

**ADMISSION OF A PARTNER**

Identify various matters that need adjustments at the time of admission of a new partner.

#### ANSWER:

The following are the various items that need to be adjusted at the time of admission of a new partner.

1. **Profit Sharing Ratio**: Calculation of new profit sharing ratio.

2. **Goodwill**: Valuation and adjustment of goodwill among the sacrificing old partners.

3. **Revaluation of Assets and Liabilities**: Assets and liabilities are revalued to ascertain the current value of the assets and liabilities of the partnership firm. Moreover, the profit or loss due to the revaluation need to be distributed among the old partners.

4. Accumulated profits, losses and reserves are distributed among the old partners in their old ratio.

5. **Adjustment of capital of the partners**.

Goodwill is an intangible asset of a firm. It is the value of a firm’s reputation and its good brand name in the market. A firm earns goodwill by its hard work and thereby winning the blind trust and faith of the customers by fulfilling their demands in both qualitative and quantitative aspects. A positive goodwill helps a firm to earn supernormal profits compared to its competitors that earns normal profits (as their goodwill is zero). In other words, goodwill ensures greater future profits as there will be greater number of satisfied customers in the future. As in the words of Lord Eldon, “Goodwill is nothing more than the probability, that the old customers will resort to the old place.”

**Characteristics of Goodwill**

The following are the characteristics of goodwill.

1) It is an intangible asset.

2) It is not a fictitious asset.

3) It is difficult to ascertain the exact value of goodwill.

4) It enhances the future as well as the present earning capacity of a business.

5) It helps in earning supernormal profits against the normal profits.

6) It assists the business to enjoy its upper hand over its counterparts.

**Factors Affecting Goodwill**

The following are the important factors that affect the goodwill of a firm.

***1)*** ***Quality Products***: If a company produces product of the best quality and in large scale, then automatically the company earns more goodwill.

***2)*** ***Location***: If a business islocated at easily reachable and convenient place, then more number of consumers will be attracted again and again which will lead to increase in sales and, therefore, the firm will earn higher goodwill.

***3)*** ***Management***: Efficient management leads to cost efficiency and increases productivity. If a firm’s management is efficient, then superior quality products can be produced at lower cost .These can be sold at lesser price. Superior quality at lower price enables a firm to earn higher goodwill.

***4)*** ***Market Structure***: If a firm is operating in a monopoly market with no close substitutes, then there will be more goodwill of the firm.

***5)*** ***Economies of Scale***: If a firm enjoys special advantages like, continuous supply of power, fuel and raw materials at a low price and produces quality product at a large scale, then the firm enjoys higher value of goodwill.

**Question 3:**

Explain various methods of valuation of goodwill.

**ANSWER:**

The following are the various methods of valuation of goodwill.

**1. Average Profit Method:** Under this method, goodwill is calculated on the average basis of the profits of past few years. The formula for calculating goodwill is:

   Goodwill = Average Profit × No. of Years Purchase

Number of Years Purchase implies number of years for which the firm expects to earn the same amount of profits.

**Steps to Calculate Goodwill by Average Profit Method:**

***Step 1*:** Ascertain the total profit of past given years.

***Step 2*:** Add all abnormal losses like, loss by fire, theft etc.

***Step 3*:** Add all normal income, if not added previously.

***Step 4*:** Less all non-business incomes and all abnormal gains and incomes like, speculation, lottery etc.

***Step 5*:** Less all normal expenses, if not deducted previously.

***Step 6*:** Calculate Average Profit, by dividing the total profit ascertained in Step 5 by number of years.

***Step 7*:** Multiply the Average Profit to the Number of Year’s Purchases to calculate the value of goodwill.

**Example:**

The profits for last 5 years are 1,00,000,   3,00,000,   (2,00,000),   5,00,000,   8,00,000.

Calculate goodwill on the basis of 4 years purchase

**2. Weight Average Method:** It is modified version of the Average Profit Method. Under this method, the weights are assigned for each year’s profit. Highest weights are assigned to the recent year’s profit and lower weights are assigned to the past year’s profits. The products of the profits and the weights are added and divided by the total weights to calculate Weighted Average Profits. The formula for calculating goodwill by this method is:

**Steps to Calculate Goodwill by Weight Average Method:**

***Step 1*:** Assign highest weights to the recent year’s profit and lower weights to the past year’s profits, like 4,3,2,1.

