13. PARTNERSHIP ACCOUNTS

ACCOUNTING FOR PARTNERSHIP FIRMS

1. BASICS OF PARTNERSHIP

Meaning:

Agreement between persons, who have agreed to share the profits or losses of the business carried on by all or any of them acting for all.

Relevant Law:

The Partnership Act, 1932.

Partnership Deed:

A registered agreement between the partners explaining the terms and conditions of their partnership including those relating to sharing profits, Remuneration, Interest on Capital, Interest on drawings etc.

Absence of above terms:

In the **absence of agreement** among the partners,

Interest on Partners' Capital, Interest on Partners' drawings, Partners' Remuneration	Shall Not be charged / allowed
Profits / Losses Sharing Ratio	Equal
Interest on Partners' Loan	6% p.a. (maximum)

2. TYPES OF CAPITAL

Fixed Capital – All transactions affecting Capital A/c relating to additional capital introduced, drawings, Interest on capital / drawings, remuneration, commission etc. are not recorded Capital Account but are recorded in a separate A/c called "Current A/c". Hence, the capital account balance does not change.

Fluctuating Capital – All the above transactions are directly recorded in the Capital Account and hence capital account balance will change from one year to another.

3. CALCULATION OF INTEREST ON CAPITAL / DRAWINGS

Interest on Capital =Capital × Interest × No. of months / days from date of introduction till year end ÷ 12 or 365

(However, maximum interest on capital is restricted to the amount of profits available)

- In case of fixed capital accounts, interest is calculated on the balance of capital accounts only and no interest is payable / chargeable on the balance of current accounts.

- ***Net loss and interest on capital:*** *Subject to contract between the partners, interest on capital is to be provided out of profits only. Thus, in case of loss, no interest on capital is to be provided. But in case of insufficient profit (i.e. net profit less than the amount of interest on capital) the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.*

Calculation of Interest on Drawings = Total Drawings × Interest Rate × Multiplication Factor

Fixed Amount is drawn:

Time of drawings	Multiplication Factor	Time of drawings	Multiplication factor
Beginning of every month	6.5 / 12	Beginning of each quarter	7.5 / 12
Middle of every month	6/12	Middle of each quarter	6 / 12
End of every month	5.5/12	End of each quarter	4.5 / 12

Note: Where the date of drawings not given, multiplication factor will be 6 / 12

Variable amount is drawn at various dates:

Step 1	Determine the no. of months / days between date of drawings and Date of year end
Step 2	Compute interest of **EACH DRAWINGS** separately using the formula: Drawings × Interest Rate × Step 1 ÷ 12 or 365

4. GUARANTEEING PROFITS FOR A PARTICULAR PARTNER

- Any of the partners may be guaranteed a minimum share of profits by all or some of the remaining partners.
- **In case his share of Profits < Guaranteed profits = Shortfall to be paid by the remaining partners or the agreed partners in their profits sharing ratio / any other agreed ratio.**

5. SALARY OR COMMISSION TO PARTNER

Salary or commission to a partner is to be allowed if the partnership agreement provides

Calculation of commission is allowed as

Net profit before charging such	Net profit after charging such
Net Profit before commission X Rate of commission / 100	**Net Profit before commission X Rate of commission / 100 + Rate**

6. GOODWILL

Nature: Goodwill is an intangible asset.

Two types: (a) Purchased Goodwill (Actually bought) (b) Self Generated Goodwill (created by own efforts). As per AS 26, self generated goodwill cannot be recognized.

Methods for valuation of goodwill:

1. Simple Average Method :

If there is no clear increasing or decreasing trend of profits, it is better to go by simple Average method.

Practical steps involved under Average Profits Method

Step 1	Calculate past profit for each of the relevant years (given) by adding abnormal losses and by deducting abnormal gains and income from Non-trade investments.
Step 2	Calculate Total profits by adding each relevant year's past profit
Step 3	Calculate Average Profits as under: Average profit = Total profit/No. of relevant years
Step 4	Calculate Average Future Maintainable profits after making future adjustment (if any)
Step 5	Calculate Goodwill as under: Goodwill = Average Future Maintainable Profits x No. of Year, purchase.

