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Allama Iqbal Open University, Islamabad

(Department of Commerce)

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Assignment No. 2 (Units: 5–9)

Total Marks: 100 | Pass Marks: 40

SOLVED ASSIGNMENT GUIDE — For Study & Reference

Note: This guide is for study and reference only. Students should understand each working and write the assignment in their own words and in their own handwriting / presentation, following AIOU instructions. All questions are compulsory and carry equal marks (20 marks each), as printed in the booklet.

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Question 1

Q. 1 i. What is a partnership deed? Discuss the essential elements of the Partnership deed. ii. Differentiate between (a) the Fixed Capital Method. (b) Fluctuating Capital Method (20)

Introduction

A partnership begins when two or more persons agree to carry on a business together and to share its profits, but the quality of that partnership over the years depends heavily on how completely and clearly the original agreement was thought through and recorded. The document that records it is the partnership deed, and part (i) of this question asks what that deed is and what it must essentially contain. Part (ii) then turns from the formation of the firm to its continuing

bookkeeping, asking for the difference between the two methods of maintaining partners' capital accounts — fixed and fluctuating — a choice that the deed itself usually records and that determines where items such as salary, interest, drawings and profit shares are posted. The two parts belong together: the deed is the firm's private constitution and the capital method is one of the most important accounting rules that constitution lays down.

(i) What Is a Partnership Deed?

A partnership deed is the written document containing the terms of the agreement between the partners on which the partnership firm is formed and carried on. It is sometimes called the articles of partnership. The law in Pakistan, following the Partnership Act, 1932, permits a partnership to be formed by an oral agreement, and many small firms do begin informally; but an oral agreement leaves every disputed point to memory and goodwill, precisely at the moment when goodwill has failed. A written deed, signed by all the partners (and, in formal practice, executed on stamp paper of the appropriate value and sometimes registered), converts understandings into evidence. Its function is threefold: it records the bargain, it provides a rule-book for the day-to-day and year-to-year questions that inevitably arise — who may draw how much, who earns what salary, whose consent is needed for what — and it supplies the answer when a dispute reaches a court or an arbitrator, since the deed is the first document such a forum will call for.

Where there is no deed, or where the deed is silent on a point, the default rules of the Partnership Act apply, and those defaults surprise many partners: profits and losses are shared equally regardless of capital contributed, no partner is entitled to a salary or commission for acting in the business, no interest is allowed on capital, interest at a statutory rate may be chargeable on a partner's loan to the firm, and every partner may take part in management. A firm whose

members intend anything different from those defaults — which is to say, almost every real firm — needs a deed saying so. Drafting the deed is therefore not bureaucratic decoration; it is the act by which the partners replace a standard legal template that probably does not fit them with rules they have actually chosen.

Essential Elements of the Partnership Deed

A complete deed normally contains the following essential elements, each of which answers a question that would otherwise become a dispute. First, the name of the firm and the nature and place of its business, together with its duration if it is formed for a fixed term or a particular venture. Second, the names and addresses of all the partners and the date of commencement. Third, the capital contributed by each partner, whether further capital may be required, and whether interest is payable on capital and at what rate. Fourth, the profit and loss sharing ratio, which need not follow the capital ratio and must be stated expressly if it does not. Fifth, the rules on partners' drawings: how much each partner may withdraw, how often, and whether interest is charged on drawings and at what rate — Assignment 2, Question 2 of this very booklet shows a deed being applied on exactly these points, with interest on capital and on drawings at 10 per cent per annum.

Sixth, partners' salaries and commissions: whether any partner who works actively in the business is to be paid a salary or commission in addition to his profit share, and how much — again, Question 2 illustrates this with a monthly salary to one partner and a monthly commission to another. Seventh, the duties, powers and responsibilities of each partner, any limits on a partner's authority to bind the firm, and the banking arrangements, including who may operate the firm's account. Eighth, the maintenance of accounts: the accounting year, the method of keeping capital accounts (fixed or fluctuating — see part (ii)), audit arrangements and each

partner's right to inspect the books. Ninth, the treatment of a partner's loan to the firm and the interest on it, distinguishing a loan, on which interest is a charge payable even out of a loss-making year, from capital, on which interest is an appropriation payable only as the deed provides. Tenth, the procedure on admission, retirement and death of a partner: how goodwill is to be valued, how the outgoing partner's or deceased partner's share is to be computed and paid, and whether the firm continues with the remaining partners. Eleventh, the rules for dissolution: how assets are to be realised, liabilities paid and any surplus divided. Twelfth, an arbitration or dispute-resolution clause, providing that disagreements be referred to an arbitrator rather than immediately to litigation. A deed covering these elements leaves very few contingencies unprovided for, and the time to negotiate them is at the beginning, when relations are cordial, not at the end, when they are not.

(ii) Fixed Capital Method — Meaning

Under the fixed capital method, each partner's Capital Account is kept deliberately stable: it is credited with the capital originally introduced and with any further capital permanently introduced, and debited with any capital permanently withdrawn, and with nothing else. All the recurring, year-by-year adjustments that partners generate — salary, commission, interest on capital, interest on drawings, drawings themselves, and the share of profit or loss — are recorded in a separate account for each partner, called the Current Account. A partner's total interest in the firm at any date is therefore the sum of two balances: the fixed capital, which rarely changes, and the current account, which may be a credit balance (the firm owes him undistributed earnings) or a debit balance (he has drawn more than he has earned, and in substance owes the firm). On the Balance Sheet the two are shown, capitals in their fixed amounts and current accounts separately.

