Reconstitution- Admission of a Partner

New Profit Sharing Ratio and Sacrificing Ratio

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Admission of a New Partner
- New Profit Sharing Ratio and its Calculation
- Sacrificing Ratio and its Calculation

Admission of a New Partner

With the passage of time, a business grows and expands. It demands more capital and more number of partners to efficiently manage the increased business activities of the firm. This requirement is met usually by admitting a new partner or partners into the partnership firm. According to the Section 31 of the Partnership Act 1932, a new partner/s can be admitted into the partnership firm with the consent of all the existing partners of the firm. It other words, there should be a consent of all the partners or a unanimous consent for admitting a new partner into the firm.

Whenever, a new partner joins a partnership firm to share the future profits and losses, it is considered as Admission of a New Partner. As we know that admission of a new partner leads to reconstitution of the partnership firm, so a new partnership agreement is formed that replaces the old agreement. This new partnership agreement defines a new (or changed) relationship among all the partners (including the new partner). The new partner, on his/her admission, acquired the two main rights. These are as follows.

i. Right to share the future profits of the partnership firm.
ii. Right to share the assets of the partnership firm.

The new partner, on his/her admission, is required to bring his/her share of goodwill and capital (whether in cash or in kind). The share of capital enables the new partner to acquire the right over the assets of the firm.

NOTE: A point to be noted here is that the new partner is not liable for any of the acts which is done before his/her admission into the firm. That is to say, the new partner is liable only for those acts which are done after his/her admission.

The below-mentioned are some of the adjustments which are required to be considered at the time of admission of a new partner.

a. New Profit Sharing Ratio
b. Sacrificing/Gaining Ratio
c. Treatment of Goodwill
d. Revaluation of Assets and Liabilities
e. Adjustment of Accumulated Profits (Reserves) and Losses
f. Adjustment of Capital of the Partners

Effects/Implications Of Admission Of a Partner

When a new partner is admitted to a firm, the changes that take place are as follows:

1) **Partnership terms become redundant** because these were decided by the old partners at the time of their admission. Hence, they will now have to decide afresh and draw up a new agreement governing their relationship including the new partner. This however, does not mean that the firm stops existing because the admission just leads to a structural change.

2) **Revaluation of Assets and reassessment of liabilities** takes place. This is because the new partner should not benefit or suffer from any appreciation or fall in the value of the assets and any reduction or increase in the liabilities. As a result, existing and old partners capital accounts have to be adjusted with the net change in their old profit-sharing ratios.

3) The **new partner** like any other existing partner will have a **right over the future profits/gains of the firm** since he will be putting his efforts to generate the same. As a result of this, the combined share of old partners might get reduced as the profits will now have to be divided among more members.

4) Like every other partner to a firm, the **new or incoming partner will have to contribute certain amount of capital** as agreed.

5) Certain other **adjustments have to be made for accumulated profits and losses, reserves, etc**. This is because these reserves and profits belong to the old partners and should be shared among them in their old profit sharing ratio. Also, any losses should be similarly, borne by the old partners.
However, all the partners (including new partner) might agree to show these reserves in the balance sheet at original value or certain value. In such a case, all Partner's Capital Account will be debited in the new profit sharing ratio and Reserve account will be credited with the agreed amount.

6) Goodwill as we know in simple terms is the brand value of a firm. This develops over a period of time through the efforts of its members. Hence, the new partner having no contribution of his own in

nurturing the brand is required to pay the existing members for their sacrifice through his Capital Account.

7) The new or incoming partner will also hold a right over the assets of the firm and **will be held responsible for the liabilities**.

New Profit Sharing Ratio (or simply New Ratio)

We learnt in the previous chapter that admission of a new partner results in reconstitution of a partnership firm. This is because due to the admission of a partner, the existing relationship between the old partners may undergo changes. One of the most important change that takes place on the eve of admission of partner is the change in the profit sharing ratio. The old partners of the firm sacrifice some portion of their respective profit share in favour of the new partner in an agreed ratio. Thus, whenever a new partner is admitted into a partnership firm, it will results into the change in the existing profit sharing ratio and new profit sharing ratio among all the partners (including new partner) is calculated. This ratio, in which all the partners have agreed to share the future profit and losses is regarded as New profit sharing ratio.

Calculation of New Ratio

The computation of the new profit sharing ratio mainly depends upon how the new partner is acquiring his/her share of profit from the old partners. The below mentioned are the three ways in which a new partner acquires his/her profit share from the old partners.

Case I: When no information regarding the acquisition of share of profit from the old partners is given

Or

When a new partner acquire his share from the old partners in their old profit sharing ratio

In this case, the profit share of the new partner as well as the profit shares of the old partners are also mentioned in the question. But, *no information regarding in what ratio the new partner acquires his share from the old partners is given*. Therefore, in this case, it is assumed that the new partner takes his share from the old partners in their old profit sharing ratio. In other words, it implies that the remaining profit (Total Profit *less* Share of New Partner) is to be shared by the old partners. In order to ascertain the new profit sharing ratio, the new partner's share is deducted from the total profit of the firm and the remaining profit will be shared by the old partners.

Let us take the help of the following example to understand this case.

***Example*:** P and Q are the partners in a firm sharing profit and losses in the ratio of 2: 1. R is admitted for $\frac{1}{3}^{rd}$ share in the profit of the firm. Calculate the new profit sharing ratio of P, Q and R.

***Solution*:** Old Ratio (P and Q) = 2 : 1

R is admitted for $\frac{1}{3}^{rd}$ share of profit

Let the total profit of the firm be Re 1

R's share in profit = $\frac{1}{3}$

∴ Remaining profit = $1-\frac{1}{3}=\frac{2}{3}$

Now, this remaining profit will be shared by P and Q in their old ratio i.e., 2: 1.

∴ P's New Share $= \frac{2}{3} \times \frac{2}{3} = \frac{4}{9}$

Q's New Share $= \frac{2}{3} \times \frac{1}{3} = \frac{2}{9}$

R's share $= \frac{1}{3}$ or $\frac{3}{9}$

∴ New Profit Sharing Ratio of P, Q and R = 4 : 2 : 3

Case II: When a new partner acquire his share of profit in a specified ratio from the old partners

At times, it is mentioned in the question that the new partner acquires his share of profit from the old partners in a specified ratio. In this case, there is no need to calculate the remaining profit of the firm and distribute it between the old partners. Instead, the profit share which the new partner takes from the individual old partners will be deducted from their respective shares and the share left after deduction is considered as the new profit share of the old partners. This case can be better understood with the help of the below mentioned examples.

***Example*:** Ankit and Aman are two partners in a partnership firm sharing profits and losses in the ratio of 2: 1. They admitted Ankush for $\frac{1}{3}^{rd}$ share of profit, which he takes $\frac{1}{6}^{th}$ from Ankit and $\frac{1}{6}^{th}$ from Aman. Calculate the new profit sharing ratio.

***Solution*:** Old Ratio (of Ankit and Aman) = 2 : 1

Ankush is admitted for $\frac{1}{3}^{rd}$ share of profit

He takes $\frac{1}{6}^{th}$ from Ankit and $\frac{1}{6}^{th}$ from Aman

Therefore,

Ankit's New Share $= \frac{2}{3} - \frac{1}{6} = \frac{4-1}{6} = \frac{3}{6}$

Aman's New Share $= \frac{1}{3} - \frac{1}{6} = \frac{2-1}{6} = \frac{1}{6}$

Ankush's share $= \frac{1}{3}$ or $\frac{2}{6}$ $\left[\frac{1}{6} + \frac{1}{6} = \frac{2}{6} \text{ or } \frac{1}{3}\right]$

∴ New Profit Sharing Ratio = 3: 1: 2

***Example*:** Ruhi and Juhi are two partners sharing profits and losses in the ratio of 5: 7. Kajal is admitted in the firm. She takes $\frac{1}{8}^{th}$ share of profit from Ruhi and $\frac{2}{8}^{th}$ share of profit from Juhi. Calculate the new profit sharing ratio.

Note: In this question, the profit share of the new partner is not mentioned in the question. The profit share of Kajal is ascertained by adding $\frac{1}{8}^{th}$ share of profit from Ruhi and $\frac{2}{8}^{th}$ share of profit from Juhi.

***Solution*:** Old Ratio (of Ruhi and Juhi) = 5 : 7

Kajal takes $\frac{1}{8}^{th}$ share from Ruhi and $\frac{2}{8}^{th}$ share from Juhi

∴ Kajal's total share of profit $= \frac{1}{8} + \frac{2}{8} = \frac{3}{8}$

Ruhi's New Share $= \frac{5}{12} - \frac{1}{8} = \frac{10-3}{24} = \frac{7}{24}$

Juhi's New Share $= \frac{7}{12} - \frac{2}{8} = \frac{14-6}{24} = \frac{8}{24}$

Kajal's Share $= \frac{3}{8}$ or $\frac{9}{24}$

∴ New Profit Sharing Ratio = 7: 8: 9

Another variant of this case is the situation, where the new partner is ***acquiring whole of his share just from one partner***. The following numerical example explains this concept.

***Example*:** Zen and Lucy are partners in a partnership firm sharing profits and losses in the ratio of 7 : 3. They admitted Kartik for $\frac{1}{6}^{\text{th}}$ share in profits, which he acquired from Zen. Calculate new profit sharing ratio.

***Solution*:** Old ratio (Zen and Lucy) = 7 : 3

Kartik is admitted for $\frac{1}{6}^{\text{th}}$ share which he acquired from Zen

∴ Zen's New Profit Share = $\frac{7}{10} - \frac{1}{6} = \frac{21-5}{30} = \frac{16}{30}$

Lucy's Profit Share = $\frac{3}{10}$ or $\frac{9}{30}$

Kartik's Profit Share = $\frac{1}{6}$ or $\frac{5}{30}$

∴ New Ratio = 16 : 9 : 5

Case III: <u>When a new partner acquire his share by surrender of a particular fraction of the shares by the old partners.</u>

In this case, the fraction of the share that is sacrificed by the old partners in favour of the new partner is mentioned in the question. In order to calculate the new profit sharing ratio, we need to first ascertain the individual share sacrificed by each of the old partners. the share of profit which is surrendered by the old partners in favour of a new partner is calculated. After this, share of profit surrendered by the old partners are added to ascertain the profit share of the new partner. Also, the share of profit surrendered by the old partners is deducted from their respective share to get their new profit share. In other words, the new profit sharing ratio among all the partners is ascertained after calculating the profit share surrendered by the old partners in favour of a new partner.

***Example*:** Laveena and Manvi are two partners in a firm sharing profit and losses in the ratio of 2: 1. They admitted Neha as a new partner. On her admission, Laveena surrenders $\frac{1}{10}^{\text{th}}$ of her share and Manvi surrenders $\frac{1}{5}^{\text{th}}$ of her share in favour of Neha. Calculate the new profit sharing ratio.

***Solution*:** Old Ratio (Laveena and Manvi) = 2 : 1

L surrenders $\frac{1}{10}^{\text{th}}$ of her share and Manvi surrenders $\frac{1}{5}^{\text{th}}$ of her share

It means, Laveena surrendered $= \frac{2}{3} \times \frac{1}{10} = \frac{2}{30}$

and Manvi surrendered $= \frac{1}{3} \times \frac{1}{5} = \frac{1}{15}$

∴ Neha's Share in profit $= \frac{2}{30} + \frac{1}{15} = \frac{2+2}{30} = \frac{4}{30}$

Laveena's New Share $= \frac{2}{3} - \frac{2}{30} = \frac{20-2}{30} = \frac{18}{30}$

Manvi's New Share $= \frac{1}{3} - \frac{1}{15} = \frac{5-1}{15} = \frac{4}{15}$ or $\frac{8}{30}$

Neha's share $= \frac{4}{30}$

∴ New Profit Sharing Ratio = 18: 8: 4 *or* 9: 4: 2

***Example*:** P and Q are two partners in a firm sharing profit and losses in the ratio of 5: 3. They admitted R and S as two new partners. P surrenders $\frac{1}{5}^{\text{th}}$ of his share in favour of R and Q surrenders $\frac{1}{3}^{\text{rd}}$ of his share in favour of S. Calculate the new profit sharing ratio.

***Solution*:** Old Ratio (P and Q) = 5 : 3

R and S are admitted in the firm

P surrenders $\frac{1}{5}^{\text{th}}$ of his share in favour of R

Q surrenders $\frac{1}{3}^{\text{rd}}$ of his share in favour of S

It means, P surrenders $= \frac{5}{8} \times \frac{1}{5} = \frac{5}{40} \Rightarrow$ to R

Q surrenders $= \frac{3}{8} \times \frac{1}{3} = \frac{3}{24} \Rightarrow$ to S

∴ R's share in profit $= \frac{5}{40}$

S's share in profit $= \frac{3}{24}$

So, P's New Share $= \frac{5}{8} - \frac{5}{40} = \frac{25-5}{40} = \frac{20}{40}$ or $\frac{60}{120}$

Q's New Share $= \frac{3}{8} - \frac{3}{24} = \frac{9-3}{24} = \frac{6}{24}$ or $\frac{30}{120}$

R's Share $= \frac{5}{40}$ or $\frac{15}{120}$

S's Share $= \frac{3}{24}$ or $\frac{15}{120}$

∴ New Profit Sharing Ratio = 60: 30: 15: 15 *or* 4: 2: 1: 1

Sacrificing Ratio

So far, we have learnt that whenever a new partner is admitted in a partnership firm, the old profit sharing ratio between the existing partners changes. This is because the exiting partners sacrifice a portion of their profit share in favour of the new partner in an agreed ratio. The ratio in which the old partners surrender their share of profit in favour of the new partner is termed as Sacrificing Ratio. In this manner, the sacrificing ratio is defined as a difference between the old profit share and the new profit share of the old partners.

Algebraically,

Sacrificing Ratio = Old Ratio – New Ratio

Note: It should be noted that the Sacrificing Ratio is computed only for the existing (or old) partners. It is not ascertained for the new partner, as he is not sacrificing any portion of his profit share, rather he is gaining profit share from the old partners.

It should also be noted that in some cases, old ratio (of existing partners) and new profit share of all the partners (including the new partner) is mentioned in the question. In such cases, Sacrificing Ratio for the old partners can be easily calculated by subtracting their New Ratio from their Old Ratio. However; if only the old ratio is mentioned, then the new ratio is to be ascertained (as per the three cases mentioned above) and then Sacrificing Ratio is calculated as the difference between the Old Ratio and the New Ratio.

Cases of Sacrificing Ratio

The following are the two cases of calculation of Sacrificing Ratio.

Case1: *When information regarding how the old partners are sacrificing their share in favour of the new partner is* ***not mentioned*** *and the share of the new partner is given.*

In this case, as no information is provided for the share sacrificed by the old partners, so it is assumed that the old partners are sacrificing in their old profit share.

Example 1**:** Sonu and Monu are the partners in a firm sharing profits and losses in the ratio of 5: 2. Nonu is admitted for $\frac{1}{7}^{\text{th}}$ share of profit. Calculate the sacrificing ratio.

Solution**:** As we can see that no information is given that could indicate how the new partner is getting his share from the old partners, so it is assumed that the old partners will sacrifice their profit share in favour of new partner in their old profit sharing ratio. So,

$$\text{Sonu's Sacrifice} = \frac{1}{7} \times \frac{5}{7} = \frac{5}{49}$$

$$\text{Monu's Sacrifice} = \frac{1}{7} \times \frac{2}{7} = \frac{2}{49}$$

∴ Sacrificing Ratio **=** 5 : 2

If in case, information regarding the share sacrificed by the old partners is mentioned, then we need to calculate the new ratio and then Sacrificing Ratio is calculated as the difference between Old Ratio and New Ratio.

