Retirement of the Partner

When a partner break off his relations from the partnership on account of various reasons and settles his account and leaves the firm ,such a situation is called retirement of a partner . The partner who leaves the firm is known as retiring partner or outgoing partner

After the retirement of a partner the old partnership comes to an end but the firm continues and a new partnership comes in to existence between the remaining partners. Thus retirement of a partner results in the reconstitution of a firm

A retiring partner is entitled to get his share of capital, interest on capital, revaluation profit, share of profit etc. up to the date of his retirement. Similarly he is liable for his share in all the losses like accumulated loss, revaluation loss, Drawings, interest on drawings, share of current year's loss up to the date of retirement, drawings, interest on drawings etc. till the date of his retirement. He is not liable for any loss incurred by the firm after his retirement.

According to the provision of section 32 of partnership act 1932,

The following are the different ways in which a partner can retire from a firm.

i. **With the consent of all other partners**: A partner must take the consent of all the co-partners of the firm before his/her retirement. Thereafter, the partner can retire from the firm if and only if all the partners agree on the decision of his/her retirement.

ii) **With an express agreement by all the partners**: In case of written agreement among the partners a partner may retire from the firm by expressing his/her intention of leaving the firm though a notice to the other partners of the firm.

iii) **By giving a written notice**: If partnership among the partners is at will then a partner may retire by giving notice in writing to all the other partners informing them about his/her intention to retire

Liability of a Partner

Liability of the Firm for the Acts before Retirement [Section 32(2)] A retiring partner remains liable for all the acts of the firm up to the date of his retirement. However, a retiring partner may be discharged from his liability by an agreement between himself, third party and the continuing partners.

Liability of the Firm for the Acts after Retirement [Section 32 (3)] A retiring partner also continues to be liable to third parties for the acts of the firm even after his retirement until a public notice of his retirement is given.

Accounting Treatment

At the time of reconstitution of firm due to Retirement of a partner, the right, duties and obligation of partners are necessary to be change then following accounting adjustment to be required in the books of firm

(1) Determination of New profit sharing Ratio and gaining ratio of remaining partners

(2) Valuation of goodwill and Accounting for goodwill.

(3) Accounting treatment of reserves and accumulated profits.

(4) Accounting for revaluation of assets and liabilities.

(5)Treatment of Joint Life Policy

(6) Calculation of Total Amount Payable to retiring partner
(7) Settlement of the amount due to the retiring partner

(6) Adjustment of capitals.

I. Calculation of New profit sharing ratio and gaining ratio

At the time of retirement of a partner, the business continues with the remaining partners. They need to decide among themselves what will be the new profit sharing ratio in the in the future.

New Ratio: The ratio, in which the continuing partners decide to share the future profits and losses, is known as new profit sharing ratio.

Gaining Ratio

The ratio in which the continuing partners acquire the outgoing partner's share is called gaining

Ratio. This ratio is calculated by taking out the difference between new profit share and old profit share. Gaining ratio is calculated when a partner retires or dies from a firm. It is called gaining ratio because the continuing partners stand to gain by acquiring the retiring partner's share in profits.

Gaining Ratio = New Share – Old Share

Calculating New Ratio and Gaining Ratio under Different Cases

Case-1 Relative Ratio between remaining partners unchanged or Nothing is mentioned about the new ratio between the remaining partners

Case-2 when the profit sharing ratio between continuing partners is changed/the new ratio between remaining partners is given

Case-3 when the continuing partners acquire (Purchase) the retiring partner's share of profit in an agreed ratio.

Case-4 when entire share of the retiring partner is taken by only one continuing partner

Case-1 Relative Ratio between remaining partners unchanged or Nothing is mentioned about the new ratio between the remaining partners:- When nothing is mentioned about the new ratio or gaining ratio , it is presumed that remaining partners continue to share profits as between themselves in the old ratio

It means that remaining partners acquire retiring partners share in their old profit sharing ratio and mutual profit sharing ratio of remaining partners will no change

If the continuing partners maintain their relative ratio, the gaining ratio and the new ratio will be the same.

In this case there is no need to calculate gaining ratio, new ratio and gaining ratio will be the same

Q. A, B and C were sharing profits in the ratio of 4:3:2. B retires from the firm. Calculate the New ratio and gaining ratio of A and C.