2. Weighted Average Method:

If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlieryears.

Practical steps involved under Weighted Average Profits Method

Step 1	Calculate profits for each of the given years.
Step 2	Select the weights to be assigned
Step 3	Calculate the weighted profit for each of the years by multiplying the simple profits by the respective weight.
Step 4	Calculate the total of weights and total of weighted profits
Step 5	Calculate Weighted Average Profits as follows: Weighted Average Profits = Total of Weighted Profits/ Total of Weights
Step 6	Calculate the value of Goodwill as under: Goodwill = Weighted Average Profit X Agreed Number of Year's purchase.

Super Profit Basis

2. **The various steps involved in valuing the Goodwill according to Super Profits method are given below:**

Step 1	Calculate Average Capital Employed as follows: = (Opening Capital Employed + Closing Capital Employed)/2 **Note:** Capital Employed = All assets (other than goodwill, fictitious assets and non-trade investments) less Outsiders Liabilities
Step 2	Calculate Normal Profits as follows: Normal Profit = Average Capital Employed X Normal Rate of Return **Note:** Normal Rate of Return refers to the rate of return normally earned by an average firm belonging to the sameindustry
Step 3	Calculate Average Future Maintainable Profits (according to steps given under AverageProfits Method)
Step 4	Calculate Super Profits as follows: Super Profits = Average Future Maintainable Profits- Normal Profits.
Step 5	Calculate Goodwill as follows: Goodwill = Super Profits X No of years purchase.

Annuity Method :

Under this method, time value of money is considered.

Step 1	Calculate the Future Super Profit
Step 2	Select the appropriate Rate of Interest/Discount
Step 3	Calculate the Present Value Factors for different years as follows: P.V Factor for 1st year $= \frac{1}{(1+r)1}$ P.V Factor for 2nd year $= \frac{1}{(1+r)2}$ and so on
Step 4	Calculate present value of Super Profits of each year by multiplying the amount offuture super profit with the present value factor.
Step 5	Calculate the value of goodwill by taking the aggregate of present values of superprofits calculated as per step 4

Capitalisation Basis :

The goodwill under this method is ascertained by deducting the actual capital employed

Step 1	Calculate Average Profits (according to steps given under Average Profits Method)
Step 2	Calculate the normal value of business: Normal value of business= $\frac{\text{Average Profits}}{\text{Normal Rate ofReturn}}$
Step 3	Calculate the Capital Employed (Value of Net Assets)as on the date of valuation of goodwill as under: Capital Employed = All assets (other than goodwill, fictitious assets and non-trade investments) at their current values less outsiders ' Liabilities.
Step 4	Calculate Goodwill as under: Goodwill = Normal value of business – Capital Employed

7. TREATMENT OF ADMISSION / RETIREMENT / DEATH OF A PARTNER

Step 1	Determination of New Profit Ratio after admission / retirement / death
Step 2	**For Admission:** Determination of Sacrifice Ratio for old partners (Old Ratio – New Ratio) **For Retirement / death:** Determination of Gaining Ratio for the Existing Partners (New Ratio – Old Ratio)
Step 3	Determination of Goodwill and sharing of goodwill
Step 4	Revaluation of assets and liabilities and distribution of profits / losses on such revaluation.
Step 5	Transfer of reserves and losses to Capital Accounts of the partners
Step 6	Determination of capital of all the partners after admission Settlement to the retired / dead partners' executors of the amount due to him.

8. TREATMENT OF GOODWILL IN CASE OF ADMISSION / RETIREMENT / DEATH

- **Generation of Goodwill and Writing Off:** Create goodwill in old ratio and write off in new ratio.
- **Adjustment of Goodwill among the partners** – Adjust directly in the Partners' Capital Accounts by debiting the partners who gain profit share and crediting the partners whose lose profit share.