***Step 2*:** Multiply the weights with its corresponding year’s profits.

***Step 3*:** Calculate the total of the products

***Step 4*:** Divide the total of the product by the total of the eights in order to calculate Weighted Average Profit.

***Step 5*:** Multiply the Weighted Average Profit by the number of years purchase.

*For example*:

The profits for the last 5 years are Rs 1,00,000,   Rs 3,00,000,   Rs (2,00,000),   Rs 5,00,000,   Rs 8,00,000.

Calculate goodwill on the basis of 4 years purchase

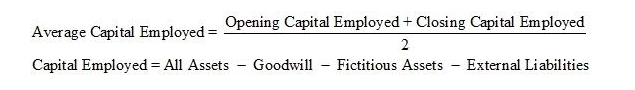
|  |  |  |
| --- | --- | --- |
| **Profit/Loss**  **Rs** | **Weights** | **Product**  **Rs** |
| 1,00,000 | 1 | 1,00,000 × 1 = 1,00,000 |
| 3,00,000 | 2 | 3,00,000 × 2 = 6,00,000 |
| (2,00,000) | 3 | (2,00,000) × 3 = (6,00,000) |
| 5,00,000 | 4 | 5,00,000 × 4  = 20,00,000 |
| 8,00,000 | 5 | 8,00,000× 5  = 40,00,000 |
| **Total** | **15** | **Rs 61,00,000** |

**3. Super Profit Method:** Under this method, goodwill is calculated on the basis of excess profit earned by a firm over the normal profit earned by its counterparts in the same industry. The excess profit over the normal profit is termed as Super Normal Profit.

**Steps to Calculate Goodwill by Super Profit Method:**

***Step 1*:** Calculate Average Profit

***Step 2*:** Calculate Average Capital Employed as:



***Step 3*:** Calculate Normal Profit by the formula:



***Step 4*:**  Calculate Super Normal Profit by the formula:

Super Normal Profit = Average Profit – Normal Profit

***Step 5*:**  Multiply the Super Normal Profit by the Number of Years Purchase to calculate goodwill.

**4. Capitalisation Method:** Under this method, goodwill is calculated by the following two methods :

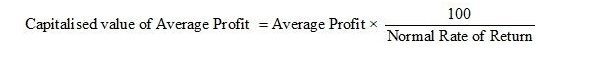
a) By capitalisation of Average Profit.

b) By capitalisation of Super Profit.

**a) Capitalisation of Average Profit**

***Step 1*:** Calculate Average Profit

***Step 2*:** Calculate Capitalised value of Average Profit by the following formula:



***Step 3*:**  Ascertain Actual Capital Employed

***Step 4*:**  Deduct Actual Capital Employed from Capitalised Average Profit to calculate goodwill.

Goodwill = Capitalised Average Profit – Actual Capital Employed

**b) Capitalisation of Super Profit**

***Step 1*:** Calculate the Capital Employed

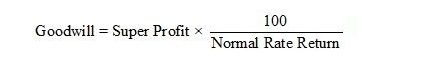
***Step 2*:** Calculate Normal Profit by the following formula:

***Step 3*:** Calculate Average Profit.

***Step 4*:** Calculate Super Normal Profit by the following formula:

Super Normal Profit = Average Profit – Normal Profit

***Step 5*:** Calculate goodwill by the following formula:



Why is there need for the revaluation of assets and liabilities on the admission of a partner?

#### ANSWER:

At the time of admission of a new partner, it becomes very necessary to revalue the assets and liabilities of a partnership firm for ascertaining its true and fair values. This is done because the value of assets and liabilities may have increased or decreased and consequently their corresponding figures in the old balance sheet may either be understated or overstated. Moreover, it may also be possible that some of the assets and liabilities are left unrecorded. Thus, in order to record the increase and decrease in the market value of the assets and liabilities, Revaluation Account is prepared and any profits or losses associated with this increase or decrease are distributed among the old partners of the firm

 it is advisable to revalue the assets and liabilities at the time of admission of a new partner for ascertaining the true and fair value of the assets and liabilities. This is done because the value of assets and liabilities may have increased or decreased and consequently their corresponding figures in the old balance sheet may either be understated or overstated. Moreover, it may also be possible that some of the assets and liabilities are left unrecorded. Thus, in order to record the increase and decrease in the market value of the assets and liabilities, Revaluation Account is prepared and any profits or losses associated with this increase or decrease are distributed among the old partners of the firm.