(ii) Fluctuating Capital Method — Meaning and the Difference

Under the fluctuating capital method there is only one account per partner, the Capital Account itself, and everything passes through it: original and additional capital, salary, commission, interest on capital on the credit side; drawings, interest on drawings and share of loss on the debit side; and the profit share credited at the year-end. The balance of the account therefore changes — fluctuates — every year, and often considerably, which is exactly what the name describes. It is the simpler method and the one a small firm without a deed provision to the contrary will usually be operating, and it is the method applied in Question 2 of this assignment, where the partners' closing capitals move a long way from their opening capitals once a large salary, a large commission, interest and a share of a negative remainder have all passed through them.

The differences can be stated systematically. Number of accounts: two per partner (Capital and Current) under the fixed method, one under the fluctuating method. Stability: capital under the fixed method changes only on permanent introduction or withdrawal of capital; under the fluctuating method it changes with every appropriation and drawing. Interest on capital: under the fixed method it is calculated on a capital that is normally constant through the year, making the computation straightforward; under the fluctuating method the balance moves, and care is needed about the base and period if the deed ties interest to the account balance. Presentation: the fixed method shows capital and current accounts as separate lines, making a partner's permanent stake and his accumulated undistributed earnings visible at a glance; the fluctuating method shows one combined figure, simpler but less informative. Debit balances: an overdrawn position appears openly as a debit current account under the fixed method, an early warning that a partner is drawing ahead of earnings, whereas under the fluctuating method the same fact is buried inside a reduced capital balance. Practice: larger firms and firms whose deed so provides generally prefer the fixed method for the clarity and control it gives; smaller firms prefer the fluctuating

method for its simplicity. Neither method changes the total amount a partner is worth in the firm by a single rupee — it is purely a difference in where the same items are recorded — and a good answer should say so, because students often imagine that a method of presentation can alter the underlying economics, which it cannot.

Basis	Fixed Capital Method	Fluctuating Capital Method
Accounts per partner	Capital A/c + Current A/c	Capital A/c only
Capital balance	Changes only on permanent introduction / withdrawal	Changes every year with all adjustments
Salary, interest, drawings, profit share	Recorded in Current Account	Recorded in Capital Account
Balance Sheet presentation	**Capitals and current accounts shown separately**	**One combined capital figure**
Overdrawn position	Visible as debit Current Account	Hidden inside reduced capital

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Conclusion

In conclusion, the partnership deed is the written constitution of the firm, recording capital, profit ratios, drawings, interest, salaries, duties, admission and retirement procedures, dissolution rules and dispute resolution, and sparing the partners the ill-fitting default rules of the Partnership Act. The fixed and fluctuating capital methods are the two ways of giving effect, in the ledger, to the financial terms the deed creates: fixed capitals with separate current accounts for clarity and

control, or a single fluctuating capital account for simplicity — identical in total effect, different in presentation and in the information they make visible.

Question 2

Q. 2 Red, Orange, and Yellow are partners in a firm sharing profit and loss in the ratio of 5:3:2, respectively. Their capital at the beginning of the year was Rs. 300,000, Rs. 200,000, and Rs. 100,000, respectively. According to the partnership deed. (20) (a) Red is entitled to a salary of Rs. 40,000 per month. (b) Interest in capital and drawing is 10% per annum. (c) Yellow is entitled to a monthly commission of Rs. 20,000 per month. The profit for the year ended on December 31, 2020, before the above adjustments was Rs. 650,000. The partners made the drawing as Red Rs. 15,000/-, Orange Rs. 10,000/- during the year. You are required to prepare a profit and loss appropriation account and its capital accounts. [Assumption stated in the answer: no dates of drawings are printed, so interest on drawings is charged for the full year; no drawing is printed for Yellow.]

Introduction

The Profit and Loss Appropriation Account is the second stage of a partnership's final accounts. The Profit and Loss Account proper has already produced the net profit — here Rs. 650,000 for the year ended 31 December 2020 — earned from trading with the outside world. The Appropriation Account then divides that profit among the partners strictly in accordance with the partnership deed: it credits partners with salary, commission and interest on capital for what the deed promises them, it charges them interest on drawings for what the deed requires of them, and it distributes whatever remains — the divisible profit — in the agreed profit-sharing ratio of 5:3:2. This question is a stern test of nerve as much as of technique, because, as the workings

immediately show, the deed's promises in this firm are larger than the year's profit, and the honest answer must follow the arithmetic wherever it leads rather than adjusting the figures to produce a comfortable-looking result.

Workings — and a Stated Assumption

Red's salary: Rs. 40,000 per month for twelve months is Rs. 480,000 for the year. Yellow's commission: Rs. 20,000 per month for twelve months is Rs. 240,000 for the year. Interest on capital at 10 per cent per annum on the opening capitals, which stood throughout the year: Red, 10 per cent of Rs. 300,000, is Rs. 30,000; Orange, 10 per cent of Rs. 200,000, is Rs. 20,000; Yellow, 10 per cent of Rs. 100,000, is Rs. 10,000 — a total of Rs. 60,000. Interest on drawings at 10 per cent: Red drew Rs. 15,000 and Orange drew Rs. 10,000; no drawing is printed for Yellow, so no interest can be charged to him. Assumption, stated openly: the booklet prints no dates for the drawings, so the period for which interest runs cannot be determined from the question; this guide charges interest for the full year — Red Rs. 1,500 and Orange Rs. 1,000, total Rs. 2,500 — and a student who instead adopts the common convention of an average six months (Rs. 750 and Rs. 500) should state that assumption in the same way, because the defect is in the data printed, not in the method. What must not be done is to omit interest on drawings silently: the deed expressly provides for it, at the same 10 per cent as interest on capital (the booklet prints ‘Interest in capital and drawing is 10% per annum’).