9. REVALUATION OF ASSETS AND LIABILITIES

- ***Increase in Assets or Decrease in Liabilities***
  Assets A/c or Liabilities A/c Dr.
  Revaluation A/c

- ***Decrease in Assets or Increase in Liabilities:***
  Revaluation A/c Dr.
  Assets A/c or Liabilities A/c

- Balance in Revaluation A/c is transferred to OLD Partners Capital A/c (in case of admission) / ALL Partners' Capital A/cs (in case of retirement / death) in Old Profit Sharing Ratio.
- Credit Balance in Revaluation A/c – Profits; Debit Balance in Revaluation A/c – Losses
- Revaluation A/c is in the nature of Nominal Account.

10. NON-PAYMENT OF MONEY DUE TO THE EXECUTORS OF THE DEAD PARTNER:

(a) **Option I:** Interest at 6% p.a. on the balance due to the dead partner.

(b) **Option II:** Proportionate share in the profits earned by the business for the remaining part of the year:

$$\frac{\text{Profits} \times \text{Amount due to the outgoing partner} \times \text{No. of days / months outstanding} \div 12 \text{ or } 365}{(\text{Capitals of existing partner} + \text{Amount due to outgoing partner})}$$

The amount payable to the retiring partner on account of his share of capital, goodwill, revaluation, joint life policy, reserves, accumulated profits and losses etc is settled as per agreement among the parties involved. According to section 37 of the partnership Act, in case of any delay in final settlement, the retiring partner may claim either interest @ 6% p.a. or proportionate share of profits earned on the basis of his share in the capital employed during the period of delay.

11. JOINT LIFE POLICY ACCOUNT (JLP)

Meaning	Life Insurance Policy taken on all the partners together.
Accounting Method I	• JLP premium is treated as expenditure and written off in P&L A/c • At the time of maturity, entire JLP proceed shared among all the partners in the Profit Sharing Ratio (PSR).
Accounting Method II	• JLP Premium is treated as asset to the extent of **surrender value.** • Balance Premium transferred to the Profit & Loss A/c • Surrender Value means "value realized from policy if it is surrendered now"

	• At the time of maturity, the difference between the surrender value and the maturity proceeds transferred to Partners' Capital in PSR.
Accounting Method III	• JLP Premium treated as asset FULLY. • JLP Reserve is created for the entire premium paid by debiting to the P&L Account. • The amount of [JLP premium – Surrender Value] is transferred from the JLP reserve A/c to the JLP A/c.

Class Work

1. Calculation of goodwill

J and K are partners in a firm. Their capital are J ₹ 3,00,000 and K ₹ 2,00,000. During the year ended 31st March, 2017 the firm earned a profit of ₹ 1,50,000. Assuming that the nor malrate of return is 20%, calculate the value of goodwill on the firm: (RTP May 2018)

By Capitalization Method; and

By Super Profit Method if the goodwill is valued at 2 years' purchase of Super Profit.

(RTP May 2018)

Solution

(i) Capitalisation Method:

Total Capitalised Value of the firm

$$= \frac{Average\ Profit\ X\ 100}{Normal\ Rate\ of\ Return} = \frac{Rs.1,50,000 X\ 100}{20} = Rs. 7,50,000$$

Goodwill = Total Capitalised Value of Business – Capital Employed

= ₹ 7,50,000 - ₹ 5,00,000 [i.e. ₹ 3,00,000 (J) + ₹ 2,00,000 (K)]

Goodwill = ₹ 2,50,000

(ii) Super Profit Method:

Normal Profit = Capital Employed X 20/100 = ₹ 1,00,000

Average Profit = ₹ 1,50,000

Super Profit = Average Profit – Normal Profit

= ₹ 1,50,000 - ₹ 1,00,000 = ₹ 50,000

Goodwill = Super Profit X Number of years purchase

= ₹ 50,000X 2= ₹ 1,00,000

2. Vasudevan, Sunderarajan and Agrawal are in partnership sharing profit and losses at the ratio of 2:5:3. The Balance Sheet of the partnership as on 31.12.2017 was as follows:

(RTP Nov 2018)

Balance Sheet of M/s Vasudevan, Sunderarajan & Agrawal

Liabilities	**₹**	**Assets**	**₹**
Capital A/cs		Sundry fixed assets	5,00,000
Vasudevan	85,000	Inventory	1,00,000
Sunderarajan	3,15,000	Trade receivables	50,000
Agrawal	2,25,000	Bank	5,000
Trade payables	30,000		
	6,55,000		**6,55,000**

The partnership earned profit ₹ 2,00,000 in 2017 and the partners withdrew ₹ 1,50,000 during the year. Normal rate of return 30%.