Ans:

Old Ratio of A,B and C = 4:3:2 or 4/9 :3/9 :2/9

New ratio of A and C is calculated by striking out the share of retiring partner and by finding out the denominator of the remaining ratio

So New ratio of A and C = 4:2 or 4/6: 2/6

Gaining Ratio = New Share – Old Share

A's Gain = A's New Share – A's Old Share

=4/6 – 4/9 or 36/54 – 24/54 =12/54

C's Gain =C's New Share – C's Old Share

=2/6 – 2/9 or 18/54 – 12/54 =6/54

Gaining ratio of A and C = 12:6 or **2:1**

Q. X,Y and Z are partners sharing profits in the ratio of 1/2,3/10,1/5 or (**5/10:3/10:2/10**).Calculate the new ratio and sacrificing ratio if X retires.

Old ratio of X,Y and Z = 5:3:2

New ratio of Y and Z = 3:2

Gaining Ratio = New share – Old share

Y's Gain = 3/5 – 3/10 or 6/10 – 3/10 =3/10

Z's Gain = 2/5 – 2/10 or 4/10 – 2/10 = 2/10

Gaining ratio of Y and Z = **3:2**

Case-2 when the continuing partners acquire (Purchase) the retiring partner's share of profit in an agreed ratio. In this case new ratio of remaining partners to be determined from following formula

New share = old share of remaining partners + acquired share or gain share

In this case, new ratio has to be calculated. Gaining ratio need not be calculated. In this case the ratio in which they acquire the retiring partner's share forms the gaining ratio

Q.A,B and C are partners sharing profits in the ratio of 3:2:1.A retires and his share is taken up (acquired) by B and C in the ratio of 3:2.Calculate the new profit sharing ratio and gaining ratio.

Old ratio of A,B and C = 3:2:1

A's share =3/6

Shares acquired by B and C from A in the ratio of 3:2 A's

share acquired by B = 3/5 of 3/6 = 3/5 X3/6 = 9/30 A's share acquired by C = 2/5 of 3/6 = 2/5 X 3/6 =6/30 B's

new share = B's old share + A's Share acquired by B

=2/6 +9/30 or 10/30+9/30 = 19/30

C's New Share = C's old share + A's share acquired by C

=1/6 +6/30 or 5/30+6/30 =11/30

New ratio of B and C = 19:11

Gaining Ratio = New Share – Old Share

B's Gain = 19/30 -2/6 or 19/30 -10/30 = 9/30

C's gain = 11/30 – 1/6 or 11/30 – 5/30 = 6/30

Gaining ratio = **9:6 or 3:2**

Q.P, Q and R are partners sharing profits in the ratio of 3:4:1.P retires from the firm and surrenders 2/3 of his share to Q and the remaining share 1/3 to R .Calculate new profit sharing ratio and gaining ratio.

Old Ratio of P,Q and R = 3:4:1

P Retires, P's share =3/8
P's share acquired by Q = 2/3 of 3/8 or 2/3 X 3/8 =6/24 or 2/8

P's share acquired by R = 1/3 of 3/8 or 1/3 X 3/8 = 3/24 or 1/8

Q's new share =Q's old Share + P's share acquired by Q = 4/8 +2/8 =6/8

R's new share = R's old share + P's share acquired by R =1/8 +1/8 =2/8

New ratio of Q and R =6:2 or **3:1**

In this, there is no need to calculate gaining ratio, it is already mentioned in the question, i.e. 2/3:1/3 or 2:1

Case-3 When entire share of the retiring partner is taken by only one continuing partner:- In such case the profit sharing ratio of the partner who acquire the

retiring partner share would be affected. The profit sharing ratio all other remaining partners would continue to be same.

The new profit sharing ratio of the gaining partner would be ascertain by adding the gain ratio from retiring partner to his old ratio.