Now the critical total. Salary Rs. 480,000, plus commission Rs. 240,000, plus interest on capital Rs. 60,000, equals Rs. 780,000 of appropriations promised by the deed. Against that stand the net profit of Rs. 650,000 plus interest on drawings of Rs. 2,500, a total available of Rs. 652,500. The appropriations exceed the amount available by Rs. 127,500. There is therefore no divisible profit; there is a divisible deficiency of Rs. 127,500, which must be borne by the partners in their

profit and loss sharing ratio, 5:3:2, in exactly the same way as a divisible profit would have been shared: Red bears five-tenths, Rs. 63,750; Orange bears three-tenths, Rs. 38,250; Yellow bears two-tenths, Rs. 25,500. This is the technically correct treatment where salary, commission and interest on capital are appropriations of profit under the deed (as they are presented here), rather than charges against profit: the partners first receive what the deed promises, and then share the shortfall as a negative remainder. An answer that scales the promises down, invents a larger profit, or quietly drops one of the deed's terms in order to end with a positive remainder would be wrong, however tidy it looked.

Profit and Loss Appropriation Account

The Appropriation Account below is drawn so that both sides total Rs. 782,500 (the appropriations of Rs. 780,000 plus the deficiency borne of Rs. 127,500 on the debit side being set against — in presentation, the account is balanced by entering the deficiency as the shares charged to the partners). In the standard ledger presentation used in the table, the debit side carries interest on capital Rs. 60,000, Red's salary Rs. 480,000 and Yellow's commission Rs. 240,000, and the credit side carries the net profit Rs. 650,000 and interest on drawings Rs. 2,500; the excess of debits over credits, Rs. 127,500, is then debited to the partners' capital accounts in the ratio 5:3:2 as their shares of the deficiency, which is the balancing mechanism shown in the capital accounts. Whether it is labelled a negative divisible profit or a deficiency, the substance is the same and the figures are the same.

Read as a business document, the account delivers an uncomfortable but valuable message. Two items dominate everything: a salary of Rs. 40,000 a month and a commission of Rs. 20,000 a month together consume Rs. 720,000 a year, more than the entire net profit of a firm whose total capital is only Rs. 600,000. The deed, as written, promises the working partners remuneration on

a scale the business cannot currently sustain, and the consequence falls mainly on Red himself, who, despite receiving the salary, bears the largest share of the resulting deficiency because he holds the largest profit share. The partners would be well advised to renegotiate the deed — for example by making salary and commission conditional on profits, or by capping them — and an examination answer that notices the commercial lesson inside the arithmetic demonstrates the analysis AIOU's instructions ask for.

Debit — Appropriations	Rs.	Credit	Rs.
Interest on capital: Red 30,000; Orange 20,000; Yellow 10,000	60,000	Net Profit b/d	650,000
Red's salary (40,000 x 12)	480,000	Interest on drawings: Red 1,500; Orange 1,000	2,500
Yellow's commission (20,000 x 12)	240,000		
Deficiency borne 5:3:2 — Red 63,750; Orange 38,250; Yellow 25,500	(127,500)*		

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Total appropriations charged	**780,000**	**Total available**	**652,500**

Partners' Capital Accounts

The capital accounts are prepared here on the fluctuating method, since the question asks simply for ‘its capital accounts’ and gives no instruction to maintain separate current accounts; under the fixed method the closing totals per partner would be identical, split between a fixed capital and a current account. Red: opening capital Rs. 300,000, plus salary Rs. 480,000, plus interest on capital Rs. 30,000, minus drawings Rs. 15,000, minus interest on drawings Rs. 1,500, minus his share of the deficiency Rs. 63,750, gives a closing capital of Rs. 729,750. Orange: opening Rs. 200,000, plus interest Rs. 20,000, minus drawings Rs. 10,000, minus interest on drawings Rs. 1,000, minus deficiency share Rs. 38,250, gives Rs. 170,750. Yellow: opening Rs. 100,000, plus commission Rs. 240,000, plus interest Rs. 10,000, minus deficiency share Rs. 25,500 (he has no drawings and no interest on drawings), gives Rs. 324,500.

The proof of the whole question is the agreement of the closing capitals with the firm's overall position. Closing capitals total 729,750 plus 170,750 plus 324,500, which is Rs. 1,225,000. Independently: opening capitals Rs. 600,000, plus the year's net profit Rs. 650,000, minus total drawings Rs. 25,000, also equals Rs. 1,225,000. The two must agree, because every appropriation — salary, commission, both interests and the sharing of the remainder, positive or negative — is a transfer between the firm and the partners or among the partners themselves, and cannot create or destroy value for the firm as a whole; only trading profit and drawings crossing

the firm's boundary change the total. Any candidate whose capitals do not pass this check has made an arithmetical error, and the check costs thirty seconds.