Example 2**:** Pinku and Chinku are the two partners sharing profits and losses in the ratio of 5 : 3. Minku is admitted for $\frac{1}{6}^{\text{th}}$ share of profit which is to be sacrificed by the old partners in the ratio of 3 : 2. Calculate the sacrificing ratio.

***Solution*:** In this example, the sacrifices made by the old partners (i.e. Pinku and Chinku) in favour of a new partner(i.e. Minku) is clearly given, i.e. 3 : 2.

So, Pinku's sacrifice $= \frac{1}{6} \times \frac{3}{5} = \frac{3}{30}$

Chinku's sacrifice $= \frac{1}{6} \times \frac{2}{5} = \frac{2}{30}$

∴ Pinku's New Ratio $= \frac{5}{8} - \frac{3}{30} = \frac{63}{120}$

and Chinku's New Ratio $= \frac{3}{8} - \frac{2}{30} = \frac{37}{120}$

Minku's Share $= \frac{1}{6}$ or $\frac{1}{6} \times \frac{20}{20} = \frac{20}{120}$

So, New Ratio = 63 : 37 : 20

Sacrificing Ratio of Pinku $= \frac{5}{8} - \frac{63}{120} = \frac{75-63}{120} = \frac{12}{120}$

Sacrificing Ratio of Chinku $= \frac{3}{8} - \frac{37}{120} = \frac{45-37}{120} = \frac{8}{120}$

Sacrificing Ratio of Pinku and Chinku is 12 : 8 or 3 : 2

Case 2: *When both the ratios- Old Ratio and New Ratio are mentioned in the question.*

In this case, both Old Ratio as well as New Ratio are mentioned, so Sacrificing Ratio can be easily computed by subtracting New Ratio from the Old Ratio.

***Example 3*:** X and Y are the two partners sharing profits and losses in ratio of 4: 7. Z is admitted in the firm. The new profit sharing ratio among X, Y and Z is decided as 3: 7: 10. Calculate the sacrificing ratio.

***Solution*: Sacrificing ratio = Old Ratio – New Ratio**

$$\text{X's sacrifice} = \frac{4}{11} - \frac{3}{20} = \frac{80-33}{220} = \frac{47}{220}$$
$$\text{Y's sacrifice} = \frac{7}{11} - \frac{7}{20} = \frac{140-77}{220} = \frac{63}{220}$$

∴ Sacrificing Ratio = 47: 63

***Example 4*:** Ramesh and Mukesh are the two partners in a firm sharing profit and losses in the ratio of 2: 3. Rakesh is admitted in the firm as a new partner. They all decided to share future profits and losses in the ratio of 4: 3: 2 Calculate the sacrificing ratio.

***Solution*: Sacrificing ratio = Old Ratio – New Ratio**

$$\text{Ramesh's sacrifice} = \frac{2}{5} - \frac{4}{9} = \frac{18-20}{45} = \frac{-2}{45}$$
$$\text{Mukesh's sacrifice} = \frac{3}{5} - \frac{3}{9} = \frac{27-15}{45} = \frac{12}{45}$$

Sometimes, there may be a situation when all the existing partners does not sacrifice their share on the admission of a new partner.

In the above case, negative sign in Ramesh's sacrifice implies that he is not sacrificing his share rather he is gaining on the admission of a new partner. In this case, the whole sacrifice on the admission of Rakesh is made by Mukesh.

It can also be interpreted as:

Mukesh's Sacrifice = Ramesh's Gain + Rakesh's Gain

$$= \frac{2}{45} + \frac{10}{45} = \frac{12}{45}$$

Valuation of Goodwill

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Meaning of Goodwill
- Characteristics of Goodwill

- Factors Affecting Goodwill
- Need for Valuation of Goodwill
- Methods for Valuation of Goodwill

Meaning

Goodwill is the value of a firm's reputation and its good brand name in the market. A firm earns goodwill by its hard work. Goodwill helps a firm in winning the trust and faith of the customers by fulfilling their demands in both qualitative and quantitative aspects. It can be said that goodwill of a firm is a result of the past efforts made by it which helps a firm to earn higher profits in present and in future as well. In other words, a positive goodwill helps a firm to earn supernormal profits as compared to the other firms that earns only normal profits. Goodwill is considered as an intangible asset of the firm. It means it cannot be seen or touched like other assets of the firm. It plays very crucial role for any firm to survive and compete in the market.

In the words of *Lord Eldon*, "Goodwill is nothing more than probability that the old customers will resort to the old place".

Characteristic of Goodwill

The below mentioned are the characteristics of goodwill.

i. It is an intangible asset.
ii. It is not a fictitious asset.
iii. It is difficult to ascertain the exact value of goodwill.
iv. It enhances the present as well as the future earning capacity of a business.
v. It helps in earning the supernormal profits against the normal profits.
vi. It is a basis for winning customer's trust and faith.
vii. A positive goodwill not only facilitates a firm to win customers' trust but also helps the company to excel over its competitors.

Nature of Goodwill

By the very definition of Goodwill, we can figure out that it is something which cannot be touched, seen or felt but has the potential to generate enormous returns for the firm by creating a positive image in the minds of customers and attracting them. Thus we can classify goodwill as an intangible asset just like patents, trademarks, etc. It therefore doesn't depreciate (i.e. reduce in value due to gradual wear and tear) but rather amortizes over its useful life which is to say that a certain portion of goodwill is written off every year depending on the value derived out of it during the year. For example: 1/5th of the goodwill is to be written off this year. The accounting treatment of goodwill is covered under Accounting Standard-26(AS-26) according to which, goodwill should not be recorded in the books of accounts unless consideration is paid for it. Also, if goodwill is computed for oneself then such a self generated goodwill should not be recorded because its value cannot be justified by way of cost incurred to acquire such an asset. Lastly, just like a tangible asset, goodwill can be sold but it happens along with the sale of the business.

Factors Affecting Goodwill

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

(i) Quality Products

One of the important factors that affects the goodwill of the firm is the quality of the product. Quality product means producing a right and standard featured products and selling them at reasonable prices. A firm that is engaged in producing the high quality goods and services is able to capture the huge demand for its product in the market. This will in turn help the firm to increase its goodwill in the market.

(ii) Location

Goodwill of a firm largely depends upon the place where the business of a firm is located. If the business is located at a convenient and easily accessible place, then large numbers of customers get attracted which in turn leads to the increase in sales. It helps the firm to earn higher goodwill.

(iii) Management

Efficient management helps the firm to fulfill its customer requirements. It also helps the firm to achieve the higher productivity along with the cost efficiency. It means efficient management helps in producing the superior quality goods and services at a lower costs, which in turn lower the prices of good and services in the market as compared to the other firms. Due to this, the firm will be able earn the higher profits resulting in higher value of goodwill of the firm.

(iv) Firm's Status in the Market

Status of a firm in the market also affects its goodwill. A firm which is not facing a huge competition in the market or enjoys the status of monopoly in the market will be able to earn higher profits. This will results in increase in the value of the goodwill.

(v) Economies of Scales

A firm that enjoys the special advantages such as continuous and easy supply of power, fuel, raw materials, etc., at reasonable price and producing the quality products at a large scale is able to enhance the goodwill of the firm.

Classification of Goodwill

Goodwill can be classified into two broad categories depending, namely:

1. Purchased Goodwill; and
2. Self-generated Goodwill

I. Purchased Goodwill

Whenever, a firm is sold to another firm generally a consideration is paid in cash or kind because the buyer will enjoy the benefits of the brand image that has been created over the years once the purchase is complete. This kind of goodwill is recorded in the books of accounts since the amount paid can be fairly determined. This goodwill arises when, for instance, the value of assets is greater than the liabilities at the time of purchase and hence, it is a balancing figure. For example, Aman owns a shop that is known for its quality and has a large number of loyal customers and Ravi offers to buy his shop as it is. As a result of this purchase, Ravi will be able to acquire the pool of customers and should therefore pay for it as well apart from the assets.

Characteristics of Purchased Goodwill:

1. This goodwill arises when a business is purchased or acquired for reasons like brand image, customers pool, business connections, etc.
2. It is recorded in the books of accounts since its value has been determined in the form of consideration paid.
3. Like any other asset, this kind of goodwill is a valuable intangible asset for a firm and hence shall be recorded under the head Assets in the balance sheet of the firm.
4. The valuation of goodwill cannot be objectively determined and is based on what the seller's perception.
5. The benefit of goodwill can be enjoyed only for a limited period of time owing to the fact that the benefit derived from it cannot be justified in quantitative terms after a certain period. Hence, it should be amortized at the earliest.

Let's understand this concept with the help of an example,

Example: Rekha Enterprises acquired the business of M/S Ram Kapoor & Sons for a net consideration of Rs. 6, 00,000 payable by cheque. The assets acquired and liabilities taken over as follows:

Assets	Amount (Rs.)	Liabilities	Amount (Rs.)
Land and Building	1,50,000	Outstanding Expenses	20,000
Debtors	80,000	Creditors	4,00,000
Inventory	7,50,000	Salary Payable	90,000

Pass the journal entries for the same.

Answer:

Rekha Enterprises

JOURNAL

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
	Land And Building A/c	Dr.		1,50,000	
	Debtors A/c	Dr.		80,000	
	Inventory A/c	Dr.		7,50,000	
	Goodwill A/c (Balancing figure)	Dr.		1,30,000	
	To Creditors A/c				4,00,000
	To Salary Payable A/c				90,000
	To Outstanding Expenses A/c				20,000
	To M/s Ram Kapoor & Sons A/c				6,00,000
	(Being assets & liabilities taken over)				
				6,00,000	
	M/s Ram Kapoor & Sons A/c	Dr.			6,00,000
	To Bank A/c				
	(Being net consideration paid)				

II. Self-generated Goodwill:

Unlike the previous kind, this goodwill is not purchased or bought for a consideration but rather generated as a result of the hard work and efforts of the members of the firm. It therefore arises because of factors such as consistent quality, satisfied customers, favourable location, etc. Since all these factors are internal to an organization hence the goodwill is an internally generated goodwill boosting the revenues for the firm.

Features of Self-generated Goodwill:

1. As mentioned above, it arises out of the efforts of a firm over the years and hence is internally generated.
2. Since the value of internally generated goodwill cannot be traced back to a cost source hence its accurate and reliable value is very difficult to determine.

3. The valuation is based on the perspective of the valuer and hence is completely subjective.

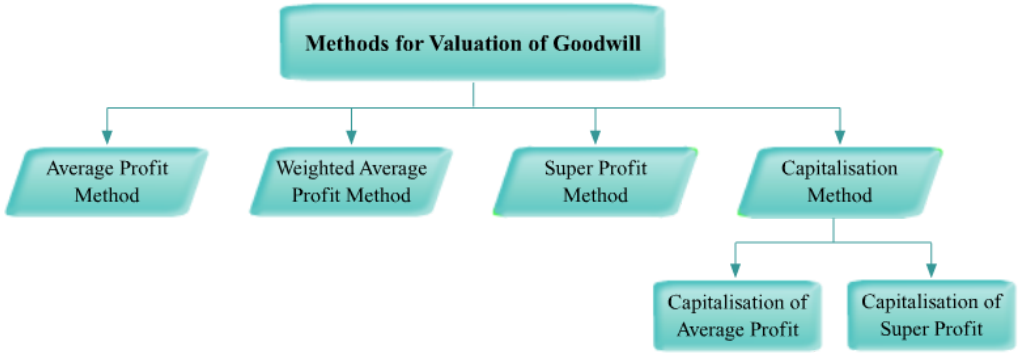
Need for Valuation of Goodwill

The following are the various situations in which the need for the valuation of goodwill arises.

i. When there is a change in the profit sharing ratio of the firm
ii. When a new partner is admitted in the firm
iii. When a partner retires or dies
iv. When a partnership firm is sold
v. When partnership firm is amalgamated with another firm

Methods for Valuation of Goodwill

The below-mentioned methods are used for valuation of goodwill of a firm.



Method 1*: *Average Profit Method

Under this method, goodwill is calculated on the average basis of the normal average profits of the last few years. To find out the value of goodwill only normal profits of the business for specified years are taken into consideration in this method. It means all the abnormal gains or losses and all non-business incomes or expenses are ignored while calculating the profits of a particular year.

The profits so calculated for different years is then added and their average is computed. This average profit is then multiplied by the number of years' purchase to ascertain the value of goodwill.

The formula for calculating goodwill under this method is-

$$\text{Goodwill} = \text{Average Profit} \times \text{Number of Years Purchase}$$

where, $\text{Average Profit} = \frac{\text{Total Profits (of past given years)}}{\text{Number of Years}}$

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

Steps to Calculate the Goodwill by Average Profit Method

***Step 1*:** Ascertain the total normal profits of the business for the past given years.

***Step 2*:** Add all abnormal losses such as loss by fire, theft, etc., to the normal profits (as mentioned above). This is because, these are not incurred in the normal course of a business.

***Step 3*:** Subtract all abnormal gains such as winnings from lottery, speculation, etc., from the normal profits. This is because, these are not earned in the normal course of a business.

***Step 4*:** Add all normal business income that were not previously added to the normal profits and subtract all normal business expenses that are not subtracted previously.

***Step 5*:** Subtract all non-business income, i.e. income which earned from outside the business of the firm.

***Step 6*:** Add all the profits for different years after considering all the above steps to find out the total profits of the past given years.

***Step 7*:** Calculate the average profits by dividing the total profits (calculated above) by number of years.

***Step 8*:** Multiply the above calculated average profits by the number of years' purchase to get the value of goodwill.

Important Notes:

Note 1 Abnormal losses are added back to the normal profit because these have already been subtracted from the profits as normal expenses of the business.

Note 2 Abnormal gains are subtracted from the the normal profits because these have been added to the normal profits as normal business income.

***Example*:** The profits of a firm for the last 5 years are given as Rs 50,000, Rs 1,50,000, Rs (1,00,000), Rs 2,50,000 and Rs 4,00,000 respectively. Calculate the value goodwill of the firm on the basis of 4 years' of purchase.

Solution

Calculation of Average Profit

$$\text{Average Profit} = \frac{\text{Total Profits for last 5 years}}{\text{Number of Years}}$$
$$= \frac{50,000+1,50,000-1,00,000+2,50,000+4,00,000}{5}$$

Average Profit = Rs 1,50,000

Calculation of Goodwill

Goodwill = Average profit × Number of years' purchase

= Rs 1,50,000 × 4 = Rs 6,00,000

***Example*:** Calculate the value of goodwill of the firm on the basis of 5 years of purchase on the basis of average profits for the last four years after taking into consideration the following information.

i. Profits for the last four years were-

   Profit for 2008- Rs 60,000

   Profit for 2009- Rs 87,000

   Profit for 2010- Rs 79,500

   Profit for 2011- Rs 93,000

ii. Abnormal loss of Rs 3,000 due to fire has been charged from the profits for the year 2008.
iii. Profits for the year 2009 included a abnormal gain of Rs 6000.
iv. There is profit of Rs 7,500 from lottery winnings during the year 2010 which was included in that year's profit.
v. On 1st April 2011, the firm has purchased furniture costing Rs 30,000 which was debited as sundry expenses by mistake, on which depreciation is to be charged at 20%.

