Chapter -3

Reconstitution Of A Partnership Firm - Admission Of A Partner

GOODWILL

Goodwill is the value of the reputation of a firm in respect of profits expected in future over and above the normal rate of profits.

In simpler Terms, Goodwill is nothing more than the probability that old customers will resort to the old place again and again. The capacity of a business to earn super-profits in the future is basically what is meant by term goodwill. **Goodwill is an intangible asset;** it cannot be seen; it cannot be felt; it cannot be transported physically. **Even then it is very real.** From an accounting point of view, it must have some monetary or saleable value. The implication of the term over and above is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, the personal reputation of the partner, or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases:

a) When the profit-sharing ratio amongst the partners is changed;
b) When a new partner is admitted;
c) When a partner retires or dies; and
d) When the business is dissolved or sold.

Let us take a simple example. There is a small Book business owned by a firm. Its net worth i.e. Asset– liabilities, is RS 140,000. Now if a purchaser is willing to pay RS 150,000 for it, the extra RS 10,000 is known in accounting as goodwill. The next question is: Why the purchaser is willing to pay RS 10,000 for goodwill.

One reason may be the future capability of the business to earn more profit than the normal profit. It may be on account of a favourable location.

The major factors which affect the value of goodwill are as follows:

The list is in no way exhaustive but only provides the basic guidelines:

(i) The quality of the goods sold.
(ii) The personal reputation of the owners i.e., their ability to attract the customers.
(iii) The location of the business premises e.g., a good position in a congested market.
(iv) The possession of near-monopoly right e.g. main agent for a particular vehicle

like Maruti car, Bajaj scooter, etc.

(v) The possession of trademarks and patents.

(vi) The presence of managerial skill.

(vii) The cost of research and development which enables the production at low cost and of good quality.

(viii)The possession of special contracts for the availability of materials

RECOMMENDATION OF ACCOUNTING STANDARD

Accounting Standards require an enterprise to recognize an intangible asset, only if and only if, certain conditions are satisfied, namely:

I. An intangible asset must have the **characteristics of an asset.** It means that it must have some value and must be identifiable so that it can be sold without disposing of other assets or future benefits flowing from other assets.

II. An intangible asset should be recognized only if the **future probable economic benefits** (i.e., increased revenue from sales) will flow to the business enterprise and not to others. It means that management can make reasonable estimates of future benefits.

III. The cost of the intangible asset can **be measured reliably**, that is, the cost is objectively verifiable. If the cost cannot be measured reliably, then it cannot be recognized as an asset.

It is thus clear that none of the conditions is satisfied by internally generated goodwill or inherent goodwill. The reasons are simple to explain. First, it is not an identifiable resource like patent, trademark, or copyright. Second, it is very difficult to assess its future benefits. Finally, the cost of internally generated goodwill cannot be reliably measured in the absence of any consideration in money or money' worth. There is no documentary evidence to support the value of goodwill as a resource.

Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Accordingly, on admission or retirement/death of a partner or even when there is a change in profit sharing ratio amongst the existing partners, goodwill should not be raised in the books of account of the partnership firm because no consideration in money or money' worth has been paid for it. The conclusion is that only purchased goodwill should be recorded in the books of account whether the payment is made directly in cash or money' worth. For example, 'A' and 'B' purchase the net assets (assets minus liabilities) of 'C' amounting to RS2,50,000 for RS3,00,000 in cash, the additional payment of RS50,000 is a payment for goodwill in cash. It is a case of purchased goodwill (an asset) and can be validly recorded in the books of A and B. When no payment is made for the purchase of goodwill and goodwill account is raised in the books, it is a case of internally generated goodwill or inherent goodwill and as per Accounting Standards, it is not permitted. For example, in the event of the reconstitution of the firm due to admission, or retirement or death of a partner, or even a change in the profit-sharing ratio without reconstitution, goodwill of the firm is evaluated. In such a situation, the value of goodwill should not be brought into books of account because it is inherent or self-generated goodwill since no money or money' worth has been paid for it. The only way out is that the value of goodwill as calculated with the help of different valuation methods should be adjusted through capital accounts of the partner(s) of the firm. In no case, the goodwill account is to be raised in the books of account, either on the reconstitution of the firm or change in the profit-sharing ratio.

The amount of goodwill is written off over some time. In case when the goodwill account exists at the time of the reconstitution of the firm, it should be written off immediately whether it is internally generated or goodwill has been bought for some consideration.

METHODS FOR GOODWILL VALUATION

There are three methods for the valuation of goodwill

1. Average profit basis,-Simple and Weighted
2. Super profit basis,-Number of Year Purchase, Annuity basis, and Capitalization of Super Profit
3. Capitalization basis- Average Profits

Average Profit Basis: In this case, the average profits of past years are adjusted for any expected change in the future. The number of the year is decided based on judgment and negotiation. For averaging the past profit, either a simple average or weighted average may be employed depending upon the circumstances. If there exists a clear increasing or decreasing trend of profits, it is better to give more weight to the profits of recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.

Let us suppose the profits of a partnership firm for the last five years were RS30,000, RS40,000, RS50,000, RS60,000, and RS70,000. In this case, a clear increasing trend is noticed and therefore, average profit may be arrived at by assigning appropriate weights as shown below :

1 Year	2 Profit RS	3 Weight	4 = 2 × 3 Weighted Profit RS
1	30,000	1	30,000
2	40,000	2	80,000
3	50,000	3	1,50,000
4	60,000	4	2,40,000
5	70,000	5	3,50,000
		15	8,50,000

So, Weighted Average Profit $= \frac{8,50,000}{15}$ = RS 56,667 (approx)

If goodwill is valued at three years' purchase of profit, the ninth is case the value of goodwill is RS56,667 (approx) × 3 = RS1,70,000.

However, if any such trend is not visible from the figures of past profits, then one should take a simple average profit and calculate goodwill accordingly. Let us suppose, profits of a partnership firm for five years were

RS30,000, RS25,000, RS20,000, RS30,000 and RS28,000. In this case, there is no clear increasing or decreasing trend of profit. So average profit comes to RS26,600 (arrived at by taking the simple average). If the goodwill is valued by taking three years of the purchase of profit, the ninth is the case, the value of goodwill becomes RS79,800.

The weighted average is used when profit has increased or decreasing Trend. Highest weight is always given to the current year, as it reflects the more realistic view of the future profitability

EXAMPLE

The past profits of five years of a partnership firm are: RS 50,000; RS 40,000; RS 52,000; RS 48,000 and RS 56,000 respectively. Calculate the value of goodwill based on 4 years' purchase of the average profits of the last five years.

ANSWER

Total profits for five years = RS(50,000 + 40,000 + 52,000 + 48,000 + 56,000) = RS 2,46,000 Average profit = Sum of profits/No. of years

Average Profit = RS 2,46,000 ÷ 5 = RS 49,200

Value of goodwill (being four years' purchase of the average profit of five years) = 4 × RS 49,200 =

RS1,96,800.

2. Super Profit Basis: In the case of super profit method, goodwill is valued based on super-profits earned by the firm.

Super Profit=Actual Profit-Normal Profit Actual Profit is the average profit

Normal Profit=Normal rate of Return (NRR) x Capital Employed

The rationale for using the super profit is the partner who gains excess earning owing to the reconstitution of the firm should compensate to partners sacrificing their share in the reconstitution. Super profit means excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit-sharing ratio has to contribute only for excess profit because normal profit he can earn by joining any partnership firm. Under the super profit method, what excess profit a partnership firm can earn is to be determined first.

Calculation of super profit:

- identify the capital employed by the partnership firm;
- Identify the average profit earned by the partnership firm based on the past few years' figures;
- Determine the normal rate of return prevailing in the locality of similar firms;
- Apply a normal rate of return on capital employed to arrive at a normal profit;
- Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

Let us suppose, total capital employed by a partnership firm was RS1,00,000 and its average profit was

RS25,000. The normal rate of return is 22% in the case of similar firms working under similar conditions. So, the normal profit is RS22,000 and the average profit is RS25,000. The partnership firm earns RS3,000 super profit.

a) **Some Years Purchase Method:** Goodwill is generally valued by multiplying the amount of super profit by a certain number of years depending upon the expectation about the maintenance of such profit in the future. If it is expected that the super profit can be maintained for another five years in the future, the value of goodwill may be taken as RS3,000 × 5 = RS15,000.

EXAMPLE

A firm of A, B, and C has a total capital investment of RS4,50,000. The firm earned net profits during the last four years as I-RS 70,000; II-RS 80,000; III-RS1,20,000 and IV-RS1,00,000. The reasonable expected return is 15 percent having regard to the risk involved. Find out the value of goodwill of the business if it is based on 3 years' purchase of the average super-profits of the past four years.

ANSWER

Average Profit = Sum of profits/no. of years Normal Profit = NRR x Capital Employed Super Profit = Average profit- Normal Profit

	RS
Total profits earned for four years :	3,70,000
Average annual profit RS3,70,000 ÷ 4	92,500
Normal Profit (15% of RS4,50,000)	67,500
Super Profit RS 92,500–RS 67,500	25,000
Value of goodwill (being 3 years' purchase of the average super profit :	
RS 25,000 x 3 =	75,000

Annuity Method: The major drawback of several year's purchase methods is that the time value of money is not considered. Although it was expected that super profit would be earned in five future years, still no evaluation was done on the value of money for the time difference. When money will be received at different points of time, its value should be different depending upon the rate of interest. If a 15% rate of interest is considered appropriate, then the discounted value of super profit to be earned in different future years will be as follows:

Year	Super Profit RS	Discount Factor @15%	Discounted value of Super Profit
1	3,000	.8696	2,608.80
2	3,000	.7561	2,268.30
3	3,000	.6575	1,972.50
4	3,000	.5718	1,715.40
5	3,000	.4972	1,491.60
		3.3522	10,056.60

So, under the annuity method, the discounted value of total super profit becomes RS10,056.60 and not RS15,000 as was done under the super profit method.