Capital Accounts	Red Rs.	Orange Rs.	Yellow Rs.
Opening capital	300,000	200,000	100,000
Add: Salary	480,000	—	—
Add: Commission	—	—	240,000
Add: Interest on capital	30,000	20,000	10,000
Less: Drawings	(15,000)	(10,000)	—
Less: Interest on drawings	(1,500)	(1,000)	—
Less: Share of deficiency (5:3:2)	(63,750)	(38,250)	(25,500)
Closing capital	729,750	170,750	324,500

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Conclusion

In conclusion, the Appropriation Account shows deed appropriations of Rs. 780,000 (salary Rs. 480,000, commission Rs. 240,000, interest on capital Rs. 60,000) against Rs. 652,500 available (net profit Rs. 650,000 plus interest on drawings Rs. 2,500 on the stated full-year assumption, the booklet printing no drawing dates), leaving a deficiency of Rs. 127,500 borne 5:3:2. Closing capitals are Red Rs. 729,750, Orange Rs. 170,750 and Yellow Rs. 324,500, totalling Rs.

1,225,000 and agreeing with opening capital plus profit minus drawings. (*In the Appropriation table the deficiency line is shown in brackets as the balancing share charged to the partners, not as an additional appropriation.)

Question 3

Q. 3 The following is the balance sheet of Abid and Akbar as of Dec. 31st: Sundry creditors 30,000; Capital – Abid 15,000, Capital – Akbar 15,000 (Owner's equities 30,000); Total 60,000. Cash account 10,000; Sundry assets 50,000; Total 60,000. The particulars [partners] shared profits and losses in the ratio 3:2. On the above date, Asghar was admitted as a partner for a 1/5 share in the business. Required: [Give r] necessary journal entries and prepare the balance sheet under the following cases separately. i. Asghar has invested Rs. 10000/- in the partnership. ii. If it is agreed that Rs. 30000/- would represent 4/5 of the total capital of the new firm. (20)

Introduction

Admission of a partner reconstitutes the firm: the old partnership ends and a new partnership, including the incoming partner, begins, even though the business itself trades on without interruption. The incoming partner acquires a share in the future profits — here Asghar takes a one-fifth share in a firm in which Abid and Akbar have until now shared profits and losses in the ratio 3:2 — and in exchange he normally introduces capital in cash or in kind. This question strips the admission to its simplest possible form: the old Balance Sheet contains only creditors, two equal capitals, cash and sundry assets; no goodwill figure, no revaluation and no reserves are mentioned; and two separate, alternative cases are set for the amount of capital Asghar introduces. The discipline of the question is to treat the two cases entirely separately, each

starting again from the original Balance Sheet, and not to allow a figure from Case (i) to leak into Case (ii).

The Position Before Admission and the New Ratio

The old firm stands as follows: liabilities are sundry creditors Rs. 30,000 and capitals of Rs. 15,000 each for Abid and Akbar, Rs. 30,000 in all, a total of Rs. 60,000; assets are cash Rs. 10,000 and sundry assets Rs. 50,000, also Rs. 60,000. The old profit ratio, 3:2, is given, and although no profit adjustment arises in either case (there is no goodwill premium, no revaluation profit and no accumulated reserve to distribute), the new ratio is worth computing for completeness, because it governs all future profits and would govern any such adjustment if one existed. Asghar takes one-fifth, leaving four-fifths for the old partners, who share that remainder between themselves in their old relative ratio of 3:2. Abid's new share is therefore three-fifths of four-fifths, that is twelve twenty-fifths; Akbar's is two-fifths of four-fifths, that is eight twenty-fifths; Asghar's is five twenty-fifths. The new ratio is 12:8:5, and each old partner's sacrifice is exactly proportional, Abid falling from fifteen twenty-fifths to twelve and Akbar from ten to eight, which confirms that Asghar's share has been surrendered by the old partners in their old ratio — the assumption that applies whenever, as here, the question states nothing to the contrary.

No other journal entry is required on this admission as the question is printed. There is no premium for goodwill to record (had Asghar paid one, it would have been credited to Abid and Akbar in their sacrificing ratio, here the same as the old ratio 3:2), no asset is revalued, and no general reserve exists. A careful answer says this explicitly rather than leaving the examiner to wonder whether the points were considered and rejected or simply missed. The only entry in each case is therefore the introduction of capital, and the only statement required is the resulting

Balance Sheet — but the figures differ between the cases, and understanding why they differ is the real content of the question.

Case (i) — Asghar Invests Rs. 10,000

In Case (i) the amount is fixed directly: Asghar brings in Rs. 10,000 in cash as his capital. The journal entry is: Cash Account debited Rs. 10,000; Asghar's Capital Account credited Rs. 10,000, with the narration that it is capital introduced by the newly admitted partner for his one-fifth share. The consequences flow mechanically. Cash rises from Rs. 10,000 to Rs. 20,000; sundry assets are untouched at Rs. 50,000; total assets become Rs. 70,000. Creditors are untouched at Rs. 30,000; capitals become Abid Rs. 15,000, Akbar Rs. 15,000 and Asghar Rs. 10,000, a total of Rs. 40,000; total liabilities and capital become Rs. 70,000, and the Balance Sheet balances. Notice that in this case Asghar's capital of Rs. 10,000 is not one-fifth of the firm's total capital of Rs. 40,000 — one-fifth of that total would be Rs. 8,000 — and that is perfectly in order: a partner's profit share and his capital proportion are two different things, determined by different considerations, and nothing in partnership law or accounting requires them to coincide unless the partners agree that they shall. That contrast is precisely what Case (ii) is designed to bring out.

