,000 – Rs. 82,000), the goodwill will be calculated as follows.

$$\text{Rs. } 18,000 \times \frac{100}{10} = \text{Rs. } 1,80,000.$$

Illustration : 10

Rajinder and Surinder are partners in a firm sharing profits in the ratio of 4:1. On April 15, 2017 they admit Narender as a new partner. On that date there was a balance of Rs. 20,000 in general reserve and a debit balance of Rs. 10,000 in the profit and loss account of the firm. Pass necessary journal entries regarding adjustment of a accumulate a profit or loss

Date	Particulars	L.F.	Debit	Credit
Apr.15	General Reserve A/c Dr.		20,000	
	To Rajinder's capital A/c To Surender's capital A/c (General Reserve balance transferred to the capital account of Rajinder and Surinder on Narender's admission)			16,000 4,000
	Rajinder's Capital A/c Dr.		8,000	
	Surender's Capital A/c Dr.		2,000	
	To Profit and Loss A/c (Debit balance of Profit and Loss A/c transferred to old partners' capital accounts)			10,000

RETIREMENT OF A PARTNER

Illustration : 11

Madhu, Neha and Tina are partners sharing profits in the ratio of 5:3:2. Calculate new profit sharing ratio and gaining ratio if

1. Madhu retires
2. Neha retires
3. Tina retires.

Solution

Given old ratio among Madhu : Neha : Tina as 5 : 3 : 2

1. If Madhu retires, new profit sharing Ratio between Neha and Tina will be Neha : Tina = 3:2 and Gaining Ratio of Neha and Tina =3:2
2. If Neha retires new profit sharing Ratio between Madhu and Tina will be

$$\text{Madhu : Tina} = 5:2$$

$$\text{Gaining Ratio of Madhu and Tina} = 5:2$$

3. If Tina retires, new profit sharing ratio between Madhu and Neha will be:

$$\text{Madhu : Neha} = 5:3$$

$$\text{Gaining ratio of Madhu and Neha} = 5:3$$

Illustration :12

Amit, Dinesh and Gagan are partners sharing profits in the ratio of 5:3:2. Dinesh retires. Amit and Gagan decide to share the profits of the new firm in the ratio of 3:2. The gaining ratio will be calculated as follows :

$$\text{Amit's Gaining Share} = \frac{3}{5} - \frac{5}{10} = \frac{6-5}{10} = \frac{1}{10}$$

$$\text{Gagan's Gaining Share} = \frac{2}{5} - \frac{2}{10} = \frac{4-2}{10} = \frac{2}{10}$$

Thus, Gaining Ratio of Amit and Gagan = 1:2. This implies Amit gains $\frac{1}{3}$ and Gagan gains $\frac{2}{3}$ of Dinesh's share of profit.

Illustration : 13

Ranjana, Sadhna and Kamana are partners sharing profits in the ratio 4:3:2. Ranjana retires; Sadhna and Kamana decided to share profits in future in the ratio of 5:3. Calculate the Gaining Ratio.

Solution

$$\text{Gaining Share} = \text{New Share} - \text{Old Share}$$

$$\text{Sadhna's Gaining Share} = \frac{5}{8} - \frac{3}{9} = \frac{45-24}{72} = \frac{21}{72}$$

$$\text{Kamana's Gaining Share} = \frac{3}{8} - \frac{2}{9} = \frac{27-16}{72} = \frac{11}{72}$$

$$\text{Gaining Ratio between Sadhna and Kamana} = 21:11.$$

Illustration : 14

A, B, and C are partners in a firm sharing profits in the ratio of 3:2:1 B retires. The goodwill of the firm is valued at Rs. 60,000 and the remaining partners A and C continue to share profits in the ratio of 3:1. The journal entries passed under various alternatives shall be as follows:

(a) If goodwill is raised at full value and retained in books

Goodwill A/c	Dr.	60,000	
To A's capital A/c			30,000
To B's capital A/c			20,000
To C's capital A/c			10,000

- (Goodwill raised at full value and credited to all the partners in their old profit sharing ratio)
- (b) If goodwill is raised at full value and written off immediately.
- (i) Goodwill A/c Dr. 60,000
 To A's capital A/c 30,000
 To B's capital A/c 20,000
 To C's capital A/c 10,000
 (Goodwill raised at full value and credited to all partners in old ratio)
- (ii) A's capital A/c Dr. 45,000
 C's capital A/c Dr. 15,000
 To Goodwill A/c 60,000
 (Goodwill written off and debited to remaining partners in the new ratio)
- (c) If goodwill is raised to the extent of retiring partner's share and written off immediately.
- (i) Goodwill A/c Dr. 20,000
 To B's capital A/c 20,000
 (Goodwill raised to the extent of B's share)
- (ii) A's capital A/c Dr. 15,000
 C's capital A/c Dr. 5,000
 To goodwill A/c 20,000
 (Goodwill written off by debiting remaining partners' in gaining ratio)
- (d) If goodwill is not to appear in firm's books at all
- A's capital A/c Dr. 15,000
 C's capital A/c Dr. 5,000
 To C's capital A/c 20,000
 (B's share of goodwill adjusted to remaining partners' capital accounts in gaining ratio)

Illustration :15

Hanny, Pammy and Sunny are partners sharing profits in the ratio of 3 : 2 : 1. Goodwill is appearing in the books at a value of Rs. 60,000. Pammy retires and at the time of Pammy's retirement, goodwill is valued at Rs. 84,000. Hanny and Sunny decided to share future profits in the ratio of 2:1. Record the necessary journal entries.

Solution

Books of Hanny and Sunny Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Hanny's Capital A/c Dr.		30,000	
	Pammy's Capital A/c Dr.		20,000	

Sunny's Capital A/c	Dr.	10,000	
To Goodwill A/c			60,000
(Existing goodwill written-off in old ratio)			
Hanny's Capital	Dr.	14,000	
Sunny's Capital	Dr.	14,000	
To Pammy's Capital A/c			28,000
(Pammy's share of goodwill adjusted to Hanny's and Sunny's capital account to the extent of their gain)			

Working Notes

- (i) Pammy's share of current value of goodwill $\frac{1}{3}$ of Rs. 84,000
 $= 84,000 \times \frac{1}{3} = \text{Rs. } 28,000$

- (ii) Gaining Share = New Share – Old Share

$$\text{Hanny's Gaining Share} = \frac{2}{3} - \frac{3}{6} = \frac{1}{6}$$

$$\text{Sunny's Gaining Share} = \frac{1}{3} - \frac{1}{6} = \frac{1}{6}$$

This gaining Ratio of Hanny and Sunny is $\frac{1}{6} : \frac{1}{6} = 1:1$

DEATH OF A PARTNER

Illustration:16

Anil, Bhanu and Chandu were partners in a firm sharing profits in the ratio of 5:3:2. On March 31, 2017, their Balance Sheet was as under: Books of Anil, Bhanu and Chandu
 Balance Sheet as on March 31, 2017

