Partnership: Retirement of a Partner

Introduction

For variety of reasons (such as old age, better business opportunity, differences with the other partners, etc) a partner may retire from the firm.

According to Sec. 32(1) of the Indian Partnership Act, a partner can retire in the following three ways:

(i) with the *consent* of all the other partners (such consent may be expressed or implied);
(ii) in accordance with an *express agreement* by the partners; and
(iii) where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

The retirement of a partner from a partnership results in the legal dissolution of the partnership. A dissolution does not require termination of the business. The retirement of a partner results in a new partnership, although daily operations of the business currently are not affected.

A partner retiring from partnership usually receives cash or other assets from the partnership. The primary accounting issue is the proper measurement of the retiring partner's capital account. For that, at the time of retirement of a partner, certain adjustments are necessary in respect of the following for determining the true claim of the ex-partner:

1. ***Adjustment in regard to Goodwill.***
2. ***Adjustment in regard to Revaluation of Assets and Liabilities.***
3. ***Adjustment in regard to Undistributed Profits.***

1. Adjustment in Regard to Goodwill

A retiring partner is entitled to his share in the goodwill of the firm as per the agreement between the partners; but in the absence of any agreement, it should be in the profit-sharing ratio.

The valuation of the goodwill is done in the agreed manner (methods have already been discussed in the chapter on admission).

In this connection, Para 36 of AS—10 is very important. This para states that 'Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business takenover, the excess should be termed as Goodwill'.

The effects of the above provision of AS—10 in Partnership Accounts are the following :

1. *Only purchased goodwill to be recorded in the books of accounts.*
2. *Non-purchased goodwill (internally generated goodwill) will be adjusted through Partners' Capital Accounts. In, effect this goodwill cannot be shown in the Partnership Balance Sheet.*

Adjustment entries in respect of non-purchased goodwill will depend upon the following situations :

Situation 1 **Goodwill is raised in the books of the firm at full value but it is written-off immediately.**

In this situation, the following entries should be passed:

(i) Goodwill Account	Dr.	[Full value]
To All Partner's Capital Account		[Old ratio]
(Being the goodwill raised in the books on retirement)		
(ii) Continuing Partners' Capital Accounts	Dr.	[New ratio]
To Goodwill Account		
(Being goodwill written-off after retirement)		

Situation 2 **Only the share of retiring partner is brought into books and then written-off.**

In this situation, the following entries should be passed:

(i) Goodwill Account	Dr.	[Share of retiring partner]
To Retiring Partner's Capital Account		
(Being retiring partner's share of goodwill raised in the books)		
(ii) Continuing Partners' Capital Accounts	Dr.	[Gaining ratio]
To Goodwill Account		
(Being the goodwill written-off in the gaining ratio to remaining partners)		

Alternative entry

Continuing Partners' Capital Accounts	Dr.	[Gaining ratio]
To Retiring Partner's Capital Account		[Share of retiring partner]
(Being the goodwill of retired partner adjusted)		

Calculation of gaining ratio

New Profit sharing ratio	***
Less: Old Profit sharing ratio	***

2. Adjustment in Regard to Revaluation of Assets and Liabilities

Unless otherwise agreed, on retirement, a partner is entitled to have the assets and liabilities of a firm revalued on a proper basis at the date of retirement, so that he gets his fair share of the firm's net assets. The purpose of revaluation is to convert the book values of the assets and liabilities into net market values.

Just like admission, here also, a Revaluation Account is prepared to ascertain the profit or loss on revaluation. The profit/loss on revaluation is transferred to All Partners' Capital Accounts in the old profit sharing ratio. After retirement, the assets and liabilities appear in the Balance Sheet at ***revised value.***

The continuing partners may decide ***not*** to show the assets and liabilities in their revised values, i.e., assets and liabilities are to appear in the ***Original Values***. In such a situation, a Memorandum Revaluation Account is prepared. The profit or loss on revaluation is transferred to ***All Partners' Capital Accounts in the old ratio.***

Thereafter, the same amount is put below the line on the reverse side of the Memorandum Account and it is closed by transferring to the Capital Accounts of the ***continuing partners in the new ratio.***

In this connection, Para 30 of AS—10 is also important. This para states that '***An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the profit and loss statement. A decrease in net book value arising on revalutaion of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it may be charged directly to that account***'.