Case (i) Balance Sheet — Liabilities	Rs.	Assets	Rs.
Sundry creditors	30,000	Cash (10,000 + 10,000)	20,000
Capital – Abid	15,000	Sundry assets	50,000

Capital – Akbar	15,000		
Capital – Asghar	10,000		
Total	**70,000**	**Total**	**70,000**

Case (ii) — Rs. 30,000 to Represent Four-Fifths of the Total Capital

In Case (ii) Asghar's capital is not stated as an amount; it must be derived from a condition: the existing capitals of Abid and Akbar, Rs. 30,000 together, are to represent four-fifths of the total capital of the new firm — four-fifths because Asghar's share is one-fifth, and the condition in effect aligns his capital proportion with his profit share. If Rs. 30,000 is four-fifths of the total, the total capital of the new firm is 30,000 multiplied by five-fourths, which is Rs. 37,500. Asghar's one-fifth is therefore 37,500 divided by five, that is Rs. 7,500 (equivalently, 37,500 minus 30,000). The journal entry is: Cash Account debited Rs. 7,500; Asghar's Capital Account credited Rs. 7,500. It is assumed, as the question directs no other treatment, that Abid's and Akbar's capitals remain at Rs. 15,000 each and are not adjusted to any new ratio between themselves; the condition concerns only the size of the total and hence the amount the incoming partner must bring.

The resulting Balance Sheet shows cash of Rs. 17,500 (Rs. 10,000 plus Rs. 7,500) and sundry assets of Rs. 50,000, a total of Rs. 67,500, against creditors of Rs. 30,000 and capitals totalling Rs. 37,500 (15,000 plus 15,000 plus 7,500), also Rs. 67,500 in total. Comparing the two cases repays a moment's attention: the firm is smaller in Case (ii) than in Case (i) by exactly Rs. 2,500 on both sides, because Asghar introduces Rs. 2,500 less cash. Case (i) gives the firm more working capital but leaves capitals disproportionate to profit shares (15,000 : 15,000 : 10,000

against shares of 12:8:5); Case (ii) sacrifices that extra cash to achieve exact proportionality between capital and shares, which many firms prefer because interest on capital, where the deed allows it, then rewards partners in the same proportions in which they share the final result.

Case (ii) Balance Sheet — Liabilities	Rs.	Assets	Rs.
Sundry creditors	30,000	Cash (10,000 + 7,500)	17,500
Capital – Abid	15,000	Sundry assets	50,000
Capital – Akbar	15,000		
Capital – Asghar (derived)	7,500		
Total	**67,500**	**Total**	**67,500**

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Conclusion

In conclusion, the single journal entry in each case records Asghar's capital introduction — Cash debited and Asghar's Capital credited — with Rs. 10,000 in Case (i), producing a Balance Sheet totalling Rs. 70,000, and with a derived Rs. 7,500 in Case (ii) (total capital Rs. 37,500, of which the old Rs. 30,000 is four-fifths), producing a Balance Sheet totalling Rs. 67,500. The new profit-sharing ratio for the future is 12:8:5. No goodwill, revaluation or reserve adjustment arises, because none is mentioned in the question as printed (the booklet's word is ‘Giver’, read as ‘Give’, in the Required line), and no figure has been imported that the question does not supply.

Question 4

Q. 4 The following is the balance sheet of Zafar and Muzammal on 31st December. Profit is being divided equally. Capital & Liabilities: Sundry creditors 20,000; Bank overdraft 6,000; Capital Zafar 8,400; Capital Muzammal 6,400; Total 40,800. Assets: Cash 200; Sundry debtors 24,400; Stock 14,000; Investment 1,200; Furniture 1,000; Total 40,800. It is arranged that Asif shall be taken in partnership, and as a result of the negotiations, it is agreed to make the following adjustments in the above balance sheet. i. Investment decreased by 25%, stock by 15%, and furniture 6%. ii. Goodwill raised in the books Rs. 4000/- iii. Bad debts written off Rs. 6000/- iv. Asif introduces Rs. 4000/- as his one-third share of the capital, the capital accounts of other partners shall be adjusted. (20)

Introduction

This admission question is richer than Question 3, because before the new partner is admitted the existing Balance Sheet must be restated to fair values. Asif is entitled to join a firm worth what the Balance Sheet says it is worth — no more and no less — and Zafar and Muzammal, who share profits equally, are entitled not to give away to the newcomer any value they have built up, nor to saddle him with losses on assets that are already overstated. The machinery for achieving fairness is the Revaluation Account: decreases in asset values and losses such as bad debts are charged to the old partners in their old ratio (here, equally), the goodwill created by the old partners' efforts is raised and credited to them in the same ratio, and only then is the new partner admitted, on capitals that have been re-based and, under adjustment (iv), re-proportioned. Each of the four printed adjustments is taken in turn, and every figure is small enough that the whole question can be proved exactly — which is what a careful candidate should do.