You are required to calculate the value of goodwill on the basis of 5 years' purchase of super profit. For this purpose calculate super profit using average capital employed.

Solution

Sr.	Valuation of Goodwill:	₹
(1)	Average Capital Employed	
	Total Assets less Trade payables as on 31.12.2017	6,25,000
	Add: 1/2 of the amount withdrawn by partners	75,000
		7,00,000
	Less: 1/2 of the profit earned in 2017	1,00,000
		6,00,000
(2)	Super Profit :	
	Profit of M/s Vasudevan, Sunderarajan & Agrawal	2,00,000
	Normal profit @ 30% on ₹ 6,00,000	1,80,000
	Super Profit	20,000
(3)	Value of Goodwill	
	5 Years Purchase of Super profit (₹ 20,000 × 5) = ₹ 1,00,000	

3. Dinesh, Ramesh and Naresh are partners in a firm sharing profits and losses in the ratio of 3 : 2 : 1. Their Balance Sheet as on 31st March, 2018 is as below :

Liabilities	₹	**Assets**	₹
Trade Payables	22,500	Land & Building	37,000
Outstanding Liabilities	2200	Furniture & Fixtures	7200
General Reserve	7800	Closing Stock	12,600
Capital Accounts		Trade Receivables	10,700
Dinesh 15,000		Cash in hand	2800
Ramesh 15,000		Cash at bank	2200
Naresh 10,000	40,000		

	72,500		72,500

The partners have agreed to take Suresh as a partner with effect from 1st April, 2018 on the following terms :

(i) Suresh shall bring ₹ 8,000 towards his capital.

(ii) The value of stock to be increased to ₹ 14,000 and Furniture & Fixtures to be depreciated by 10%.

(iii) Reserve for bad and doubtful debts should be provided at 5% of the Trade Receivables.

(iv) The value of Land & Buildings to be increased by ₹ 5,600 and the value of the goodwill be fixed at ₹ 18,000.

(v) The new profit sharing ratio shall be divided equally among the partners.

The outstanding liabilities include ₹ 700 due to Ram which has been paid by Dinesh. Necessary entries were not made in the books.

Prepare (i) Revaluation Account, (ii) Capital Accounts of the partners,

(iii) Balance Sheet of the firm after admission of Suresh.

(QP Nov 18)

Solution:

(a) **Revaluation Account**

2018			₹	2018		₹
April 1	To Provision for bad and doubtful debts		535	April 1	By Inventory in trade	1,400
	To Furniture and fittings		720		By Land and Building	5,600
	To Capital A/cs: (Profit on revaluation transferred)					
	Dinesh	2,872.50				
	Ramesh	1,915.00				
	Naresh	957.50	5,745			
			7,000			7,000

Partners' Capital Accounts

Particulars	Dinesh ₹	Ramesh ₹	Naresh ₹	Suresh ₹	Particulars	Dinesh ₹	Ramesh ₹	Naresh ₹	Suresh ₹
To Dinesh & Ramesh			1,500	4,500	By Balance b/d	15,000	15,000	10,000	–
					By General Reserve	3,900	2,600	1,300	
To Balance c/d	26,972.50	21,015	10,757.50	3,500	By Cash	–	–	–	8,000
					By Naresh & Suresh	4,500	1,500	–	–

					By Outstanding Liabilities (Ram)	700	–	–	
					By Revaluation A/c	2,872.50	1,915	957.50	-
	26,972.5	21,015	12,257.50	8,000		26,972.50	21,015	12,257.50	8,000