The word annuity is used to mean an identical annual amount of super profit. So, for discounting it is possible to refer to the annuity table. As per the annuity table, the present value of RS 1 to be received at the end of each year for n year @15% interest p.a. is 3.3522. So value of goodwill under annuity method is RS 3,000×3.3522 =10,056.60.

EXAMPLE

Calculate the goodwill by annuity method of super profit from the following facts:

- Annual maintainable profit after tax is RS 65,000.
- Capital employed is RS 4,00,000.
- The normal rate of return is expected at 12% p.a.
- The present value of an annuity of RS 1 for five years is 3.604776.

ANSWER

	RS
Annual maintainable profit	65,000
Less: Normal profit based on capital employed and normal	

rate of return i.e., 12% of RS4,00,000	(48,000)
Super profit	17,000
The present value of an annuity of RS 1 for five years at 12% compound interest is	3.604776

The present value of annuity of RS 17,000 for five years at 12% compound interest = 17,000 x 3.604776 =61,281 (Approx.)

Capitalization of Super Profit: Goodwill = Super Profit/ Normal rate of Return (NRR) = RS17,000/ 12% =14,167

4. **Capitalization Basis:** Under this basis, the value of the whole business is determined by applying a normal rate of return. If such value (arrived at by applying the normal rate of return) is higher than the capital employed in the business, then the difference is goodwill. The steps to be followed under this method are given below:

a) Determine the normal rate of return.

b) Find out the average profit of the partnership firm for which goodwill is to be determined.

c) Determine the capital employed by the partnership firm for which goodwill is to be determined.

d) Find out the normal value of the business by dividing average profit by normal rate of return.

Deduct average capital employed from the normal value of the business to arrive at goodwill.

Goodwill = Normal Capital-Actual Capital

Normal capital = Average Profit/NRR

Let us suppose the capital employed by a partnership firm is RS1,00,000. Its average profit is

RS20,000. The normal rate of return is 15%.

Normal Value of business= $\frac{\text{RS } 20{,}000}{15\%}$ =RS1,33,333

15% Value of goodwill = RS1,33,333 – RS1,00,000 = RS33,333

EXAMPLE

1. The net tangible assets of a firm are worth RS4,10,000 and the average profit of the last four years amounts to

RS 60,000. Find out of the value of goodwill if the reasonable return on capital invested is 12%.

SOLUTION

	RS
Capital invested in the business	4,10,000
A normal rate of return	12%
Average profit earned by the firm	60,000
Value of the firm (Capitalization of average profit):	
60,000/12%=	5,00,000
Goodwill = Value of the firm –Net Assets = RS 5,00,000 - RS 4,10,000	90,000

Above method are explained below with the help of the following illustrations:

ILLUSTRATION 1

Lee and Lawson are in equal partnership. They agreed to take Hicks as a one-fourth partner. For this, it was decided to find out the value of goodwill. M/s. Lee and Lawson earned profits during 2013-2016 as follows:

Year	***Profits*** RS
2013	*1,20,000*
2014	*1,25,000*
2015	*1,30,000*
2016	*1,50,000*

On 31.12.2016 capital employed by M/s. Lee and Lawson were RS 5,00,000. The rate of normal profit is 20%.

Required

Find out the value of goodwill following various methods.

SOLUTION

Average Profit:

Year	Profit	Weight	Weighted Profit RS
2013	1,20,000	1	1,20,000
2014	1,25,000	2	2,50,000
2015	1,30,000	3	3,90,000

2016	1,50,000	4	6,00,000
		10	13,60,000

Weighted Average Profit = RS13,60,000 divided by 10 = RS1,36,000

Method(1): Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase Value of Goodwill: RS1,36,000 ×3 = RS4,08,000
Method(2): Super Profit Basis

Average Profit 1,36,000

Less: Normal Profit

20% on RS 5,00,000 (1,00,000)

RS 36,000

Assumption: Goodwill is valued at 3 years' purchase. Value of Goodwill = RS36,000 × 3 = RS1,08,000
Method (3): Annuity Basis

Assumptions:

Interest rate is equivalent to normal profit rate i.e. 20%p.a.

Goodwill is valued at 3years'purchases Valuation of Goodwill: RS36,000 × 2.1065 =RS75,834

Method (4): Capitalisation Basis

Normal Value of business: $\frac{₹\ 1,36,000}{20} \times 100$ = RS 6,80,000

Less: Capital Employed in M/s. Lee and Lawson = (RS 5,00,000)

Goodwill = RS 1,80,000

ILLUSTRATION 2

The following particulars are available in respect of the business carried on by Rathore

			RS
(1)	*Capital Invested*		*1,50,000*
(2)	*Trading Results:*		
	2013	*Profit*	*40,000*
	2014	*Profit*	*36,000*
	2015	*Loss*	*6,000*
	2016	*Profit*	*50,000*
(3)	*Market Rate of interest on investment*	*10%*	

(4)	*Rate of risk-return on capital invested in a business*	*2%*
(5)	*Remuneration from alternative employment of the proprietor (if not engaged in business).*	RS *6,000 per annum*

You are required to compute the value of goodwill based on 5years' purchase of super profit of the business calculated on the average profits of the last four years.

SOLUTION

Average maintainable profits:		RS
Trading profit during	2013	40,000
	2014	36,000
	2015	50,000
		1,26,000
Less: Loss during	2016	(6,000)
Total		1,20,000
Average Profits		30,000
Less: Remuneration for the proprietor		(6,000)
Average maintainable Profit		24,000
Less: Normal Profit (12% on capital employed)		(18,000)
Super Profit		6,000
Goodwill at 5 year's purchase of super Profit		30,000

NEED FOR VALUATION OF GOODWILL

Whenever there is any change in the existing relationship of the partners in terse, some partners have to sacrifice their future profit and some others would gain. Those who are sacrificing future profit should be compensated by the others who are gaining. This adjustment of the partnership rights may arise due to the admission of a new partner, change in the profit-sharing ratio, retirement or death of a partner, and dissolution of the partnership. The partners, who gain in terms of profit-sharing ratio, have to pay for such gain as a proportion to the value of goodwill. The partners, who lose in terms of profit-sharing ratio, receive payments for the sacrifice as a proportion to the value of goodwill. The dissolution of partnership firms is not covered in this study material and will be discussed in the Intermediate Course Study Material.

VALUATION OF GOODWILL IN CASE OF ADMISSION OF A PARTNER

Whenanewpartnerisadmittedintoapartnership, certainadjustmentsinaccountsbecomenecessary. Chiefly, this is because the new partner will acquire a share in the profits of the firm and because of this, the old partners will stand to lose. Suppose, A and B are partners sharing profits in the ratio of 3:2. If their profits are RS20,000, A will get RS12,000 and B will get RS8,000. If C is admitted and given one-fourth share in profits, then out of RS20,000 he will get RS5,000. The remaining RS15,000 will be divided between A and B; A will get RS9,000 and B will get

RS6,000. Thus on C's admission A loses RS3,000 per year and B loses RS2,000 per year. C will have to compensate A and B for this loss. It is no argument to say that on C's admission the profits will not remain at RS20,000; extra profits will arise and therefore, A and B will both get more than what they previously got. But it should be noted that the additional profits will be earned by the combined efforts of all the partners' A, B and C. Therefore if A and B get a share of the extra profits they are not particularly obliged to C. Out of the present profits of

RS20,000 they have to give up a share in favor of C and, therefore, they are entitled to compensation. The problem of compensation is the chief problem while dealing with the admission of a partner. This is tackled through goodwill.

But one point should be made clear here. Goodwill is compensation to old partners for their sacrifice in connection with the admission of a new partner. So it is to be credited to the partners according to their profit sacrificing ratio. Whatever share the new partner is getting, it may be sacrificed by the old partners in proportion to their old profit sharing ratio or different proportion.

For example, Nigam and Dhameja are in partnership sharing profits and losses equally. They agreed to take Ghosh as a one-third partner. Now one-third share of Ghosh may come out of sacrifice made by Nigam and Dhameja equally (i.e. at their old profit sharing ratio). See the following profit sharing pattern:

ProfitSharingPattern

Partners	Old Share	New Share	Sacrifice	Gain
Nigam	$\frac{1}{2}$	$\frac{1}{2}\left[1-\frac{1}{3}\right]=\frac{2}{3}\times\frac{1}{2}=\frac{1}{3}$	$\frac{1}{2}-\frac{1}{3}=\frac{1}{6}$	–
Dhameja	$\frac{1}{2}$	$\frac{1}{2}\left[1-\frac{1}{3}\right]=\frac{2}{3}\times\frac{1}{2}=\frac{1}{3}$	$\frac{1}{2}-\frac{1}{3}=\frac{1}{6}$	–
Ghosh	–	$\frac{1}{3}$	–	$\frac{1}{3}$

In other words, one-third share of Ghosh was borne by Nigam and Dhameja at their old profit sharing ratio. By this process Nigam sacrificed 1/2–1/3 = 1/6 in share and Dhameja sacrificed 1/2–1/3 = /1/6 in share. So the profit sacrificing ratio becomes:

Nigam = Dhameja

1/6 = 1/6

1 : 1

Which is the same as the old profit sharing ratio?

But if the new profit sharing ratio of Nigam, Dhameja, and Ghosh becomes 4:2:3, then profit sacrificed by Nigam and Dhameja on Ghosh's admission is not at the old profit sharing ratio. In this case, profit sacrificing ratio is as follows:

Niga

m = 1/2–4/9=1/18 Dhameja = 1/2–2/9=5/18

i.e. 1 : 5

If Ghosh pays goodwill of RS24,000, then in the first case, Nigam and Dhameja should share it equally; but in the second case Nigam should get RS4,000 and Dhameja should get RS20,000.

Take another example: Nigam and Dhameja are equal partners. They agreed to take Ghosh as a one-third partner. The new profit sharing ratio is 4:2:3. Nigam and Dhameja agreed RS27,000 as a value of goodwill.