In case of Partnership, revaluation profit or loss is transferred directly to Partners' Capital Accounts. Therefore, an increase in net book value arising on revaluation of fixed assets may be credited to Revaluation Account (in place of Revaluation Reserve Account because it will be utilimately closed by transferring to Partners' Capital Accounts) and loss on revaluation of fixed assets may be debited to Revaluation Account (in place of Profit and Loss Account because it will be ultimately closed by transferreing to Partners' Capital Accounts).

> ***In this chapter or elsewhere the effects of revaluation of fixed assets have been shown through the Revaluation Account (in place of Revaluation Reserve Account / Profit and Loss Account because the effect will be same on Partners' Capital Accounts).***

3. Adjustment in Regard to Undistributed Profit

At the time of retirement, if there is any reserve or credit balance of Profit and Loss Account, it should be distributed amongst all the partners in the old profit-sharing ratio. The entry will be:

Reserve/Profit and Loss Account	Dr.	
To All Partners' Capital Accounts		[Old profit-sharing ratio]
(Being the distribution of profit in the old ratio)		

Conversely, if there is any accumulated loss, it should be treated in the similar way. The entry will be:

All Partners' Capital Accounts	Dr.	[Old profit-sharing ratio]
To Profit and Loss Account		
(Being the distribution of accumulated loss in the old profit-sharing ratio)		

Computation of Retiring Partner's Interest in the Firm

For calculating the amount of money payable to the retiring partner, the following items should be considered:

1. Opening balance of Capital and Current Account of retiring partner.
2. Share of undistributed reserve and profit.
3. Share of revaluation profit or loss.
4. Share of profit till the date of his retirement.
5. Share of firm's goodwill.
6. The salary or/and interest due to the retiring partner till the date of his retirement.
7. The drawing and interest thereon, of the retiring partner.

Mode of Payment of Retiring Partner's Interest

The total amount due to a retiring partner can be paid off in one of the following manner. But what basis should be taken in a particular case, depends upon the partnership deed. If there is no agreement, the partners should decide it mutually.

1. *In one lump sum* This method is suitable when the amount payable to the retiring partner is small. Under this method, the total amount is paid off at a time.

2. *In Instalments* This method is suitable when the amount payable to the retiring partner is substantial. If the firm is unable to pay the total amount due to the partner at the time of his retirement, it must recognise a liability for the remaining portion. Under this method, payment is made in instalments. The number of instalments, the time and amount of each instalment, can all be decided in advance. Generally, the total amount payable to the retiring partner is transferred to his Loan Account . The Loan Account is credited with the agreed rate of interest and it is debited with the instalments paid.

3. *By way of an Annuity* The continuing partners may agree to settle the claim of the retiring partner by paying him a fixed annual sum called an annuity either for a certain term of years or for the life-time of the retiring partner. Under this method, the total amount payable to the retiring partner is transferred to an " Annuity Suspense Account", which must be credited with interest at a fixed rate p.a. on the diminishing balance and debited with the annuity paid. In the event of the retiring partner dying before this amount is exhausted, the balance of the " Annuity Suspense Account" is transferred to the continuing Partners' Capital Accounts in the profit-sharing ratio. If the credit balance of the Annuity Supense Account is exhausted before the death of the retiring partner, subsequent instalment of annuity should be charged to Profit and Loss Appropriation Account. Alternatively, it can be transferred to the Partners' Current Accounts.