Solution

Calculation of Average Profit

$$\text{Average Profit} = \frac{\text{Profits for last 4 years}}{\text{Number of years}}$$

Years	2008	2009	2010	2011
Profits	60,000	87,000	79,500	93,000
Add: Abnormal Losses	3,000			
Less: Abnormal Gains		(6,000)		
Abnormal Gains (lottery)			(7,500)	
Add: Furniture purchased wrongly debited				30,000
Less: Depreciation on Furniture				(6,000)
Adjusted Profit	**63,000**	**81,000**	**72,000**	**1,17,000**

$$\text{Average Profit} = \frac{63,000+81,000+72,000+1,17,000}{4} = \frac{3,33,000}{4} = \text{Rs } 83,250$$

Calculation of Goodwill

Goodwill = Average Profit × Number of years' Purchase

= Rs 83,250×5 = Rs 4,16,250

***Working Notes*:**

During the year 2011, Furniture costing Rs 30,000 has been purchased which was debited as sundry expenses by mistake. This cost has to be added back to the profits for the year 2011 because it has been wrongly charged as normal expenses of the business.

On the other hand, depreciation on Furniture at 20% i.e. Rs 6,000 is a normal business expenses which should be subtracted from the profits for the year 2011.

Calculation of Depreciation on Furniture

$$\text{Depreciation} = \text{Rs}\,30,000 \times \frac{20}{100} = \text{Rs}\,6000$$

Therefore, the final profits for the year 2011 is Rs 1,17,000 (i.e. Rs 93,000 + Rs 30,000 – Rs 6,000).

***Method 2*: Weighted Average Profit Method**

Weighted Average Profit Method is similar to the Average Profit Method for calculating goodwill of a firm. Under this method, the only difference is that the weights such as 1, 2, 3, 4...etc. are assigned to profit of each year.

Generally, the highest weight is assigned to the recent year's profit and lower weights are assigned to the past year's profits. The product of the weights and the profit is calculated and then are added to find out the sum total of the products. This total of product is then divided by the total of the weights to compute the weighted average profit. To find out the value of goodwill under this method, the weighted average profit so calculated is multiplied by the number of years' purchase.

The formula for calculating goodwill by this method is-

$$\text{Goodwill} = \text{Weighted Average Profit} \times \text{Number of Years' Purchase}$$

where,

$$\text{Weighted Average Profit} = \frac{\text{Total Product of Profits}}{\text{Total of Weights}}$$

Steps of Calculate Goodwill by weighted Average Profit Method

Step 1: Assign the weights to each year's profit in ascending order starting from past years profit. It means lowest weight will be assigned to the most past profits and highest weight to the most recent profits. For example, if 2012 is the current year preceded by 2011, 2010, 2009 and 2008, then the weights are assigned from 2012 to 2008 as 5, 4, 3, 2, 1.

Step 2: Multiply the weights with the corresponding year's profit.
Step 3: Calculate the total of the products.
Step 4: Divide the total of the products by the total of the weights in order to calculate weighted average profit.

Step 5: Multiply the weighted average profit by the number of years purchase to get the value of goodwill.

Superiority of Weighted Average Profit Method over Average Profit Method

Weighted Average Profit Method enjoys an edge over the Average Profit Method in producing better and reliable results. This is particularly in those scenario, where profits are continuously showing an increasing or decreasing trend over a period of years. This is because the Weighted Average Profit Method assigns more weightage to the recent years' profits. Therefore, in order to compute a reliable valuation of goodwill one should go for Weighted Average Profit Method.

***Example*:** The profits of a firm for last 5 years were-

Profit for 2007- Rs 40,000
Profit for 2008- Rs 70,000
Profit for 2009- Rs 60,000
Profit for 2010- Rs 1,10,000
Profit for 2011- Rs 1,00,000

Calculate the value of goodwill of the firm by the Weighted Average Profit Method on the basis of four years' purchase.

Solution

Calculation of Weighted Average Profits Method

Year	Profit (Rs)	Weights	Product (Profit × Weights) (Rs)
2007	40,000	1	40,000
2008	70,000	2	1,40,000
2009	60,000	3	1,80,000

2010	1,10,000	4	4,40,000
2011	1,00,000	5	5,00,000
Total		15	Rs 13,00,000

$$\text{Weighted Average Profit} = \frac{\text{Total of the Products}}{\text{Total of Weights}} = \frac{13,00,000}{15} = \text{Rs } 86,667 (\text{approx.})$$

∴ Goodwill = Weighted Average Profit × Number of years' purchase = Rs 86,667 × 4 = Rs 3,46,668 (approx.)

***Method 3*: Super Profit Method**

A firm earn its profits from the capital employed in the business. Capital employed means the shareholders' fund. i.e. sum total of share capital and reserves and surplus (i.e. undistributed profits). It can also be defined as the difference between total assets (other than fictitious assets) and external liabilities of a firm.

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. This excess of profit over the normal profit is termed as super profit. Therefore, to compute the value of goodwill under this method, super profits are multiplied by the number of years' purchase.

The formula for calculating goodwill by this method is-

$$\text{Goodwill} = \text{Super Profit} \times \text{Number of Years' Purchase}$$

Steps to Calculate Goodwill by Super Profit Method

Step 1: Calculate Average Profit of the firm

Step 2: Calculate Capital Employed of the firm.

Capital Employed = Total Assets (other than fictitious assets) – External/Outside Liabilities

Or

Capital Employed = Share Capital + Free Reserves – Fictitious Assets

Step 3: Calculate Normal Profits on Capital Employed on the basis of Normal Rate of Return as;

$$\text{Normal Profit} = \text{Capital Employed} \times \frac{\text{Normal Rate of Return}}{100}$$

Step 4: Calculate Super Profit by deducting the Normal Profit from the Average Profit.

Super Profit = Average Profit – Normal Profit

Step 5: Multiply the Super Profits by the Number of Years' Purchase to get the value of goodwill.

***Example*:** The past four years profit of a firm are Rs 20,000, Rs 18,000, Rs 22,000 and Rs 25000 respectively. The capital investment (capital employed) of the firm is Rs 90,000. The rate of return expected from the investment is 15%. Calculate the value of goodwill on the basis of 3 years' purchase.

Solution

Calculation Average Profit

$$\text{Average Profit} = \frac{\text{Total Profits of Past 4 years}}{\text{Number of Years}} = \frac{20,000+18000+22000+25000}{4} = \frac{85000}{4} = \text{Rs } 21,250$$

Calculation of Normal Profit

Normal profit = Capital Invested × Rate of Return

= Rs 90,000 × 15% = Rs 13,500

Calculation Super Profit

Super profit = Average Profit – Normal Profit

= Rs 21,250 – Rs 13,500 = Rs 7,750

Calculation of goodwill

Good will = Super Profit × Number of years purchase

= Rs 7,750 × 3 = Rs 23,250

Method 4*: *Capitalisation Method

Under this method, goodwill of a firm can be calculated by either of the following two ways.

A. Capitalisation of Average Profit
B. Capitalisation of Super Profit

(A) Capitalisation of Average Profit

Under this method, first of all the capitalised value of the business is calculated. This value is calculated by capitalising the average profit on the basis of normal rate of return of a business. To calculate the value goodwill of the firm the actual capital employed of a firm is deducted from the value of the business so calculated.

Therefore,the formula for calculating goodwill by this method is-

$$\text{Goodwill} = \text{Capitalised Value of Average Profit} - \text{Actual Capital Employed}$$

Steps to Calculate Goodwill by Capitalisation of Average Profit Method

Step 1: Calculate average profit of the firm.

Step 2: Calculate Capitalised value of Average Profit on the basis of normal rate of return by the following formula.

$$\text{Capitalised Value of Average Profit} = \text{Average Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

Step 3: Ascertain Actual Capital Employed of the firm.

Capital Employed = Total Assets (other than fictitious assets) – External Liabilities

Step 4: Deduct Actual Capital Employed from the Capitalised value of Average Profit to compute the value of goodwill.

Goodwill = Capitalised Average Profit – Actual Capital Employed

***Example*:** A firm has average profit of Rs 96,000 and its normal rate of return is 12%. Total assets of the firm are Rs 8,80,000 and liabilities are Rs 4,00,000. Calculate the value of goodwill of the firm.

Solution

Calculation of Capitalised Value of Average Profit

$$\text{Capitalised Value of Average Profit} = \text{Average Profit} \times \frac{100}{\text{Rate of return}}$$

$$= \text{Rs } 96,000 \times \frac{100}{12} = \text{Rs } 8,00,000$$

Calculation of Capital Employed

Capital Employed = Total Assets – Total Liabilities

= Rs 8,80,000 – Rs 4,00,000 = Rs 4,80,000

Goodwill = Capitalised value of Average Profit – Capital Employed

= Rs 8,00,000 – Rs 4,80,000 = Rs 3,20,000

(B) Capitalisation of Super Profit

Under this method, goodwill is calculated by capitalising the super profits of the firm. It means under this average profit is calculated but instead of capitalisation of average profit, capitalising of super profit is done.

The formula for calculating goodwill by this method is-

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

Steps to Calculate Goodwill by Capitalisation of Super Profit

Step 1: Calculate Capital Employed of the firm as:

Capital Employed = Total Assets – External Liabilities

Step 2: Calculate Normal Profit of the firm as:

$$\text{Normal Profit} = \text{Average Capital Employed} \times \frac{\text{Normal Rate of Return}}{100}$$

Step 3: Calculate Average Profit.

Step 4: Calculate Super Profit of the firm by deducting Normal Profit from Average Profit, as:

Super Profit = Average Profit – Normal Profit

Step 5: Calcualte goodwill of the firm by the following formula:

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

***Example*:** The profits of a firm for the last four years are Rs 80,000, Rs 55,000, Rs (30,000), and Rs 75,000 respectively. The value of the total assets of the firm is Rs 5,50,000 and external liabilities are Rs 2,90,000. The firm expects earn a normal rate of return at 15%. Calculate the value of goodwill of the firm.

Solution

Calculation of Average Profit

$$\text{Average Profit} = \frac{\text{Total Profits of last 4 years}}{\text{Number of years}}$$
$$= \frac{80{,}000 + 55{,}000 - 30{,}000 + 75{,}000}{4} = \frac{1{,}80{,}000}{4} = \text{Rs } 45{,}000$$

Calculation of Normal Profit

$$\text{Normal Profit} = \text{Capital Employed} \times \frac{\text{Normal Rate of Return}}{100}$$

Capital Employed = Total Assets – Total Liabilities

= Rs 5,50,000 – Rs 2,90,000 = Rs 2,60,000

$$\text{Normal Profit} = \text{Rs } 2{,}60{,}000 \times \frac{15}{100} = \text{Rs } 39{,}000$$

Calculation of Super Profit

Super Profit = Average Profit – Normal Profit

= Rs 45,000 – Rs 39,000 = Rs 6,000

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$
$$= 6{,}000 \times \frac{100}{15} = \text{Rs } 40{,}000$$

Treatment of Goodwill

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Treatment of Goodwill
- Hidden Goodwill

Introduction

When a new partner is admitted in a partnership firm, he is entitled a share in the firm's profits, assets and also firm's goodwill. But as, this goodwill is accorded to the hard work and past-efforts of the old partners, so the new partner compensate the old partners by paying them some amount either in cash or kind. The amount that is brought in by the new partner is regarded as *Premium for Goodwill*. This amount of goodwill brought in by the new partner is shared by the existing partners in their sacrificing ratio.

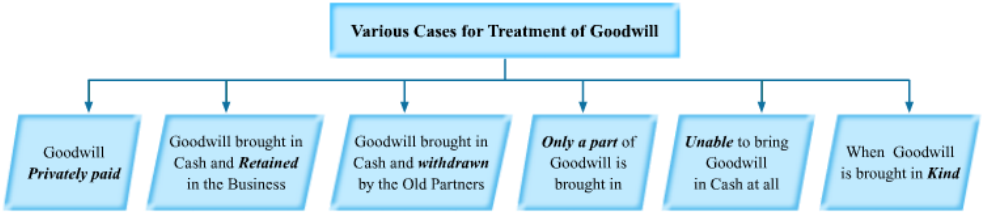
Accounting Standard 26- Treatment of Goodwill

As per the ***Accounting Standard 26*** **of ICAI**, 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. This implies that the goodwill of a partnership firm is a self-generated goodwill, that is, the firm itself evaluates the value of the goodwill. The AS-26 standard specifies that goodwill should be immediately written off after it has been raised. That is, as per this accounting standard, goodwill has to be adjusted through Partners' Capital Account.

Important Note: It should be noted that the treatment of goodwill in the cases of retirement and death of a partner remains the same. There is no difference in the treatment of goodwill and its posting in the Partners' Capital Account in both the cases.

Treatment of Goodwill

There are various cases for treatment of the goodwill in the books of accounts on the eve of admission of a new partner. These cases are presented in the flow-chart diagram below.



However; an important point that is to be taken care of is that irrespective of any case of goodwill, if goodwill already appears in the Balance Sheet of the Old Firm, then first of all this goodwill is to be transferred (i.e. written-off) to the old Partners' Capital A/c in their old profit sharing ratio. It is done by debiting the old partners' capital account and crediting the goodwill account in their old profit sharing ratio. The following Journal entry is passed to write-off the old goodwill.

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

Cases of Goodwill

Case 1: When the new partner pays his share of goodwill privately to the old partners

No accounting entry is recorded in the books of account in this case.

Case 2: When Share of Goodwill is brought in Cash and retained in the Business

When the new partner brings his/her share of goodwill in cash, it is transferred to sacrificing Partner's Capital Account in their sacrificing ratio. In short, it can be said that the existing partners share the amount of goodwill brought in by the new partner in their sacrificing ratio.

Journal Entry

(i) For Premium or Goodwill brought in cash by the New Partner

	Cash or Bank A/c		Dr.
		To Premium for Goodwill A/c	

(ii) For sharing Premium of Goodwill by the Sacrificing partners

	Premium for Goodwill A/c		Dr.
		To Sacrificing Partner's Capital A/c {In sacrificing ratio}	

Important Note **:**

Note I: **When the New Partner also brings in Cash as his/ her Capital Contribution**

Besides bringing goodwill, more oftenly, the new partner also brings certain portion in cash as his share of capital. In this case, Cash Account is debited and New Partner's Capital Account is credited with the amount of cash brought in by the partner.

Journal Entry for bringing Cash as Capital Contribution

Cash A/c		Dr.
	To New Partner's Capital A/c	

Example: Hitesh and Ritesh are the two partners in a partnership firm sharing profits and losses in the ratio of 2: 1. Dinesh is admitted for $\frac{1}{3}$rd share of profits. He brought in Rs 36,000 as his share of premium for goodwill and Rs 40,000 as his capital contribution. On his admission, the goodwill already appeared in the books of account at Rs 12,000. Pass the necessary Journal entries.

Solution

(i) *For Writting-off the goodwill already appeared in the books*

Hitesh's Capital A/c		Dr.	8,000		
Ritesh's Capital A/c		Dr.	4,000		[In Old Ratio]
	To Goodwill A/c			12,000	
(Goodwill written-off) **(JE-1)**					

(ii) *For Capital brought in Cash*

	Cash A/c		Dr.	40,000	
		To Dinesh's Capital A/c			40,000
	(Amount of capital brought by Dinesh) **(JE-2)**				

(iii) *For Premium for Goodwill brought in Cash*

	Cash A/c		Dr.	36,000	
		To Premium for Goodwill A/c			36,000
	(Share of goodwill brought in by Dinesh) **(JE-3)**				

(iv) For sharing Premium for Goodwill by the Sacrificing Partners

	Premium for Goodwill A/c		Dr.	36,000	
		To Hitesh's Capital A/c			24,000
		To Ritesh's Capital A/c			12,000
	(Premium for goodwill credited to Hitesh's and Ritesh's capital A/c in their sacrificing ratio) **(JE-4)**				

Posting in Partners' Capital Account

Partners' Capital A/c

Dr.