Books of Anil, Bhanu and Chandu
 Balance Sheet as on March 31, 2017

Liabilities	Amount	Assets	Amount
Creditors	11,000	Buildings	20,000
Reserve Fund	6,000	Machinery	30,000
Anil's Capital	30,000	Stock	10,000
Bhanu's Capital	25,000	Patents	11,000
Chandu's Capital	15,000	Debtors	8,000
		Cash	8,000
	87,000		87,000

Anil died on October 1, 2017. It was agreed between his executors and the remaining partners that:

(a) Goodwill to be valued 2 ½ year's purchase of the average profits of the previous four years which were :

Year 2013-14 – Rs.13,000, Year 2014-15 – Rs. 12,000,

Year 2015-16 – Rs.20,000, Year 2016-17 – Rs.15,000

(b) Patents be valued at Rs.8,000; Machinery at Rs.28,000; and Building at Rs.25,000.

(c) Profit for the year 2017-18 be taken as having accrued at the same rate as that of the previous year.

(d) Interest on capital be provided at 10% p.a.

(e) Half of the amount due to Anil be paid immediately.

Solution :

Dr. Books of Anil, Bhanu and Chander Anil's Capital Account Cr

2017	Particulars	J.F.	Amount (Rs.)	Date 2017	Particulars	J.F.	Amount (Rs.)
Oct.1	Anil's Executors		57,000	April,1 Oct. 1	Balance b/d		30,000
					Reserve Fund		3,000
					Bhanu's Capital		11,250
					Chandu's Capital		7,500
					Profit & Loss (Suspense)		3,750 1,500
			57,000		Interest on Capital		57,000

Dr. Anil's Executor's Account

Cr

Date 2017	Particulars	J.F.	Amount (Rs.)	Date 2017	Particulars	J.F.	Amount (Rs.)
Oct.1	Bank		28,500	Oct.1	Anil's Capital		57,000
	Balance c/d		28,500				
			57,000				57,000

Working notes:

Notes: 1

Revaluation Account

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	Patents		3,000		Building		5,000
	Machinery		2,000				
			5,000				5,000

Notes: 2

Goodwill = 2½ years' purchase × Average Profit

Rs. 13,000 + Rs.12,000 + Rs.20,000 + Rs.15,000

Average Profit =

4

$$= \frac{\text{Rs. } 60,000}{4} = \text{Rs. } 15,000$$

$$\text{Goodwill} = \frac{5}{2} \times \text{Rs. } 15,000 = \text{Rs. } 37,500$$

$$\text{Anil's Share of Goodwill} = \frac{5}{10} \times \text{Rs. } 37,500 = \text{Rs. } 18,750$$

Notes: 3

Profit from the date of last balance sheet to date of death (April 1, 2017 to October 1, 2017) = 6 months

$$\text{Profit for 6 months} = \text{Rs. } 15,000 \times \frac{6}{12} = \text{Rs. } 7,500$$

$$\text{Anil's share of profit} = \text{Rs. } 7,500 \times \frac{5}{10} = \text{Rs. } 3,750$$

Notes: 4

Interest on Capital (April 1, 2017 to October 1, 2017)

$$= \text{Rs. } 30,000 \times 10/100 \times 6/12 = \text{Rs. } 1,500$$

Section A

1. Identify various matters that need adjustments at the time of admission of a new partner.
2. Why it is necessary to ascertain new profit sharing ratio even for old partners when a new partner is admitted?
3. What is goodwill? What factors affect goodwill?
4. Explain various methods of valuation of goodwill.
5. Compute the value of goodwill on the basis of four years' purchase of the average profits based on the last five years? The profits for the last five years were as follows:

	Rs.
2013	40,000
2014	50,000
2015	60,000
2016	50,000
2017	60,000

6. Capital employed in a business is Rs. 2,00,000. The normal rate of return on capital employed is 15%. During the year 2015 the firm earned a profit of Rs. 48,000. Calculate goodwill on the basis of 3 years purchase of super profit?
7. The books of Ram and Bharat showed that the capital employed on 31.12.2016 was Rs. 5,00,000 and the profits for the last 5 years : 2015 Rs. 40,000; 2014 Rs. 50,000; 2013 Rs. 55,000; 2012 Rs. 70,000 and 2011 Rs. 85,000. Calculate the value of goodwill on the

basis of 3 years purchase of the average super profits of the last 5 years assuming that the normal rate of return is 10%?

8. Rajan and Rajani are partners in a firm. Their capitals were Rajan Rs. 3,00,000; Rajani Rs. 2,00,000. During the year 2015 the firm earned a profit of Rs. 1,50,000. Calculate the value of goodwill of the firm assuming that the normal rate of return is 20%?
9. A business has earned average profits of Rs. 1,00,000 during the last few years. Find out the value of goodwill by capitalisation method, given that the assets of the business are Rs. 10,00,000 and its external liabilities are Rs. 1,80,000. The normal rate of return is 10%?

Section B

1. Puneet, Pankaj and Pammy are partners in a business sharing profits and losses in the ratio of 2 : 2 : 1 respectively. Their balance sheet as on March 31, 2017 was as follows:

Balance Sheet as on March 31, 2017

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors	1,00,000	Cash at Bank	20,000
Capital		Stock	30,000
Accounts:		Sundry Debtors	80,000
Puneet 60,000		Investments	70,000
Pankaj 1,00,000		Furniture	35,000
Pammy <u>40,000</u>	2,00,000	Buildings	1,15,000
Reserve	50,000		
	<u>3,50,000</u>		<u>3,50,000</u>

Mr. Pammy died on September 30, 2017. The partnership deed provided the following:

- (i) The deceased partner will be entitled to his share of profit up to the date of death calculated on the basis of previous year's profit.
- (ii) He will be entitled to his share of goodwill of the firm calculated on the basis of 3 years' purchase of average of last 4 years' profit. The profits for the last four financial years are given below: for 2013–14; Rs. 80,000; for 2014–15, Rs. 50,000; for 2015–16, Rs. 40,000; for 2016–17, Rs. 30,000.

The drawings of the deceased partner up to the date of death amounted to Rs. 10,000. Interest on capital is to be allowed at 12% per annum. Surviving partners agreed that Rs. 15,400 should be paid to the executors immediately and the balance in four equal yearly instalments with interest at 12% p.a. on outstanding balance.

Show Mr. Pammy's Capital account, his Executor's account till the settlement of the amount due.