Illustration 12

On 31st March, 1995, the Balance Sheet of M/s. A, B and C sharing profits and losses in proportion to their capitals, stood as follows :

Liabilities		Rs	Assets	Rs
Sundry Creditors		1,00,000	Land and Buildings	2,00,000
Capital A/cs :			Machinery	3,00,000
A	2,00,000		Closing Stock	1,00,000
B	3,00,000		Sundry Debtors	1,00,000
C	2,00,000	7,00,000	Cash and Bank Balances	1,00,000
		8,00,000		8,00,000

On 31st March, 1995, A desired to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the Assets and Liabilities on that date on the following basis :

(1) Land and Buildings be appreciated by 30%.
(2) Machinery is to be depreciated by 20%.
(3) Closing Stock is to be valued at Rs 75,000.
(4) Provision for bad debts is to be made at 5%.
(5) Old credit balances of Sundry Creditors Rs 20,000 is to be written-back.
(6) Joint Life Policy of the partners surrendered and cash obtained Rs 80,000.
(7) Goodwill of the entire firm be valued at Rs 1,40,000 and A's share of the Goodwill be adjusted in the accounts of B and C who share the future profits equally. No Goodwill Account being raised.
(8) The capital of the firm is to be the same as before retirement. Individual capital be in their profit sharing ratio.
(9) Amount due to A is to be settled on the following basis : 50% on retirement and the balance 50% within one year.

Prepare Revaluation Account, Capital Accounts of Partners, Cash and Bank Account and Balance Sheet as on 1.4.1995 of M/s. B and C. *[C.A. (Foundation) — May, 1995]*

Solution

In the books of M/s. A, B and C

Revaluation Account

Dr. **Cr.**

Particulars	Rs	Particulars	Rs
To Machinery A/c	60,000	By Land and Buildings A/c	60,000
To Closing Stock A/c	25,000	By Sundry Creditors A/c	20,000
To Provision for Bad Debts A/c	5,000	By Partners' Capital A/cs (A : Rs 2,857; B : Rs 4,286; C : Rs 2,857)	10,000
	90,000		90,000

Cash and Bank Account

Dr. **Cr.**

Particulars	Rs	Particulars	Rs
To Balance b/d	1,00,000	By A Capital A/c	1,30,000
To Joint Life Policy A/c	80,000	By Balance c/d	2,40,000
To B Capital A/c	30,000		
To C Capital A/c	1,60,000		
	3,70,000		3,70,000

Partners' Capital Accounts

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
To Revaluation A/c	2,857	4,286	2,857	By Balance b/d	2,00,000	3,00,000	2,00,000
To A Capital A/c (Goodwill)	—	10,000	30,000	By J.L.P. A/c	22,857	34,286	22,857
To Bank A/c (50% paid-off)	1,30,000	—	—	By B Capital A/c (Goodwill)	10,000	—	—
To A Loan A/c	1,30,000	—	—	By C Capital A/c (Goodwill)	30,000	—	—
To Balance c/d (required)	—	3,50,000	3,50,000	By Bank A/c (Bal. figure)	—	30,000	1,60,000
	2,62,857	3,64,286	3,82,857		2,62,857	3,64,286	3,82,857

Balance Sheet of M/s. B and C as on 1st April, 1995

Liabilities		Rs	Assets		Rs
Partners' Capital A/cs : Rs			Land and Buildings		2,60,000
B	3,50,000		Machinery		2,40,000
C	3,50,000	7,00,000	Closing Stock		75,000
A's Loan Account		1,30,000	Sundry Debtors	1,00,000	
Sundry Creditors		80,000	Less: Provision for Bad Debts	5,000	95,000
			Cash and Bank Balances		2,40,000
		9,10,000			9,10,000

Working Note : **Calculation of Share of Goodwill**

Particulars	A (Rs)	B (Rs)	C (Rs)
Right of Goodwill before retirement (2 : 3 : 2)	40,000	60,000	40,000
Right of Goodwill after retirement (1 : 1)	—	70,000	70,000
Sacrifice (–) / Gain (+)	(–) 40,000	(+) 10,000	(+) 30,000

Illustration 13

Gold, Silver and Diamond are partners in a firm sharing profits and losses in the ratio of 5 : 3 : 2. Gold retires on 1.4.2003 on which date the Balance Sheet of the firm stood as under :

Liabilities		Rs	Assets	Rs
Capital Accounts :			Goodwill	10,000
Gold	80,000		Furniture	30,000
Silver	50,000		Office Equipments	25,000
Diamond	40,000	1,70,000	Building	60,000
General Reserve		20,000	Stock	77,000
Sundry Creditors		90,000	Sundry Debtors	75,000
Bills Payable		15,000	Cash	18,000
		2,95,000		2,95,000

It is provided in the Deed of Partnership that in the event of death or retirement of a partner, goodwill is to be valued at 2 years' purchase of the average profits of the last 4 years. The profits for the last 4 years were : 2002-03 : Rs 30,000; 2001-02 : Rs 24,000; 2000-01 : Rs 20,000; 1999-2000 : Rs 18,000.