Particulars	Hitesh	Ritesh	Dinesh	Particulars	Hitesh	Ritesh	Dine
Goodwill **(JE-1)**	8,000	4,000	-	Cash A/c **(JE-2)**			40,0
				Goodwill A/c **(JE-4)**	24,000	12,000	

Case 3: When the Goodwill is brought in by the New Partner and is Withdrawn by the Old Partners (fully or partly)

In the Case 2, we learnt that the premium for goodwill brought in the new partner is retained in the business. That is, the old partners are not withdrawing this amount of premium of goodwill. But, in case, if the old partners decide to withdraw the premium either fully or partly, then an additional Journal entry is passed. This is:

Journal Entry

For Withdrawal of Premium Money (Fully or Partly)

Sacrificing Partners' Capital A/c		Dr.
	To Cash or Bank A/c	
(Amount of goodwill withdrawn)		

Example: Abbu and Tabbu are two partners in a firm sharing profits and losses in the ratio of 5: 3. They admitted Rinku as a new partner for $\frac{1}{4}$th share of profit. He brought Rs 1,75,000 as capital and Rs 80,000 as premium for goodwill. Abbu withdrew his whole share of premium and Tabbu withdrew 50% of her premium amount. Pass the necessary Journal entries.

***Solution*:**

(i)	Cash A/c		Dr.	1,75,000	
		To Rinku's Capital A/c			1,75,000
	(Amount of capital brought in by Rinku) **(JE-1)**				
(ii)	Cash A/c		Dr.	80,000	
		To Premium for Goodiwill A/c			80,000
	(Amount of premium for goodwill brought in by Rinku) **(JE-2)**				

Note: Instead of above two entries, one single entry can also be passed as-

Cash A/c			Dr.	2,55,000	
	To Rinku's Capital A/c				1,75,000
	To Premium for Goodwill A/c				80,000
(Amount of capital and premium for goodwill brought in cash)					
(iii)	Premium for Goodwill A/c		Dr.	80,000	
		To Abbu's Capital A/c			50,000
		To Tabbu's Capital A/c			30,000
	(Amount of premium for goodwill credited to capital accounts of Abbu and Tabbu in their sacrificing ratio) **(JE-3)**				
(iv)	Abbu's Capital A/c		Dr.	50,000	
	Tabbu's Capital A/c		Dr.	15,000	
		To Cash A/c **(JE-4)**			65,000
	(Amount of premium withdrawn whole by Abbu and 50% by Tabbu in cash)				

Posting in Partners' Capital Account

Partners' Capital A/c

Dr.							Cr.
Particulars	**Abbu**	**Tabbu**	**Rinku**	**Particulars**	**Abbu**	**Tabbu**	**Rinku**
Cash A/c **(JE-4)**	50,000	15,000	-	Cash A/c **(JE-1)**			1,75,000
				Goodwill A/c **(JE-3)**	50,000	30,000	

Case 4*: *When Only a Part of Premium or Goodwill is brought in by the New Partner in Cash

There may be a situation when the new partner is not able to bring whole amount of his/her share of goodwill in cash. In such a case, the premium for goodwill account is credited with the amount of premium which is brought in by the new partner. At the time of the transfer of the premium amount to the sacrificing partners' capital account, the new partner's capital account is to be debited with the unpaid amount of premium (i.e. the amount which he/she is unable to bring).

Journal Entry

Cash A/c		Dr.
	To Premium for Goodwill A/c	
(With the share of goodwill brought in by the new partner)		

Premium for Goodwill A/c		Dr.
	To Sacrificing Partners' Capital A/c	
(With the share of goodwill brought in by the new partner in sacrificing ratio)		
New Partner's Capital A/c		Dr.
	To Sacrificing Partners' Capital A/c	
(With the share of goodwill ***not*** brought in by the new partner in sacrificing ratio)		

Generally, instead of the above two separate Journal entries, in different textbooks a compound Journal entry is shown as:

Premium for Goodwill A/c		Dr.	(with amount of goodwill brought in by the new partner)	
New Partner's Capital A/c		Dr.	(with unpaid share of premium for goodwill)	
	To Sacrificing Partners' Capital A/c			(In Sacrificing Ratio)

Example: X and Y are the two partners sharing profits and losses in the ratio of 4: 3. They admit Z for $\frac{1}{5}$th share of profit. Z's share of goodwill is Rs 49,000 out which he able to bring only Rs 28,000. Pass the necessary journal entries.

Solution

Cash A/c		Dr.	28,000	
	To Premium for Goodwill A/c			28,000
(Amount of goodwill brought in by Z)				

***JE-1**

Premium for Goodwill A/c		Dr.	28,000	
	To X's Capital A/c $\left(28,000 \times \frac{4}{7}\right)$			16,000
	To Y's Capital A/c $\left(28,000 \times \frac{3}{7}\right)$			12,000
(Amount of goodwill credited to capital accounts of X and Y in their sacrificing ratio of 4 : 3)				

****JE-2**

Z's Capital A/c		Dr.	21,000	
	To X's Capital A/c $\left(21,000 \times \frac{4}{7}\right)$			12,000
	To Y's Capital A/c $\left(21,000 \times \frac{3}{7}\right)$			9,000
(Amount of *unpaid* goodwill credited to capital accounts of X and Y in their sacrificing ratio of 4 : 3)				

***Working Notes*:**

Calculation of New Profit Sharing Ratio

Let the total profit of firm be Re 1

Z's share = $\frac{1}{5}$, $\text{Remaining share} = 1 - \frac{1}{5} = \frac{4}{5}$

X's new share = $\frac{4}{7} \times \frac{4}{5} = \frac{16}{35}$

Y's new share = $\frac{3}{7} \times \frac{4}{5} = \frac{12}{35}$

Z's share = $\frac{1}{5}$ or $\frac{1}{5} \times \frac{7}{7} = \frac{7}{35}$

New Share = 16 : 12 : 7

Calculation of Sacrificing Ratio

Sacrificing Ratio of X = Old Ratio - New Ratio = $\frac{4}{7} - \frac{16}{35} = \frac{4}{35}$

Sacrificing Ratio of Y = Old Ratio - New Ratio = $\frac{3}{7} - \frac{12}{35} = \frac{3}{35}$

Posting in Partners' Capital Account

Partners' Capital A/c							
Dr.							
Particulars	**X**	**Y**	**Z**	**Particulars**	**X**	**Y**	**Z**
X's Capital A/c **(JE-2)**			12,000	Goodwill A/c **(JE-1)**	16,000	12,000	
X's Capital A/c **(JE-2)**			9,000	Z's Capital A/c **(JE-2)**	12,000	9,000	

Case 5:* *When the New Partner is not able to bring his Share of Goodwill or Premium in Cash at all

At the time of admission, when the new partner is ***not*** able to bring his/her whole share of goodwill, then the New Partner's Capital Account is debited and old Partners' Capital A/c will be credited in their sacrificing ratio with the amount of goodwill which is ***not*** brought by the new partner.

Journal Entry

New Partner's Capital A/c		Dr.	{In Sacrificing Ratio}
	To Sacrificing Partners' Capital A/c		
(With new partner's share of goodwill)			

Example: Bittu and Chintu are the two partners sharing profits and losses in the ratio of 5 : 4. They admitted Montu for $\frac{1}{5}$th share of profit. The partners decided to share future profits and losses in ratio of 2: 2: 1. Montu brings Rs 1,10,000 as his capital but is unable to bring his share of goodwill of Rs 90,000. Pass the necessary Journal entries.

Solution

Cash A/c		Dr.	1,10,000	
	To Montu's Capital A/c			1,10,000
(Amount of capital brought in by Montu) **(JE-1)**				
Montu's Capital A/c		Dr.	90,000	
	To Bittu's Capital A/c $\left(90,000 \times \frac{7}{9}\right)$			70,000
	To Chintu's Capital A/c $\left(90,000 \times \frac{2}{9}\right)$			20,000
(Montu's share of goodwill, Capital Accounts of Bittu and Chintu are credited in their sacrificing ratio of 7 : 2) **(JE-2)**				

***Working Notes*:**

Calculation of Sacrificing Ratio

Sacrificing Ratio = Old Ratio – New Ratio

$\text{Bittu's sacrifice} = \frac{5}{9} - \frac{2}{5} = \frac{25-18}{45} = \frac{7}{45}$

$\text{Chintu's sacrifice} = \frac{4}{9} - \frac{2}{5} = \frac{20-18}{45} = \frac{2}{45}$

so, Sacrificing Ratio = 7: 2

Note: *As the new partner, Montu is not able to bring any amount of goodwill in cash, so no Journal entry has been passed for bringing-in of goodwill in cash.*

Posting in Partners' Capital Account

Partners' Capital A/c							
Dr.							
Particulars	**Bittu**	**Chintu**	**Montu**	**Particulars**	**Bittu**	**Chintu**	**Montu**

Bittu's Capital A/c **(JE-2)**			70,000	Cash A/c **(JE-1)** *(for capital)*			1,10,0
Chintu's Capital A/c **(JE-2)**			20,000	Montu's Capital A/c **(JE-4)**	70,000	20,000	

Case 6*: *When the Premium for Goodwill is brought in Kind

There may be a situation, when on the admission, the new partner does not bring his share of goodwill in cash. Instead he/she brings his/her share of goodwill in kind (usually in form of the assets). In such a case, all the assets brought in by the new partner is debited and share of premium for goodwill is credited.

Journal Entry

(i) For Assets brought in by the New Partner

	Assets A/c		Dr.
		To Premium for Goodwill A/c	

(ii) For Sharing Premium of Goodwill by the Sacrificing Partners

Premium for Goodwill A/c		Dr.	{In Sacrificing Ratio}
	To Sacrificing Partners' Capital A/c		

Example: Riya and Jiya are the partners in a firm sharing profits and losses in the ratio of 4: 1. They admitted Priya for $\frac{1}{5}$th share in the future profits. She contributed the followings assets as her share of goodwill.

Furniture Rs 7,000, Building Rs 15,000, Stock Rs 4,000 and Debtors Rs 4000. Pass the necessary Journal entries.

Solution

Furniture A/c		Dr.	7,000	
Building A/c		Dr.	15000	
Stock A/c		Dr.	4,000	
Debtors A/c		Dr.	4,000	
	To Premium for Goodwill A/c			30,000
(Assets brought in by Priya for her share of goodwill)				
Premium for Goodwill A/c		Dr.	30,000	
	To Riya's Capital A/c			24,000
	To Jiya's Capital A/c			6,000
(Premium for goodwill credited to the capital accounts of Riya and Jiya in their sacrificing ratio)				

Distribution of Goodwill in case when some of the Old Partners are Gaining, Some are Sacrificing

It is not always necessary that all the old partners may sacrifice their share on the admission of a new partner. Sometimes, there may be some of the old partners who are not sacrificing, while there may be some old partners who may be gaining due to the admission of the new partner. In this case, the partners who gain are called Gaining Partners and the partners who lose are called Sacrificing Partners.

Let us understand how the goodwill is distributed in this case.

***Example*:** X and Y are the partners sharing profits and losses in the ratio of 5: 3. On April 1, 2012, they decided to admit C for $\frac{1}{3}rd$ share in profits. The new ratio is 2: 4: 3. C brings in Rs 15,000 as capital and the necessary amount for goodwill/premium in cash for his share of profits. The goodwill of the firm valued is at Rs 63,000. Pass the necessary Journal entries for the treatment of goodwill.

Solution:

Calculation of Sacrificing / Gaining Ratio

Sacrificing Ratio = Old Ratio – New Ratio

Partners	=	Old Ratio	–	New Ratio	=	Sacrifice/Gain
X	=	$\frac{5}{8}$	–	$\frac{2}{9}$	=	$\frac{29}{72}$
Y	=	$\frac{3}{8}$	–	$\frac{4}{9}$	=	$-\frac{5}{72}$

The negative sign implies that Y is gaining. This implies that Y need to compensate X as X is sacrificing and Y is gaining.

Calculation of C's Goodwill

C's Goodwill = Firm's Goodwill × C's share

$$C's\ Goodwill = 63,000 \times \frac{1}{3} = Rs\,21,000$$

Cash/Bank A/c		Dr.	36,000	
	To C's Capital A/c			15,000
	To Premium for Goodwill A/c			21,000
(Amount of capital and goodwill brought in by C)				
Premium for Goodwill A/c		Dr.	21,000	
Y's Capital A/c $\left(63,000 \times \frac{5}{72}\right)$			4,375	
	To X's Capital A/c			25,375
(Premium for Goodwill brought in by C adjusted to X's Capital Account. Also, Y is compensating X with 4,375 as Y is gaining)				

***Example*:** A, B and C are partners sharing profits and losses is the ratio of 2: 3: 1. They decided to admit D into the partnership for $\frac{1}{5}th$ share in future profits. At the time of D's admission, the Balance Sheet showed general reserve of Rs 45,000. D brought in Rs 20,000 for his share of goodwill. The new ratio is 3: 3: 2: 2. Pass the necessary Journal entries and show the relevant items in the partners' Capital Account.

Solution

Calculation of Sacrificing / Gaining Ratio

Sacrificing Ratio = Old Ratio – New Ratio

Partners	=	Old Ratio	–	New Ratio	=	Sacrifice/Gain
A	=	$\frac{2}{6}$	–	$\frac{3}{10}$	=	$\frac{1}{30}$
B	=	$\frac{3}{6}$	–	$\frac{3}{10}$	=	$\frac{6}{30}$
C	=	$\frac{1}{6}$	–	$\frac{2}{10}$	=	$-\frac{1}{30}$

The negative sign implies that C is gaining. This implies that C need to compensate A and B.

Calculation of Firm's Goodwill

Firm's Goodwill = D's Goodwill × Reciprocal of D's Share

$$Firm's\ Goodwill = 20,000 \times \frac{5}{1} = Rs\,1,00,000$$

Cash/Bank A/c		Dr.	20,000	
	To Premium for Goodwill A/c			20,000
(Amount of capital and goodwill brought in by D)				
Premium for Goodwill A/c		Dr.	20,000	
C's Capital A/c $\left(1,00,000 \times \frac{1}{30}\right)$		Dr.	3,334	
	To A's Capital A/c			3,334
	To B's Capital A/c			20,000
(Premium for Goodwill brought in by D adjusted to A and B's Capital Account. Also, C is compensating A and B with 3,334 as he is gaining)				

General Reserve A/c	Dr.		

			45,000	
	To A's Capital A/c			15,000
	To B's Capital A/c			22,500
	To C's Capital A/c			7,500
(General Reserve transferred to the partner's capital accounts in the ratio 2: 3: 1)				

Partners' Capital Account

Dr. **Cr.**

Particulars	A	B	C	D	Particulars	A	B	C	D
A's Capital A/c			477		General Reserve	15,000	22,500	7,500	
B's Capital A/c			2,857		Premium for Goodwill A/c	2,857	17,143		
					C's Capital A/c	477	2,857		

Hidden Goodwill

In case of Hidden Goodwill, the value of goodwill is not mentioned at the time of admission of a new partner. It can be considered as one of the method for calculating the value of goodwill of the firm. This is more prominent in cases, where the new partner does not bring his/her share of goodwill in cash. In such cases, goodwill of the firm remains hidden and the value of the firm's goodwill is determined by taking the difference between the capitalised value of the firm and the net worth of the firm. Capitalised value of the firm is ascertained by capitalising the new partner's capital on the basis of his/her share of profits. The following formula is used to ascertain the value of the firm's goodwill.