2. Following is the Balance Sheet of Prateek, Rockey and Kushal as on March 31, 2017.

Books of Prateek, Rockey and Kushal Balance Sheet as on March 31, 2017

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors	16,000	Bills Receivable	16,000
General Reserve	16,000	Furniture	22,600
Capital Accounts:		Stock	20,400
Prateek 30,000		Sundry Debtors	22,000
Rockey 20,000		Cash at Bank	18,000
Kushal <u>20,000</u>	70,000	Cash in Hand	3,000
	<u>1,02,000</u>		<u>1,02,000</u>

Rockey died on June 30, 2017. Under the terms of the partnership deed, the executors of a deceased partner were entitled to:

- Amount standing to the credit of the Partner's Capital account.
- Interest on capital at 5% per annum.
- Share of goodwill on the basis of twice the average of the past three years' profit and
- Share of profit from the closing date of the last financial year to the date of death on the basis of last year's profit.

Profits for the year ending on March 31, 2015, March 31, 2016 and March 31, 2017 were Rs. 12,000, Rs. 16,000 and Rs. 14,000 respectively. Profits were shared in the ratio of capitals.

Pass the necessary journal entries and draw up Rockey's capital account to be rendered to his executor.

3. Narang, Suri and Bajaj are partners in a firm sharing profits and losses in proportion of $\frac{1}{2}$, $\frac{1}{6}$ and $\frac{1}{3}$ respectively. The Balance Sheet on April 1, 2015 was as follows:

Books of Suri and Bajaj
Balance Sheet as on April 1, 2015

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Bills Payable	12,000	Freehold Premises	40,000
Sundry Creditors	18,000	Machinery	30,000
Reserves	12,000	Furniture	12,000
Capital Accounts:		Stock	22,000

Narang	30,000		Sundry Debtors	20,000	
Suri	30,000		Less: Reserve for Bad	<u>1,000</u>	19,000
Bajaj	<u>28,000</u>	88,000	Debt Cash		7,000
		<u>1,30,000</u>			<u>1,30,000</u>

Bajaj retires from the business and the partners agree to the following:

- Freehold premises and stock are to be appreciated by 20% and 15% respectively.
- Machinery and furniture are to be depreciated by 10% and 7% respectively.
- Bad Debts reserve is to be increased to Rs. 1,500.
- Goodwill is valued at Rs. 21,000 on Bajaj's retirement.
- The continuing partners have decided to adjust their capitals in their new profit sharing ratio after retirement of Bajaj. Surplus/deficit, if any, in their capital accounts will be adjusted through current accounts.

Prepare necessary ledger accounts and draw the Balance Sheet of the reconstituted firm.

- The Balance Sheet of Rajesh, Pramod and Nishant who were sharing profits in proportion to their capitals stood as on March 31, 2015:

Books of Rajesh, Pramod and Nishant Balance Sheet as on March 31, 2015

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Bills Payable	6,250	Factory Building	12,000
Sundry Creditors	10,000	Debtors	10,500
Reserve Fund	2,750	Less: Reserve	<u>500</u>
Capital		Bills Receivable	7,000
Accounts:		Stock	15,500
Rajesh	20,000	Plant and	11,500
Pramod	15,000	Machinery	
Nishant	<u>15,000</u>	Bank Balance	13,000
	50,000		
	<u>69,000</u>		<u>69,000</u>

Pramod retired on the date of Balance Sheet and the following adjustments were made:

- Stock was valued at 10% less than the book value.
- Factory buildings were appreciated by 12%.
- Reserve for doubtful debts be created up to 5%.
- Reserve for legal charges to be made at Rs. 265.
- The goodwill of the firm be fixed at Rs. 10,000.
- The capital of the new firm be fixed at Rs. 30,000. The continuing partners decide to keep their capitals in the new profit sharing ratio of 3 : 2.

Pass journal entries and prepare the balance sheet of the reconstituted firm after transferring the balance in Pramod's Capital account to his loan account.

Section C

1. Following is the Balance Sheet of Jain, Gupta and Malik as on March 31, 2016.

Books of Jain, Gupta and Malik
Balance Sheet as on March 31, 2016

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors	19,800	Land and Building	26,000
Telephone bills Outstanding	300	Bonds	14,370
Accounts Payable	8,950	Cash	5,500
Accumulated profits	16,750	Bills Receivable	23,450
Capitals :		Sundry Debtors	26,700
Jain 40,000		Stock	18,100
Gupta 60,000		Office Furniture	18,250
Malik <u>20,000</u>	1,20,000	Plants and Machinery	20,230
		Computers	13,200
	1,65,800		1,65,800

The partners have been sharing profits in the ratio of 5:3:2. Malik decides to retire from business on April 1, 2016 and his share in the business is to be calculated as per the following terms of revaluation of assets and liabilities : Stock, Rs.20,000; Office furniture, Rs.14,250; Plant and Machinery Rs.23,530; Land and Building Rs.20,000.

A provision of Rs.1,700 to be created for doubtful debts. The goodwill of the firm is valued at Rs.9,000.

The continuing partners agreed to pay Rs.16,500 as cash on retirement of Malik, to be contributed by continuing partners in the ratio of 3:2. The balance in the capital account of Malik will be treated as loan.

Prepare Revaluation account, capital accounts, and Balance Sheet of the reconstituted firm.

2. Arti, Bharti and Seema are partners sharing profits in the proportion of 3:2:1 and their Balance Sheet as on March 31, 2016 stood as follows :

Books of Arti, Bharti and Seema
Balance Sheet as on March 31, 2016

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Bills Payable	12,000	Buildings	21,000
Creditors	14,000	Cash in Hand	12,000
General Reserve	12,000	Bank	13,700
Capitals:		Debtors	12,000
Arti 20,000		Bills Receivable	4,300
Bharti 12,000		Stock	1,750
Seema <u>8,000</u>	40,000	Investment	13,250
	78,000		78,000

Bharti died on June 12, 2016 and according to the deed of the said partnership, her executors are entitled to be paid as under :

- a. The capital to her credit at the time of her death and interest thereon @ 10% per annum.
- b. Her proportionate share of reserve fund.
- c. Her share of profits for the intervening period will be based on the sales during that period, which were calculated as Rs.1,00,000. The rate of profit during past three years had been 10% on sales.
- d. Goodwill according to her share of profit to be calculated by taking twice the amount of the average profit of the last three years less 20%. The profits of the previous years were :

2013	– Rs.8,200
2014	– Rs.9,000
2015	– Rs.9,800

The investments were sold for Rs.16,200 and her executors were paid out. Pass the necessary journal entries and write the account of the executors of Bharti.