Journal Entries:

		RS	RS
Ghosh's Capital Account	Dr.	9,000	
To Nigam's Capital Account			1,500
To Dhameja's Capital Account			7,500
(Goodwill adjustment in the profit sacrificing ratio–			

Nigam - RS 27,000 × 1/18 Dhameja - RS 27,000 × 5/18)

As per the Accounting Standards, it is not recommended to raise a goodwill account but to show the adjustment of goodwill through partners' capital accounts.

ACCOUNTING TREATMENT OF GOODWILL IN CASE OF ADMISSION OF A NEW PARTNER

The goodwill should be recorded in the books only when some consideration in money or money's worth as been paid for it. Therefore, only purchased goodwill should be recorded in the books of the firm. In case of admission of a partner, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth is paid for it. If the incoming partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed to other existing partners. When a new partner is admitted to a firm, the old partners generally sacrifice in favor of the new partner in terms of a lower profit sharing ratio in the future. Therefore, the premium for goodwill brought in by the new partner shall be given to the existing partners based on the profit sacrificing ratio. The profit sacrificing ratio is computed by deducting the new profit sharing ratio from the old profit sharing ratio. If the difference is positive, then there is a profit sacrifice and in case the difference is negative, then there is again in terms of higher future profit sharing ratio. In case of admission of a partner, only those existing partners are entitled to a share for goodwill who have sacrificed a part of their profits in favor of the new partner. Sometimes, goodwill may be evaluated in case of admission of a partner when an incoming partner is unable to bring in cash any premium for goodwill. In that situation also, the value of goodwill should not be raised in the books since it is inherent goodwill. Rather it is preferable that such value of goodwill should be adjusted through partners' capital accounts. It may also be noted that when the incoming partner pays any premium for goodwill privately to the existing partners, no entry is required in the books of the firm. In that case, the amount to be paid to each partner should be calculated as per the profit sacrificing ratio.

Example 1: A, B & C are in partnership sharing profits and losses in the ratio 2:2:1. They want to admit D into partnership with one-fifth share. D brings in RS30,000 as capital and 10,000 as premium for goodwill.

The necessary journal entry will be:

Bank A/c	Dr.	RS 40,000	
To A's Capital A/c			RS 4,000
To B's Capital A/c			RS 4,000
To C's Capital A/c			RS 2,000
To D's Capital A/c			RS 30,000
(Amount brought in by Das Capital and premium for goodwill which is credited to the old partners' Capital accounts in profit sacrificing ratio)			

Example 2: A & B are equal partners. They wanted to take C as a third partner and for this purpose, goodwill was valued at RS1,20,000. The journal entry for adjustment of the value of goodwill through partners' capital accounts will be:

C's Capital A/c	Dr.	RS 40,000	
To A's Capital A/c			RS 20,000
To B's Capital A/c			RS 20,000
(Adjustment for goodwill)			

The net effect in partners' capital accounts is shown based on

profit sacrificing ratio: A = 1/6 × RS1,20,000 = RS20,000(Cr.)

B = 1/6 × RS1,20,000 = RS20,000 (Cr.)

C = 1/3 × RS1,20,000 = RS40,000 (Dr.)

Example 3: A & B are equal partners. They wanted to admit C as 1/6th partner who brought 60,000 as goodwill. The new profit sharing ratio is 3:2:1. Profit sacrificing ratio is to be computed as follows: Old Share – New Share = Share Sacrificed A=1/2less3/6=0

B=1/2less2/6=1/6

So the entire goodwill should be credited to B's Capital A/c.

Cash A/c Dr. RS 60,000

To B's Capital A/c RS 60,000

(Goodwill brought in by C credited to B's Capital A/c)

Example 4: A, B & C are equal partners. They decided to take D who brought in RS36,000 as goodwill. The new profit sharing ratio is 3:3:2:2.

Old Share – New Share = Share Sacrificed A = 1/3 less 3/10 = 1/30

B = 1/3 less 3/10 = 1/30 C = 1/3 less 2/10 = 4/30

So goodwill should be shared in the ratio 1:1:4

Bank A/c Dr.	RS 36,000	
To A's Capital A/c		RS 6,000
To B's Capital A/c		RS 6,000
To C's Capital A/c		RS 24,000
(Goodwill brought in by D credited to old partners' accounts in their profit sacrificing ratio 1:1:4)		

ILLUSTRATION 3

The following is the Balance Sheet of Yellow and Green as of 31st December 2016:

Liabilities	RS	***Assets***	RS
Trade payables	*20,000*	*Cash at Bank*	*10,000*
Capital:		*Sundry Assets*	*55,000*
Yellow	*25,000*		
Green	*20,000*		

	65,000		*65,000*

The partners shared profits and losses in the ratio of 3:2. On the above date, Black was admitted as a partner on the condition that he would pay Rs 20,000 as Capital. Goodwill was to be valued at 3 years' purchase of the average of four years' profits which were:

	RS		RS
2012	*9,000*	*2014*	*12,000*
2013	*14,000*	*2015*	*13,000*

The new profit sharing ratio is 6:5:5.

Give journal entries and Balance Sheet if goodwill is adjusted through partners' capital accounts.

			RS	RS
(i)	Bank Account To Black's Capital Account (Amount brought in by Black as capital)	Dr.	20,000	 20,000
(ii)	Black's Capital Account To Yellow's Capital Account To Green's Capital Account (Black's share of goodwill adjusted through old partners' capital accounts in the profit sacrificing ratio 18:7)	Dr.	11,250	 8,100 3,150

Balance Sheet as on....................

Liabilities	RS	RS	**Assets**	RS
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	33,100			
Green	23,150			
Black	8,750	65,000		
		85,000		85,000

Note: Calculation of Profit Sacrificing Ratio Old Share – New Share = Share Sacrificed Yellow 3/5– 6/16=18/80

Green $\frac{2}{5} - \frac{5}{16}$ = 7/80

ILLUSTRATION 4

With the information given in illustration 3, let us give journal entries and prepare a balance sheet assuming that goodwill is brought in cash.

SOLUTION

Goodwill brought in cash

Bank Account	Dr.	31,250	
To Black's Capital Account			20,000
To Yellow's Capital Account			8,100
To Green's Capital Account			3,150
(Amount brought in by Black as capital and as goodwill; goodwill credited to Yellow and Green's Capital accounts in the profit sacrificing ratio)			

Balance Sheet as on....................

Liabilities	RS	RS	Assets	RS
Trade payables		20,000	Cash at Bank	41,250
Capital:			Sundry Assets	55,000
Yellow	33,100			
Green	23,150			
Black	20,000	76,250		
		96,250		96,250

ILLUSTRATION 5

Continuing with the same illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash, but withdrawn.

SOLUTION

Goodwill brought in cash but withdrawn

In addition to the treatment under Illustration 3 the following additional entry will be made:

Yellow's Capital Account	Dr.	8,100	
Green's Capital Account	Dr.	3,150	

To Bank Account (Amount is withdrawn by Yellow and Green in respect of goodwill credited to them)		11,250

Balance Sheet as on....................

Liabilities	RS	RS	Assets	RS
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	25,000			
Green	20,000			
Black	20,000	65,000		
		85,000		85,000

ILLUSTRATION 6

Based on the information given in illustration 3, let us give journal entries and prepare a balance sheet assuming that goodwill is paid privately.

There will be no entry for goodwill but Black will pay RS 8,100 to Yellow and RS 3,150 to Green. For capital brought in by Black, the entry is:

Bank Account Dr.	20,000	
To Black's Capital Account		20,000
(Amount brought in by Black as capital)		

Balance Sheet as on....................

Liabilities	RS	RS	Assets	RS
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	25,000			
Green	20,000			
Black	20,000	65,000		
		85,000		85,000

ACCOUNTING TREATMENT OF GOODWILL IN CASE OF CHANGE IN PROFIT SHARING RATIO

In case of achange in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners based on profit sacrificing ratio.

ILLUSTRATION 7

B & C are equal partners. They wanted to change the profit-sharing ratio into 4:3:2. Make the necessary journal entries. Goodwill of the firm is valued at RS 90,000.

SOLUTION

Journal Entry

		RS	RS
A's Capital	Dr.	10,000	
To C's Capital A/c			10,000

In this case, due to the change in profit sharing ratio A's gain is = 4/9 less 1/3 = 1/9

B's gain is = 1/3 less 1/3 =0

C's loss is = 1/3 less 2/9 =1/9

So, A should compensate C to the extent of 1/9th of goodwill i.e.

RS 90,000 × 1/9 = RS 10,000

ILLUSTRATION 8

A, B, and C are in partnership sharing profits and losses in the ratio of 4:3:3. They decided to change the profit-sharing ratio to 7:7:6. Goodwill of the firm is valued at RS 20,000. Calculate the sacrifice / gain by the partners and make the necessary journal entry.

SOLUTION

Partner	New Share		Old Share		Difference
A	$\frac{7}{20}$	—	$\frac{4}{10}$	=	$(\frac{1}{20})$
	$\frac{7}{20}$	—	$\frac{3}{10}$	=	$\frac{1}{20}$

B C	$\frac{6}{20}$	—	$\frac{3}{10}$	=	0

Thus, B gained 1/20th share while A sacrificed 1/20th share i.e. RS20,000 x = RS1,000. For C there was no loss no gain.

Journal Entry

		RS	RS
B's Capital A/c	Dr.	1,000	
To A's Capital A/c			1,000
(Being goodwill adjusted through partners' capital accounts in sacrificing/gaining ratio)			

ILLUSTRATION 9

A B, C, and D are in partnership sharing profits and losses equally. They mutually agreed to change the profit-sharing ratio to 3:3:2:2. Give the necessary journal entry.

SOLUTION

Gains by $\frac{3}{10} - \frac{1}{4} = \frac{1}{20}$

B gains by $\frac{3}{10} - \frac{1}{4} = \frac{1}{20}$

C loses by $\frac{1}{4} - \frac{2}{10} = \frac{1}{20}$

D loses by $\frac{1}{4} - \frac{2}{10} = \frac{1}{20}$

So if goodwill is valued at RS20,000, A and B should pay @RS1,000 each (i.e.,RS20,000×1/20) as compensation to C and D respectively for their sacrifice.