Furniture and Building are revalued at Rs 25,000 and Rs 75,000 respectively, stock is overvalued by 10%.

It was decided that Gold should be paid Rs 50,000 immediately on retirement and the balance on his Capital Account is to be treated as a loan to the firm. Silver and Diamond contribute necessary sums in equal proportions for payments to Gold and to leave Rs 20,000 cash as working capital. Assuming, that above mentioned arrangements are given effect to, you are required to show the Revaluation Account, Cash Account and the Capital Accounts of the partners. Also show the Balance Sheet of the firm after Gold's retirement.

Solution

In the books of the Firm

Revaluation Account

Dr. **Cr.**

Particulars	Rs	Particulars	Rs
To Furniture A/c	5,000	By Building A/c	15,000
To Stock A/c (Note 2)	7,000		
To Partners' Capital A/cs :	3,000		
Gold — Rs 1,500; Silver — Rs 900; Diamond — Rs 600			
	15,000		15,000

Dr. **Partners' Capital Accounts** **Cr.**

Particulars	Gold	Silver	Diamond	Particulars	Gold	Silver	Diamond
To Bank A/c	50,000	—	—	By Balance b/d	80,000	50,000	40,000
To Gold Loan A/c	59,500	—	—	By General Reserve A/c	10,000	6,000	4,000
To Balance c/d	—	93,700	77,800	By Goodwill A/c (Note 1)	18,000	10,800	7,200
				By Revaluation A/c	1,500	900	600
				By Cash A/c	—	26,000	26,000
	1,09,500	93,700	77,800		1,09,500	93,700	77,800

Dr. **Cash Account** **Cr.**

Particulars	Rs	Particulars	Rs
To Balance b/d	18,000	By Gold Capital A/c	50,000
To Partners' Capital A/cs (Balancing figure)		By Balance c/d	20,000
Silver — Rs 26,000; Diamond — Rs 26,000	52,000		
	70,000		70,000

Balance Sheet (after Gold's retirement) as on 1st April, 2003

Liabilities		Rs	Assets	Rs
Capital A/cs :			Goodwill	46,000
Silver	93,700		Building	75,000
Diamond	77,800	1,71,500	Office Equipments	25,000
Gold Loan A/c		59,500	Furniture	25,000
Sundry Creditors		90,000	Stock	70,000
Bills Payable		15,000	Sundry Debtors	75,000
			Cash	20,000
		3,36,000		3,36,000

Working Notes : (1) **Calculation of the Value of the Goodwill and its Treatment**

Total profit for the last 4 years Rs (30,000 + 24,000 + 20,000 + 18,000) = Rs 92,000. Average profit (Rs 92,000 ÷ 4) = Rs 23,000. Goodwill is 2 years' purchase of the average profits of the last 4 years, i.e., Rs 23,000 x 2 = Rs 46,000. Goodwill Account has already been raised at Rs 10,000. Therefore, before Gold's retirement, Goodwill Account is to be raised further by Rs 36,000, i.e., Rs (46,000 – 10,000).

(2) Actual Value of Stock = $\frac{\text{Rs } 77{,}000}{110} \times 100$ = Rs 70,000. Therefore, it is overvalued by Rs 77,000 – 70,000 = Rs 7,000.