3. Nithya, Sathya and Mithya were partners sharing profits and losses in the ratio of 5:3:2. Their Balance Sheet as on March 31, 2015 was as follows :

Books of Nithya, Sathya and Mithya Balance Sheet at March 31, 2015

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Creditors	14,000	Investments	10,000
Reserve Fund	6,000	Goodwill	5,000
Capitals:		Premises	20,000
Nithya 30,000		Patents	6,000
Sathya 30,000		Machinery	30,000
Mithya <u>20,000</u>	80,000	Stock	13,000
		Debtors	8,000
		Bank	8,000
	<u>1,00,000</u>		<u>1,00,000</u>

Mithya dies on August 1, 2015. The agreement between the executors of Mithya and the partners stated that :

- Goodwill of the firm be valued at $\frac{1}{22}$ times the average profits of last four years. The profits of four years were : in 2011-12, Rs.13,000; in 2012-13, Rs.12,000; in 2013-14, Rs.16,000; and in 2014-15, Rs.15,000.
- The patents are to be valued at Rs.8,000, Machinery at Rs.25,000 and Premises at Rs.25,000.
- The share of profit of Mithya should be calculated on the basis of the profit of 2014-15.
- Rs.4,200 should be paid immediately and the balance should be paid in 4 equal half-yearly instalments carrying interest @ 10%.

Record the necessary journal entries to give effect to the above and write the executor's account till the amount is fully paid. Also prepare the Balance Sheet of Nithya and Sathya as it would appear on August 1, 2015 after giving effect to the adjustments.

TEXT / REFERENCE BOOKS

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- Narayanaswamy R, Financial Accounting, PHI Learning Pvt Ltd, 6th Edition, 2017.
- M. Hanif & A. Mukherjee, Financial Accounting I, McGraw Hill Education, 4th Edition, 2018.
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UNIT V DISSOLUTION OF PARTNERSHIP

DISSOLUTION OF PARTNERSHIP

It means changes the existing relationship between partners but the firm may continue its business as before. The dissolution of partnership may take place in any of the following ways:

- (1) Change in existing profit sharing ratio among partners;
- (2) Admission of a new partner;
- (3) Retirement of a partner;
- (4) Death of a partner;
- (5) Insolvency of a partner;
- (6) Completion of the venture, if partnership is formed for that; and
- (7) Expiry of the period of partnership, if partnership is for a specific period of time

DISSOLUTION OF A FIRM

Dissolution of a partnership firm may take place without the intervention of court or by the order of a court, in any of the ways specified later in this section. It may be noted that dissolution of the firm necessarily brings in dissolution of the partnership.

Dissolution of a firm takes place in any of the following ways:

1. **Dissolution by Agreement:** A firm is dissolved :
 - (a) with the consent of all the partners or
 - (b) in accordance with a contract between the partners.
2. **Compulsory Dissolution:** A firm is dissolved compulsorily in the following cases:
 - (a) when all the partners or all but one partner, become insolvent, rendering them incompetent to sign a contract;
 - (b) when the business of the firm becomes illegal; or
 - (c) when some event has taken place which makes it unlawful for the partners to carry on the business of the firm in partnership, e.g., when a partner who is a citizen of a country becomes an alien enemy because of the declaration of war with his country and India.
3. **On the happening of certain contingencies:** Subject to contract between the partners, a firm is dissolved :
 - (a) if constituted for a fixed term, by the expiry of that term;

- (b) if constituted to carry out one or more ventures, by the completion thereof; (c) by the death of a partner;
- (d) by the adjudication of a partner as an insolvent.
4. Dissolution by Notice: In case of partnership at will, the firm may be dissolved if any one of the partners gives a notice in writing to the other partners, signifying his intention of seeking dissolution of the firm.
5. Dissolution by Court: At the suit of a partner, the court may order a partnership firm to be dissolved on any of the following grounds:
- (a) when a partner becomes insane;
 - (b) when a partner becomes permanently incapable of performing his duties as a partner;
 - (c) when a partner is guilty of misconduct which is likely to adversely affect the business of the firm;
 - (d) when a partner persistently commits breach of partnership agreement;
 - (e) when a partner has transferred the whole of his interest in the firm to a third party;
 - (f) when the business of the firm cannot be carried on except at a loss; or
 - (g) when, on any ground, the court regards dissolution to be just and equitable.

Distinction between Dissolution of Partnership and Dissolution of Firm

Basis	Dissolution of Partnership	Dissolution of Firm
1. Termination of business	The business is not terminated.	The business of the firm is closed.
2. Settlement of assets and liabilities	Assets and liabilities are revalued and new balance sheet is drawn.	Assets are sold and liabilities are paid-off.
3. Court's intervention	Court does not intervene because partnership is dissolved by mutual agreement.	A firm can be dissolved by the court's order.
4. Economic relationship	Economic relationship between the partners continues though in a changed form.	Economic relationship between the partners comes to an end.
5. Closure of books	Does not require because the business is not terminated.	The books of account are closed.
6. Other dissolution	It may or may not involve dissolution of the firm.	It necessarily involves dissolution of partnership.

SETTLEMENT OF ACCOUNTS

In case of dissolution of a firm, the firm ceases to conduct business and has to settle its accounts. For this purpose, it disposes off all its assets for satisfying all the claims against it. In this context it should be noted that, subject to agreement among the partners, the following rules as provided in Section 48 of the Partnership Act 1932 shall apply.

a) Treatment of Losses

Losses, including deficiencies of capital, shall be paid :

- (i) first out of profits,
- (ii) next out of capital of partners, and

lastly, if necessary, by the partners individually in their profits sharing ratio.

b) Application of Assets

The assets of the firm, including any sum 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 the third parties;
- (ii) In paying each partner proportionately what is due to him/her from the firm for advances as distinguished from capital (i.e. partner' loan);
- (iii) In paying to each partner proportionately what is due to him on account of capital; and
- (iv) the residue, if any, shall be divided among the partners in their profit sharing ratio.

Thus, the amount realised from assets along with contribution from partners, if required, shall be utilised first to pay off the outside liabilities of the firm such as creditors, loans, bank overdraft, bill payables, etc. (it may be noted that secured loans have precedence over the unsecured loans); the balance should be applied to repay loans and advances made by the partners to the firm. (in case the balance amount is not adequate enough to pay off such loans and advances, they are to be paid proportionately); and surplus, if any is to be utilised in settlement of the capital account balances, after adjusting all profits and losses.

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

- (a) The property of the firm shall be applied first in the payment of debts of the firm and then the surplus, if any, shall be divided among the partners as per their claims, which can be utilised for payment of their private liabilities.
- (b) The private property of any partner shall be applied first in payment of his private debts and the surplus, if any, may be utilised for payment of the firm's debts, in case the firm's liabilities exceed the firm's assets.