Value of Firm's Goodwill = Capitalised Value of the Firm – Net Worth

where,

Capitalised Value of the Firm = Capital of New Partner × Reciprocal of New Partner's Share

Net Worth = Total Capital of New Firm (including New Partner's Capital) + Accumulated Profits and Reserves (if any)

OR

Net Worth = Total Assets – External Liabilities

Steps to Calculate Value of Firm's Goodwill

Step 1: Calculate the capitalised value of the firm as:

Capitalised Value of the Firm = Capital of New Partner × Reciprocal of New Partner's Share

Step 2: Calculate the net worth of the firm as:

Net Worth = Total Capital of New Firm (including New Partner's Capital) + Accumulated Profits and Reserves (if any)

OR

Net Worth = Total Assets – External Liabilities

Step 3: Subtract the value ascertained in step 2 from the value ascertained in step 1 to compute the value of goodwill of the firm. That is,

Value of Firm's Goodwill = Capitalised Value of the Firm – Net Worth

Step 4: Share of goodwill of the new partner is calculated by multiplying the value of goodwill of the firm (as calculated in step 3) by his/her share in profits.

New Partner's Share of Goodwill = Value of Firm's Goodwill × New Partner's Share

***Example*:** A and B are two partners in a firm sharing profits and losses in the ratio of 5: 3. They admitted C into the firm for $\frac{1}{6}^{th}$ share of profits. C brings capital of Rs 90,000. The capital balance of A and B are Rs 80,000 and Rs 1,20,000 respectively. Calculate the firm's goodwill and C's share of goodwill.

***Solution*:**

Calculation of Capitalised Value of the Firm

Capitalised value of the firm = C's Capital × Reciprocal of his share

$$= \text{Rs}\,90,000 \times \frac{6}{1} = \text{Rs}\,5,40,000$$

Calculation of Net Worth of the Firm

Net Worth = Total Capital of New Firm (including C's Capital) + Accumulated Profits and Reserves

= Rs 80,000 + Rs 1,20,000 + Rs 90,000 = Rs. 2,90,000

so, Goodwill of the Firm = Capitalised Value of Firm – Net Worth

= Rs 5,40,000 – Rs 2,90,000 = Rs 2,50,000

C's Share of Goodwill $= \text{Rs}\,2,50,000 \times \frac{1}{6} = \text{Rs}\ 41,667\ (\text{Approx.})$

Example: Rihana and Ankita are partners in a firm. They admit Arjun as a new partner with $1/4^{th}$ share in the profits of the firm. Arjun brings Rs 3,50,000 as his share of capital. The value of the total assets of the firm was Rs 10,50,000 and external liabilities were valued at Rs 3,50,000 on that date. Pass the necessary Journal entry to record goodwill at the time of Arjun's admission. Also show your workings.

***Solution*:**

Journal

Date	Particulars		L.F.	Debit Amount Rs	Credit Amount Rs
	Arjun's Capital A/c	Dr.		1,75,000	
	To Rihana's Capital A/c				87,500
	To Ankita's Capital A/c				87,500
	(Arjun's Share of Goodwill distributed among old partners in their sacrificing ratio 1:1)				

Working Note

Calculation of Goodwill brought in by Arjun

Value of Firm's Goodwill = Capitalised Value of the Firm – Net Worth

$$\text{Capitalised Value of the Firm} = \text{Capital brought in by Arjun} \times \text{Reciprocal of his Share}$$

$$= 3,50,000 \times \frac{4}{1} = 14,00,000$$

Net Worth = Total Assets – External Liabilities

= 10,50,000 – 3,50,000 = 7,00,000

Goodwill of the Firm = 14,00,000 – 7,00,000

= 7,00,000

$$\text{Arjun's Share of Goodwill} = 7,00,000 \times \frac{1}{4} = 1,75,000$$

Strengthen this topic Take a Topic Test
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Revaluation Account, Cash Account, Balance Sheet and Adjustments

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Adjustment of Accumulated Profits and Losses
- Revaluation of Assets and Reassessment of Liabilities
- Partners' Capital Account
- Cash Account
- New Balance Sheet

Adjustment of Accumulated Profits and Losses

If there are any accumulated profits or losses appearing in the books of the old firm at the time of admission of a new partner, then these are distributed among the old partners in their old profit sharing ratio. Such accumulated profits or losses are generally in the form reserves such as Reserve Fund, General Reserve, Profit and Loss Account, Investment Fluctuation Reserves, Workmen's Compensation Reserves, etc. The new partner is not entitled to any share of such accumulated profits as all these reserves and losses are accrued to the hard work and past efforts of the old partners.

Accounting treatment of Accumulated Profits and Losses

(i) *For Distribution of Accumulated Profits and Reserves*

Profit and Loss A/c	Dr.	[In Old Ratio]
General Reserve A/c	Dr.	
Reserve Fund A/c	Dr.	
Workmen's Compensation Fund A/c*	Dr.	With excess amount only
Contingency Reserve A/c*	Dr.	
Investment Fluctuation Fund A/c*	Dr.	
To Old Partners' Capital A/c		
(Undistributed profits and reserves are distributed among old partners in their old profit sharing ratio)		

* Workmen's Compensation Fund, Contingency Reserve and Investment Fluctuation Reserve are distributed among the partners only with the excess amount. It means, the difference of the two values, i.e. the value that appears in the Old Balance Sheet of the firm (before admission) and the value that is given in the adjustments. If the value that is given in the adjustments is ***lesser than*** the value that is appearing in the Old Balance Sheet then the difference amount is transferred to the Old Partners' Capital Account in their old ratio. Also, the value that is given in the adjustment is shown on the Liabilities side of the New Balance Sheet (after admission).

On the other hand, if the value given in the adjustment is ***more than*** the value that is appearing in the Old Balance Sheet then the difference amount is debited to the Revaluation Account of the firm and is ***not transferred to the Old Partners' Capital Account***. This is because, an increase in the value of such reserves/funds is considered a loss to the firm, hence, is debited to the Revaluation Account. In this situation, the value given in the adjustment is shown on the Liabilities side of the New Balance Sheet.

For example,

I. If WCF appears on the Liabilities side of the Old Balance Sheet at **Rs 25,000** and in adjustments, a claim of workmen's compensation of **Rs 20,000** is given, then the excess amount of Rs 5,000 (i.e. Rs 25,000 – Rs 20,000) is distributed among the old partners in their old profit sharing ratio. The claim of workmen's compensation of Rs 20,000 is shown on the Liabilities side of the New Balance Sheet.

II. If WCF appears on the Liabilities side of the Old Balance Sheet at **Rs 30,000** and in adjustment, a claim of workmen's compensation of **Rs 40,000** is given, then the difference amount of Rs 10,000 (i.e. Rs 40,000 – Rs 30,000) is debited to the Revaluation Account. This is because there an increase in the value of compensation, hence, it is a loss to the firm. The claim of workmen's compensation of Rs 40,000 is shown on the Liabilities side of the New Balance Sheet.

Note 1: If in the question, ***no adjustments*** related to Workmen's Compensation Fund, Contingency Reserve and Investment Fluctuation Reserve reserves ***are given***, then such reserves/funds ***are transferred to*** the Old Partners' Capital Account with the whole amount.

Note 2: Often, there exists some reserves in the form Employees Provident Fund, Provision for Tax, Taxation Reserve, Joint Life Policy (JLP) Reserve and Depreciation Reserve (such as Machinery Replacement Reserve) in the Old Balance Sheet. It should be noted that such items are ***not distributed among the partners*** and are shown on the Liabilities side of the New Balance Sheet of the new firm.

(ii) *For Distribution of Accumulated Losses*

Old Partner's Capital A/c		Dr.
	To Profit and Loss A/c (Debit balance)	
	To Deferred Advertisement Expenses A/c	
(Undistributed losses are distributed among old partners in their old profit sharing ratio)		

***Example*:** Pinki and Rinki are the two partners sharing profits and losses in the ratio of 3: 2. They admitted Chinki as a new partner for $\frac{1}{6}$th share in profits. The new profit sharing ratio among them agreed as 3: 2: 1. On the date of her admission, the firm had a reserve fund of Rs 29,000 and also had a debit balance of Rs 15,000 in the Profit and Loss Account. Pass the necessary Journal entries in the books of accounts.

Solution

(i)	Reserve Fund A/c		Dr.	29,000		
		To Pinki's Capital A/c			17,400	[In Old Ratio]
		To Rinki's Capital A/c			11,600	
	(Reserve Fund transferred to the capitals accounts of Pinki and Rinki in their old profit sharing ratio)					

(ii)	Pinki's Capital A/c		Dr.	9,000	
	Rinki's Capital A/c		Dr.	6,000	
		To Profit and Loss A/c			15,000
	(Debit balance of Profit and Loss Account is transferred to Old Partners' Capital Account in their old ratio)				

Revaluation of Assets and Reassessment of Liabilities

Sometimes the value of the assets and liabilities of a firm does not appear at its current value in the books of account. With the passage of time, their values in the books may differ from its current values. It means there could be an increase or decrease in the values. Therefore, at the time of admission of a new partner, it is desirable to ascertain the true current value of all the assets and liabilities. There may also be a situation when some assets or liabilities of a firm are not recorded in the books of account. So, in order to reveal the assets and liabilities of a firm at their current values, an account in the name of Revaluation Account is prepared. This account may sometimes be called as Profit and Loss Adjustment Account.

Any increase in the value of assets and decrease in the value of liabilities is credited to the revaluation account. This is because, it is a profit or gain for a firm. On the other hand, any decrease in the value of assets and increase the value of liabilities are debited to this account. This is because, it is a loss to the firm. Also, any unrecorded assets of the firm will be credited and unrecorded liability of the firm will be debited to this account. If credit side of revaluation account is more than its debit side then it reveals the profit. On the other hand, if debit side is more than its credit side it will be considered as net loss. Any profit or loss from this account will be transferred to the old partner's capital in their old profit sharing ratio.

Journal Entries to be recorded for Revaluation of Assets and Liabilities

*For **Increase** in the Value of **Assets***		*For **Decrease** in the Value of **Assets***	
Assets A/c	Dr.	Revaluation A/c	Dr.
To Revaluation A/c		To Assets A/c	
{By increased value}		{By decreased value}	

*For **Increase** in the Value of **Liability***		*For **Decrease** in the Value of **Liability***	
Revaluation A/c	Dr.	Liability A/c	Dr.
To Liability A/c		To Revaluation A/c	
{By increased value}		{By decreased value}	

*For recording **Unrecorded Assets***		*For recording **Unrecorded Liability***	
Assets A/c	Dr.	Revaluation A/c	Dr.
To Revaluation A/c		To Assets A/c	

For Transfer of Profit on Revaluation (*i.e. credit side > debit side*)		For Transfer of Loss on Revaluation *(i.e. debit side > credit side*)	
Revaluation A/c	Dr.	Old Partner's Capital A/c	Dr.
To Old Partner's Capital A/c		To Revaluation A/c	
{Old Ratio}		{Old Ratio}	

Procedure to Prepare Revaluation Account

The following are the various steps involved in preparation of Revaluation Account.

1. First of all, any decrease in the value of assets and increase in the value of liabilities are recorded on the ***Debit side*** of Revaluation Account.
2. Secondly, any increase in the value of assets and decrease in the value of liabilities is recorded on the ***Credit side*** of the account.
3. If there is any Unrecorded Asset of the firm then it is shown on the ***Credit side*** of the account.

4. Similarly, any Unrecorded Liabilities are shown on the ***Debit side*** of the Revaluation Account.
5. Then, Outstanding expenses of the firm are recorded on the ***Debit side*** and Prepaid expenses are recorded on the ***Credit side*** of the Revaluation Account.
6. Similarly, any income that is received in advance is shown on the ***Debit side*** and Prepaid expenses (i.e. expenses incurred in advance) are recorded on the ***Credit side*** of the Revaluation Account.
7. Lastly, if the total of the debit side exceeds the total of the credit side, then it is regarded as *Revaluation Loss* and is transferred to the Debit Side of the Partners' Capital Account in their old profit sharing ratio. On the other hand, if the total of the debit side is short of the total of the credit side, then it is regarded as *Revaluation Profit* and is transferred to the Credit Side of Partners' Capital Account in their old profit sharing ratio.

Format of Revaluation Account

Revaluation A/c

Dr.			**Cr.**
Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Decrease in Value of Assets	×××	Increase in Value of Assets	×××
Increase in Value of Liabilities	×××	Decrease in Value of Liabilities	×××
Unrecorded Liabilities	×××	Unrecorded Assets	×××
Outstanding Expenses (e.g. Salaries)	×××	Prepaid Expenses (Salaries in advance)	×××
Income received in advance	×××	Income Earned but not yet received	×××
Revaluation Profit* A's Capital A/c B's Capital A/c (Transferred to Credit side of Partners' Capital Account in Old Ratio)	×××	Revaluation Loss# A's Capital A/c B's Capital A/c (Transferred to Debit side of Partners' Capital Account in Old Ratio)	×××

* If Credit Side > Debit Side

If Credit side < Debit Side

Note : A special care is need to be taken while going through the adjustments, especially for '***to***' and '***by***'.

***Example*:**

The value of Machinery in the Old Balance Sheet of a firm is given as Rs 20,000. Treat the following adjustments.
a) Machinery depreciated by Rs 5,000.
b) Machinery depreciated to Rs 12,000.
c) Machinery appreciated by Rs 3,000.
d) Machinery appreciated to Rs 25,000.

Solution

Case (a)- In this case, machinery is depreciated by Rs 5,000, therefore, in the Revaluation Account, the decrease in the value of machinery is to be shown on the debit side with Rs 5,000 and on the Assets side of the New Balance Sheet, machinery is to be shown at Rs 15,000 (i.e. Rs 20,000 – Rs 5,000).

Case (b)- In this case, machinery is depreciated to Rs 12,000. It means there is a fall in the value of machinery by Rs 8,000 (i.e. Rs 20,000 – Rs 12,000). So, in the Revaluation Account, the fall in the value of machinery is to be shown on the debit side with Rs 8,000 and the machinery is to be shown on the Assets side of the New Balance Sheet at its final value of Rs 12,000.

Case (c)- In this case, machinery is appreciated by Rs 3,000, therefore, in the Revaluation Account, the increase in the value of machinery is to be shown on the credit side with Rs 3,000 and on the Assets side of the New Balance Sheet, machinery is to be shown at Rs 23,000 (i.e. Rs 20,000 + Rs 3,000).

Case (d)- In this case, machinery is appreciated to Rs 25,000. It means there is an increase in the value of machinery by Rs 5,000 (i.e. Rs 25,000 – Rs 20,000). So, in the Revaluation Account, the increase in the value of machinery is to be shown on the credit side with Rs 5,000 and on the Assets side of the New Balance Sheet, machinery is to be shown at its final value of Rs 25,000.

Posting in Revaluation Account and Balance Sheet

Revaluation Account

Dr. **Cr.**

Particulars	Amount Rs	Particulars	Amount Rs
(Case-a) Machinery	5,000	**(Case-c)** Machinery	3,000
(Case-b) Machinery	8,000	**(Case-d)** Machinery	5,000

Balance Sheet

Liabilities	Amount Rs	Assets		Amount Rs
		(Case-a) Machinery	20,000	
		Less: Depreciation	5,000	15,000
		(Case-b) Machinery	20,000	
		Less: Depreciation	8,000	12,000
		(Case-c) Machinery	20,000	
		Add: Appreciation	3,000	23,000
		(Case-d) Machinery	20,000	
		Add: Appreciation	5,000	25,000

Adjustments related to Provision for Doubtful Debts- It is one of the most common adjustment, where the students often make mistakes. However; it should always be remember that any adjustment related to provision for doubtful debts such as Provision on debtors should be brought up to 10%, Provision on debtors to be increased by Rs 2,200, etc. is to be provided on the amount of debtors and not on the provision. Also, it should be remember that any increase (or decrease) in amount of provisions implies a fall (or rise) in the amount of debtors and accordingly, is shown on the debit (or credit) side of the Revaluation Account.