Illustration 14

A, B, C and D were partners in a firm sharing profits and losses in the ratio of 4 : 3 : 2 : 1. The Balance Sheet of the firm as on 31st December, 2002 is given below :

Liabilities	Rs	Assets	Rs
A's Capital	4,00,000	Land and Building	3,40,000
B's Capital	3,00,000	Plant and Machinery	4,50,000
C's Capital	2,00,000	Furniture and Fittings	1,20,000
D's Capital	1,00,000	Fixed Deposit with Bank	80,000
Reserves	50,000	Stock-in-trade	35,000
Bills Payable	12,000	Sundry Debtors	26,000
Sundry Creditors	8,000	Bills Receivable	10,000
Bank Overdraft	5,000	Cash in Hand	14,000
	10,75,000		10,75,000

On 30th September, 2003, D retired from the firm. The partnership deed of the firm had the following provisions regarding the procedure to be followed in the event of retirement of a partner :

(a) The retiring partner will be entitled to his share of profit in proportion to the number of months he served as a partner in the year of his retirement. The profit of the year immediately preceding the year of his retirement will be taken as the basis for calculating his share of profit.

(b) The retiring partner will be entitled to a share of goodwill on the basis of two years' purchase of the average profit of the three years preceding the year of his retirement. The profits of 2000, 2001 and 2002 were Rs 66,000, Rs 87,000 and Rs 72,000 respectively.

(c) No Goodwill Account will be raised in the books, but the retiring partner's share of goodwill is to be adjusted through the Capital Accounts of the continuing partners.

(d) Reserve, undistributed profit or loss, if any, must be transferred to the Capital Accounts of the partners.

A, B and C decided to share the future profits and losses equally and to maintain a fixed capital of Rs 2,00,000 each, making necessary addition or withdrawal of cash immediately without affecting the bank overdraft balance. The total amount due to D will remain in the business of the firm as loan, earning 10% interest per annum.

Show the Journal Entries and the Capital Accounts of the partners on the basis of the above mentioned conditions which were duly complied with.

Solution

In the books of the Firm
Journal Entry

Date	Particulars		Dr. Rs	Cr. Rs
2003 Sept. 30	Reserves A/c	Dr.	50,000	
	To A Capital A/c			20,000
	To B Capital A/c			15,000
	To C Capital A/c			10,000
	To D Capital A/c			5,000
	(Being the reserves transferred to Partners' Capital Accounts before D's retirement)			
	Profit and Loss Suspense A/c (Note 1)	Dr.	5,400	
	To D Capital A/c			5,400
	(Being D's share of profit transferred to his Capital Account)			

B Capital A/c (Note 2)	Dr.	5,000	
C Capital A/c	Dr.	20,000	
To A Capital A/c			10,000
To D Capital A/c			15,000
(Being the adjustment in regard to Goodwill made through the Partners' Capital Accounts)			
D Capital A/c	Dr.	1,25,400	
To 10% D Loan A/c			1,25,400
(Being D's capital transferred to D's Loan Account)			
Cash A/c	Dr.	10,000	
To C Capital A/c			10,000
(Being the amount of capital brought in by C to make his capital equal to Rs 2,00,000)			
A Capital A/c	Dr.	2,30,000	
B Capital A/c	Dr.	1,10,000	
To Cash A/c			3,40,000
(Being excess money withdrawn by the partners to make their capitals equal to Rs 2,00,000)			

Dr. **Partners' Capital Accounts** **Cr.**

Particulars	A	B	C	D	Particulars	A	B	C	D
To A & D Capital A/c	—	5,000	20,000	—	By Balance b/d	4,00,000	3,00,000	2,00,000	1,00,000
To 10% D Loan A/c	—	—	—	1,25,400	By Reserves A/c	20,000	15,000	10,000	5,000
To Cash A/c (Note 3)	2,30,000	1,10,000	—	—	By P & L Suspense A/c	—	—	—	5,400
To Balance c/d	2,00,000	2,00,000	2,00,000	—	By B & C Capital A/c	10,000	—	—	15,000
					By Cash A/c	—	—	10,000	
	4,30,000	3,15,000	2,20,000	1,25,400		4,30,000	3,15,000	2,20,000	1,25,400

Working Notes :

(1) Profit for the year 2002 is Rs 72,000. Profit for 9 months will be Rs 72,000 ÷ 12 x 9 = Rs 54,000. D will get 1/10 of Rs 54,000, i.e., Rs 5,400.