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

ACCOUNTING TREATMENT

When the firm is dissolved, its books of account are to be closed and the profit or loss arising on realisation of its assets and discharge of liabilities is to be computed. For this purpose, a Realisation Account is prepared to ascertain the net effect (profit or loss) of realisation of assets and payment of liabilities which may be transferred to partner's capital accounts in their profit sharing ratio. Hence, all assets (other than cash in hand bank balance and fictitious assets, if any), and all external liabilities are transferred to this account. It also records the sale of assets, and payment of liabilities and realisation expenses. The balance in this account is termed as profit or loss on realisation which is transferred to partners' capital accounts in their profit sharing ratio

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

Illustration:

Supriya and Monika are partners, who share profit in the ratio of 3:2. Following is the balance sheet as on March 31, 2017.

Balance Sheet of Supriya and Monika as on March 31, 2017

Liabilities	Amount	Assets	Amount
Supriya's Capital	32,500	Cash and Bank	40,500
Monika's Capital	11,500	Stock	7,500
Sundry Creditors	48,000	Sundry debtors 21,500	
Reserve fund	13,500	Less: Provision <u>500</u>	21,000
		for doubtful debts Fixed	36,500
		Assets	
	1,05,500		1,05,500

The firm was dissolved on March 31, 2017. Close the books of the firm with the following information:

- (i) Debtors realised at a discount of 5%,
- (ii) Stock realised at Rs.7,000,
- (iii) Fixed assets realised at Rs.42,000, (iv) Realisation expenses of Rs.1,500, (v) Creditors are paid in full.

Prepare necessary ledger accounts.

Solution

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Assets transferred:		Provision for doubtful debts	500
Stock	7,500	Sundry creditors	48,000
Sundry debtors	21,500	Bank	
Fixed assets	36,500	Debtors 20,425	
Bank		Stock 7,000	
Creditors 48000		Fixed assets <u>42,000</u>	69,425
Realisation expenses 1500	49,500		
Profit transferred to:			
Supriya Capital 1,755			
Monika Capital <u>1,170</u>	2,925		
	1,17,925		1,17,925

Illustration :1

Nayana and Arushi were partners sharing profits equally Their Balance Sheet as on March 31, 2017 was as follows:

Balance Sheet of Nayana and Arushi as on March 31, 2017

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capitals:		Bank	30,000
Nayana 100000		Debtors	25,000
Arushi 50000	1,50,000	Stock	35,000
Creditors	20,000	Furniture	40,000
Arushi's current account	10,000	Machinery	60,000
Workmen Compensation Fund	15,000	Nayana's current account	10,000
Bank overdraft	5,000		
	2,00,000		2,00,000

The firm was dissolved on the above date:

1. Nayana took over 50% of the stock at 10% less on its book value, and the remaining stock was sold at a gain of 15%. Furniture and Machinery realised for Rs.30,000 and Rs.50,000 respectively;
2. There was an unrecorded investment which was sold for Rs. 25,000;
3. Debtors realised 90% only and Rs.1,200 were recovered for bad debts written-off last year;
4. There was an outstanding bill for repairs which had to be paid for Rs.2,000.

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

Solution

Books of Nayana and Arushi Journal

Particular		Debit	Credit
Realisation A/c	Dr	1,60,000	
To Debtors A/c			25,000
To Stock A/c			35,000
To Furniture A/c			40,000
To Machinery A/c			60,000
(Assets transferred to Realisation Account)			
Creditors A/c	Dr	20,000	
Bank overdraft A/c		5,000	
To Realisation A/c			25,000
(Liabilities transferred to Realisation Account)			
Realisation A/c	Dr	27,000	
To Bank A/c			27,000
Creditors, Bank overdraft, Outstanding repair bill paid)			
Bank A/c	Dr	1,57,825	
To Realisation A/c			1,57,825
(Assets sold and bad debts recovered)			
Nayana's Capital A/c	Dr	15,750	
To Realisation A/c			15,750
(Half stock take over by Nayana at 10% less)			
Realisation A/c	Dr	15,575	
To Nayana's Current A/c			5,788
To Arushi's Current A/c			5,787
(Realisation profit transferred to partner's current account)			
Workman Compensation Fund A/c	Dr	15,000	
To Nayana's Current A/c			7,500
To Arushi's Current A/c			7,500
(Compensation fund transferred to partners' Current account)			
Arushi Current A/c	Dr	23,287	
To Arushi's Capital A/c			23,287
Current account balance transferred to Capital account)			
Nayana Capital A/c	Dr.	12,462	
To Nayana's Current A/c			12,462
(Current account balance transferred to Capital account)			
Nayana's Capital A/c	Dr	87,538	
Arushi's Capital A/c	Dr	73,287	
To Bank A/c			1,60,825
(Final amounts due to partners paid)			

Realisation Account

Particulars		Amount	Particulars		Amount
Debtors	25,000		Creditors		20,000
Stock	35,000		Bank overdraft		5,000
Furniture	40,000		Bank:		
Machinery	<u>60,000</u>	1,60,000	Investment	25,000	
Bank:			Furniture	30,000	
Creditors	20,000		Machinery	50,000	
Bank overdraft	5,000		Debtors (90%)	31,500	
Outstanding bill	<u>2,000</u>	27,000	Stock :	20,125	
Profit transferred to :			Bad debts recovered	<u>1,200</u>	1,57,825
Nayana's capital	5,788		Nayana's capital (stock taken over)		15,750
Arushi's capital	<u>5,787</u>	11,575			
		1,98,575			1,98,575

Dr. Partners' Current Accounts Cr

Date	Particulars	J. F.	Nayana	Arushi	Date	Particulars	J. F.	Nayana	Arushi
	Balance b/d Realisation		10,000			Balance b/d Workmen Compensation Fund Realisation (profit)		7,500	10,000
	Arushi's capital		15,750	23,287		Nayana's Capital		5,788	7,500
								12,462	5,787
			25,750	23,287				25,750	23,287

Dr. Partner's Current Accounts Cr

Date	Particulars	J.F.	Nayana	Arushi	Date	Particulars	J.F.	Nayana	Arushi
	Nayana's current account		12,462			Balance b/d		1,00,000	50,000
	Bank		87,538	73,287		Arushi's current account			23,287
			1,00,000	73,287				1,00,000	73,287

Dr. Partner's Current Accounts Cr

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	Balance b/d		30,000		Realisation		27,000
	Realisation		1,57,825		Nayana's capital		87,538
					Arushi's capital		73,287
			1,87,825				1,87,825

Illustration : 2

Following is the Balance Sheet of Ashwani and Bharat on March 31, 2017.