The Adjustments Worked Out

Adjustment (i) reduces three assets. The investment of Rs. 1,200 falls by 25 per cent, a decrease of Rs. 300, to Rs. 900. The stock of Rs. 14,000 falls by 15 per cent, a decrease of Rs. 2,100, to Rs. 11,900. The furniture of Rs. 1,000 falls by 6 per cent, a decrease of Rs. 60, to Rs. 940. Total decrease under this head: Rs. 2,460. Adjustment (iii), bad debts of Rs. 6,000 written off, reduces sundry debtors from Rs. 24,400 to Rs. 18,400 and is a further loss of Rs. 6,000; it is a write-off of debts now known to be bad, not a provision against doubtful ones, so the debtors figure itself is reduced and no provision account is created. The total loss on revaluation is therefore 2,460 plus 6,000, which is Rs. 8,460, borne equally by Zafar and Muzammal as the old partners in their old (equal) ratio: Rs. 4,230 each. Adjustment (ii) works in the opposite direction: goodwill of Rs. 4,000 is raised in the books, appearing as a new asset, and credited to the old partners equally, Rs. 2,000 each, since they alone created it before Asif's arrival. The net effect on each old partner's capital is a credit of Rs. 2,000 for goodwill minus a debit of Rs. 4,230 for the revaluation loss, a net reduction of Rs. 2,230.

Applying that net reduction: Zafar's capital falls from Rs. 8,400 to Rs. 6,170, and Muzammal's falls from Rs. 6,400 to Rs. 4,170. Their combined adjusted capital is Rs. 10,340. Journal entries summarise the same story: Revaluation Account is debited Rs. 300, Rs. 2,100 and Rs. 60 with the three assets credited for the decreases; Revaluation Account is debited Rs. 6,000 with Sundry Debtors credited for the bad debts; Goodwill Account is debited Rs. 4,000 with Zafar and Muzammal credited Rs. 2,000 each; and the net loss on revaluation, Rs. 8,460, is transferred by debiting Zafar and Muzammal Rs. 4,230 each and crediting Revaluation Account. Presenting the revaluation as a formal account, as the table below does, keeps the gains and losses visible and auditable instead of burying them as unexplained jumps in the capital accounts.

Revaluation Account — Debit	Rs.	Credit	Rs.
To Investment (25% decrease)	300	By Goodwill raised (transferred effect)	
To Stock (15% decrease)	2,100		
To Furniture (6% decrease)	60		
To Sundry Debtors (bad debts written off)	6,000		
Total losses	**8,460**	**Net loss borne equally: Zafar 4,230; Muzammal 4,230**	**8,460**

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Adjustment (iv) — Re-Proportioning the Capitals and the Cash Asif Brings

Asif introduces Rs. 4,000 as his one-third share of the capital, and the capitals of the other partners are to be adjusted. If Rs. 4,000 is one-third, the total capital of the new firm must be Rs. 12,000, and the old partners together must hold the remaining two-thirds, Rs. 8,000. Since Zafar and Muzammal divide profits equally, and nothing in the question gives them unequal shares in the new firm, their adjusted shares of that two-thirds are equal: each is to stand at Rs. 4,000, with

Asif's Rs. 4,000 making the third equal third. (The new profit ratio is accordingly 1:1:1 — Asif one-third, and the remaining two-thirds divided equally between the old partners.) Zafar's capital must therefore fall from its adjusted Rs. 6,170 to Rs. 4,000, a withdrawal of Rs. 2,170 in cash; Muzammal's must fall from Rs. 4,170 to Rs. 4,000, a withdrawal of Rs. 170. Such withdrawals are the normal mechanism of a capital adjustment clause: the excess capital is not forfeited, it is repaid to the partner to whom it belongs, and recording it as a cash repayment (rather than leaving an unexplained difference) is what makes the final Balance Sheet balance.

The cash movement can now be proved before the Balance Sheet is drawn. The firm begins the admission with cash of only Rs. 200 — a strikingly small balance against a bank overdraft of Rs. 6,000, and a reminder that this firm is short of liquidity, which may itself be one reason for admitting a partner bringing fresh money. Asif brings in Rs. 4,000, raising cash to Rs. 4,200. The repayments to Zafar (Rs. 2,170) and Muzammal (Rs. 170) total Rs. 2,340, reducing cash to Rs. 1,860. That figure, Rs. 1,860, is the cash that must appear in the new Balance Sheet, and if the Balance Sheet balances with it, every adjustment has been correctly carried through. Entries: Cash debited Rs. 4,000, Asif's Capital credited Rs. 4,000 on his admission; Zafar's Capital debited Rs. 2,170 and Muzammal's Capital debited Rs. 170, Cash credited Rs. 2,340 on the adjustment repayments.

Partner	Capital after revaluation & goodwill Rs.	Required capital Rs.	Cash withdrawn Rs.
Zafar	6,170	4,000	2,170
Muzammal	4,170	4,000	170

Asif	— (introduces 4,000)	4,000	—
Total	**10,340 + 4,000 introduced**	**12,000**	**2,340**

Balance Sheet of the New Firm

The Balance Sheet of the reconstituted firm is as follows. Liabilities: sundry creditors Rs. 20,000 (unchanged — admission and revaluation do not affect outside creditors), bank overdraft Rs. 6,000 (unchanged), and capitals of Rs. 4,000 each for Zafar, Muzammal and Asif, Rs. 12,000 in total; the liabilities side totals Rs. 38,000. Assets: cash Rs. 1,860 as proved above, sundry debtors Rs. 18,400 after the bad debts write-off, stock Rs. 11,900 after the 15 per cent reduction, investment Rs. 900 after the 25 per cent reduction, furniture Rs. 940 after the 6 per cent reduction, and goodwill Rs. 4,000 as raised; the assets side also totals exactly Rs. 38,000. The agreement of the two sides at Rs. 38,000, down from the original Rs. 40,800, is the final proof: the reduction of Rs. 2,800 in the firm's total is fully explained by the net revaluation loss and goodwill (a net Rs. 4,460 reduction in net assets before admission: losses Rs. 8,460 minus goodwill Rs. 4,000) combined with the admission cash flows (plus Rs. 4,000 introduced, minus Rs. 2,340 repaid).