Journal Entry

A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	
To C's Capital Account			1,000
To D's Capital Account			1,000
(Being goodwill adjusted through partners' capital A/cs at			

ACCOUNTING TREATMENT OF GOODWILL IN CASE OF RETIREMENT OR DEATH OF A PARTNER

In the case of retirement of a partner, the continuing partners will gain in terms of profit-sharing ratio. Therefore they have to pay to retire partner for his share of goodwill in the firm in the gaining ratio. Similarly, in case of the death of the partner, the continuing partners should bear the share of goodwill due to the heirs of the deceased partner. For this purpose, the goodwill is value don the date of the retirement or death and adjusted through the capital accounts of the partners.

Example: A, B & C are equal partners. C wanted to retire for which value of goodwill is considered as RS90,000. The necessary journal entry will be:

A's Capital A/c	Dr.	RS 15,000	
B's Capital A/c	Dr.	RS 15,000	
To C's Capital A/c			RS 30,000
(C's share of goodwill adjusted to existing partners' capital accounts in profit gaining ratio)			

Reconstitution: Change in Existing Profit Sharing Ratio

Meaning of Partnership and Reconstitution of Firm:

- **Partnership:** As per Section 4 of the Indian Partnership Act, 1932, "Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

- **Reconstitution of the firm:** Partnership agreement defines the relationship among the partners and whenever there is a change in relationship, it results in the reconstitution of the firm. Such a reconstitution of the firm always leads to a change in the profit-sharing ratio among the partners. A firm is reconstituted, whenever there is a:
  i. Change in the profit-sharing ratio among the existing partners.
  ii. Admission of a new partner.

iii. Retirement of an existing partner.
iv. Death of a partner.
v. The amalgamation of two or more partnership firms.

Concept of Change in the Profit Sharing Ratio among existing partners:

- **Meaning:**
  i. It means the reconstitution of the firm whereby the profit-sharing ratio among all the partner's changes.
  ii. It can be due to a change in capital contribution or increased participation in management by one or more partners.
  iii. It can also be on account of one or more partner(s) acquiring a share of profit in the business from another partner(s). Therefore, the aggregate amount of gain of one (or more) partner(s) is equal to the aggregate amount loss/sacrifice borne by another partner (s).
  iv. Therefore, if the share of one (or more) partner(s) increases then share of profit of one (or more) partner(s) decreases.
  v. It leads to the dissolution of a partnership but not the dissolution of the firm. This is because the existing partnership agreement ends and the new agreement comes into effect.

- **Adjustment for Change in Profit Sharing Ratio:** Issues that need to be considered at the time of change in Profit Sharing Ratio:
  i. Determining Sacrificing and Gaining ratio,
  ii. Treatment for Goodwill,
  iii. Accounting treatment for Reserves and Accumulated Profit or losses,
  iv. Revaluation of Assets and Reassessment of Liabilities, and
  v. Adjusting the capital accounts of the partners for the same.

Meaning and the Computation of Sacrificing and Gaining Ratio:

The prime purpose of computing the sacrificing and gaining ratio is to determine the amount of compensation (goodwill) that the gaining partner shall pay to the sacrificing partner. Following points help us in understanding their meaning:

i. Sacrificing Ratio:

- **Meaning:** It is that ratio in which one or more partners forego their share of profits in favor of one or more partners of the firm. In simple terms, the ratio of the sacrifice made by one or more partners.

- **Computation:**
  Sacrificed Share = Old Share – New Share

ii. **Gaining Ratio:**

- **Meaning:** It is that ratio in which one or more partners gain a share of profit as a result of the sacrifice made by other partners of the firm. In simple terms, the ratio of gained share in profits of two or more partners in terms of the ratio.

- **Computation:**
  Gaining Share = New Share – Old Share

Accounting Treatment of Goodwill:

- **AS-26 on Intangible Assets:** Following are the points specified for Goodwill by AS-26 on Intangible Assets:
  i. It should be recorded in the books only when consideration in money or money's worth has been paid.
  ii. It should not be recorded in the books in the event of admission, retirement, death, or change in the profit sharing ratio among the partners as no consideration is paid for such goodwill.
  iii. In case, where no consideration is paid for goodwill, it has to be adjusted through the Partners' Capital Account.
  iv. In case the goodwill is raised in the books, it should be written off immediately.
  v. In case of a change in profit sharing ratios, the compensation payable by the gaining partner for his gain to the sacrificing partner or partners is known as Goodwill or Premium for Goodwill.

- **A premium on Goodwill:**
  i. Whenever there is an increase in the profit share of a partner, it means that such a partner purchases share of profit from other partners or partners by acquiring his or their share.
  ii. The partner whose share of profit increases should compensate the partner or partners whose share(s) is decreased i.e. gaining partners should compensate sacrificing partner(s).
  iii. This compensation payable by the gaining partner for his gain to the sacrificing

partner or partners is known as Goodwill or Premium for Goodwill.

iv. Amount of Compensation Payable is calculated as follows:

$$\text{Compensation Payable} = \text{Value of Firm's Goodwill} \times \text{Share of Profit Gained}$$

- **Entry to be passed to adjust Goodwill, when there is a change in the profit-sharing ratio and no Goodwill Account is Opened:**

  i. In the case of Fluctuating Capitals:

  Gaining Partners' Capital A/cs ...Dr. [In gaining ratio]
  To Sacrificing Partners' Capital A/cs [In sacrificing ratio] (Being the adjustment made for goodwill on change in the profit-sharing ratio)

  ii. In case of Fixed Capitals:

  Gaining Partners' Current A/cs ...Dr. [In gaining ratio]
  To Sacrificing Partners' Current A/cs [In sacrificing ratio] (Being the adjustment made for goodwill on change in profit sharing ratio)

- **Entry to be passed to adjust Goodwill, when there is a change in the profit-sharing ratio and when Goodwill Account is Opened:**

  i. In the case of Fluctuating Capitals:

  a. Goodwill A/c ...Dr. [In Old Profit Sharing Ratio]
  To Partners' Capital A/cs
  (Being the goodwill raised and credited to Partners' Capital Accounts in Old Profit Sharing Ratio)

  b. Partners' Capital A/cs ...Dr. [In New Profit Sharing Ratio]
  To Goodwill A/c
  (Being the goodwill debited Partners' Capital Accounts in New Profit Sharing Ratio)

  ii. In case of Fixed Capitals:

  a. Goodwill A/c ...Dr. [In Old Profit Sharing Ratio]
  To Partners' Current A/cs
  (Being the goodwill raised and credited to Partners' Current Accounts in Old Profit Sharing Ratio)

  b. Partners' Current A/cs ...Dr. [In New Profit Sharing Ratio]
  To Goodwill A/c
  (Being the goodwill debited to Partners' Current Accounts in New Profit Sharing Ratio)

- **Accounting treatment for the goodwill that is existing in the books of the firm:**

  - Writing off the amount of goodwill by debiting it to the Partners' Capital Accounts or the Current Accounts in their old profit sharing ratio and by crediting Goodwill

Account.

All Partners' Capital/Current A/c's ...Dr. [in old ratio]

To Goodwill A/c [with exiting book value of goodwill]

- Such goodwill appearing in the books of account is written off because the fresh valuation of goodwill is made which includes the value of already existing goodwill.
- To avoid the double recording of goodwill, already existing goodwill is to be written off and only the fresh goodwill is to be recorded.
- Where the partners decide to carry forward the value of goodwill in the books of account, the net effect of increase or decrease is to be given to the goodwill value.

Treatment of Reserves, Accumulated Profits or Losses that exist in the books of account at the time of change in profit sharing ratio:

If any reserves and accumulated profits or losses exist in the books of a firm at the time of change in profit sharing ratio, they are to be transferred to the Partners' Capital Accounts or their Current Accounts in their old profit sharing ratio as such existing reserves and profits are earned before the reconstitution of the firm.

- **Workmen Compensation Reserve:**

  i. It is a reserve that is set aside or appropriated out of the firm's profits to meet any of the possible liabilities for employees' compensation if it arises.

  ii. Claim to such liabilities may or may not arise.

  iii. The amount of claim may or may not be equal to the number of reserves.

Accounting Treatment of Workmen Compensation Reserve under different situations: Following are the journal entries for explaining accounting treatment of Workmen Compensation Reserve under different situation:

a. **When the claim against the workmen compensation reserve does not exist:** In this situation, the amount of this reserve is transferred to Partners' Capital Accounts in their old profit sharing ratio. Entry to be passed is:

Workmen Compensation Reserves A/c ...Dr.
To Partners' Capital (or Current) A/c
(Being workmen compensation reserves credited to partners' capital or current accounts in

their old profit sharing ratio)

b. When a claim for workmen compensation reserve exists: In such a situation, treatment shall depend on the number of liabilities:

i. **The claim is equal to reserves:** Amount of reserves is transferred to Provision for Workmen Compensation Claim Account. Entry to be passed:

Workmen Compensation Reserves A/c ...Dr.

To Provision for Workmen Compensation

Claim A/c (Being the provision made for estimated

compensation claim)

ii. **Claim amount is lower than the reserve:** Excess of Workmen Compensation Reserve over the Workmen Compensation Claim is credited to all partners in their old profit sharing ratio. Entry is:

Workmen Compensation Reserve A/c ...Dr.

To Provision for Workmen

Compensation Claim A/c To Partners'

Capital or Current A/c

(Being the surplus of Workmen Compensation Reserve transferred to Partners' Capital or Current Account in their old profit sharing ratio)

iii. **Claim amount is higher than the reserve:** Amount over reserve is debited to Revaluation Account as the loss is to be borne by the partners in the old profit sharing ratio. Entry is:

- Workmen Compensation
  Reserve A/c ...Dr. Revaluation A/c ...Dr.
  To Provision for Workmen Compensation Claim A/c
  (Being amount of estimated claim debited to Workmen Compensation Reserve and Revaluation Account)

- Partners' Capital or Current A/cs ...Dr. (In Old Ratio)
  To Revaluation A/c
  (Being the loss on revaluation transferred to Capital or Current Account of partners in their old profit sharing ratio)

- **Investments Fluctuation Reserve:**
  - **i.** It is a reserve that is set aside out of the profits to meet a fall in the market value of investments.
  - **ii.** To decide the treatment of this reserve, it is necessary to first determine whether the book value and the market value are the same or different and if different, which value is higher and which is lower.