Balance Sheet Ashwani and Bharat as on March 31, 2017

Liabilities		Amount	Assets		Amount
Creditors		76,000	Cash at bank		17,000
Mrs.Ashwani's loan		10,000	Stock		10,000
Mrs.Bharat loan		20,000	Investments		20,000
Investment fluctuation fund		2,000	Debtors	40,000	
Reserve fund		20,000	Less: Provision for doubtful debts	4,000	36,000
Capitals:			Buildings		70,000
Ashwani	20,000		Goodwill		15,000
Bharat	<u>20,000</u>	40,000			
		<u>1,68,000</u>			<u>1,68,000</u>

The firm was dissolved on that date. The following was agreed transactions took place.

- Aswhani promised to pay Mrs. Ashwani's loan and took away stock for Rs.8,000.
- Bharat took away half of the investment at 10% less. Debtors realised for Rs.38,000. Creditor's were paid at less of Rs.380. Buildings realised for Rs.1,30,000, Goodwill Rs.12,000 and the remaining Investment were sold at Rs.9,000. An old typewriter not recorded in the books was taken over by Bharat for Rs. 600. Realisation expenses amounted to Rs. 2,000.

Prepare Realisation Account, Partner's Capital Account and Bank Account

Solution

Particulars	Amount	Particulars	Amount
Investment	20,000	Provision for doubtful debts	4,000
Debtors	40,000	Creditors	76,000
Buildings	70,000	Mrs. Ashwani loan	10,000
Stock	10,000	Mrs. Bharat loan	20,000
Goodwill	<u>15,000</u>	Investment fluctuation fund	2,000
Ashwani's Capital (Mrs. Ashwani's loan)		Ashwani's Capital [stock]	8,000
Bank (Mrs. Bharat's loan)		Bharat's capital (Typewriter)	600
Bank (creditors)		Bharat's capital (Investment)	9,000
Bank (realisation expenses)		Bank:	
Profit transferred to:		Investment	9,000
Ashwani's Capital 27,990		Debtors	38,000
Bharat's Capital <u>27,990</u>		Buildings	1,30,000
	1,55,000	Goodwill	<u>12,000</u>
			1,89,000
	3,18,600		3,18,600

Partner's Capital Accounts

Date	Particulars	J.F.	Ashwani	Bharat	Date	Particulars	J.F.	Ashwani	Bharat
	Realisation (stock)		8,000	—		Balance b/d		20,000	20,000
	Realisation [sale of typewriter]			600		Reserve fund		10,000	10,000
	Realisation [investment]			9,000		Realisation [Mrs. Ashwani's loan]		10,000	—
	Bank		59,990	48,390		Realisation (profit)		27,990	27,990
			67,990	57,990				67,990	57,990

Bank Account

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	Balance b/d		17,000		Realisation [creditors]		75,620
	Realisation		1,89,000		Realisation [expenses]		2,000
					Realisation (Mrs. Bharat's loan)		20,000
					Ashwani's capital		59,990
					Bharat's capital		48,390
			2,06,000				2,06,000

Illustration : 3

The following is the Balance sheet of A, B and C on December 31, 2007:

Liabilities	₹	Assets	₹
Creditors	20,000	Cash	6,000
Reserve Fund	15,000	Stock	20,000
A's Capital	25,000	Plants & Tools	20,000
B's Capital	15,000	Sundry Debtors	10,000
		Bills Receivable	10,000
		C's Capital Overdrawn	9,000
	75,000		75,000

C is insolvent but his estate pays ₹ 2,000. It is decided to wind up the partnership. The assets realized as follows:

- Sundry Debtors 7,500
- Bills Receivable 7,000
- Stock 16,000
- Plant & Tools 14,000
- The cost of winding up came to 2,500

Give accounts to close the books of the firm taking the capitals as fixed

Solution

Dissolution A/c

Particulars	₹	Particulars	₹
To Stock	20,000	By Sundry Debtors	7,500
To Plant & Tools	20,000	By Bills Receivable	7,000
To Sundry Debtors	10,000	By Stock	16,000
To Bills Receivables	10,000	By Plant & Tools	14,000
To Cash (cost of winding up)	2,500	By Loss on Dissolution	
		A 6,000	
		B 6,000	18,000
		C 6,000	
	62,500		62,500

Partner's Current A/c

Particulars	A (Rs)	B (Rs)	C (Rs)	Particulars	A (Rs)	B (Rs)	C (Rs)
To Loss on Dissolution	6,000	6,000	6,000	By Reserve Fund	5,000	5,000	5,000
To C's Capital A/c	-	-	9,000	By Cash A/c	-	-	2,000
To C's Current A/c(1)	5,000	3,000	-	By A's Current A/c	-	-	5,000
				By B's Current A/c	-	-	3,000
				By Cash A/c	6,000	4,000	-
	11,000	9,000	15,000		11,000	9,000	15,000

Cash A/c

Particulars	₹	Particulars	₹
To Balance b/d	6,000	By Expenses of winding up	2,500
To C's Current A/c	2,000	By Creditors A/c	20,000
To A's Current A/c	6,000	By A's Capital A/c	25,000
To B's Current A/c	4,000	By B's Capital A/c	15,000
To Realization A/c (Dissolution A/c)			
Sundry Debtors A/c	7,500		
Bills Receivable A/c	7,000		
Stock A/c	16,000		
Plants & Tools A/c	14,000		
	62,500		62,500

Garner vs. Murray Decision:

In England, Garner, Murray and Wilkins were three equal partners with unequal capital in a business. On June 30, 1990, they decided to dissolve their partnership firm. At the time of dissolution, the capital account of Wilkins showed a debit balance of some amount and nothing dissolved, the capital account of Wilkins showed a debit balance of some amount and nothing could be recovered from his due to insolvent. Garner wanted to share this loss in profit sharing ratio but Murray said loss on account Wilkins's insolvency was to business loss but a capital loss. Thus it should be divided in the capital ratio. A suit was filed:

The case was decided by lord justice Joyee. According to this decision:

- The solvent partners should bring in cash equal to their share of the loss on realization.
- Deficiency of the insolvent partner should be shared vb, solvent partners in the ratio of their adjusted capital just before dissolution.

- If a partner has a debit balance of his/her capital account on the relevant date, her/she will not bear loss an account of insolvent partner even though he/she may be financially more sound as company to other solvent partners.