New Ratio = old Ratio + Gaining Ratio

Q. A,B and C are partners sharing profits in the ratio of 2:2:1.B retires and his share is entirely taken by C .Calculate new Ratio

Old Ratio of A, B and C =2:2:1

B retires and B's share is entirely taken over by C

B's share =2/5

A's new share =2/5 (Unchanged)

C's new share = C's old share + B's share acquired by C

1/5 + 2/5 =3/5

New ratio of A and C = 2/5: 3/5 or **2:3**

Case-4 when the profit sharing ratio between continuing partners is changed/the new ratio between remaining partners is given

If the continuing partners decide to share future profits in some other ratio, the gaining ratio will also change.

In this case it is necessary to calculate gaining ratio.

Gaining Ratio = New Share – Old Share

Q.A,B and C were sharing profits in the ratio of 3:2:1.C retires from the firm. A and B decided to share future profits in the ratio of 7:5.Calculate gaining ratio.

Old ratio of A,B and C = 3:2:1

New ratio of A and B = 7:5

Gaining Ratio = New Share – Old Share

A's Gain = 7/12 – 3/6 or 7/12 -6/12 =1/12

B's Gain = 5/12 – 2/6 or 5/12 – 4/12 =1/12

Gaining ratio = **1:1**

Treatment of goodwill

When an existing partner of a firm decides to retire from the firm, the continuing partners will gain in future profits. The continuing partner who gains by acquiring an additional right to share future profits must compensate the retiring partner who sacrifices his right to share future profits. The amount of compensation will be equal to the proportionate amount of firm's goodwill.

Retiring partner's share of goodwill = **Goodwill of the Firm X Retiring partner's Share**

Note: As per Accounting Standard 10(AS-10) **goodwill is recorded in the books only when some consideration in money is paid for it**. So goodwill can be recorded only when it is purchased. So as per AS-10 goodwill account can't be raised in the books. Therefore, goodwill is to be adjusted through partners' capital account on retirement.

In case of retirement and death of a partner, goodwill account cannot be raised. There are namely two probable situations on which the treatment of goodwill rests.

1. If **goodwill already appears** in the books of the firm.
2. If **no goodwill appears** in the books of the firm.

Situation 1: If goodwill <u>already appears</u> in the books of the firm.

Step 1: Write off the existing goodwill

If goodwill already appears in the old balance sheet of the firm (if mentioned in the question), then first of all, this goodwill should be written off and should be distributed among all the partners of the firm including the retiring or the deceased partner in their old profit sharing ratio. The following Journal entry is passed to write off the old/existing goodwill.

All Partners' Capital A/c Dr.
    To Goodwill A/c
(Goodwill written of among all the partners in their old ratio)

Step 2: Adjusting goodwill through partner's capital account.

After writing off the old goodwill, the goodwill need to be adjusted through the partner's capital account with the share of the goodwill of the retiring or the deceased partner. The following Journal entry is passed.

Remaining Partner's Capital A/c Dr.

To Retiring/Deceased Partner's Capital A/c

(Gaining Partner's Capital A/c is debited in their gaining share and retiring/deceased partner's capital account in credited for their share of goodwill)

Situation 2: If <u>no goodwill appears</u> in the books of the firm.

As no goodwill appears in the books of the firm, so the goodwill is adjusted through the partner's capital account with the share of the goodwill of the retiring or the deceased partner. The following Journal entry is passed.

Remaining Partner's Capital A/c Dr.

To Retiring/Deceased Partner's Capital A/c

(Gaining partner's capital account is debited in their gaining share and retiring/deceased partner's capital account in
credited for their share of goodwill)

Hidden Goodwill

Sometimes, a firm may agree to settle the retiring partner by making a lump sum payment. The amount paid may be more than what is due to him based on his capital account after making all adjustments like share of revaluation, share of accumulated profits etc. Then the excess paid shall be treated as retiring partner's share of goodwill (Hidden goodwill)

Accounting Adjustment of accumulated Reserve and profits/ losses

At the time of Retirement of a partner, any reserve or accumulated profits/losses exists in the books of the firm, these should be transferred to All partners' Capital accounts (if capitals are fluctuating) or Current Accounts (If capitals are fixed) in their old profit sharing ratio.