Partners' Capital Account

Partners' Capital Account is prepared to ascertain the closing capital balances of the partners of a firm. These capital balances are shown on the Liabilities side of the New Balance Sheet. The below given is the comprehensive format of the Partners' Capital Account.

Procedure to Prepare Partners' Capital Account

The following are the various steps involved in preparation of Partners' Capital Account.

1. First of all, the opening balance of capital is shown on the credit side of the Partners' Capital Account as 'Balance b/d'. In case, if the capital balance of any of the partners appears on the Assets side of the Balance Sheet (in the question), then it is shown on the debit side of the Capital Account as 'Balance b/d'.

2. Then, Revaluation Profit is transferred to the Credit side and in case of Loss, it is transferred to the Debit side of the capital account.

3. Thirdly, we need to transfer reserves such as, *General Reserve, Reserve Fund, Investment Fluctuation Fund*, Workmen Compensation Fund and Contingency Reserve* (see NOTE)*, *Credit Balance of P & L etc.* are transferred to the credit side of the capital account in the old profit sharing ratio of old partners.

4. Similarly, on the debit side, losses such as *Debit Balance of P & L, Deferred Revenue Expenditure, Advertisement Suspense Account, etc.* are transferred to the debit side of the capital account in the old profit sharing ratio of old partners.

5. Goodwill already appearing in the old balance sheet is transferred to the debit side of the capital account in the old profit sharing ratio of old partners.

6. Also, at the time of admission, any amount brought in cash by the new partner as his/her *Capital* contribution and *Premium for Goodwill* is recorded on the credit side of the Partners' Capital Account.

7. Premium for goodwill brought in by the new partner is also transferred to the credit side of the Partners Capital Account in the sacrificing ratio of the old partners. In case any partner gains, then his/her gaining share is recorded is recorded on the debit side of the account.

8. If any share of premium credited to the old partners is withdrawn by them, then it is recorded on the debit side of the Partners' Capital Account.

9. If any of the partners has taken-over any of the assets, then it is shown on the Debit side and if any liability is paid-off by any partner, then it is shown on the credit side of the capital account.

10. Finally, if the total of the credit side exceeds the total of the debit side, then the final capital balance of the partners is shown 'Balance c/d' on the Debit side. On the contrast, if the total of the debit side exceeds the total of the credit side, then the final capital balance of the partners is shown as 'Balance c/d' on the Credit side.

11. If the Partners' Capital Account shows a credit balance (Cr. Side > Dr. Side), then it is also shown on the Liabilities side of the Balance Sheet. On the other hand, if the Partners' Capital Account shows a debit balance (Dr. Side > Cr. Side), then it is shown on the Assets side of the Balance Sheet.

12. Also, often there exists some reserves in the form Employees Provident Fund, Provision for Tax, Taxation Reserve, Joint Life Policy (JLP) Reserve and Depreciation Reserve (such as Machinery Replacement Reserve) in the Old Balance Sheet. It should be noted that such items are ***not distributed among the partners*** and are shown on the Liabilities side of the New Balance Sheet of the new firm.

Partners' Capital Account

Dr.							**Cr.**
Particulars	**A**	**B**	**C**	**Particulars**	**A**	**B**	**C**
Profit and Loss A/c (Debit Balance)	–	–	–	Balance b/d	–	–	–
Deferred Revenue Expenditure (Advertisement Expenditure)	–	–	–	General Reserve	–	–	–
Goodwill A/c ♣	–	–	–	Reserve Fund	–	–	–
Revaluation Loss	–	–	–	Profit and Loss (Credit Balance)	–	–	–
Bank A/c ■ (For withdrawal of goodwill by Old Partners')	–	–	–	Bank/Cash A/c (with amount of capital brought in C in Cash)	–	–	–
Assets (Taken over by Partners')	–	–	–	Premium for Goodwill	–	–	–
				Liabilities (If taken over by Partners')	–	–	–
				Revaluation Profit	–	–	–
				Workmen's Compensation Fund*	–	–	–
				Investment Fluctuation Fund*	–	–	–
				Contingency Reserve*	–	–	–
Balance c/d (If Cr. Side > Dr. side)	–	–	–	Balance c/d (If Dr. side > Cr. Side)	–	–	–

***Note*:**

* Workmen's Compensation Fund, Investment Fluctuation Fund and Contingency Reserve are transferred to the Partners' Capital A/c (Credit side) only with the excess amount.

♣ This represents the amount of existing Goodwill that is already appearing on the Assets side of the Old Balance sheet and written-off among the old partners in their old profit sharing ratio.

■ This represents the amount of Goodwill withdrawn by the Old Partners.

Cash/Bank Account

On the admission of a new partner, cash/bank is brought in by him/her for his/her share of goodwill and capital contribution. Also, it may be possible that some of the partners of the firm withdraw or bring some cash into the firm. Therefore, a need may arise to prepare the Cash Account. Cash account is prepared to ascertain the cash balance of the firm at the end of an accounting period. This cash balance is

shown on the Assets side of the Balance Sheet of the new firm. Usually, Cash Account is presented in the Working Notes, but it can also be shown after Partners' Capital Account and before preparing Balance Sheet.

Procedure to Prepare Cash/Bank Account

The following are the various steps involved in the preparation of Cash Account or Bank Account.

1. First of all, the opening balance of Cash/Bank (as given in the Balance Sheet of the question) is transferred to Debit side of the Cash/Bank Account. In case, the question specifies Bank Overdraft, then it is shown on the Credit side of the Cash/Bank Account.

2. Secondly, any cash brought in by the new partner as his/her capital or premium for goodwill is recorded on the debit side of the Cash Account.

3. If the partner withdraw their share of goodwill then it is recorded on the credit side of the account.

4. In case of adjustment of capital, if new capital balance exceeds the old capital balance then the deficient amount brought in by the partner is shown on the debit side of the Cash Account.

5. Similarly, if old capital balance exceeds the new capital balance then the surplus amount withdrawn by the partner is shown on the credit side of the Cash Account.

6. If the Cash Account reveals the debit balance (i.e. Dr. side > Cr. side), then is shown on the Assets side of the New Balance Sheet. On the other hand, if the Cash Account reveals the credit balance (i.e. Cr. side > Dr. side), then it implies a Bank Overdraft and shown on the Liabilities side of the New Balance Sheet.

Format of Cash/Bank Account

Cash/Bank Account			
Dr.			**Cr.**
Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Balance b/d		Balance b/d**	
New Partner's Capital A/c (For cash/bank brought in by the new partners' for capital + goodwill)		Partners' Capital A/c (For Cash paid back to Partner)	
Partners' Capital A/c (For Cash bring in by the partner)		Partners' Capital A/c (For withdrawal of goodwill brought in by New Partner/Withdrawal of goodwill already appearing in the old books)	
Balance c/d*		Balance c/d#	

** If Bank Overdraft is given on the Liabilities side of the Old Balance Sheet.

* If the total of the Credit side > the total of the Debit side. This *negative cash balance* (or Bank Overdraft) is shown on the Liabilities side of the New Balance Sheet.

If the total of the Debit side > the total of the Credit side. This *positive cash balance* (or Bank Balance) is shown on the Assets side of Balance Sheet.

New Balance Sheet

After the preparation of Revaluation Account, Partners' Capital Account and Cash Account, the last step is to prepare New Balance Sheet of the newly reconstituted firm (i.e. after the admission of the new partner). The below mentioned is the procedure and a comprehensive format of Balance Sheet.

Procedure to Prepare New Balance Sheet

The following are the various steps involved in the preparing New Balance Sheet.

1. First of all, all the assets are recorded on the Right Hand Side of the Balance Sheet and all the Liabilities are recorded on the Left Hand Side on their net value i.e. after all adjustments in their values.

2. There can be two probable cases of adjustments namely, ***to*** or ***by***. In case the assets are increased or decreased ***to,*** then the final value itself is shown in the New Balance Sheet. For Example, value of machinery increased ***to*** Rs 18,000. In the New Balance Sheet machinery will be shown at Rs 18,000. On the other hand, if the assets are increased or decreased ***by,*** then the value of asset is shown at its net value (i.e. after adding or subtracting the value

as the case may be). For example, Machinery of Rs 20,000 is increased ***by*** Rs 4,000. In the New Balance Sheet, machinery will be shown at Rs 24,000 (20,000 + 4,000).

3. Similarly, Liabilities are also shown at their final value after considering the above adjustments.

4. The funds such as Workmen's Compensation Fund, Investment Fluctuation Fund and Contingency Reserve are shown in the New Balance Sheet at the value given in the adjustment. Example- In case no adjustment regarding these funds is given, then these are not shown in the New Balance Sheet; rather these are distributed among the old partners.

5. Then, the Unrecorded Assets and Unrecorded Liabilities found at the time of revaluation are also shown in the New Balance Sheet.

6. Capital Balances of the partners revealed through Partners Capital Account after all adjustment are recorded on the Liabilities side of the Balance Sheet. In case the Partners' Capital Account shows a debit balance (i.e. balance c/d on credit side) then it is shown on the Assets side of the Balance Sheet.

7. Similarly, closing debit balance revealed through Bank Account (or Cash Account) is shown on the Assets Side of the New Balance Sheet. In case, Bank Account shows a credit balance (i.e. Balance c/d on the debit side), then it is shown on the Liabilities side of the New Balance Sheet as Bank Overdraft. (*Cash Account can never show a credit balance*)

New Balance Sheet
after admission of New Partner

Liabilities	Amount Rs	Assets	Amount Rs
Bank Overdraft		Cash in Hand	
Creditors		Cash at Bank	
General Reserve		Debtors	
Depreciation Reserve		*Less*: Provision for Doubtful Debts	
Contingency Reserve		Bills Receivable	
Workmen's Compensation Fund		Stock	
Investment Fluctuation Fund		Land and Building	
Machinery Replacement Reserve		Plant and Machinery	
Employee Provident Fund		JLP	
Provision for Tax		Unrecorded Assets (if given in the adjustments)	
JLP Reserve		Investments	
Bills Payable		Goodwill	
Unrecorded Liabilities (if given in the adjustments)		Patents	
Capitals:		Capitals**:	
A:		A:	
B:		B:	
C:		C:	
	*		○

Note: The equality of * and ○ ensures the arithmetic accuracy of the solution.
** If the closing balance of the Partners' Capital Account (i.e. Balance c/d) happens to appear on the credit side of the Partners' Capital Account, then it is shown on the Assets side of the New Balance Sheet.

Treatment of Workmen Compensation Reserve

In accounting as studied in the previous grade, we follow the principle of conservatism as per which all provisions and reserves are created before hand in anticipation of possible losses. Going by the same principle this reserve is created out of the firm's profits to compensate an employee when a liability arises due to an accident in the workplace or any other reason that is considered reasonable. However, the liability may or may not arise and it may as well happen that the liability may exceed the amount of reserve so created. We shall now discuss all these cases when a new partner enters the firm and the profit sharing ratio changes.

Accounting Treatment

Case 1: In case of no claim against the workmen compensation reserve: Now this reserve was created out of profit which belonged to the old partners so the same shall be transferred to Old Partner's Capital/Current Account in their Old Profit Sharing Ratio.

Journal Entry:

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)

	Workmen Compensation Reserve A/c Dr. To Old Partner's Capital/ Current A/c (In old ratio) (Being amount in the Workmen Compensation Reserve credited to Old Partner's Capital A/c in their Old Profit-Sharing Ratio)			

Case 2: If there is a claim against workmen compensation reserve: Now, the treatment in this case will depend on the amount of the liabilities. There can be three possible scenarios in this case:

a. **If the amount of claim is lower than the amount in the workmen compensation reserve:** In this case, the estimated amount of the claim will be transferred to the Provision for Workmen Compensation Claim and the excess amount will be credited to Old Partner's Capital/Current A/cs.

Journal Entry:

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Workmen Compensation Reserve A/c Dr To Provision for Workmen Compensation Claim A/c To Old Partner's Capital/Current A/cs (In old ratio) (Being the provision for estimated claim made and balance transferred to Old Partner's Capital A/c in their old profit-sharing ratio)			

a. **If the amount of claim is equal to the amount in the workmen compensation reserve:** In this case the entire amount in the Workmen Compensation Reserve will be transferred to the Provision for Workmen Compensation Claim Account and no amount is distributed to the old partners.

Journal Entry:

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Workmen Compensation Reserve A/c Dr To Provision for Workmen Compensation Claim A/c (Being the claim amount credited to the provision made)			

a. **If the amount of claim is higher than the amount in the workmen compensation reserve:** In this case, the entire amount of the Workmen Compensation Reserve is transferred to the Provision and the shortage amount shall be debited to revaluation account as it is a loss for the firm. This loss will then be borne by the old partner's in their old profit sharing ratio.

Journal Entry:

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
	Workmen Compensation Reserve A/c Revaluation A/c To Provision for Workmen Compensation Claim A/c (Being the amount of claim debited to Workmen Compensation Reserve and Revaluation Account)	Dr Dr			

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
	Old Partner's Capital/Current A/cs(In old ratio) To Revaluation A/c (Being loss on revaluation transferred to old partner's capital or current account in their old profit sharing ratio)	Dr			

Note: *In case, Claim for Workmen Compensation is determined or accepted, it becomes a liability. In this case, Workmen Compensation Claim Account is credited instead of Provision for Workmen Compensation Claim Account.*

Treatment of Investment Fluctuation Reserve

The motive of this reserve is to provide for any anticipated fall in the value of the investments made. As, we all know investments are a valuable asset of the firm and any decline in their value should be thus accounted for. Like any other reserve, it is also created out of the profits and its accounting treatment at the time of admission of the partner is explained in the cases below.

Case 1: When there is no change in the value of the investments: This means that the book value and market value of the investment are same. Since, this reserve was created out of profits belonging to the old partners; it shall be distributed to them in the old profit- sharing ratio.

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
	Investment Fluctuation Reserve A/c To Old Partner's Capital/Current A/cs (In Old Ratio)	Dr			

Case 2: When the market value of the Investment is below the Book Value: In this case, treatment will depend on the amount of decrease in the value of Investment.

a. **When fall in value is less than Investment Fluctuation Reserve:** The amount of fall is transferred from this reserve to Investment Account and the balance is transferred to the Old Partner's Capital Account in their old profit-sharing ratio.

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Investment Fluctuation Reserve A/c Dr To Investment A/c To Old Partner's Capital/Current A/cs			

a. **When fall in the value is equal to the Investment Fluctuation Reserve**: The entire amount from the Investment Fluctuation Reserve is transferred to the Investment Account and nothing is left to be distributed among the old partners.

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Investment Fluctuation Reserve A/c Dr To Investment A/c			

a. **When fall in the value is more than Investment Fluctuation Reserve**: In this case, we transfer the entire amount from the reserve to the Investment Account and remaining amount is debited to Revaluation account. This is because it is a loss for the firm and shall be borne by the old partners.

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Investment Fluctuation Reserve A/c Dr Revaluation A/c Dr To Investments A/c			

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Old Partner's Capital/Current A/cs (In Old Ratio) Dr To Revaluation A/c			

Case 3: When Market Value of the Investment Increases: In such a situation, the entire amount of the Investment Fluctuation Reserve will be transferred to the Old Partner's Capital Account in their old profit sharing ratio as the reserves are created to account for losses only. Thus, the increase in value is a gain for the firm and is credited to revaluation account which then is a profit belonging to the old partners.

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Investment Fluctuation Reserve A/c Dr To Old Partner's Capital/Current A/cs (In old Ratio)			

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Investment A/c Dr To Revaluation A/c (Investment brought up to the market value)			

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Revaluation A/c Dr To Old Partner's Capital/Current A/cs (In old ratio)			

Adjustment of Capital

Objective

After going through this lesson, you shall be able to understand the concept of Adjustment of Capital of Partners.