Accounting Treatment of Investment Fluctuation Reserve:

i. When Book Value and Market Value are the same: Entry has to be passed to transfer the amount of Investment Fluctuation Reserve to Partners' Capital or Current Accounts in their old profit sharing ratio as below:

Investment Fluctuation Reserve A/c ...Dr.

To Partners' Capital (or Current) A/cs [In Old Ratio]

ii. When Market Value if less than the Book Value: In this case, treatment of Investments Fluctuation Reserve shall depend on the quantum of decrease, which has 3 possibilities as follows:

a. Fall in Value is Less than Investments Fluctuation Reserve: The amount of Investment Fluctuation Reserve to the extent of fall in value, is transferred to Investment Account and balance is distributed among the partners in their old profit sharing ratio for which following entry is to be passed:

Investment Fluctuation Reserve A/c ...Dr.

To Investment A/c [Book Value

– Market Value] To Partners' Capital (or Current) A/cs [In

Old Ratio]

b. Fall in Value is Equal to Investments Fluctuation Reserve: In this case, the amount of Investment Fluctuation Reserve is transferred to Investment Account and no amount is distributed among the partners. Entry for the same is as follows:

Investment Fluctuation Reserve A/c ...Dr.
Investment A/c

c. Fall in Value is More than Investments Fluctuation Reserve: In this case, amount of Investments Fluctuation Reserve along with balance amount of fall in value is transferred to Investment Account and the amount above the reserve is debited to the Revaluation Account for which following entries are passed:

- Investment Fluctuation Reserve

A/c ...Dr. Revaluation A/c ...Dr.
Investment A/c

- Partners' Capital (or Current) A/cs ...Dr. [In Old Ratio]
  To Revaluation A/c

iii. **When there is an Increase in Market Value of Investment:** In this case, the total amount of Investment Fluctuation Reserve is distributed among partners and increase in the value of an investment is credited to Revaluation Account for which following entry is to be passed:

- Investment Fluctuation Reserve A/c ...Dr.
  To Partners' Capital (or Current) A/cs [In Old Ratio]

- Investment A/c ...Dr.
  To Revaluation A/c [Investment Brought up to Market Value]

- Revaluation A/c ...Dr.
  To Partners' Capital (or Current) A/cs [In Old Ratio]

Adjustment of Accumulated Profits, Losses and Reserve through Partners' Capital Accounts, i.e. When Accumulated Profits, Losses and Reserves are to be retained in the Books:

I. If the partners of the firm decided that the existing balances of Profit and Loss Account or Reserve should continue to appear at the same amount in the Balance Sheet of the reconstituted firm, then an adjustment entry for the net effect of accumulated profits, losses and reserves is passed since they were earned in past.

II. Such entry is passed through the Partners' Capital Accounts using the

following steps: **Step 1:** Net effect of Reserves, Accumulated Profits, and

Losses are to be calculated. **Step 2:** Gain/Loss of Share is to be calculated.

Step 3: Share of Gaining and Sacrificing Partners in the Net Accumulated Profits, Losses, and Reserves is to be calculated as below:

- For Gaining Partner = Net Effect ⍰Share Gained
- For Sacrificing, Partner = Net Effect ⍰Share Sacrificed

Step 4: Adjustment entries are to be passed as follows:

- **In case if Positive Effect (Net Profit):**

Gaining Partners' Capital/Current A/cs ...Dr.
To Sacrificing Partners' Capital/Current A/cs

- **In case of Negative Effect (Net Loss):**

Sacrificing Partners' Capital/Current A/cs ...Dr.
To Gaining Partners' Capital/Current A/cs

Treatment of reserves, accumulated profits, and losses when nothing is mentioned in the question:
Journal Entries to be passed for the mentioned transactions are as follows:

a. For distributing reservaccumulated profits: General Reserves A/c ...Dr.
Profit and Loss A/c ...Dr.
Workmen Compensation Reserves A/c* ...Dr. Investment Fluctuation Reserve A/c** ...Dr.
To All Partners' Capital A/c (In old profit sharing ratio)

*Amount of workmen compensation reserve distributed shall be excess of reserves over liability.
**Amount of investment fluctuation reserve distributed shall be excess of the reserve over the difference between Book Value and Market Value.

b. For writing off accumulated losses:
All Partners' Capital A/c ...Dr. (In old profit sharing ratio) To Profit and Loss A/c

Accounting Treatment for revaluation of assets and reassessment of liabilities:

In the event of a change in profit sharing ratio of the partners, assets are revalued and liabilities are to be reassessed. Such revaluation will result in gain or loss which is to be distributed to the partners in their old profit sharing ratio. The partners are not necessarily required to record the revised values in the books of the firm. The partners may decide to:

i. Record revised values of assets and liabilities; or

ii. Not to record the revised values of assets and liabilities.

Accounting treatment under each of the options is different and hence, partners need to be careful of the treatment for the option chosen.

I. Accounting Treatment when revised values of assets and liabilities are to be recorded: In such a situation, revaluation of assets and reassessment of liabilities are to be recorded in an account known as 'Revaluation Account' or 'Profit and Loss Adjustment Account'.

- **Understanding Revaluation Account:** In the event of a change in profit sharing ratio of the partners, assets are revalued and liabilities are to be reassessed. Such revaluation will result in gain or loss which is to be distributed to the partners in their old profit sharing ratio. To record such an increase or decrease in revaluation, the revaluation account is maintained.

- **Features of the Revaluation Account are as follows:**

  i. An increase in assets value and a decrease in liabilities are to be credited to the Revaluation Account.

  ii. A decrease in assets and an increase in liabilities are to be debited to the Revaluation Account.

  iii. Unrecorded assets are credited and unrecorded liabilities are to be debited to the revaluation account.

  iv. If the credit side is bigger than the debit side of the account, it is referred to as gain or profit on revaluation.

  v. If the debit side is bigger than the credit side of the account, it is referred to as loss on revaluation.

  vi. Finally, such profit or loss is credited or debited to the Partners' Capital or Current Accounts in their old profit-sharing ratio.

- **Accounting entries to record the Revaluation of Assets and Reassessment of Liabilities:**

  i. Increase in the value of an asset:

  Asset A/c (Individually) ...Dr.

  To Revaluation A/c

  ii. The decrease in the value of an asset:

Revaluation A/c ...Dr.

To Asset A/c (Individually)

iii. **Increase in the amount of liability:**

Revaluation A/c ...Dr. To Liability A/c (Individually)

iv. **The decrease in the amount of liability:**

Liability A/c (Individually) ...Dr.

To Revaluation A/c

v. **Recording an unrecorded asset:**

Unrecorded Asset A/c ...Dr.

To Revaluation A/c

vi. **Recording an unrecorded liability:**

Revaluation A/c ...Dr.

To Unrecorded Liability A/c

vii. **Transfer of Balance in Revaluation Account:**

a. **In case of gain in Revaluation Account:**

Revaluation A/c ...Dr. (Individually in old profit sharing ratio)

To Partners' Capital (or Current) A/cs

b. **In case of loss in Revaluation Account:**

Partners' Capital (or Current) A/cs ...Dr.

To Revaluation A/c (Individually in old profit sharing ratio)

- **Expenses on Reconstitution of the Firm:**

i. Expenses that are incurred by the firm to give effect to the change in profit sharing ratio may be incurred as remuneration to a partner or as payment to an outside party for the rendering of services. These expenses are debited to the Revaluation Account being an expense incurred in the event of the reconstitution of the firm.

ii. Following entry is passed when remuneration is paid

to a partner: Revaluation A/c ...Dr.

Particulars	Amount	Particulars	Amount

To Concerned Partners' Capital A/c
(Being the remuneration credited to concerned Partners' Capital Account)

Generally, remuneration paid to the partner is the consideration paid for the services rendered by him.

iii. This remuneration may sometimes include expenses that are borne by the partner. In the absence of information as to who paid the expenses, it is assumed that the partner has paid the expenses. If the partner is to bear the expenses and also has been paid by him, no entry is passed.

iv. If expenses that were to be borne by the partner but are paid by the firm, entry is passed as follows:
Concerned Partners' Capital A/c ...Dr.
To Cash/Bank A/c

(Being the expenses to be borne by the partner paid by the firm)

v. If expenses are incurred and paid by the firm: Revaluation A/c ...Dr.
To Cash/Bank A/c
(Being the expenses for reconstituting the firm)

It implies that the amount borne by the firm is debited to the Revaluation Account.

- **Specimen of a Revaluation Account:**

Dr. REVALUATION ACCOUNT Cr.

To Assets (individually) -The decrease in value on revaluation	...	By Assets (individually) -Increase in value on revaluation	...
To Liabilities (individually) -Increase in the amount on reassessment	...	By Liabilities (individually) -The decrease in the amount on reassessment	...
To Unrecorded Liabilities A/c	...	By Unrecorded Assets A/c By	...
To Partners' Capital A/c (Remuneration)	...	Loss on Revaluation transferred to Partners' Capital (or Current) A/cs*	...
To Cash/Bank A/c (Expenses)	...		...
To Gain (Profit) on Revaluation transferred to Partners' Capital (or Current) A/cs*	...		
	...		...

- **Treatment for profit or loss arising from the revaluation of assets and reassessment of liabilities:**

    i. In the event of a change in the profit-sharing ratio, assets are revalued and liabilities are reassessed. This is done to increase or decrease the value of assets and liabilities up to the date of a change in profit sharing ratio.

    ii. The net gain or loss arising on account of such revaluation and reassessment is for the period before the change in profit sharing ratio. Such gain or loss is, therefore, credited or debited to the Partner's Capital Accounts in their old profit sharing ratio.

II. Accounting Treatment when revised values of assets and liabilities are not to be recorded: When revised values of assets and liabilities are not to be recorded in the books, gain or loss on revaluation is adjusted through Partners' Capital Accounts bypassing adjustment entry to the Capital or Current Accounts.

