

RETIREMENT & DEATH OF A PARTNER

RETIREMENT

Retirement of a partner means the withdrawal of a partner himself from the business for various reasons such as old age, lack of interest in business etc. A partner can retire from the business either as per the terms of agreement or voluntarily, on retirement he is entitled to get all the sums due to him up to the date of retirement, as well as he is liable for his share in all losses till the date of his retirement.

Accounting Aspects on Retirement

1. Change in Profit sharing ratio.
2. Calculation of gaining ratio.
3. Adjustment regarding goodwill.
4. Adjustment of reserves and accumulated profits/losses.
5. Revaluation of assets and liabilities.
6. Ascertainment of profit or loss up to the date of retirement.
7. Calculation of total amount due to the retiring partner.
8. Settlement of total amount due to the retiring partner.
9. Adjustment of capitals of continuing partner.

Change in Profit Sharing Ratio

While retiring a partner the profit sharing ratio of the existing partners may be revised. The share of outgoing partner is often acquired by the existing partners in their profit sharing ratio itself, unless otherwise agreed upon ie; the profit sharing ratio among the remaining partners will not change. Suppose, A,B & C share profits in the ratio of 3 : 2 : 1 and B retires, the ratio between A and C will be 3 : 1, whereas if they decide to be equal partners, the new ratio will be 1 : 1.

Gaining Ratio

The ratio in which the continuing partners share the profit of outgoing partner is called gaining ratio.

$$\begin{aligned} \text{GAINING RATIO} &= \text{NEW RATIO} - \text{OLD RATIO} \\ \therefore \text{GAINING SHARE} &= \text{NEW SHARE} - \text{OLD SHARE} \end{aligned}$$

Treatment of goodwill

A partner who is retiring from the firm is entitled to his share of goodwill, as it is created by the firm with the efforts of all the partners including the retiring partner. The accounting treatment for goodwill in such a situation depends upon whether goodwill already appears in the books or not.

a) **When Goodwill does not appear in the books** – In this case there are four ways:

- i) **Goodwill is raised at its full value and retained in the books:** Here Goodwill A/c is debited with its full value and all partners' capital Accounts are credited in their old ratio. The full value of Goodwill appears in the balance of the reconstituted firm.

Example: A, B and C are partners in the ratio of 3:2:1 and B retires. The goodwill of the firm is valued at Rs. 60000 and remaining partners A and C continue to share profits in 3:1.

Goodwill A/c	Dr	60000	
	To A's Capital A/c		30000
	To B's Capital A/c		20000
	To C's Capital A/c		10000
(Goodwill is raised at its full value in old ratio)			

- ii) **Goodwill raised at its full value and written off immediately:** The partners have decided that the goodwill is not to be shown in the books after reconstitution. Based on the above example, the journal entries are as follows:

Goodwill A/c	Dr	60000	
	To A's Capital A/c	30000	
	To B's Capital A/c	20000	
	To C's Capital A/c	10000	
(Goodwill is raised at its full value in old ratio)			

A's Capital A/c	Dr	45000	
C's Capital A/c	Dr	15000	
	To Goodwill A/c		60000
(Goodwill written off in new ratio)			

- iii) **The Goodwill is raised to the extent of retired / diseased partner's share and written off immediately:** In the above example, B's share of goodwill is Rs. 20000

Goodwill A/c	Dr	20000	
	To B's Capital A/c	20000	
(Goodwill is raised to the extent of B's share)			

A's Capital A/c	Dr	15000	
C's Capital A/c	Dr	5000	
	To Goodwill A/c	20000	
(Goodwill written off in their gaining ratio 3:1)			

- iv) **No Goodwill account is raised in the books of accounts:** If it is decided that the goodwill account should not appear in the books, it is adjusted through partners' capital accounts.

Since, the outgoing partner's share of profit is acquired by the continuing partners; they have to compensate the retiring partner in their gaining ratio as follows:

Continuing Partners' Capital A/c	Dr
To Retiring partner's Capital Account	
(Share of goodwill of the retiring/diseased partner adjusted to the continuing partners in their gaining ratio)	

In the above example, it will be:

A's Capital A/c	Dr	15000	
C's Capital A/c	Dr	5000	
To B's Capital A/c			20000
(B's share of Goodwill adjusted to remaining partners' capital accounts in their gaining ratio 3:1)			

In case, if any of the continuing partners sacrifice some share in profits on retirement, his capital account will also be credited along with the retiring partner's capital account.

Journal Entry:

Gaining Partner's Capital Account	Dr	
To Retiring Partner's Capital Account		
To Sacrificing Partner's Capital Account		

(Both the retiring partner's sacrifice and the continuing partner's sacrifice are compensated by the gaining partner)

e.g: 1. A,B and C are partners sharing profits in the ratio of 3:2:1. C retires from the firm and the new ratio agreed between A and B is 1:1 . Show the accounting treatments of goodwill on the assumption that the total amount of goodwill of the firm is Rs.6000/-

C's share of goodwill = $6000 \times \frac{1}{6} = 1000$

A's gain = NR – OR = 0

B's gains = $\frac{1}{6}$

B's Capital A/c	Dr	1000	
To C's Capital A/c			1000

b) **When Goodwill is already Appearing in the Books** – There are three situations:

- If value of Goodwill appearing in the books of the firm equals with the current value of goodwill: No adjustment is required in this case.
- If the book value of goodwill is lower than its current value: In this the goodwill is raised to its present value by debiting difference amount to goodwill account and crediting all partners' capital accounts in their old ratio.

Example: X, Y and Z are partners in the ratio of 5:3:2. Goodwill appears in the books at a value of Rs. 20000. Y retires and the goodwill is valued at Rs.24000.