(A) Distribution of Accumulated Reserve and Profit

General Reserve A/C Dr

Profit & Loss A/C Dr

To All Partners Capital A/C (Old ratio, individually)

(Being Accumulated profit transferred to All partners capital A/C in their old ratio)

5. (B) Distribution of Accumulated Losses

All Partners' Capital A/C….. Dr

To Profit & Loss A/C

(Being Accumulated Loss transferred to

All partners' capital A/C in their old ratio)

Revaluation of Assets and Liabilities

The assets and liabilities should be revalued on the same basis as is done in case of admission of a partner. A revaluation account or profit and loss adjustment account is prepared for this purpose. The profit or loss on revaluation is transferred to **all** the partners' capital accounts in their old profit sharing ratio.

Journal entry: - If **Revaluation Profit:**

Revaluation A/C Dr

To All Partners Capital A/C (Individually, Old Ratio)

(Being revaluation profit distributed among all partners)

If Revaluation Loss:

All Partners Capital A/C Dr

To Revaluation A/C

(Being Revaluation loss distributed among all partners)

Ascertainment of profit and loss up to the date of retirement

Where the retirement occurs on the last date of the financial year, determination of profit or loss of the firm is not a problem. But, where the retirement takes place **during the course of an accounting year**, the actual profit obtained or loss incurred from the last balance sheet to the date of retirement is to be ascertained. Generally it may be ascertained on the basis of last year's profit ,on the basis of the average profit of a certain number of year's etc .Such derived amount is only an estimate. Hence the journal entry for the same would be:

In case of profit:

Profit and Loss Suspense A/C Dr.

Retiring Partner's Capital A/C

(Being Retiring partner's share of profit up to the date of retirement)

Note: In this case, Profit and Loss Suspense A/C will show debit balance. At the end of the year it will be closed by transferring it to P & L Account. Until the date, it will appear on the **asset side of the Balance sheet**

In Case of Loss:

Retiring Partner's Capital A/C Dr

Profit and Loss Suspense A/C

(Being Retiring partner's share of Loss up to the date of retirement)

Note: In this case, Profit and Loss Suspense A/C will show credit balance. At the end of the year it will be closed by transferring it to P & L Account. Until the date, it will appear on the **Liability side of the Balance sheet.**

Joint Life Policy – Accounting Treatment

The partners of a firm may decide to take a Joint Life Policy on the lives of all the partners of the firm. The partners take this policy with the aim to reduce the financial burden on the firm at the time of payment of a large sum to the retiring partner

The firm pays the premium on the Joint Life Policy. The Insurance Company pays the amount of the Joint Life Policy on the maturity of the policy or the death of a partner, whichever is earlier.

Meaning of Surrender value: Surrender value refers to the realization value of an insurance policy of the joint life policy is surrendered to the insurance company before the date of maturity

The methods of accounting for Joint Life Policy are as under

Case1: Premium Paid is treated as Expenses

When the partners decide to treat the premium on Joint Life Policy as an expense, then they debit the Premium A/c to the Profit and Loss A/c every year to close it. In this situation, the full amount of policy received from the Insurance Company becomes a gain.

Journal Entry

When premium paid is treated as Revenue expenditure

(1)When surrender value of JLP to be recorded

Joint Life Policy A/C………………..Dr. (with surrender value)

To All Partners Capital A/C (in Old Ratio)

(Being the surrender value of JLP recorded)

Note: JLP, If maintained will appear on the Assets side of the balance sheet

(2) When Joint Life Policy is written off by the Continuing partner

Remaining partners capital A/C………………….Dr (in new ratio)

To Joint Life Policy A/C

(Being the surrender value of JLP written off)

Note: - Now JLP will not appear in the balance sheet

Case2: Premium Paid is treated as Capital Expenditure

In this case joint life policy has already been recorded in the books of accounts as its surrender value and it will be appearing in the balance sheet hence No further entry is required

(1) When Joint Life policy Written Off (should not be shown in the balance sheet)

Remaining partners capital A/C.....................Dr (in new ratio)

To Joint Life Policy A/C

(Being the surrender value of JLP written off)

(2) When Joint life Policy Reserve (on liabilities side)are given: Such reserve amount transfer in to All partners capital account in old profit sharing ratio

Joint Policy Reserve A/C ....Dr

To All Partners Capital A/c (in old ratio)

(Being JLP Reserve transferred to partners' capital a/c in old ratio)

Calculation of Total Amount Due to the Retiring Partner

The total amount due to the retiring partner is determined by preparing his capital account on the date of retirement.