For the treatment mentioned above, the following steps should be followed:

i. Calculate the net effect of Revaluation (i.e. net effect of increase or decrease in assets and liabilities).

ii. Calculate the share of sacrifice or gain by the partners using the formula as follows: Sacrifice/(Gain) = Old Share – New Share

iii. Calculate the proportionate amount of net effect of revaluation.

For Gaining Partner = Share Gained * Net Effect of Revaluation

For Sacrificing Partner = Share Sacrificed * Net Effect of Revaluation

iv. Journal entry is to be passed for the amount determined in the previous step as follows:

- **In the case of gain or profit on revaluation:**
  Gaining Partners' Capital A/cs ...Dr.
  To Sacrificing Partners' Capital A/cs
- **In case of loss on revaluation:**
  Sacrificing Partners' Capital A/cs ...Dr. To Gaining Partners' Capital A/cs

Adjustment of Capital:

- **Need to Adjust Capital:**

i. In the event of a change in profit sharing ratio, adjustments are made for a change in values of assets and liabilities, goodwill and distribution of reserves, accumulated profits and losses, change in partners' capitals.

ii. Also, if the partners decide the total capital of the firm and also that the capital shall be in profit sharing ratio of the partners, then also the capital of the partners has to be adjusted.

iii. In case the partners' capital(s) fall(s) short or has a shortage of the required capital, then such partner(s) will have to bring more capital.

iv. In case the partners' capital(s) is (are) surplus (excess) of the required capital, then such a partner(s) may withdraw surplus or excess capital.

v. Any shortage or surplus of Capital can be adjusted through Current Accounts.

vi. Accounting Treatment:

- For Adjusting Shortage of Capital:
  Bank A/c or Concerned Partners' Current A/c ...Dr.
  To Concerned Partners' Capital A/c

- For Adjusting Surplus of Capital:
  Concerned Partners' Capital A/c ...Dr. To Bank A/c or Concerned Partners' Current A/c

- **Adjustment of Partners' Capital, if total Capital of the new firm is already given:**
  i. When the total capital of the new firm (reconstituted firm) is already given, then it is divided among the partners in their new profit-sharing ratio. This respective share of capital will be their new capital.
  ii. Once this is done, the surplus (excess) or deficit (shortage) capital is calculated by comparing the new capital and present adjusted capital.

CHAPTER-5

ADMISSION OF NEW PARTNER

INTRODUCTION

New partners are admitted for the benefit of the partnership firm. A new partner is admitted either for increasing the partnership capital or for strengthening the management of the firm. When a new partner joins a firm, it is desirable to bring all appreciation or reduction in the value of assets into accounts as on the date of admission. Similarly, if the books contain any liability which has not been paid or if the books do not contain a liability that has to be paid, suitable entries should be passed. The purpose of such entries is to make an updated Balance Sheet on the date of admission. Also, all profits which have accrued but not yet brought into books and similarly, all losses which have occurred but not recorded, should now be brought into books so that the Capital Accounts of the old partners reflect the proper figure. As a result of the passing of such entries, any subsequent profits or losses will be automatically shared by the incoming partner along with old partners.

Also, the value of goodwill is to be assessed and proper accounting treatment is required to bring the value of goodwill into books of accounts. Treatment for goodwill has already been discussed in unit 2 of this chapter.

REVALUATION ACCOUNTS OR PROFIT AND LOSS ADJUSTMENT ACCOUNTS

When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reductions in the value of assets and an increase in liabilities and credited with an increase in the value of assets and a decrease in the value of liabilities. The difference between the two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio. The entries to be passed are :

ADMISSION OF NEW PARTNER

1. Revaluation Account Dr.
   To Assets Account with the reduction in the value of the assets (individually which show a decrease)
   To the Liabilities Accounts(Individually which with the increase in the liabilities. have to be increased)
2. Assets Account (Individually) Dr. with the increase in the value of the of assets
   Liabilities Accounts Dr. with the reduction in the amount liabilities
   To Revaluation Account
3. Revaluation Account Dr. with the profit in the old profit sharing ratio.
   To Capital A/cs of the old partners
   or
   Capital A/cs of the old partners Dr. with the loss in old profit sharing ratio.
   To Revaluation Account

As a result of the above entries, the capital account balances of the old partners will change and the assets and liabilities will have to be adjusted to their proper values. They will now appear in the Balance Sheet at revised figures.

Alternatively, the partners may agree that revalued figures will not be shown in the Balance Sheet and Assets and liabilities would appear in the Balance Sheet at their old values.

In this case, the Memorandum Revaluation Account is opened. Any increase in the value of assets and/or decrease in the liabilities is credited to Memorandum Revaluation Account. The journal entry will be:

Assets Accounts Dr (with an increase in the value of individual assets)
Liabilities Accounts Dr. (with a decrease in the value of individual liabilities)
To Memorandum Revaluation Account

Similarly, any decrease in the value of assets and/or increase in the liabilities is debited to Memorandum Revaluation Account. The journal entry will be:

Memorandum Revaluation Account Dr.
To Assets Accounts (with an increase in the value of individual assets)
To Liabilities Accounts (with a decrease in the value of individual liabilities)

If the credit side of the Memorandum Revaluation Account is more than the debit side, there is a profit. This profit should be transferred to the old Partner's Capital Accounts in the old profit sharing ratio. The journal entry will be:

Memorandum Revaluation Account Dr.

To Old Partner's Capital Accounts

If the debit side of the Memorandum Revaluation Account is more than the credit side, there is a loss that is transferred to old Partner's Capital Accounts in the old profit sharing ratio. The journal entry will:

Old Partners' Capital Accounts Dr.

To Memorandum Revaluation Account

After completing the above procedure, reverse entries are made for an increase in the values of assets and/or decrease in the liabilities, and decrease in the values of assets and/or increase in the liabilities) in the latter portion of the Memorandum Revaluation Account. The profit on revaluation is to be transferred to all Partners' Capital Accounts in the new profit sharing ratio. The journey entry will be:

Memorandum Revolution Account Dr.

To All Partners' Capital Accounts (New profit and loss sharing ratio)

The loss on revaluation should be transferred to all Partners' Capital Accounts in the new profit sharing ratio. The journal entry will be:

All Partners' Capital Accounts Dr. (New profit and loss sharing

ratio) To Memorandum Revaluation Account

It should be noted that if there is a profit in the first half of the Memorandum Revaluation Account, the latter half of the Memorandum Revaluation Account must show a loss. Conversely, if the first half of the Memorandum Revaluation Account shows a loss, the latter half of the Memorandum Revaluation Account must show a profit.

When a Memorandum Revaluation Account is prepared, the book values of assets and liabilities do not change. In effect, the resultant profit or loss on revaluation is adjusted through the Partners' Capital Accounts. In this way, the amount invested as a capital by the incoming partner may be set at a level that reflects the current fair value of the partnership, even though the book values of assets and liabilities of the existing partnership remain unchanged in the books of accounts.

In case partners desire to disclose assets and liabilities in the balance sheet at old figures without opening the Revaluation account then the change (i.e. increase or decrease) in the value of assets and liabilities may be adjusted through Partners' Capital Accounts directly.

Illustration 1

The following is the Balance Sheet of Ram and Mohan, who share profits in the ratio of 3:2 as on 1st January 2011:

Liabilities	`	*Assets*	`
Sundry Creditors	15,000	Buildings	18,000
Ram's Capital	20,000	Plant and Machinery	15,000
Mohan's Capital	25,000	Stock	12,000
		Debtors	10,000
		Bank	5,000
	60,000		60,000

On this date Shyam was admitted on the following :

1. He is to pay ` 25,000 as his capital and ` 10,000 as his share of goodwill for a one-fifth share in profits.
2. The new profits sharing ratio will be 5:3:2.
3. The assets are to be revalued as under :

	`
Building	25,000
Plant and Machinery	12,000
Stock	12,000
Debtors (because of doubtful debts)	9,500

4. It was found that there was a liability for ` 1,500
5. for goods received but not recorded in books.

Give journal entries to record the above.

solution

Journal entries

2011 Dr. (`) Cr. (`)

Jan. 1	Bank Account Dr.		35,000	
	To Shyam's Capital Account			35,000
	(Being amount brought in by Shyam for capital and goodwill)			
	Shyam's Capital Account	Dr.	10,000	
	To Ram's Capital Account			5,000
	To Mohan's Capital Account			5,000
	(Being Shyam's share of goodwill adjusted to existing partners' capital accounts in the profit sacrificing ratio 1:1)			
	Revaluation Account	Dr.	5,000	
	To Plant and Machinery Account			3,000
	To Provisions for Doubtful Debts Account			500
	To Sundry Creditors Account			1,500
	(Being recording of the reduction in the value of assets and the liability which had been previously omitted)			
	Building Account	Dr.	7,000	
	To Revaluation Account			7,000
	(Being increase in the value of building brought into account)			
	Revaluation Account	Dr.	2,000	

To Ram's Capital Account 1,200

To Mohan's Capital Account 800

(Being profit on revaluation credited to Ram and Mohan in the old profit sharing ratio)

working note:

Profit sacrificing ratio:

Ram = 3/5 less 1/2 =

1/10 Mohan = 2/5 less

3/10 = 1/10

Illustration 2

Continuing with the same illustration 1, let us also give the Balance Sheet of the partnership firm after Shyam's admission.

solution

Balance Sheet of Ram, Mohan, and Shyam as of January 1, 2011

Liabilities	`	`	*Assets*	`	`
Sundry Creditors		16,500	Buildings		25,000
Capital Account			Plant and Machinery		12,000
Ram	26,200		Stock		12,000
Mohan	30,800		Sundry Debtors	10,000	
Shyam	25,000	82,000	*Less :* Provision for		
			Doubtful Debts	(500)	9,500
			Bank		40,000
		98,500			98,500

Illustration 3

A and B are partners sharing profits and losses in the ratio of 3:2. Their Balance Sheet as on 31.3.2011 is given below:

Liabilities	`	*Assets*	`
Creditors	30,000	Freehold premises	2,00,000
Bills Payable	20,000	Plant	40,000
Capital Accounts:		Furniture	20,000
A	2,00,000	Office equipment	25,000
B	1,00,000	Stock	30,000
		Debtors	25,000
		Bank	10,000
	3,50,000		3,50,000

On 1.4.2011 they admit C on the following terms:

(1) C will bring ` 50,000 as capital and ` 10,000 for goodwill for 1/5 share;

(2) Provision for doubtful debts is to be made on debtors @ 2%

(3) Stock to be written down by 10%

(4) Freehold premises is to be revalued at ` 2,40,000, plant at ` 35,000, furniture ` 25,000 and office equipment ` 27,500.