Adjustment of Capital

On the admission of a new partner, it may happen that all the partners of a firm may decide that the capital of all the partners should be in proportionate to their new profit sharing ratio. That is, to put in different words, it implies that after the admission of the new partner, the capital balances of all the partners (including that of the new partner) are in their new profit sharing ratio. For example, let us suppose that the old capitals of the existing partners, A and B are Rs 40,000 and Rs 30,000 and after the admission of C (admitted for 1/5 share and brings Rs 10,000 as capital) the profit sharing ratio becomes 2 : 2 : 1. Now, if all the partners decide that after admission the capital accounts has to be in their new profit sharing ratio, then their final capital balances should be in the ratio of 2 : 2: 1 (say Rs 20,000, Rs 20,000 and Rs 10,000). The technique involved in making the capital balances in the profit sharing ratio is known as Adjustment of Capital.

Cases of Adjustment of Capital

The calculation of the new capital of each partner depends on the following two situations.

i. When the Capital of the New Partner is ***given***.
ii. When the Capital of New Partner is ***not given***.

(i) When the Capital of the New Partner is Given

In case of the adjustment of capital, if the capital of the new partner is mentioned in the question, then this capital balance (of the new partner) is used as a basis to ascertain the new capital balances of the old partners. The new capital balances so calculated are proportionate to the new profit sharing ratio of the old partners.

Under this method, first of all, the total capital of the firm is computed on the basis of new partner's capital. It is calculated by multiplying the new partner's capital by reciprocal of his share of profit. That is,

Total Capital of Firm = Capital of New Partner × Reciprocal of New Partner's Profit Share

Out of this total capital of the firm, the new capital balances of the old partners is calculated on the basis of their new profit sharing ratio. After ascertaining the new capital of the old partners, it is compared with their old capital balances (after all the adjustments such as reserves, goodwill, etc in the Partners' Capital Account). If the new capital balance so ascertained exceeds the old capital balance then, the difference amount is required to be brought in by the partner in cash or bank. On the other hand, if the new capital balance is lesser than the old capital balance then, the difference amount is to be paid back to that partner.

The below-mentioned are the steps that are followed to ascertain the new capital balances of the old partners.

***Step 1*:** Calculate the total capital of the firm on the basis of the new partner's capital as:

Total Capital of Firm = Capital of New Partner × Reciprocal of New Partner's Profit Share

***Step 2*:** Calculate the new capital of each of the old partners by multiplying total capital of firm (as calculated in Step 1) by their respective new profit share.

New Capital of Old Partners (Partner A) = Total Capital of Firm × New Profit Share of Partner A

New Capital of Old Partners (Partner B) = Total Capital of Firm × New Profit Share of Partner B

***Step 3*:** Calculate the old capital of the old partners (A and B) after considering all the adjustments (such as reserves, goodwill, revaluation profits or losses, etc.) in the Partners' Capital Account.

Step 4*:** Compare the amount of capitals ascertained in Step 2 and Step 3. If the amount ascertained in the Step 2 (i.e. New Capital) is *more* than the amount ascertained in the Step 3 (i.e. Old Capital after all adjustments), then it is termed as ***deficit and the difference amount is to be brought in by the old partners. On the other hand, if the amount ascertained in the Step 2 (i.e. New Capital) is *lesser* than the amount ascertained in the Step 3 (i.e. Old Capital), then it is termed as ***surplus*** and the difference amount is to be paid back to the old partners.

***Step 5*:** Pass the necessary Journal entries for adjusting above deficit or surplus.

Journal Entry to be passed for this purpose

For Deficiency in Capital		*For Surplus in Capital*	
Cash/Bank A/c	Dr.	Partner's Capital A/c	Dr.
To Partner's Capital A/c		To Cash/Bank A/c	
(Deficiency made good by bringing additional amount by the partner)		(Excess capital withdrawn by the partner)	

Example: Raghav and Raman are two partners sharing profits and losses in the ratio of 3 : 1. Ankit is admitted into the firm for $\frac{1}{3}^{rd}$ share of profit. He brings Rs 40,000 as capital. The capital of Raghav and Raman after all adjustments are Rs 55,000 and Rs 25,000 respectively. It is decided that the capital accounts of the old partners should be adjusted according to their new profit sharing ratio. Calculate the new capital of Raghav and Raman and pass the necessary Journal entries for the same.

Solution

Calculation of New Profit Sharing Ratio

Old Ratio = 3 : 1

Ankit's share = $\frac{1}{3}$

Let the total profit be Re 1

Remaining Profit $= 1 - \frac{1}{3} = \frac{2}{3}$

Raghav's New Share $= \frac{2}{3} \times \frac{3}{4} = \frac{6}{12}$

Raman's New Share $= \frac{2}{3} \times \frac{1}{4} = \frac{2}{12}$

Ankit's Share $= \frac{1}{3}$ or $\frac{4}{12}$

∴ New Ratio = 6: 2: 4 or 3: 1: 2

Capital of Ankit = Rs 40,000

Therefore,

Total Capital of the Firm = Capital of Ankit × Reciprocal of his share

$$= \text{Rs}40,000 \times \frac{3}{1} = \text{Rs}1,20,000$$

Raghav's New Capital $= 1,20,000 \times \frac{3}{6} = \text{Rs } 60,000$

Raman's New Capital $= 1,20,000 \times \frac{1}{6} = \text{Rs. } 20,000$

Calculation of Total Cash to be brought in /paid off by the Partners

Raghav's New Capital Balance	=	Rs. 60,000
Raghav's Old Capital Balance	=	Rs (55,000)
Deficiency		Rs 5, 000

Since, the new capital balance of Raghav is *more than* his old capital balance, therefore the difference amount i.e. Rs. 5000 has to be brought in by him.

Raman's New Capital Balance	=	Rs. 20,000
Raman's Old Capital Balance	=	Rs (25,000)
Surplus		Rs (5, 000)

Since, the new capital balance of Raman is *less than* his old capital balance, therefore the difference amount i.e. is Rs. 5000 has to be paid back to him.

Journal Entry

JE-1	Cash A/c	Dr.	5000	
	To Raghav's Capital A/c			5000
	(Deficiency made good by bringing additional amount)			
JE-2	Raman's Capital A/c	Dr.	5000	
	To Cash A/c			5000
	(Excess capital withdraw by Raman)			

Posting in the Partners' Capital Account

Partners' Capital Account

Dr. **Cr.**

Particulars	Raghav	Raman	Ankit	Particulars	Raghav	Raman	Ankit
Cash/Bank (Amount paid back to Raghav)		5,000		Cash/Bank (Amount brought in by Raman)	5,000		
Balance c/d ** (New Capital Balances)	60,000	20,000	40,000				

** These balances are to be shown on the Liabilities side of the Balance Sheet of the New Firm as the Capital Balances of the Raman, Raghav and Ankit.

Comprehensive Examples

Ajay and Vijay are two partners sharing profits and losses in the ratio of 3:1. The following is their Balance Sheet s on March 31, 2012.

Balance Sheet
as on March 31, 2012

Liabilities		Amount (Rs)	Assets		Amount (Rs)
Capital A/cs:			Building		60,000
Ajay	94,000		Goodwill		16,000
Vijay	87,000	1,81,000	Stock		46,000
Sundry Creditors		12,000	Debtors	50,000	
			Less: Provision	(2,500)	47,500
			Investments (Market Value Rs 8,000)		10,000
			Cash		11,000
			Deferred Revenue Expenditure		2,500
		1,93,000			1,93,000

They decided to admit Dhruv into their partnership firm for 1/5th share of profits on following terms:

1. Dhruv brings Rs 36,000 for his share of goodwill and Rs 70,000 as his Capital.
2. Stock is overvalued by Rs 1,000 and Building is appreciated by Rs 6,000.

3. Write-off bad debts amounting Rs 5,500.
4. A provision of Rs 1,500 is made for the outstanding repair bill.
5. It was decided to show investments at their market value.
6. On Dhruv's admission, capital of the partners decided to be proportionate to their new profit sharing ratio on the basis of Dhruv's capital.
7. Adjustment of Capitals are to be made in Cash.

Prepare Revaluation Account, Partners' Capital Accounts, Cash Account and the Balance Sheet of the new firm.

Solution

Revaluation Account

Dr. **Cr.**

Particulars		Amount (Rs)	Particulars		Amount (Rs)
Stock		1,000	Building		6,000
Bad Debts	5,500		Loss on revaluation transferred to:		
Less: Old Provision	(2,500)	3,000	Ajay's Capital A/c	1,125	
Provision for Outstanding Repair Bill		1,500	Vijay's Capital A/c	375	1,500
Investments (10,000 – 8,000)		2,000			
		7,500			7,500

Partners' Capital Account

Dr. **Cr.**

Particulars	Ajay	Vijay	Dhruv	Particulars	Ajay	Vijay	Dhruv
Deferred Revenue Expenditure	1,875	625		Balance b/d	94,000	87,000	
Goodwill A/c	12,000	4,000		Cash A/c			70,000
Revaluation A/c (Loss)	1,125	375		Premium for Goodwill A/c	27,000	9,000	
Cash A/c (*Balancing Figure*) ***** See Video***		21,000		Cash A/c (*Balancing Figure*) ***** See Video***	1,04,000		
Balance c/d ***** See Video***	2,10,000	70,000	70,000				
	2,25,000	96,000	70,000		2,25,000	96,000	70,000

Cash Account

Dr. **Cr.**

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Balance b/d	11,000	Vijay's Capital A/c	21,000
Dhruv's Capital A/c	70,000	Balance c/d	2,00,000
Premium for Goodwill A/c	36,000		
Ajay's Capital A/c	1,04,000		
	2,21,000		2,21,000

Balance Sheet

as on March 31, 2012

Liabilities		Amount Rs	Assets		Amount Rs
Capital A/cs:			Building		66,000
Ajay	2,10,000		Stock		45,000
Vijay	70,000		Debtors	50,000	
Dhruv	70,000	3,50,000	*Less*: Bad-debts	(5,500)	44,500
Sundry Creditors		12,000	Investments		8,000
Provision for Outstanding Repair Bill		1,500	Cash		2,00,000

	3,63,500		3,63,500

***Working Notes*:**

WN1 *Calculation of New Profit Sharing Ratio*

Old Ratio (Ajay and Vijay) = 3:1

Dhruv's Share = $\frac{1}{5}$

Let Total Profit be 1

$\therefore$ Remaining Profit = $1-\frac{1}{5}=\frac{4}{5}$

Ajay's New Share = $\frac{3}{4}\times\frac{4}{5}=\frac{12}{20}$

Vijay's New Share = $\frac{1}{4}\times\frac{4}{5}=\frac{4}{20}$

Dhruv's Share = $\frac{1}{5}\times\frac{4}{4}=\frac{4}{20}$

$\therefore$ New Profit Sharing Ratio = 3 : 1: 1

WN2 *Adjustment of Capital*

Dhruv's Capital = 70,000

Dhruv's Share = $\frac{1}{5}$

Total Capital of New Firm = Dhruv's Capital $\times$ Reciprocal of his Share = $70,000\times\frac{5}{1}$ = Rs 3,50,000

New Profit Sharing Ratio = 3:1:1

Ajay's New Capital = $3,50,000\times\frac{3}{5}$ = Rs 2,10,000

Vijay's New Capital = $3,50,000\times\frac{1}{5}$ = Rs 70,000

Dhruv's New Capital = $3,50,000\times\frac{1}{5}$ = Rs 70,000

Particulars	Ajay	Vijay
New Capital Balance	2,10,000	70,000
Adjusted Old Capital Balance	(1,06,000)	(91,000)
Cash brought in by/paid to the partner	**1,04,000 (Cr.)**	**21,000 (Dr.)**

When the Total Capital of the New Firm is Given

Sometimes the total capital of the new firm is clearly mentioned in the question. In this case, there is no need to calculate the total capital of the firm on the basis of the new partner's capital. However; the steps number 2, 3, 4 and 5 need to be followed.

Example: Shruti and Kanika are the partners in a firm sharing profits and losses in the ratio of 2: 1. They admitted Maya for $\frac{1}{5}$th share in the profits. The total capital of the new firm is agreed to be Rs 3,00,000. Maya is required to bring $\frac{1}{5}$th of this amount as her capital contribution. The capital of the old partners is also required to be adjusted in their new profit sharing ratio. The capital balances of Shruti and Kanika after adjusting against all the required adjustments were Rs 1,50,000 and Rs 90,000 respectively. Calculate the new capital of Shruti and Kanika and pass the necessary journal entries.

Solution

Calculation of New Profit Sharing Ratio

Old Ratio = 2: 1

Maya's share in profits $= \frac{1}{5}$th

Let the total profit be Re 1

Remaining profit $= 1 - \frac{1}{5} = \frac{4}{5}$

Shruti's New Share $= \frac{4}{5} \times \frac{2}{3} = \frac{8}{15}$

Kanika's New Share $= \frac{4}{5} \times \frac{1}{3} = \frac{4}{15}$

Maya's Share $= \frac{1}{5}$ or $\frac{3}{15}$

∴ New Profit Sharing Ratio = 8: 4: 3

Calculation of New Capital of All Partners

Shruti's Capital $= \text{Rs } 3,00,000 \times \frac{8}{15} = \text{Rs } 1,60,000$

Kanika's Capital $= \text{Rs } 3,00,000 \times \frac{4}{15} = \text{Rs } 80,000$

Maya's Capital $= \text{Rs } 3,00,000 \times \frac{3}{15} = \text{Rs } 60,000$

Calculation of Excess or Deficit of Capital of Old Partners

		Shruti	**Kanika**
New Capital		1,60,000	80,000
Old Capital		(1,50,000)	(90,000)
	Deficit/(Surplus)	10, 000	(10, 000)

Since, the Shruti's new capital balance is ***more than*** her old capital balance, therefore, she is required to bring Rs 10,000 as additional capital. On the other hand, Kanika's new capital balance is ***lesser than*** her old capital balance, therefore, she can withdraw the excess amount of capital i.e. Rs 10,000.

Journal Entry

(i)	Cash A/c		Dr.	10,000	
		To Shruti's Capital A/c			10,000
	(Deficiency made good by bringing additional amount of capital by Shruti)				
(ii)	Kanika's Capital A/c		Dr.	10,000	
		To Cash A/c			10,000
	(Excess amount withdrawn by Kanika)				

Posting in the Partners' Capital Account

Partners' Capital Account

Dr. **Cr.**

Particulars	**Shruti**	**Kanika**	**Maya**	**Particulars**	**Shruti**	**Kanika**	**Maya**
Cash/Bank (Amount paid		10,000		Cash/Bank (Amount brought	10,000		

to Kanika)				in by Raman)			
Balance c/d ** (New Capital Balances)	1,60,000	80,000	60,000				

** These balances are to be shown on the Liabilities side of the Balance Sheet of the New Firm as the Capital Balances of the Shruti, Kanika and Maya.

Example: Star and Sky are two partners sharing profits and losses equally. Their Balance Sheet is given below:

Balance Sheet
as on March 31, 2012

Liabilities		Amount (Rs)	Assets		Amount (Rs)
Capital A/cs:			Land		75,000
Star	82,000		Furniture		20,000
Sky	99,000	1,81,000	Stock		25,000
General Reserve		10,000	Debtors	50,000	
Sundry Creditors		10,000	*Less*: Provision	(1,000)	49,000
Bills Payable		5,000	Cash		37,000
		2,06,000			2,06,000

They decided to admit Moon into their partnership firm for 1/3rd share in the future profits on the following terms.