According to Garner vs. Murray decision, the following point should be considered in case of an insolvency of a partner while dissolving the partnership firm:

- First of all, realization account is prepared and its profit or loss is transferred to all partner's capital account including insolvent partner in their profit sharing ratio.
- Solvent partners of the firm should bring the loss on realization in cash. In this situation, bank account is debited and solvent partners' capital accounts are credited.
- The ratio of last adjusted of the solvent partners should be calculated.
- Undistributed profit or loss and reserve should be distributed among all partners in their profit-sharing ratio.
- If any amount is received from the insolvent partner from his/her private estate, it should be credited to his/her capital account.
- After making all adjustment, the recorded debit balance of the insolvent partner should be transferred to the capital accounts of solvent partner in the ratio of last adjusted capital.
- The solvent partners, who have credit balance in their capital accounts, should draw out or bank balance of their capital account by debiting their capital accounts and crediting cash or bank account. It's just reverse, if there is a debited balance in the capital account, and then such partner should bring necessary cash in the business to balance off his/her capital account.

Illustration :4

Long, Short and Thin were carrying on business in partnership sharing profits and losses in the ratio of 3 : 2 : 1 respectively. They decided to dissolve the firm on 31st December, 2006 on which date their Balance Sheet stood as follows

Liabilities	Rs	Assets	Rs
Creditors	47,000	Land and Building	57,000
Long's Loan A/c	10,000	Stock	50,000
Capital Accounts:		Debtors	50,000
Long	90,000	Cash	3,000
Short	10,000	Profit	1,500
Thin	10,000	Short's Current A/c	2,000
Long's Current A/c	1,500	Thin's Current A/c	5,000
	1,68,500		1,68,500

Land and Buildings were sold for 40,000 and Stock and Debtors realized 30,000 and 42,000 respectively. The Goodwill was sold for 600, the expenses of realization amounted to 1,200. Thin is insolvent and a final dividend of 50 paise a rupee is received from his estate in full settlement.

Prepare the necessary accounts closing the books of the firm applying the ruling given in Garner Vs. Murray.

Solution

Realization Account

Particulars	Rs	Particulars	Rs
To Sundry Assets:		By Sundry Creditors:	47,000
Land & Buildings	57,000	By Cash A/c	
Stock	50,000	Sale of Land & Building	40,000
Debtors	50,000	Stock	30,000
To Cash (Expenses)	1,200	Debtors	42,000
To Cash (Sundry creditors)	47,000	Goodwill	600
		By Loss on Realization:	
		Long 22,800	
		Short 15,200	
		Thin 7,600	45,600
	2,05,200		2,05,200

Partner's Capital Accounts

Particulars	Long (Rs)	Short (Rs)	Thin (Rs)	Particulars	Long (Rs)	Short (Rs)	Thin (Rs)
To Profit & Loss A/c	750	500	250	By Balance b/d	90,000	10,000	10,000
To Short's Current A/c	-	2,000	-	By Long's Current A/c	1,500	-	-
To Thin's Current A/c	-	-	5,000	By Cash A/c	-	7,842	1,425
To Loss on Realization	22,800	15,200	7,600	By Long's Capital A/c	-	-	1,283
To Thin's Capital	1,283	142	-	By Short's Capital A/c	-	-	142
To Cash A/c	66,667	-	-				
	91,500	17,842	12,850		91,500	17,842	12,850

Cash Account

Particulars	₹	Particulars	₹
To Balance	3,000	By Realization (Expenses)	1,200
To Realization (Sale of assets)	1,12,600	By Sundry Creditors	47,000
To Shorts' Capital	7,842	By Long's Loan A/c	10,000
To Thin's Capital	1,425	By Long's Capital A/c	66,667
	1,24,867		1,24,867

PIECEMEAL DISTRIBUTION

When the partnership firm is dissolved, its business comes to end. In this situation, generally it is assumed that all the assets are realized immediately on the date of dissolution and the accounts of all the partners and the creditor are settled on the same day. But in real practice, this assumption is unrealistic, because assets of the firm cannot be realized immediately. They are sold gradually, therefore, it takes time. Similarly, cash received on the sale of assets is paid as and when realized to the rightful claimant. In other words, the process of realizing the assets takes a long time and cash is distributed as and when it is realized. The process of realizing the assets piece by piece or part by part and distributing the cash to the rightful claimant as and when the cash is received without waiting for the realization of all the assets of the firm is called piecemeal distribution.

On a gradual realization of assets, first of all, realization expenses are paid. After that, the debts of the firm to the third parties i.e. outside liabilities are paid. Then, the amount due to a partner as loan should be paid and finally, the capitals of the partners are paid.

There are two methods for distribution of cash under piecemeal distribution:

1. Surplus capital method or proportionate capital method
2. Maximum loss method

Surplus capital method or proportionate capital method

This method is suitable when the capitals of the partners are not in profit sharing ratio as well as all the partners are solvent.

Under this method, a partner, who has the highest capital i.e. more than proportionate to other partners' capital in view of profit sharing ratio, is paid first the available cash to bring down his/her capital in proportionate to other. After that cash available is distributed to their profit sharing ratio. This process is continued till the available cash is distributed fully. Finally, the balance of capital account represents profit or loss on realization and this will be in the profit sharing ratio of each partner. This is proof of correctness of distribution of cash piece by piece.

The following steps are used in this method:

- First of all, adjusted capitals of the partners are determined by adjusting undistributed profit or loss, balance of current accounts, etc.

- After that, such adjusted capitals of the partners should be divided by their respective profit sharing ratio and get the minimum amount called. 'Base capital.'
- Multiply 'Base capital' calculated in step b by respective profit sharing ratio of each partner and get 'Relative Capital.'
- Deduct 'Relative' calculated in step d by profit sharing ratio of each partner and get the minimum amount called 'Revised base Capital'.
- Again divide 'surplus capital' capital in step d by profit sharing ratio of each partner and get the minimum amount called 'Revised base Capital'.
- Multiple 'Revised Base Capital' of step e by profit sharing ratio of each partner and get 'Revised Relative Capital'.
- Deduct 'Revised Relative Capital' of step F from 'surplus Capital' of step d and get 'absolute surplus Capital'.

After all there, absolute surplus capital of a partner is returned first case. In case, the capitals are in profit sharing ratio. The cash is distributed among the partners in their profit sharing ratio.

Maximum loss method

It is an alternative method of piecemeal distribution. After payment of all the outside liabilities and partners' loan, under this method, maximum possible loss on every realization is calculated. In other words, the amount available for distribution among partners is compared with the total amount of capital payable to the partners and the maximum loss is ascertained on the assumption that in future assets will not realize any amount. The maximum possible loss so ascertained is deducted from the capital balance of the partners in their profit sharing ratio and balance left in the capital account after deducting the maximum loss will be the amount payable to the partner.