Working Note:

Calculation of sacrificing ratio

Partners	New share	Old share	Sacrifice	Gain
Dinesh	¼	3/6	6/24	
Ramesh	¼	2/6	2/24	
Naresh	¼	1/6		2/24
Suresh	¼			6/24

Entry for goodwill adjustment

Naresh (2/24 of ₹18,000)	Dr.		1,500	
Suresh (6/24 of ₹18,000)	Dr.		4,500	
To Dinesh (6/24 od ₹18,000)				4,500
To Ramesh (2/24 of ₹18,000)				1,500

Balance Sheet of M/s. Dinesh, Ramesh, Naresh and Suresh as on 1-4-2018

Liabilities	₹	₹	Assets	₹	₹
Trade payables		22,500	Land and Buildings		42,600
Outstanding Liabilities (2,200-700)		1,500	Furniture		6,480
Capital Accounts of Partners :			Inventory of goods		14,000
Mr. Dinesh	26,972.50		Trade receivables	10,700	
Mr. Ramesh	21,015.00		Less: Provisions	(535)	10,165
Mr. Naresh	10,757.50		Cash in hand		2,800
Mr. Suresh	3,500.00	62,245	Cash at Bank (2,200+8,000)		10,200
		86,245			86,245

Death of Partner

4. The following is the Balance Sheet of M/s. LMN Bros as at 31st December, 2017, they share profit equally:

Balance Sheet as at 31st December, 2017

Liabilities		₹	Assets		₹
Capital	L	8,200	Machinery		10,000
	M	8,200	Furniture		5,600
	N	9,000	Fixture		4,200
General Reserve		3,000	Cash		3,000
Trade payables		4,700	Inventories		1,900
			Trade receivables	9,000	

			Less: Provision for Doubtful debts	600	8,400
		33,100			33,100

N died on 3rd January, 2018 and the following agreement was to be put into effect.

(a) Assets were to be revalued: Machinery to ₹ 11,700; Furniture to ₹ 4,600; Inventory to ₹ 1,500.

(b) Goodwill was valued at ₹ 6,000 and was to be credited with his share, without using a Goodwill Account.

(c) ₹ 2,000 was to be paid away to the executors of the dead partner on 5th January, 2018.

(d) After death of N, L and M share profit equally. You are required to prepare:

(i) Journal Entry for Goodwill adjustment.

(ii) Revaluation Account and Capital Accounts of the partners.

Solution:

Journal Entry in the books of the M/s LMN

Date	Particulars		Dr. ₹	Cr. ₹
Jan 3 2018	L's Capital A/c	Dr.	1,000	
	M's Capital A/c	Dr.	1,000	
	To N's Capital A/c			2,000
	(Being the required adjustment for goodwill through partner's capital accounts)			

Revaluation Account

Dr. Particulars	₹	Particulars	Cr. ₹
To Furniture A/c (₹ 5,600 – 4,600)	1,000	By Machinery A/c (₹ 11,700 - 10,000)	1,700
To Inventory A/c (₹ 1,900 – 1,500)	400		
To Partners' Capital A/cs (L - ₹ 100, M - ₹ 100, N - ₹ 100)	300		
	1,700		1,700

Partners' Capital Accounts

	L	M	N		L	M	N
To N (Goodwill)	1,000	1,000	-	By Balance b/d	8,200	8,200	9,000
To Cash A/c	-	-	2,000	By General Reserve A/c	1,000	1,000	1,000
To Executors A/c	-	-	10,100	By Revaluation A/c (Profit)	100	100	100
To Balance C/d	8,300	8,300	-	By L (Goodwill)	-	-	1000
				By M (Goodwill)	-	-	1000
	9,300	9,300	12,100		9,300	9,300	12,100

Working Note:

Statement showing the Required Adjustment for Goodwill

Particulars	L	M	N
Right of goodwill before death	1/3	1/3	1/3
Right of goodwill after death	1/2	1/2	-
Gain / (Sacrifice)	(+) 1/6	(+) 1/6	(-) 1/3