***Accounting Entries in the Books of Accounts:***

The following Journal entries are recorded in the Revaluation Account on the date of admission of a new partner.

***i)*** ***For increase in value of asset***s:

|  |  |  |
| --- | --- | --- |
| Assets A/c | | Dr. |
|  | To Revaluation A/c |  |
| (Increase in the value of assets) | |  |
|  |  |  |

***ii) For decrease in value of assets***:

|  |  |  |
| --- | --- | --- |
| Revaluation A/c | | Dr. |
|  | To Asset A/c |  |
| (Decrease in the value of assets) | |  |
|  |  |  |

***iii) For increase in liabilities***:

|  |  |  |
| --- | --- | --- |
| Revaluation A/c | | Dr. |
|  | To Liabilities |  |
| (Increase in the value of liabilities) | |  |
|  |  |  |

***iv) For decrease in liabilities***:

|  |  |  |
| --- | --- | --- |
| Liability A/c | | Dr. |
|  | To Revaluation A/c |  |
| (Decrease in the value of liabilities) | |  |
|  |  |  |

***v) For recording of unrecorded assets***:

|  |  |  |
| --- | --- | --- |
| Unrecorded Assets A/c | | Dr. |
|  | To Revaluation A/c |  |
| (Recording of unrecorded assets) | |  |
|  |  |  |

***vi) For recording of unrecorded liabilities***:

|  |  |  |
| --- | --- | --- |
| Revaluation A/c | | Dr. |
|  | To Unrecorded Liabilities A/c |  |
| (Recording of unrecorded liabilities) | |  |
|  |  |  |

***vii) For transfer of credit balance of Revaluation Account***:

|  |  |  |
| --- | --- | --- |
| Revaluation | | Dr. |
|  | To Old Partner’s Capital A/c |  |
| (Profit on revaluation is transferred to the Old Partner’s Capital Account in their old profit sharing ratio) | |  |
|  |  |  |

**Or,**

***vii) For transfer of debit balance of Revaluation Account***:

|  |  |  |
| --- | --- | --- |
| Old Partner’s Capital A/c | | Dr. |
|  | To Revaluation A/c |  |
| (Loss on revaluation is transferred to the Old Partner’s Capital Account in their old profit sharing ratio | |  |

If it is agreed that the capital of all the partners be proportionate to the new profit sharing ratio, how will you work out the new capital of each partner? Give examples and state how necessary adjustments will be made.

**ANSWER:**

When a new partner is admitted, sometimes it is agreed that the capital of all the partners should be proportionate to the new profit sharing ratio. The calculation of the new capital of each partner depends on the following situations:

1) When the capital of the new partner is given

2) When the total capital of the firm is given.

1) ***When the capital of the new partner is given***

In this situation, the calculation of the new capital of all the partners involves the following steps:

***Step 1*:** The total capital of the new firm is calculated on the basis of new partner’s capital.

***Step 2*:** The new capital of each partner is calculated by dividing the total capital of the firm by their individual new profit share.

***Step 3*:** After posting all adjustments and items in the Partners’ Capital Account, calculate credit minus debit side of the old Partners’ Capital Account.

***Step 4*:**The new capital ascertained in the ***Step 2*** is written as ‘Balance c/d’ on the credit side of the Partner’s Capital Account.

***Step 5*:**If the amount ascertained in ***Step 2*** (New capital) exceeds the capital amount ascertained in ***Step 3*** (Old Capital), then it is termed as ‘Deficit’ and the difference amount is to be brought in by the old partners. On the contrast, if the amount ascertained in the ***Step 2*** (New Capital) is lesser than the capital amount ascertained in the ***Step 3*** (old Capital), then it is termed as ‘Surplus’ and the difference amount is returned to the old partners.

Let us understand the above steps with the help of an example.

A and B are partners sharing profit and loss equally. They agree to admit C for share in profit. C brings Rs 50,000 as capital. The old capitals of A and B are Rs 60,000 and Rs 40,000 respectively, at the time admission of C.