Retiring partner's capital account shall have the following items on the credit side:

- **Capital on the date of last balance sheet**
- **Interest on capital, salary, commission etc. payable to him from the date of last balance sheet to the date of retirement.**
- **His share of goodwill of the firm**
- **His share of undistributed profits and reserves**

- **His share in revaluation profit**
- **His share in joint life policy surrender value**
- **His share in profit up to the date of retirement, since the last balance sheet**

Retiring partner's capital account shall have the following items on the credit side:

- **His share of accumulated losses**
- **His share of revaluation loss**
- **His drawings during the period**
- **His interest on drawings**
- **His share of loss till the date of retirement since the last Balance Sheet, if any**

Retiring Partner's Capital Account (Specimen)

Particulars	Amount	Particulars	Amount
To Drawings	XXXX	By Balance b/d	XXXX
To Interest on Drawings	XXXX	By Gaining partners Capital(Retiring partner's share of goodwill)	XXXX
To Revaluation Loss (If any)	XXXX		
To Retiring Partner's Loan (B/F)	XXXX	By Reserves/P & L A/C	XXXX
OR		By Revaluation Account (Profit)	XXXX
To Cash/Bank (B/F)	XXXX	By Joint life policy(Share of surrender value)	XXXX
	XXXX		XXXX

Settlement of total amount due to the retiring partner

The amount due to the retiring partner is settled as per the provisions of the partnership deed. It may be paid in full at the time of retirement. Sometimes, the firm may not be in a position to pay the amount due to him in lump sum. In such a case, the amount due is transferred to retiring partner's loan account and is paid in instilments together with interest.

Note: According to section 37 of the Indian Partnership Act,1932,the outgoing(Retiring) Partner has an option to receive either interest **@ 6 % p.a** till the date of payment or such share of profit which has been earned with his money(based on capital ratio).

Journal Entry-When retiring partner is paid cash in full (Lump Sum):

Retiring Partner's Capital A/C Dr

To Cash/Bank

(Amount due to the retiring partner paid off)

Journal Entry-When the retiring partner's whole amount is transferred to his loan account

Retiring Partner's Capital A/C Dr

To retiring Partner's Loan A/C

(Amount due to the retiring partner transferred to his Loan A/C)

Journal Entry-When the retiring partner is partly paid in cash and the remaining amount transferred to his loan account

Retiring Partner's Capital A/C Dr (Total Amount Due)

To Cash/Bank (Amount paid)

To Retiring Partner's Loan (Amount transferred to loan)

(Amount due to the retiring partner is settled)

Loan account of the Rating Partner

Journal Entry: 1. when the amount due to the retiring partner is transferred to his loan account

Retiring Partner's Capital A/C Dr

To retiring Partner's Loan A/C

(Amount due to the retiring partner transferred to his Loan A/C)

2. When yearly interest due

Interest Account Dr (Interest of the current year)

To Retiring Partner's Loan account

(Interest due)

3. For payment of yearly installment (yearly Principal amount + Yearly interest)

Retiring Partner's Loan A/C Dr

To Cash/Bank

(Being yearly installment paid)

Note: 1. Balance of retiring partner's loan account is shown on the liability side of the balance sheet.

2. Journal entry (2) and (3) above will be repeated till the loan is paid off.

Q. P,Q and R are partners in a firm .Q retires from the firm on 1-1-2014.On his date of retirement,Rs.1,20,000 is due to him and R promise to pay **four** equal annual instilments together with interest at 10% per annum .Prepare Q's Loan Account for the 4 Years.

Repayment period =4 years

Amount of equal yearly installment = 1,20,000/4 = 30,000

Total amount to be repaid each year = 30000 + Yearly interest

R's Loan Account

Date	Particulars	Amount	Date	Particulars	Amount
31-12-14	To cash (30,000+12,000)	42,000	1-1-14	By R's Capital A/C	1,20,000
31-12-14	To Balance c/d	90,000	31-12-14	By Interest (1,20,000*10%)	12,000
		1,32,000			1,32,000
31-12-15	To Cash (30,000 +9,000)	39,000	1-1-15	By Balance b/d	90,000
31-12-15	To Balance c/d	60,000	31-12-15	By Interest (90,000 *10%)	9,000
		99,000			99,000
31-12-16	To Cash (30,000 +6,000)	36,000	1-1-16	By Balance b/d	60,000
31-12-16	To Balance c/d	30,000	31-12-16	By Interest (60,000 *10%)	6,000
		66,000			66,000
31-12-17	To Cash (30,000 + 3,000)	33,000	1-1-17	By Balance b/d	30,000
			31-12-17	By Interest (30,000 *10%)	3,000
		33,000			**33,000**