Goodwill A/c	Dr	4000	
To X's Capital A/c			2000
To Y's Capital A/c			1200
To Z's Capital A/c			800
(Increase in the value of goodwill credited to all partners capital accounts in their old ratio)			

- iii) If the book value of goodwill is higher than its current value: Here the difference amount is credited to goodwill account and debited to all partners' capital accounts in their old ratio.

Example: X, Y and Z are partners in the ratio of 5:3:2. Goodwill appears in the books at a value of Rs. 24000. Y retires and the goodwill is valued at Rs.20000.

X's Capital A/c	Dr	2000	
Y's Capital A/c	Dr	1200	
Z's Capital A/c	Dr	800	
			To Goodwill A/c
			4000
(Decrease in the value of goodwill debited to all partners capital accounts in their old ratio)			

Hidden Goodwill

In case a firm may agree to settle the retiring partner by making a lump sum payment which is more than what is due to him. Then the excess paid shall be treated as his share of goodwill, which is called hidden goodwill.

Revaluation of Assets and Liabilities

Assets and Liabilities are to be revalued at the time of retirement as in the case of admission of a partner. It is to be done, in order to find out the appropriate share of retiring partner in the firm. It can be done through a revaluation account or profit and loss adjustment account and the profit or loss on revaluation is transferred to all the partners' capital accounts in their old ratio.

Accounting treatment – similar to admission of a partner

Adjustment of Accumulated Profits / Losses

General reserve, profit and loss account credit balance and unused reserves like workmen's compensation fund (in liability side) should be transferred to all partner's capital accounts in their old ratio. Accounting treatment:

General Reserve A/c	Dr
Workmen's compensation fund A/c	Dr
Profit and Loss A/c	Dr
	To Partners' capital account (individually)

Disposal of amount due to the retiring partner

1. **Lump Sum Payment:** The total amount due to the retiring partner shown by his capital account may be paid in full at the time of retirement, the entry will be:

Retiring partner's capital account Dr
 To Cash / Bank

2. **Payment in Installments:** If the firm is not in a position to pay off the entire amount in lump sum, the amount due to him is transferred to his loan account and it will be paid in installments along with the interest as per the agreement.

Entry:

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

Note: This loan amount will be shown on the liability side of the balance after retirement.

As per section 37 of the Indian Partnership Act, the outgoing partner can claim proportionate share in the profit earned on the amount due to him from the date of his retirement to the date of final payment or interest @ 6% per annum at his option.

Each installment consists of Principal amount and Interest at an agreed rate. Interest due on loan is credited to loan account and installments (principal amount plus interest) are paid at agreed intervals.

Journal entries:

- a. For interest due on loan
 Interest on loan A/c Dr
 Retired partner's loan A/c
- b. For payment of installments:
 Retired partner's loan A/c Dr
 To Cash/Bank A/c (Principal amount + interest)
- c. For closing interest on loan at the end of financial period
 Profit and Loss A/c Dr
 To Interest on loan A/c

Note: 1. The above entries are repeated until the loan account is closed.
2. Interest on loan is calculated on the outstanding amount of loan.

3. **Part payment and balance in installments:** In this case, a part payment is made to the retiring partner and the balance amount in the capital account is transferred to retiring partner's loan account.

Entry:

Retiring partner's capital A/c Dr (Total amount due)
 To Bank A/c / Cash A/c (Part payment made)
 To Retiring partner's loan A/c (Balance amount as loan)

Adjustment of capitals of continuing partners

In certain cases, after the retirement of a partner, the remaining partners may decide to adjust their capitals in proportion to their new profit sharing ratio as follows:

Steps:

- a. Fix an amount as capital of the new firm or find out the existing capital balance after making all adjustments. This is called adjusted capital.
- b. Add the adjusted capitals of continuing partners. This will become the total capital of the firm.
- c. Ascertain share of capital of continuing partner in the total capital in proportion to their new ratio by the following equation:

$$\text{Total capital required} \times \text{New profit sharing ratio of each partner}$$

- d. If the existing capital balance of any partner after all adjustments is more than that of the new capital, he can withdraw the surplus or it may be transferred to the current account. Whereas if there is any deficiency, it should be brought in or adjusted from his current account.

In case of excess capital:

Entry:

Partner's capital account	Dr
To Cash / Current Account	

In case, if the existing capital is less than the new capital, he is required to bring the necessary amount to make good the deficit.

Entry:

Cash / Current Account	Dr
To Partner's Capital Account	

DEATH OF A PARTNER

A partnership will come to an end as soon as a partner dies, although the firm may continue with the remaining partners. The accounting treatments for various adjustments in case of death of a partner are similar to that of a retiring partner. However there are some differences between retirement and death.

1. Retirement is planned and which usually takes place at the end of the accounting period. Death may take place at any time.
2. Partner's connection with the firm is voluntarily broken in the case of retirement. It is automatic in the case of death.
3. Amount payable to the retiring partner is transferred to his loan account. But in case of death it is transferred to the Executor's account.

The amount due to the deceased partner is calculated in the same manner as in the case of retirement and the payment of deceased partner's share in the firm will be received by his legal representatives. Most of the accounting treatments are similar to that of retirement.

Whenever a firm is not in a position to make the full payment immediately in cash, amount due to the deceased partner is transferred to his Executor's Loan Account.

Entry:

Deceased partner's capital a/c Dr
 To Deceased partners' Executor's loan a/c

If the amount due to the deceased partner is paid in full:

Entry:

Deceased Partner's Capital A/c Dr
 To Cash A/c

Vist: HssVoice Blog for latest updates

www.hssplustwo.blogspot.com