***Step 1***: The total capital of the new firm on the basis of C =

***Step 2***: A’s new capital =

B’s share in new firm =

***Step 3***:

|  |  |  |
| --- | --- | --- |
|  | A | B |
| New Capital | 50,000 | 50,000 |
| *Less:*Existing Capital | (60,000) | (40,000) |
| Withdrawal (deposit) | 10,000 | (10,000) |

**2) *When the total capital of the new firm is given*:**

When the capital of new partner is not mentioned then his/her capital is ascertained on the proportionate basis of total capital of the firm. The amount ascertained is to be brought in by the new partner in the form of his/her portion of capital. In order to ascertain the proportionate capital of the new partner, the following steps are to be followed.

***Step 1***: Ascertain the total old capital of the old partners (after making all adjustments)

***Step 2***: Ascertain the total capital of the new firm by multiplying the total of old capitals of the old partners (ascertained in the Step 1) with reciprocal of total share of old partners. That is,



***Step 3:*** Calculate New Capital of each partner on the basis of Total Capital ascertained in Step 2. That is, multiplying the Total Capital by the new profit sharing ratio individually for all the partners (including the new partner).

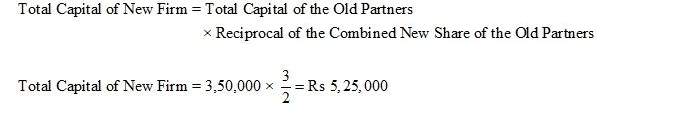
Let us understand the above steps with the help of an example.

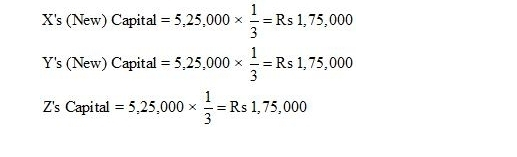
X and Y are partners in a firm sharing profit and loss equally. They agree to admit Z for share in profit and decided to share future profit and loss equally. X’s capital is Rs 2,00,000 and Y’s capital is Rs 1,50,000. Z brings sufficient capital for his share in profit.

***Step 1***: ***Calculation of Total Capital of Old Partners (after all adjustments)***

The total capital of the old partners = Rs 2,00,000 + Rs 1,50,000 = Rs 3,50,000

***Step 2***: ***Calculation of Total Capital of New Firm***





***Step 3***: ***Calculation of New Capital of Each Partner***

**Question 5:**

Explain how will you deal with goodwill when new partner is not in a position to bring his share of goodwill in cash.?

**ANSWER:**

When the new partner is not in a position to bring his share of goodwill in cash, then goodwill account is adjusted through the old Partners’ Capital Account. New Partner’s Capital Account or Current Account is debited with his/her share of goodwill and the partners who sacrifice their share in favour of the new partner are credited in their sacrificing ratio. The following Journal entry is passed in the books of accounts.

|  |  |  |
| --- | --- | --- |
| New Partner’s Capital A/c | | Dr. |
|  | To Old Partners’ Capital A/c |  |
| (New partner capital account is debited with his/her share  of goodwill and sacrificing Partners’ Capital Account are  credited in their sacrificing ratio) | |  |
|  |  |  |

**NOTE**: As per the ***Para 16 of Accounting Standard 10***, goodwill is recorded in the books only when some consideration in money or money’s worth has been paid for it. This practice is mandatory to follow. In the case of admission, retirement, death or change in profit sharing ratio among existing partners, Goodwill Account cannot be raised as no consideration is paid for it.

**Question 6:**

Explain various methods for the treatment of goodwill on the admission of a new partner?

**ANSWER:**

The methods for the treatment of goodwill on the admission of a new partner are given below.

1. Premium Method

2. Revaluation Method

It should be noted that before following any of the below mentioned methods of goodwill, if goodwill already appears in the old books (old Balance Sheet) of the firm, then first of all, this goodwill should be written off among all the old partners in their old profit sharing ratio. The following Journal entry is passed to distribute the goodwill.

|  |  |  |
| --- | --- | --- |
| Old Partners’ Capital A/c | | Dr. |
|  | To Goodwill A/c |  |
| (Goodwill written off among the old partners in their old profit sharing ratio) | | |

**1. Premium Method-** This method is used when a new partner pays his/her share of goodwill in cash. The following are the different situations under this method.