If a partner's share of maximum possible loss exceeds the amount shown on credit side of such partner's capital account, then such partner should be treated as insolvent partner and his/her deficiency should be borne by solvent partners as stated under the Garner vs. Murray rule. The amount standing to the credit of the partners after share of maximum loss and their share of insolvent partner's deficiency will be equal to the cash available for the distribution among the partners. This process of maximum possible loss is repeated till all the assets are disposed

Illustration :5

A, B and C are partners having capital of ₹ 20,000; ₹ 10,000 and ₹ 5,000. The profit-sharing ratio of A, B and C is 2:2:1 respectively. Calculate the surplus capital.

Solution:

Statement Showing Surplus Capital

	A	B	C
Profit sharing ratio	2	2	1
Actual Capital	20,000	20,000	5,000
Capital's of partner's on the basis of C's capital (C is having the least capital)	10,000	10,000	10,000
Surplus Capital	10,000	-----	-----

Paying the surplus capital to A, the remaining capital should be distributed among all the partners among their capital sharing ratio of 2 : 2 : 1.

QUESTION BANK

Section A

1. State the difference between dissolution of partnership and dissolution of partnership firm.
2. State the accounting treatment for:
 - i. Unrecorded assets
 - ii. Unrecorded liabilities
3. On dissolution, how will you deal with partner's loan if it appears on the (a) assets side of the balance sheet, (b) liabilities side of balance sheet.
4. Distinguish between firm's debts and partner's private debts.
5. State the order of settlement of accounts on dissolution.

Section B

1. Explain the process dissolution of partnership firm?
2. What is a Realisation Account?
3. Reproduce the format of Realisation Account.
4. The book value of assets (other than cash and bank) transferred to Realisation Account is Rs. 1,00,000. 50% of the assets are taken over by a partner Atul, at a discount of 20%; 40% of the remaining assets are sold at a profit of 30% on cost; 5% of the balance being obsolete, realised nothing and remaining assets are handed over to a Creditor, in full settlement of his claim.
You are required to record the journal entries for realisation of assets.
5. Record necessary journal entries to record the following unrecorded assets and liabilities in the books of Paras and Priya:

- a. There was an old furniture in the firm which had been written-off completely in the books. This was sold for Rs. 3,000,
 - b. Ashish, an old customer whose account for Rs. 1,000 was written-off as bad in the previous year, paid 60%, of the amount,
 - c. Paras agreed to takeover the firm's goodwill (not recorded in the books of the firm), at a valuation of Rs. 30,000,
 - d. There was an old typewriter which had been written-off completely from the books. It was estimated to realize Rs. 400. It was taken away by Priya at an estimated price less 25%,
 - e. There were 100 shares of Rs. 10 each in Star Limited acquired at a cost of Rs. 2,000 which had been written-off completely from the books. These shares are valued @ Rs. 6 each and divided among the partners in their profit sharing ratio.
6. All partners wishes to dissolve the firm. Yastin, a partner wants that her loan of Rs. 2,00,000 must be paid off before the payment of capitals to the partners. But, Amart, another partner wants that the capitals must be paid before the payment of Yastin's loan. You are required to settle the conflict giving reasons.
7. What journal entries would be recorded for the following transactions on the dissolution of a firm after various assets (other than cash) on the third party liabilities have been transferred to Reliasation account.
- a) Arti took over the Stock worth Rs. 80,000 at Rs. 68,000.
 - b) There was unrecorded Bike of Rs. 40,000 which was taken over By Mr. Karim.
 - c) The firm paid Rs. 40,000 as compensation to employees.
 - d) Sundry creditors amounting to Rs. 36,000 were settled at a discount of 15%.
 - e) Loss on realisation Rs. 42,000 was to be distributed between Arti and Karim in the ratio of 3:4.

Section C

1. Shilpa, Meena and Nanda decided to dissolve their partnership on March 31, 2017. Their profit sharing ratio was 3:2:1 and their Balance Sheet was as under:

Balance Sheet of Shilpa, Meena and Nanda as on March 31, 2017

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capitals:		Land	81,000
Shilpa	80,000	Stock	56,760
Meena	40,000	Debtors	18,600
Bank loan	20,000	Nanda's capital	23,000
Creditors	37,000	Cash	10,840
Provision for doubtful debts	1,200		
General reserve	12,000		
	1,90,200		1,90,200

The stock of value of Rs. 41,660 are taken over by Shilpa for Rs. 35,000 and she agreed to discharge bank loan. The remaining stock was sold at Rs. 14,000 and debtors amounting to Rs. 10,000 realised Rs. 8,000. Land is sold for Rs. 1,10,000. The remaining debtors realised 50% at their book value. Cost of realisation amounted to Rs. 1,200. There was a typewriter not recorded in the books worth Rs. 6,000 which were taken over by one of the Creditors at this value. Prepare Realisation Account.

- 2 Surjit and Rahi were sharing profits (losses) in the ratio of 3:2, their Balance Sheet as on March 31, 2017 is as follows:

Balance Sheet of Surjit and Rahi as on March 31, 2017

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Creditors	38,000	Bank	11,500
Mrs. Surjit loan	10,000	Stock	6,000
Reserve	15,000	Debtors	19,000
Rahi's loan	5,000	Furniture	4,000
Capital's:		Plant	28,000
Surjit	10,000	Investment	10,000
Rahi	8,000	Profit and Loss	7,500
	86,000		86,000

The firm was dissolved on March 31, 2017 on the following terms:

- a) Surjit agreed to take the investments at Rs. 8,000 and to pay Mrs. Surojit's loan.
- b) Other assets were realised as follows:

Stock Rs. 5,000

Debtors Rs. 18,500

Furniture Rs. 4,500

Plant Rs. 25,000

c) Expenses on realisation amounted to Rs. 1,600.

d) Creditors agreed to accept Rs. 37,000 as a final settlement.

You are required to prepare Realisation account, Partner's Capital account and Bank account.

3. Ashu and Harish are partners sharing profit and losses as 3:2. They decided to dissolve the firm on December 31, 2017. Their balance sheet on the above date was:

Balance Sheet of Ashu and Harish as on December 31, 2017

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capitals:		Building	80,000
Ashu 1,08,000		Machinery	70,000
Harish 54,000	1,62,000	Furniture	14,000
Creditors	88,000	Stock	20,000
Bank overdraft	50,000	Investments	60,000
		Debtors	48,000
		Cash in hand	8,000
	<u>3,00,000</u>		<u>3,00,000</u>

Ashu is to take over the building at Rs. 95,000 and Machinery and Furniture is take over by Harish at value of Rs. 80,000. Ashu agreed to pay Creditor and Harish agreed to meet Bank overdraft. Stock and Investments are taken by both partner in profit sharing ratio. Debtors realised for Rs. 46,000, expenses of realisation amounted to Rs. 3,000. Prepare necessary ledger account.

TEXT / REFERENCE BOOKS

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