A word on the goodwill figure completes the answer. The question directs that goodwill be ‘raised in the books’, so it remains as an asset in the new Balance Sheet, as shown. That is one legitimate treatment, directed here by the question itself; firms sometimes prefer to write goodwill off again against all partners (including the newcomer) in the new ratio, but a student must follow the instruction printed, and here the instruction is explicit. Similarly, the revaluation

changes were all decreases, which is realistic for a firm whose book values had drifted above realisable values, and every one of them was charged to the old partners only, because they, and not Asif, owned the assets while the values fell.

New Balance Sheet — Liabilities	Rs.	Assets	Rs.
Sundry creditors	20,000	Cash (200 + 4,000 − 2,340)	1,860
Bank overdraft	6,000	Sundry debtors (24,400 − 6,000)	18,400
Capital – Zafar	4,000	Stock (14,000 − 15%)	11,900
Capital – Muzammal	4,000	Investment (1,200 − 25%)	900
Capital – Asif	4,000	Furniture (1,000 − 6%)	940
		Goodwill (raised)	4,000
Total	**38,000**	**Total**	**38,000**

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Conclusion

In conclusion, the revaluation loss of Rs. 8,460 (investment Rs. 300, stock Rs. 2,100, furniture Rs. 60, bad debts Rs. 6,000) is borne equally by the old partners, goodwill of Rs. 4,000 is credited equally to them, their adjusted capitals of Rs. 6,170 and Rs. 4,170 are then reduced by

cash repayments of Rs. 2,170 and Rs. 170 to the required Rs. 4,000 each, Asif introduces Rs. 4,000 for his one-third share, and the new firm's Balance Sheet balances at Rs. 38,000 with equal capitals of Rs. 4,000. (*In the Revaluation table, goodwill is conventionally recorded by a separate entry — Goodwill debited, old partners credited — and it is shown in the note rather than as a credit of the Revaluation Account itself; the net loss transferred, Rs. 8,460, is unaffected.)

Question 5

Q. 5. What will be the accounting treatment at the time of retirement of a partner? Explain with a suitable example. (20) [The example in this answer is illustrative, constructed for teaching, and is flagged as such.]

Introduction

Retirement is the mirror image of admission. A partner who retires (or whose death brings his association with the firm to an end, the accounting being substantially the same) withdraws from a going concern that continues, in reconstituted form, without him. The central accounting problem is fairness in both directions: the retiring partner must receive the full value of everything his association has created up to the date of retirement — his capital, his share of reserves and accumulated profits, his share of any increase in asset values and of goodwill — and the continuing partners must not be made to pay for value that does not exist, nor inherit hidden losses on overstated assets that properly belong, in part, to the man who is leaving. Every element of the treatment described below serves that one principle of settling the account completely and finally at the retirement date, because after that date the retiring partner has no claim on future profits (beyond any statutory rights if his share is left in the firm as a loan) and no liability for future losses.

Step 1 — Revaluation of Assets and Liabilities

First, assets and liabilities are revalued exactly as on an admission, through a Revaluation (or Profit and Loss Adjustment) Account. Increases in asset values and decreases in liabilities are credited, decreases in asset values, increases in liabilities and newly recognised obligations are debited, and the resulting profit or loss on revaluation is shared by all the partners, including the retiring partner, in their old profit-sharing ratio — the ratio in force while the values were changing. It would be unjust for a retiring partner to leave just before a building he helped to buy is recognised at its appreciated value, and equally unjust for him to escape his share of a stock write-down that accrued during his time. Unrecorded assets and liabilities discovered at this point are brought in through the same account. The retiring partner's capital account receives his share of the revaluation result as its first retirement adjustment.

Step 2 — Reserves, Goodwill and the Retiring Partner's Entitlements

Second, accumulated reserves and undistributed profits standing in the Balance Sheet (general reserve, and the credit balance of the Profit and Loss Account) are distributed to all partners, including the retiring partner, in the old ratio, because they represent past profits that were earned while he was a partner and were retained rather than drawn. Undistributed losses, conversely, are debited in the same way. Third, goodwill is valued as at the retirement date and the retiring partner is credited with his share of it in the old ratio, because the firm's reputation and customer connection were built partly by his efforts and the continuing partners will enjoy them after he has gone. The corresponding debit falls on the continuing partners in their gaining ratio — the ratio in which they have gained profit share by the retirement — which is the technically correct counterpart of the sacrificing ratio used on admission: those who gain the retiring partner's share of future profits are those who compensate him for it. If the partners

prefer not to raise a goodwill asset in the books, this adjustment is made directly through the capital accounts (continuing partners debited in gaining ratio, retiring partner credited), leaving no goodwill figure in the new Balance Sheet; if goodwill already stands in the books, any necessary top-up or write-down is handled through the same mechanism.