(5) Partners agreed that the values of the assets and liabilities remain the same and, as such, there should not be any change in their book values as a result of the above mentioned adjustments.

You are required to make the necessary adjustment in the Capital Accounts of the partners and show the Balance Sheet of the New Firm.

solution

	Particulars	`		*Particulars*	`
To	Provision for Bad Debts A/c	500	By	Freehold premises A/c	40,000
To	Stock A/c	3,000	By	Furniture A/c	5,000
To	Plant A/c	5,000	By	Office equipment A/c	2,500
To	Profit on Revaluation A/c				
	A's Capital-3/5	23,400			
	B's Capital-2/5	15,60 0			

		47,500			47,500
To	Freehold premises A/c	40,000	By	Provision for Bad Debts A/c	500
To	Furniture A/c	5,000	By	Stock A/c	3,000
To	Office equipment A/c	2,500	By	Plant A/c	5,000
				Loss on Revaluation A/c	
				A's Capital -12/25	18,720
				B's Capital-8/25	12,480
				C's Capital-5/25	7,800
		47,500			47,500

	Particulars	A `	B `	C `		*Particulars*	A `	B `	C `
To	A's Capital A/c B's Capital A/c			6,000 4,000	By	Balance b/d	2,00,000	1,00,000	-
To	Loss on revaluation A/c	18,720	12,480	7,800	By	Bank A/c			60,000
To	Balance c/d	2,10,680	1,07,120	42,200	By	C's Capital A/c	6,000	4,000	-
					By	Profit on revaluation A/c	23,400	15,600	-
		2,29,400	1,19,600	60,000			2,29,400	1,19,600	60,000

Balance Sheet as at 1.4.2011

Liabilities	`	*Assets*	`
Creditors	30,000	Freehold premises	2,00,000
Bills Payable	20,000	Plant	40,000
Capital A/c		Furniture	20,000
A	2,10,680	Office equipment	25,000
B	1,07,120	Stock	30,000
C	42,200	Debtors	25,000
		Bank (` 10,000 + ` 50,000 + ` 10,000)	70,000

	4,10,000		4,10,000

Illustration 4

A and B are partners in a firm, sharing profits and losses in the ratio of 3:2. The Balance Sheet of A and B as on 1.1.2009 was as follows:

Liabilities	`	*Amount* `	*Assets*	`	*Amount* `
Sundry creditors		12,900	Building		26,000
Bills payable		4,100	Furniture		5,800
Bank overdraft		9,000	Stock-in-trade		21,400
Capital accounts:			Debtors	35,000	
A	44,000		Less: Provision	200	34,800
B	36,000	80,000	Investment		2,500
			Cash		15,500
		1,06,000			1,06,000

'C' was admitted to the firm on the above date on the following terms:

(i) C is admitted for 1/6 share in the future profits and to introduce a capital of ` 25,000.

(ii) The new profit sharing ratio of A, B, and C will be 3:2:1 respectively.

(iii) 'C' is unable to bring in cash for his share of goodwill, they decide to calculate goodwill based on C's share in the profits and the capital contribution made by him to the firm.

(iv) Furniture is to be written down by ` 870 and stock to be depreciated by 5%. A provision is required for debtors @ 5% for bad debts. A provision would also be made for outstanding wages for ` 1,560. The value of buildings having appreciated being brought up to ` 29,200. The value of investments is increased by ` 450.

(v) It is found that the creditors included a sum of ` 1,400, which is not to be paid off. Prepare the following:

(i) Revaluation account.

(ii) Partners' capital accounts.

solution

revaluation account

Dr.		`		Cr. `
To	Furniture	870	By Building	3,200
To	Stock	1,070	By Sundry creditors	1,400
To	Provision for doubtful debts		By Investment	450
	(` 1,750 - ` 200)	1,550		
To	Outstanding wages	1,560		
		5,050		5,050

Partners' Capital Accounts

Dr.							Cr.
	A `	B `	C `		A `	B `	C `
To A			4,500	By Balance b/d	44,000	36,000	–
To B			3,000	By Cash A/c	–	–	25,000
To Balance c/d	48,500	39,000	17,500	By C			
				(working note 2)	4,500	3,000	–
	48,500	39,000	25,000		48,500	39,000	25,000

working notes :

1. *Calculation of goodwill:*

   C's contribution of ` 25,000 consists of only 1/6th of capital.

   Therefore, total capital of firm should be ` 25,000 x 6 = ` 1,50,000

   But combined capital of A, B and C amounts ` 44,000 + 36,000 + 25,000 = ` 1,05,000 Thus, the hidden goodwill is ` 45,000 (` 1,50,000 - ` 1,05,000).

   Goodwill will be shared by A & B in their sacrificing ratio.

2. Calculation of sacrificing ratio

Partners	New share	Old share	Sacrifice	Gain
A	$\frac{3}{6}$	$\frac{3}{5}$	- $\frac{3}{30}$	
B	$\frac{2}{6}$	$\frac{2}{5}$	- $\frac{2}{30}$	
C	$\frac{1}{6}$			$\frac{1}{6}$

Therefore, A will get = ` 45,000x $\frac{3}{30}$ = ` 4,500;

B will get = ` 45,000x $\frac{2}{30}$ = ` 3,000; and

C will be debited on account of goodwill = ` 45,000x $\frac{1}{6}$ = ` 7,500

RESERVES IN BALANCESHEET

Whenever a new partner is admitted, any reserve, etc. lying in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio. (In examination problems it should be done even if there are no instructions on this point).

Illustration 5

Dalal, Banerji, and Mallick are partners in firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March 2011 is as below

Liabilities		`	*Assets*	`
Sundry Creditors		12,850	Land and Buildings	25,000
Outstanding Liabilities		1,500	Furniture	6,500
General Reserve		6,500	Stock of goods	11,750
Capital Account :			Sundry Debtors	5,500
Mr. Dalal	12,000		Cash in hand	140
Mr. Banerji	12,000		Cash at Bank	960
Mr. Mallick	5,000	29,000		
		49,850		49,850

The partners have agreed to take Mr. Mistri as a partner with effect from 1st April 2011 on the following terms :

(1) Mr. Mistri shall bring ` 5,000 towards his capital.

(2) The value of the stock should be increased by ` 2,500 and Furniture should be depreciated by 10%.

(3) Reserve for bad and doubtful debts should be provided at 10% of the debtors.

(4) The value of land and buildings should be enhanced by 20% and the value of the goodwill be fixed at ` 15,000.

(5) The value of the goodwill is fixed at ` 15,000.

(6) General Reserve will be transferred to the Partners' Capital Accounts.

(7) The new profit sharing ratio shall be Mr. Dalal 5/15, Mr. Banerji 5/15, Mr. Mallick 3/15, and Mr. Mistri 2/15.

The outstanding liabilities include ` 1,000 due to Mr. Sen which has been paid by Mr. Dalal. Necessary entries were not made in the books.

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

solution

revaluation account

2011			`	2011		`
April 1	To Provision for bad and doubtful debts		550	April 1	By Stock in trade	2,500
	To Furniture and fittings		650		By Land and Building	5,000
	To Capital A/cs:					
	(Profit on revaluation					

	transferred)					
	Dalal	2,520				
	Banerji	2,520				
	Mallick	1,260	6,300			
			7,500			7,500

Particulars	Dalal `	Banerji `	Mallick `	Mistri `	Particulars	Dalal `	Banerji `	Mallick `	Mistri `
To Dalal				1,000	By Balance b/d	12,000	12,000	5,000	–
To Banerji				1,000	By General Reserve	2,600	2,600	1,300	
To Balance c/d	19,120	18,120	7,560	3,000					
					By Cash	–	–	–	5,000
					By Mistri	1,000	1,000	–	–
					By Outstanding Liabilities	1,000	–	–	
					By Revaluation A/c	2,520	2,520	1,260	–
	19,120	18,120	7,560	5,000		19,120	18,120	7,560	5,000

working note:

Calculation of sacrificing ratio

Partners	New share	Old share	Sacrifice	Gain
Dalal	$\frac{5}{15}$	$\frac{2}{5}$	$-\frac{1}{15}$	
Banerji	$\frac{5}{15}$	$\frac{2}{5}$	$-\frac{1}{15}$	
Mallick	$\frac{3}{15}$	$\frac{1}{5}$	No gain No loss	–
Mistri	$\frac{2}{15}$			$\frac{2}{15}$

Sacrifice by Mr. Dalal and Mr. Banerji = ` 15,000 x $\frac{1}{15}$ = ` 1,000 each

Illustration 6

With the information given in illustration 4, after preparing the revaluation account and partners' capital accounts, prepare the Balance Sheet of the firm after the admission of Mr. Mistri.

solution

Balance Sheet of M/s. Dalal, Banerji, Mallick, and Mistri as on 1-4-2011

Liabilities	`	`	*Assets*	`	`
Sundry Creditors		12,850	Land and Buildings		30,000
Outstanding Liabilities		500	Furniture		5,850
Capital Accounts of Partners :					
			Stock of goods		14,250
Mr. Dalal	19,120		Sundry Debtors	5,500	
Mr. Banerji	18,120		*Less :* Provisions	(550)	4,950
Mr. Mallick	7,560		Cash in hand		140
Mr. Mistri	3,000	47,800	Cash at Bank		5,960
		61,150			61,150

COMPUTATION OF NEW PROFIT SHARING RATIO

When a new partner is admitted and there is no agreement to the contrary, it is supposed that old partners will continue to have inter seat the old profit sharing ratio.