Journal Entry for First Year

Date	**Particulars**	**LF**	**Debit**	**Credit**
	When Amount due to R transferred to his loan A/C			
1-1-14	**R's Capital A/C Dr**		**1,20,000**	
	To R's Loan A/C			

	(R's capital A/C closed by transfer it to R's Loan A/C)			**1,20,000**
31-12-14	When interest due at the end of the year: **Interest A/C Dr** **To R's Loan A/C** (Loan interest due for one year)		**12,000**	**12,000**
31-12-14	When first installment paid (Interest +1st installment of Principal amount) **R's Loan A/C Dr** **To Cash** (First instalment paid)		**42,000**	**42,000**

Note: 2nd and 3rd will be repeated for 3 more years.

Adjustment of Capitals

The capitals of the continuing partners may be required to be adjusted in any one of the following three ways:-

Case-I when the total capital of the new firm is given

Case-II when the total capital of the new firm is not given

Case-III When the retiring partner is to be paid through cash brought in by the continuing partners in such a way as to make their capitals proportionate to their new profit sharing ratio

Case-I when the total capital of the new firm is given

The various steps involved in adjusting the capitals of the partners are given below:

Step-1 Calculate the adjusted old capitals of continuing partners (i.e after all other adjustments)

Step-2 Calculate the new capital of remaining partners by dividing the total capital in their new profit sharing ratio.

Step-3 Calculate the surplus/deficiency in each of the remaining partners' capital accounts by comparing the new capitals with the adjusted old capitals.

Step-4 Adjust the surplus by paying off or by transfer to the credit of current account and adjust the deficiency by asking the concerned partner to bring in the necessary amount or by transfer to the debit of his current account

Journal Entry:

In case the adjusted old capital is less than new capital:

Cash/Particular Partner's Current A/C Dr

To Particular Partner's Capital A/C

(Being the shortage brought in/adjusted by the partner)

In case the adjusted old capital is more than the new capital:

Particular Partner's Capital A/C Dr

To Cash/Particular Partner's Current A/C

(Being the excess capital withdrawn/adjusted by the partner)

Case-II when the total capital of the new firm is not given

The various steps involved in adjusting the capitals of the partners are given below:

Step-1 Calculate the adjusted old capitals of remaining partners after all other adjustments

Step-2 Calculate the Total Capital of the new firm:

Total Capital of the new firm = Combined adjusted capitals of remaining partners.

Step-3 Calculate new capital of remaining partners as per new ratio

Step-4 Calculate the surplus/deficiency in each of the remaining partners' capital accounts by comparing the new capitals with the adjusted old capitals.

Step-5 Adjust the surplus by paying off or by transfer to the credit of current account and adjust the deficiency by asking the concerned partner to bring in the necessary amount or by transfer to the debit of his current account

Case-III When the retiring partner is to be paid through cash brought in by the continuing partners in such a way as to make their capitals proportionate to their new profit sharing ratio

The various steps involved in adjusting the capitals of the partners are given below:

Step-1 Calculate the adjusted old capitals of remaining partners after all other adjustments

Step-2 Calculate the required amount payable to the retiring partner

Step-3 Calculate Total Capital of the new firm as follows

Total Capital of the new firm = Combined adjusted capitals of remaining partners + Shortage of cash to be brought in by continuing partners in order to make payment to retiring partner

Step-4 Calculate new capital of remaining partners as per new ratio

Step-5 Calculate the surplus/deficiency in each of the remaining partners' capital accounts by comparing the new capitals with the adjusted old capitals.

Step-6 Adjust the surplus by paying off or by transfer to the credit of current account and adjust the deficiency by asking the concerned partner to bring in the necessary amount or by transfer to the debit of his current account