Fourth, the retiring partner's capital account is completed with the ordinary year-to-date items up to the retirement date: interest on capital where the deed allows it, salary or commission due to him for the broken period, his share of the firm's profit (or loss) from the start of the accounting year to the date of retirement — estimated, where retirement falls mid-year, on a time basis or on the basis of the previous year's results, as the deed directs — less his drawings and interest on drawings to that date. Fifth, joint life policies, where the firm holds them on the partners' lives, are dealt with according to their treatment in the books: a policy surrendered or maturing on a death is shared in the old ratio, and a policy retained is valued at its surrender value. Each of these items is a separate, identifiable credit or debit on one account, which is why the retiring partner's Capital Account, fully worked, is the heart of the accounting treatment: it is the complete statement of what the firm owes him.

Step 3 — Settlement: Payment, Instalments or Loan

Sixth, the amount finally due is settled in one of three ways. It may be paid immediately in cash, in which case the retiring partner's Capital Account is debited and Cash or Bank credited, and he disappears from the firm's books entirely. It may be paid in instalments, the unpaid balance being transferred to a Retiring Partner's Loan Account bearing interest as agreed, each instalment being part principal and part interest. Or, where the deed or a fresh agreement so provides, the whole amount may be left in the firm as a loan, again at an agreed or statutory rate of interest; in that case the former partner becomes a creditor of the firm, ranked behind its trade creditors in

substance if the firm later fails, and entitled, under the Partnership Act where his share is retained and used in the business without settlement, to elect between interest and a share of the profits attributable to the use of his share — a powerful reason for firms to settle promptly and document the arrangement. Where a partner has died, the amount due is paid to his executors or legal representatives on the same computation. Finally, the continuing partners' new profit-sharing ratio is recorded, any agreed adjustment of their capitals to the new ratio is made in cash or through current accounts, and a new Balance Sheet is drawn up which must balance without the retiring partner: that balancing is the arithmetic proof that the settlement has been completely recorded.

Illustrative Example (Constructed for Teaching — Not Booklet Data)

Illustrative example — all figures in this section are constructed for teaching and are not taken from the booklet. Suppose A, B and C share profits in the ratio 3:2:1, and their capitals stand at A Rs. 60,000, B Rs. 40,000 and C Rs. 20,000. A general reserve of Rs. 12,000 stands in the books. C retires. On revaluation, assets increase by Rs. 6,000 net, giving a revaluation profit of Rs. 6,000. The firm's goodwill is valued at Rs. 30,000. A and B will in future share equally, so A's gain is one-half minus three-sixths, which is nil (3/6 is exactly one-half), and B's gain is one-half minus two-sixths, which is one-sixth — B alone has gained C's share, a result that often surprises students and shows why the gaining ratio must be computed partner by partner and not assumed. C's entitlements are: capital Rs. 20,000; share of general reserve, one-sixth of Rs. 12,000, Rs. 2,000; share of revaluation profit, one-sixth of Rs. 6,000, Rs. 1,000; share of goodwill, one-sixth of Rs. 30,000, Rs. 5,000 — a total due of Rs. 28,000. The goodwill adjustment is recorded by debiting B, the sole gaining partner, with Rs. 5,000 and crediting C with Rs. 5,000, raising no goodwill asset. If the firm pays C Rs. 13,000 immediately and retains

Rs. 15,000 as a loan at, say, an agreed interest rate, the entries are: C's Capital Account debited Rs. 13,000 with Cash credited, and C's Capital Account debited Rs. 15,000 with C's Loan Account credited, which closes C's capital account at nil and leaves him correctly shown as a lender.

After those entries the continuing firm can be proved. Capitals become: A, Rs. 60,000 plus reserve share Rs. 6,000 plus revaluation share Rs. 3,000, equals Rs. 69,000; B, Rs. 40,000 plus reserve share Rs. 4,000 plus revaluation share Rs. 2,000 minus goodwill debit Rs. 5,000, equals Rs. 41,000; C, nil, replaced by a loan of Rs. 15,000. The example demonstrates, in miniature, every step of the general treatment: revaluation shared in the old ratio, reserves shared in the old ratio, goodwill credited to the retiring partner and debited to the continuing partners in the gaining ratio (here concentrated entirely on B), the profit share and drawings to the retirement date (assumed nil in this simplified illustration, and stated as such), and settlement split between cash and loan. Change any assumption — a mid-year retirement adding a profit share to the date of leaving, or a deed prescribing equal gains — and the same machinery accommodates it, because the steps are principles, not a memorised pattern tied to particular numbers.

C's Capital Account (illustrative)	Rs.
Balance b/d	**20,000**
Share of general reserve (1/6 of 12,000)	2,000
Share of revaluation profit (1/6 of 6,000)	1,000
Share of goodwill (1/6 of 30,000), via B	5,000
Total due to C	**28,000**

Paid in cash	(13,000)
Transferred to C's Loan Account	(15,000)
Balance c/d	**Nil**

Conclusion

In conclusion, the accounting treatment on retirement is: revalue assets and liabilities and share the result in the old ratio; distribute reserves and undistributed profits (or losses) in the old ratio; credit the retiring partner with his share of goodwill, debiting the continuing partners in their gaining ratio; complete his capital account with interest, salary and profit share to the date of retirement, less drawings and interest on drawings; and settle the final balance in cash, by instalments, or by transfer to a loan account, before drawing up the reconstituted firm's Balance Sheet. Handled in that order, the retiring partner receives everything that is his, the continuing partners pay for nothing that is not theirs, and the firm's books prove the settlement to the last rupee — as the illustrative example, flagged as constructed teaching data and not booklet figures, demonstrates.