(2) Valuation of Goodwill

$$\text{Average profit of last three years} = \frac{(\text{Rs } 66{,}000 + 87{,}000 + 72{,}000)}{3} = \text{Rs } 75{,}000$$

Goodwill = Rs 75,000 x 2 = Rs 1,50,000.

Adjustment for Goodwill

Particulars	A (Rs)	B (Rs)	C (Rs)	D (Rs)
Right of Goodwill before D's retirement (4 : 3 : 2 : 1)	60,000	45,000	30,000	15,000
Right of Goodwill after D's retirement (1 : 1 : 1)	50,000	50,000	50,000	—
Sacrifice (–) / Gain (+)	(–) 10,000	(+) 5,000	(+) 20,000	(–) 15,000

(3) It is assumed that on the date of retirement, i.e., 30th September, 2003 the firm has sufficient cash balance to pay off the excess capital of A and B, though the last Balance Sheet as on 31st December, 2002 does not show sufficient cash.

Illustration 15

X and Y are partners sharing profits equally. It has been agreed that if a partner retires, the other partner, if he desires to carry on the business, shall pay to the retiring partner his share by four equal half yearly instalments, plus interest @ 5% p.a. with half-yearly rests. Goodwill is to be valued on the basis of five years capitalization of the average annual super profits of 3 preceding financial years, fixed assets being revalued for the purpose. The Balance Sheet of the firm as 31.12.2001 is as follows:

Liabilities	Rs	Assets	Rs
Creditors	9,160	Cash in hand	13,000
Capital — X	22,420	Book debts	10,200
Capital — Y	16,650	Closing stock	5,730
		Building	19,300
	48,230		48,230

Y retires on 1.1.2002 and X decides to carry on the business. The profits for the three years ended on 31.12.2002 were Rs 13,500 ; Rs 14,500; and Rs 14,000.

For the purpose of dissolution, building has been revalued at Rs 24,800. No interest on capital was charged and partners did not draw any salary.

Show the computation of goodwill; prepare Y's Loan Account. Assume that normal managerial remuneration is Rs 6,000 p.a. and normal return on capital is 12%.

Solution

In the books of X
Y Loan Account

Dr. | **Cr.**

Date	Particulars	Rs	Date	Particulars	Rs
30.6.2002	To Bank A/c (Rs 6,507.50 + Rs 650.75)	7,158.25	1.1.2002	By Y Capital A/c (See Note)	26,030.00
31.12.2002	To Bank A/c (Rs 6,507.50 + Rs 488.06)	6,995.56	30.6.2002	By Interest A/c (For 6 months)	650.75
31.12.2002	To Balance c/d	13,015.00	31.12.2002	By Interest A/c (for 6 months on Rs 19,522.50)	488.06
		27,168.81			27,168.81
30.6.2003	To Bank A/c (Rs 6,507.50 + Rs 325.38)	6,832.88	1.1.2003	By Balance b/d	19,522.50
31.12.2003	To Bank A/c (Rs 6,507.50 + Rs 162.69)	6,670.19	30.6.2003	By Interest A/c (for 6 months on Rs 13,0775)	325.38
			31.12.2003	By Interest A/c (for 6 months on Rs 6,507.50)	162.69
		13,503.07			13,503.07

Working Note :

Capital Employed		Rs	Average Annual Super Profit	Rs	Amount due to Y	Rs
Assets :			**Average Profit :**		**Capital :**	16,650
Cash	13,000		(13,500 + 14,500 + 14,000)/3	14,000	Share of Revaluation profit	
Book Debt	10,200		Less: Managerial Remuneration	6,000	(1/2 of Rs 5,500)	2,750
Closing Stock	5,730			8,000	Share of goodwill	
Building	24,800	53,730	Less: Normal rate of return @ 12%	5,348	(1/2 of Rs 13,260)	6,630
Liabilities : Creditors		9,160	Super profit	2,652		26,030
		44,570	Value of goodwill Rs 2,652 x 5 =	13,260		