1. Moon brings Rs 12,000 for his share of goodwill and necessary amount for his capital contribution.
2. Stock is undervalued by Rs 2,000 and bills payable to be increased by Rs 1,500.
3. Provision of 5% to be maintained on debtors.
4. Furniture to be depreciated by 10%. Value of land falls to Rs 67,000 and creditors were reduced by Rs 6,000.
5. Old partners withdraw 50% of their general reserve and 50% of their share of goodwill.
6. Total Capital of firm on Moon's admission is fixed at Rs 3,00,000.
7. Capital of partners shall be proportionate to their new profit sharing ratio. Adjustment of capitals to be made in cash.
8. New profit sharing ratio is 1:1:1.

Prepare Revaluation Account, Partners' Capital Accounts, Cash Account and Balance Sheet of the new firm.

Solution

Revaluation Account

Dr. **Cr.**

Particulars	Amount (Rs)	Particulars		Amount (Rs)
Bills Payable	1,500	Sundry Creditors		6,000
Furniture	2,000	Stock		2,000
Provision for Doubtful Debts (2,500 – 1,000)	1,500	Loss on revaluation transferred to:		
Land	8,000	Star's Capital A/c	2,500	
		Sky's Capital A/c	2,500	5,000
	13,000			13,000

Partners' Capitals Account

Dr. **Cr.**

Particulars	Star	Sky	Moon	Particulars	Star	Sky	Moon
Cash A/c (2,500 + 3,000)	5,500	5,500		Balance b/d	82,000	99,000	
Revaluation A/c (Loss)	2,500	2,500		General Reserve	5,000	5,000	
Cash A/c (*Balancing Figure*) ***** See Video***		2,000		Cash A/c			1,00,000
Balance c/d ***** See Video***	1,00,000	1,00,000	1,00,000	Premium for Goodwill	6,000	6,000	
				Cash A/c (*Balancing*	15,000		

				Figure) ** ***See Video***			
	1,08,000	1,10,000	1,00,000		1,08,000	1,10,000	1,00,000

Cash Account

Dr. **Cr.**

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Balance b/d	37,000	Star's Capital A/c	5,500
Moon's Capital A/c	1,00,000	Sky's Capital A/c (5,500 + 2,000)	7,500
Premium for Goodwill	12,000	Balance c/d	1,51,000
Star's Capital A/c	15,000		
	1,64,000		1,64,000

Balance Sheet

as on March 31, 2012

Liabilities		Amount (Rs)	Assets		Amount (Rs)
Capital:			Land		67,000
Star	1,00,000		Furniture		18,000
Sky	1,00,000		Debtors	50,000	
Moon	1,00,000	3,00,000	*Less*: Provision	(2,500)	47,500
Sundry Creditors		4,000	Stock		27,000
Bills Payable		6,500	Cash		1,51,000
		3,10,500			3,10,500

***Working Notes*:**

WN1*Calculation of Sacrificing Ratio of Star and Sky*

Old Ratio (Star and Sky) = 1:1
New Ratio (Star, Sky and Moon) = 1:1:1

$$\text{Sacrificing Ratio} = \text{Old Ratio} - \text{New Ratio}$$

$$\text{Star} = \frac{1}{2} - \frac{1}{3} = \frac{3-2}{6} = \frac{1}{6}$$

$$\text{Sky} = \frac{1}{2} - \frac{1}{3} = \frac{3-2}{6} = \frac{1}{6}$$

$$\text{Sacrificing Ratio} = 1:1$$

WN2 *Adjustment of Capital*

$$\text{Total Capital of New Firm} = 3,00,000$$

$$\text{New Profit Sharing Ratio} = 1:1:1$$

$$\text{Star's New Capital} = 3,00,0000 \times \frac{1}{3} = 1,00,000$$

$$\text{Sky's New Capital} = 3,00,000 \times \frac{1}{3} = 1,00,000$$

$$\text{Moon's Capital} = 3,00,000 \times \frac{1}{3} = 1,00,000$$

Particulars	Star	Sky
New Capital Balance	1,00,000	1,00,000
Adjusted Old Capital Balance	(85,000)	(1,02,000)

Cash brought in by/paid to the partner	**15,000 (Cr.)**	**2,000 (Dr.)**

(ii) When the Capital of New Partner is *Not* Given

Sometimes, it may be possible that the capital to be brought in by the new partner is not mentioned in the question. In such a case, his/her share of capital is ascertained by computing the total capital of the firm on the basis of the combined capital and combined ratio of the old partners. The amount of capital so ascertained is required to be brought in by the new partner as his/her capital contribution.

Note: In this case, the capital of the new partner is *not mentioned in the question and it is mentioned that the new partner will bring in proportionate capital.* For example, C is to bring in proportionate capital. The below mentioned are different steps involved in ascertaining the capital of the new partner.

***Step 1*:** Calculate the difference of the total of the credit side and the total of the debit side of the Old Partners' Capital Account after all adjustments.

***Step 2*:** These balances are written as '**Balance c/d**' on the debit side of the Old Partners' Capital Account.

Step 3*:** The proportionate capital of the new partner is calculated by multiplying the combined capital (after all adjustments as calculated in ***Step 1) by reciprocal of combined new profit share of old partners and the profit share of the new partner. This is done as:

New Partner's Capital = Combined Capital of the Old Partners (after all the adjustments) × Reciprocal of the Combined New Share of the Old Partners × Profit Share of the New Partner

***Step 4*:** The amount of proportionate capital as calculated above (in Step 3) is shown on the credit side of the New Partner's Capital Account as 'Cash/Bank'. This entry indicates the amount of proportionate capital brought in by the new partner.

***Example*:** A and B are two partners with capital balances as Rs 2,00,000 and Rs 1,50,000 respectively and sharing profits and losses in the ratio of 3: 2. They agree to admit C for $\frac{1}{3}$rd share in profits. C brings sufficient capital for his share in profits. That is, C brings in proportionate capital. After all the required adjustments, the total of credit side of A's Capital Account is Rs 2,40,000 and total of debit side is Rs 1,00,000. Similarly, the total of credit side of B's Capital Account is Rs 1,90,000 and that of debit side is Rs 60,000. Ascertain the amount of capital brought in by C.

Solution

***Step 1*:** Calculate the difference of the total of the credit side and the total of the debit side of the A and B Partners' Capital Account after all adjustments.

Difference of Credit Side and Debit side of A's Capital Account = Rs 2,40,000 - Rs 1,00,000 = Rs 1,40,000.

Difference of Credit Side and Debit side of B's Capital Account = Rs 1,90,000 - Rs 60,000 = Rs 1,30,000.

***Step 2*:** These balances are written as 'Balance c/d' on the debit side of the Old Partners' Capital Account.

Partners' Capital Account

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
Balance c/d	1,40,000	1,30,000					

Step 3*:** The proportionate capital of the new partner is calculated by multiplying the combined capital (after all adjustments as calculated in ***Step 1) by reciprocal of combined new profit share of old partners and the profit share of the new partner. This is done as:

New Partner's Capital = Combined Capital of the Old Partners (after all the adjustments) × Reciprocal of the Combined New Share of the Old Partners × Profit Share of the New Partner

$$C's\,Capital = (1,40,000 + 1,30,000) \times \frac{1}{\frac{6}{15}+\frac{4}{15}} \times \frac{1}{3}$$
$$= (1,40,000 + 1,30,000) \times \frac{1}{\frac{2}{3}} \times \frac{1}{3}$$
$$= 2,70,000 \times \frac{3}{2} \times \frac{1}{3} = Rs1,35,000$$

***Step 4*:** The amount of proportionate capital as calculated above (in Step 3) is shown on the credit side of the C's Partner Capital Account as 'Cash/Bank'. This entry indicates the amount of proportionate capital brought in by C.

Partners' Capital Account

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
				Cash/Bank			1,35,000
Balance c/d	1,40,000	1,30,000					

Working Notes:

Calculation of New Profit Sharing Ratio

Old Ratio (X and Y) = 3: 2

Z's Share $= \frac{1}{3}$

Let total profit be Re 1

Z's share in profit $= \frac{1}{3}$

Remaining Profit for X and Y $= 1 - \frac{1}{3} = \frac{2}{3}$

X's New Share $= \frac{2}{3} \times \frac{3}{5} = \frac{6}{15}$

Y's New Share $= \frac{2}{3} \times \frac{2}{5} = \frac{4}{15}$

Z's Share $= \frac{1}{3}$ or $\frac{5}{15}$

∴ New Ratio = 6: 4: 5

Example: J and K are two partners sharing profits and losses in ratio of 2 : 1. Their Balance Sheet for year ending March 31,2012 is as follows:

Balance Sheet
as on March 31, 2012

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Capital A/cs:			Land and Building	25,000
J	20,000		Plant and Machinery	20,000
K	22,000	42,000	Patents	5,000
Bank Loan		15,000	Stock	2,000
Sundry Creditors		18,750	Sundry Debtors	3,000
			Cash	5,000
			Profit and Loss A/c (Dr.)	15,750
		75,750		75,750

They decided to admit L as a new partner for 1/4th share in the profits on the following terms:

1. L brings capital proportionate to his share on the basis of old partners' capital after all adjustments and Rs 15,000 as his share of goodwill.

2. Depreciate machinery by 10% and write-off patents to 40%.
3. Stock is undervalued by Rs 1,750 and there is an appreciation in the value of land and building to Rs 32,000.
4. New profit sharing ratio will be 2:1:1.

Prepare Revaluation Account, Partners' Capital Accounts, Cash Account and Balance Sheet of the new firm.

Solution

Revaluation Account

Dr. **Cr.**

Particulars		Amount (Rs)	Particulars	Amount (Rs)
Plant and Machinery		2,000	Stock	1,750
Patents		3,000	Land and Building	7,000
Profit on revaluation transferred to:				
J's Capital A/c	2,500			
K's Capital A/c	1,250	3,750		
		8,750		8,750

Partners' Capital Accounts

Dr. **Cr.**

Particulars	J	K	L	Particulars	J	K	L
Profit and Loss A/c (Dr.)	10,500	5,250		Balance b/d	20,000	22,000	
				Revaluation A/c (Profit)	2,500	1,250	
Balance c/d ** ***See Video***	22,000	23,000	15,000	Premium for Goodwill	10,000	5,000	
				Cash A/c			15,000
	32,500	28,250	15,000		32,500	28,250	15,000

Cash Account

Dr. **Cr.**

Particulars	Amount (Rs)	Particulars	Amount (Rs)
Balance b/d	5,000		
Premium for Goodwill	15,000		
L's Capital A/c	15,000	Balance c/d	35,000
	35,000		35,000

Balance Sheet

as on March 31, 2012

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Capital:			Land and Building	32,000
J	22,000		Plant and Machinery	18,000
K	23,000		Patents	2,000
L	15,000	60,000	Sundry Debtors	3,000
Bank Loan		15,000	Stock	3,750
Sundry Creditors		18,750	Cash	35,000
		93,750		93,750

***Working Notes*:**

WN1 *Calculation of Sacrificing Ratio of J and K*

Old Ratio (J and K) = 2:1
New Ratio (J, K and L) = 2:1:1

$$\text{Sacrificing Ratio} = \text{Old Ratio} - \text{New Ratio}$$

$$J = \frac{2}{3} - \frac{2}{4} = \frac{8-6}{12} = \frac{2}{12}$$

$$K = \frac{1}{3} - \frac{1}{4} = \frac{4-3}{12} = \frac{1}{12}$$

$$\text{Sacrificing Ratio} = 2 : 1$$

WN2 *Calculation of Capital brought in by L*

$$\text{New Ratio} = 2:1:1$$

$$\text{Combined Share of J and K} = \frac{2}{4} + \frac{1}{4} = \frac{3}{4}$$

$$\text{Combined Capital of J and K after all adjustments } (23{,}000 + 22{,}000) = 45{,}000$$

$$\text{Total Capital of New Firm} = \text{Total Adjusted Capitals of Partners} \times \text{Reciprocal of Combined Shares of Old Partners}$$

$$= 45{,}000 \times \frac{4}{3} = 60{,}000$$

$$\text{L's Capital} = 60{,}000 \times \frac{1}{4} = 15{,}000$$

Memorandum Revaluation Account

Whenever we use the word memorandum before an account, it means that these accounts are not used for Balance Sheet presentation. This account too has the same purpose; it is prepared when all the partners including the new or incoming partners agree that the assets and liabilities will appear in the Balance sheet at their original values and not at the revised values. This account also known as Memorandum Profit And Loss Adjustment Account, records any increase or decrease in the value of assets and liabilities instead of the Revaluation Account. This account is divided into two parts.

i. The first part records any increase or decrease in the value of assets and liabilities just like the Revaluation Account. Any profit or loss thus arising is transferred to the Old Partner's Capital Account in their old-profit sharing ratio.

ii. The second part is prepared in order to nullify the effect of entries passed in the first part. This means all the entries passed in the first part are reversed. The balance of the second part is then transferred to all the partners' capital accounts including the new partner's Capital account. This is because now we are deviating from the revalued figures and hence the effect of this should reflect on all partners accounts rather than Old partners only who were effected with the revalued figures in the first part.

Journal Entries:

i. **When value of assets increase and that of liabilities decrease:**

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Assets A/c (To be recorded individually) Dr Liabilities A/c (To be recorded individually) To Memorandum Revaluation A/c			

i. **When value of assets decrease and that of liabilities increase:**

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)

	Memorandum Revaluation A/c Dr To Assets A/c (To be recorded individually) To Liabilities A/c (To be recorded individually)			

i. **For transferring the balance of first part of the Memorandum Revaluation Account:**

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Memorandum Revaluation A/c (In case of profit) Dr To Old Partner's Capital A/cs (In Old Ratio)			

OR

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Old Partner's Capital A/c(In Old ratio) Dr To Memorandum Revaluation A/c (In case of loss)			

i. **For recording the entries in second part, entry (a) and (b) will be reversed:**

Entry a) reversed:

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Memorandum Revaluation A/c Dr To Assets A/c (To be recorded individually) To Liabilities A/c (To be recorded individually)			

Entry b) reversed:

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Assets A/c (To be recorded individually) Dr Liabilities A/c (To be recorded individually) Dr			

	To Memorandum Revaluation A/c			

For transferring the balance of the second part:

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	All Partner's Capital A/c(In New Ratio) Dr To Memorandum Revaluation A/c (In case debit side exceeds credit side)			

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Memorandum Revaluation A/c (In case credit side exceed debit side) Dr To All Partner's Capital A/cs (In New Ratio)			

Note: *One must remember that if the first part of Memorandum Revaluation Account results in Profit then the second part will result in loss and vice-versa.*

Difference between Revaluation Account and Memorandum Revaluation A/c

Basis	Revaluation Account	Memorandum Revaluation A/c
Segments/ Parts	It is prepared as a one whole account and does have any parts or segments.	It is divided into two parts, with the first part recording the changes in the values of assets and liabilities and the second part nullifying the changes recorded in the first part.
Motive	It is used to record the effect of revaluation of the liabilities and assets when they are to appear at their new (revised) value.	It is used to record the effect of revaluation of the liabilities and assets when they are to appear at their old value.
Transfer of Balance	Balance transferred to Old Partner's Capital Account in their Old Profit Sharing Ratio.	Balance of first part transferred to the Old Partner's Capital Account in their Old profit sharing ratio. Balance of Second Part to be transferred to the Capital Accounts of the Partners including the new partner in case of admission and continuing partner in case of retirement, in the new profit sharing ratio.

Topics

- New Profit Sharing Ratio and Sacrificing Ratio
- Valuation of Goodwill
- Treatment of Goodwill
- Revaluation Account, Cash Account, Balance Sheet and Adjustments
- Adjustment of Capital