For example, A and B are in partnership sharing profits and losses at the ratio of 3:2. They admitted C as 1/5 partner. For the computation of the new profit sharing ratio.

(i) Firstly, deduct the share offered to new partner

from 1. 1 – 1/5 = 4/5

(ii) Divide the balance of share between A and B in the ratio

of 3:2. A = 4/5 x 3/5 = 12/25

B = 4/5 × 2/5 = 8/25

(iii) New profit sharing

ratio is A: B: C
12/25 : 8/25
: 1/5 or 12/25 :
8/25 : 5/25
i.e. 12 : 8 : 5

Illustration 7

A and B are in partnership sharing profits and losses at the ratio 3:2. They take C as a new partner. Calculate the new profit sharing ratio if -

(i) C purchases 1/10 share from A

(ii) A and B agree to sacrifice 1/10th share to C in the ratio of 2 : 3

(iii) Simply gets 1/10th share of profit.

solution

New profit sharing ratio :

A = 3/5 – 1/10 = 5/10

B = 2/5 i.e. 4/10 C = 1/10

i.e. 5 : 4 : 1

A's sacrifice 1/10× 2/5 = 2/50 B's sacrifice 1/10 × 3/5 = 3/50 New profit sharing ratio

A = 3/5 – 2/50 = 28/50 B = 2/5 – 3/50 = 17/50 C = 1/10 i.e. 5/50

i.e. 28 : 17 : 5

Balance of share to be divided between A and B : 1 – 1/10= 9/10

Distribution :

A = 9/10 × 3/5 = 27/50 B = 9/10 × 2/5 = 18/50 C = 1/10. i.e. = 5/50 i.e. 27 : 18 : 5

Illustration 8

A and B are in the partnership sharing profits and losses in the proportion of three-fourth and one-fourth respectively. Their balance sheet as on 31st March 2011 was as follows:

Cash ` 1,000; sundry debtors ` 25,000; stock ` 22,000: plant and machinery ` 4,000; sundry creditors ` 12,000; bank overdraft ` 15,000; A's capital ` 15,000; B's capital

` 10,000.

On 1st April 2011, they admitted C into partnership on the following terms:

C to purchase one–third of the goodwill for ` 2,000 and provide ` 10,000 as capital. Goodwill not to appear in books.

Further profits and losses are to be shared by A, B, and C equally.

Plant and machinery are to be reduced by 10% and ` 500 are to be provided for estimated bad debts. Stock is to be taken at a valuation of ` 24,940.

By bringing in or withdrawing cash and capitals of A and B are to be made proportionate to that of C on their profit-sharing basis.

Set out entries to the above arrangement in the firm's journal and give the partners' capital accounts in tabular form.

solution

Journal entries

as on 1st April 2011

	Dr. (`)	Cr. (`)
Revaluation Account Dr.	900	
To Plant and machinery Account		400
To Provision for bad debts Account		500
(Plant & machinery reduced by 10% and		

` 500 provided for bad debts)			
Stock Account	Dr.	2,940	
To Revaluation Account			2,940
(Value of stock increased by ` 2,940)			
Revaluation Account	Dr.	2,040	
To A's Capital Account			1,530
To B's capital Account			510
(Profit on revaluation transferred)			
Cash Account	Dr.	12,000	
To C's capital Account			12,000
(Cash brought in by C as his capital)			
C's Capital Account	Dr.	2,000	
B's capital Account	Dr.	500	
To A's Capital Account			2,500
(Entry for goodwill purchased by B and C)			
A's Capital Account	Dr.	9,030	
B's capital Account	Dr.	10	
To Cash Account			9,040
(Excess amount of capital withdrawn)			

	A `	B `	C `		A `	B `	C `
To A's Capital A/c	-	500		By Balance b/d	15,000	10,000	–
To Cash	9,030	10		By Revaluation A/c	1,530	510	–
To Balance c/d	10,000	10,000	10,000	By Cash	2,000	–	10,000
				By B's Capital A/c	500		
	19,030	10,510	10,000		19,030	10,510	10,000

working note:

Calculation of goodwill

C pays ` 2,000 on account of goodwill for 1/3rd share of profit/loss. Total goodwill is ` 2,000 x 3 = ` 6,000.

Gaining ratio:

B: 1/3-1/4 =

1/12 C: 1/3

Goodwill to be paid to A:

By B ` 6,000 x 1/12 =	`500
By C ` 6,000 x 1/3 =	`2,000
Total	`2,500

Illustration 9

A and B are partners of X & Co. sharing profits and losses in a 3:2 ratio between themselves. On 31st March 2011, the balance sheet of the firm was as follows:

Balance Sheet of X & Co. as at 31.3.2011

Liabilities	`	`	*Assets*	`
Capital accounts:			Plant and machinery	20,000
A	37,000		Furniture and fittings	5,000
B	28,000			
		65,000	Stock	15,000
Sundry creditors		5,000	Sundry debtors	20,000
			Cash in hand	10,000
		70,000		70,000

X agrees to join the business on the following conditions as and from 1.4.2011:

(a) He will introduce ` 25,000 as his capital and pay ` 15,000 to the partners as premium for goodwill for 1/3rd share of the future profits of the firm.

(b) A revaluation of assets of the firm will be made by reducing the value of plant and machinery to ` 15,000, stock by 10%, furniture and fitting by ` 1,000 and by making a provision of bad and doubtful debts at ` 750 on sundry debtors.

Prepare profit and loss adjustment account, capital accounts of partners including the incoming partner X assuming that the relative ratios of the old partners will be in equal proportion after admission.

solution

Profit and Loss Adjustment Account

Dr. *2011*	`	*2011*		Cr. `
April 1		April 1		
To Plant and machinery A/c	5,000	By Partners' capital accounts		
To Stock A/c	1,500	- Loss on revaluation		
To Furniture and fitting A/c	1,000	A (3/5)	4,950	
To Provision for bad and doubtful debts	750	B (2/5)	3,300	8,250
	8,250			8,250

Partners' Capital Accounts

	A `	B `	X `		A `	B `	X `
To Profit & loss adjustment A/c	4,950	3,300	–	By Balance b/d	37,000	28,000	–
				By Cash A/c	–	–	40,000
To A's & B's capital A/cs	–	–	15,000	By X's capital A/c [W. N.(ii)]	12,000	3,000	–
To Balance c/d	44,050	27,700	25,000				
	49,000	31,000	40,000		49,000	31,000	40,000

working notes:

(i) **New profit sharing ratio :**

On admission of X who will be entitled to 1/3rd share of the future profits of the firm. A and B would share the remaining 2/3rd share in equal proportion i.e. 1:1.

A: 2/3 x 1/2

= 1/3 B: 2/3

x 1/2 = 1/3

X:1/3

A B and X would share profits and losses in an equal ratio.

(ii) Adjustment of goodwill :

X pays `15,000 as premium for goodwill for 1/3rd share of the future profits.

Thus, total value of goodwill is ` 15,000 x 3 i.e. ` 45,000

Sacrificing ratio:

A: 3/5 - 1/3 =

4/15 A: 2/5 -

1/3 = 1/15

Hence, sacrificing ratio is 4:1

Adjustment of X's share of goodwill through existing partners' capital accounts in the profit sacrificing ratio:

	`
A: 15,000 x 4/5 =	12,000
B: 15,000 x 1/5 =	3,000
	15,000

HIDDEN GOODWILL

When the value of the goodwill of the firm is not specifically given, the value of goodwill has to be inferred as follows:

	`
Incoming partner's capital x Reciprocal of the share of incoming partner	xxx
Less: Total capital after taking into consideration the capital brought in by an incoming partner	xxx
Value of Goodwill	xxx

Illustration 10

A and B are partners with capitals of ` 7,000 each. They admit C as a partner with 1/4th share in the profits of the firm. C brings ` 8,000 as his share of capital. Give the necessary journal entry to record goodwill.

solution:

Journal Entry

Particulars	Dr. (`)	Cr. (`)
C's Capital A/c [` 10,000 x 1/4] Dr.	2,500	
To A's Capital A/c		1,250
To B's Capital A/c		1,250
(Being the share of C in the hidden goodwill adjusted through capital accounts by crediting sacrificing partners in their sacrificing ratio)		

Liabilities	`	*Assets*	`
Capital A/cs		Sundry Fixed Assets	60,000
A	45,000	Stock	30,000
B	45,000	Bank	20,000
Sundry Creditors	20,000		
	1,10,000		1,10,000

On 1.1.2012 they agreed to take C as 1/3rd partner to increase the capital base to ` 1,35,000. C agrees to pay ` 60,000. Show the necessary journal entries and prepare partners' capital accounts.

solution

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

Journal entries

		`	`
Bank A/c	Dr.	60,000	
To C's Capital A/c			60,000
(Cash brought in by C for 1/3rd share)			
C's Capital A/c	Dr.	15,000	
To A's Capital A/c			7,500
To B's Capital A/c			7,500
A's Capital A/c	Dr.	7,500	
B's Capital A/c	Dr.	7,500	
To Bank A/c			15,000
(Amount of goodwill due to A and B withdrawn)			

workings :

(1) Old Profit Sharing Ratio : 1 : 1

(2) New Profit Sharing Ratio : 1:1:1

(3) C's share of capital ` 1,35,000 × 1/3 = ` 45,000

(4) Goodwill ` 60,000 – ` 45,000 = ` 15,000 for 1/3rd share. Total Goodwill : ` 15,000 × 3 = ` 45,000

Partners' Capital A/cs

Particulars	*A* `	*B* `	*C* `	*Particulars*	*A* `	*B* `	*C* `
To A			7,500	By Balance b/d	45,000	45,000	–
To B			7,500	By Bank	–	–	60,000
To Bank	7,500	7,500	–	By C	7,500	7,500	–
To Balance c/d	45,000	45,000	45,000				
	52,500	52,500	60,000		52,500	52,500	60,000