***i) When the new partner privately pays his/her share of goodwill to the old partners.***

In this case, there is no need to pass any Journal entry in the books of accounts as the goodwill is privately paid.

***ii) When the new partner brings his/her share of goodwill in cash and the goodwill is retained in the business.***

Accounting Entries

a)      For premium or goodwill brought in cash by the new partner

|  |  |  |
| --- | --- | --- |
| Cash/Bank A/c | | Dr. |
|  | To Premium for Goodwill A/c |  |
| (Amount of goodwill brought in by the new partner) | | |

b) For transferring of new partner’s goodwill among the old partners, i.e. if goodwill is retained in the business.

|  |  |  |
| --- | --- | --- |
| Premium for Goodwill A/c | | Dr |
|  | To Sacrificing Partners’ Capital A/c |  |
| (Goodwill brought in by the new partner is distributed among the old partners in their sacrificing ratio) | | |

c)  If the new partner’s share of goodwill is withdrawn by the old partner, then

|  |  |  |
| --- | --- | --- |
| Sacrificing Partner’s Capital A/c | | Dr. |
|  | To Cash A/c |  |
| (Amount of goodwill withdrawn by the old partners) | | |

iii) If the new partner partly brings his/her share of goodwill

a)      For bringing goodwill in cash

|  |  |  |
| --- | --- | --- |
| Cash A/c | | Dr. |
|  | To Premium for Goodwill A/c |  |
| (Amount of goodwill brought in cash by the new partner) | | |

b) For transferring of goodwill to the old partners

|  |  |  |  |
| --- | --- | --- | --- |
| Goodwill A/c | | Dr. | (With the amount of goodwill brought in by the new partner) |
| New Partner’s Capital A/c | | Dr. | (With the amount of goodwill ***not*** brought in by the new partner) |
|  | To Sacrificing Partners’ Capital A/c |  |  |
| (Goodwill amount of the new partner distributed among the old partners in their sacrificing ratio) | | |

**2. Revaluation Method-** When the new partner is ***not*** able to bring goodwill in cash at all.

|  |  |  |  |
| --- | --- | --- | --- |
| New Partner’s Capital A/c | | Dr. | (With the whole amount of goodwill that is ***not*** brought in by the new partner) |
|  | To Old Partners’ Capital A/c |  |  |
| (Goodwill amount of the new partner distributed among the old partners in their sacrificing ratio) | | |

**NOTE**: As per the ***Para 16 of Accounting Standard 10***, goodwill is recorded in the books only when some consideration in money or money’s worth has been paid for it. This practice is mandatory to follow. In  case of admission, retirement, death or change in profit sharing ratio among existing partners, Goodwill Account cannot be raised as no consideration is paid for it.

**Question 7:**

How will you deal with the accumulated profit and losses and reserves on the admission of a new partner?

**ANSWER:**

When a new partner is admitted in a partnership firm, then all past accumulated profits or losses and reserves are distributed among all the old partners in their old profit sharing ratio. This is because these profits and losses are attributable to the hard work and labours of the old partners and consequently, the old partners are liable to bear past losses or profits, if any. The new partner is not entitled for a share in these profits as he/she did not contribute anything for the past performance of the business.

**Accounting Treatment of Accumulated Profits and Losses**

i) ***For distributing accumulated profits and reserves***

|  |  |  |
| --- | --- | --- |
| Profit and Loss A/c | | Dr. |
| General Reserve A/c | | Dr. |
| Reserve Fund A/c | | Dr. |
| Workmen’s Compensation Fund A/c | | Dr. |
| Contingency Reserve A/c | | Dr. |
|  | To Old Partners’ Capital A/c |  |
| (Undistributed profits and reserves are distributed among old partners in their old profit sharing ratio) | |  |
|  |  |  |

ii) ***For distributing accumulated losses***

|  |  |  |
| --- | --- | --- |
| Old Partners’ Capital A/c | | Dr. |
|  | To Profit and Loss (Debit balance) A/c |  |
|  | To Deferred Advertisement Expenses A/c |  |
|  | To Preliminary Expenses A/c |  |
| (Undistributed losses are distributed among old  partners in their old profit sharing ratio) | |  |