CHAPTER – 3

Quick Revision Notes

RECONSTITUTION OF A PARTNERSHIP FIRM – ADMISSION OF A PARTNER

A. VALUATION OF GOODWILL

Methods of Valuation of Goodwill

Value of goodwill = Actual/Average Profit x No. of years' purchase

(a) Actual/Average Profit = Total Profits / Total number of year for which profit and loss is given

The following adjustments should be taken into account while calculating and loss average profit:

- (I) Abnormal loss of a year such as loss from fire or theft etc. should be added back to that profit.
- (II) Abnormal income of a year such as income from speculation or lottery etc. should be deducted out of profit of that year.
- (III) Normal expenses of a year, if not deducted out of profits, should be deducted out of profits of that year.
- (IV) Normal income of a year, if not added in the profits, should be added to the profit of that year.
- (V) Remuneration of proprietor of a year should be deducted out of profits of that year.
- (b) Number of year's purchase means for how many years, the firm will earn the same amount of profit because of its previous efforts, after being purchased by another firm.

After making the above adjustment the average profit is known as actual average profit or average maintainable profit in future.

Weighted Average Profit Method

(a) Weighted Average Profit = Total of products of profits/losses

Total of weights

(b) Value of Goodwill = Weighted average profit x No. of years' purchase

Weighted average profit method for valuation of goodwill is better than the simple average method because it gives a higher weight age to the profits to the recent years. However, weighted average should be used only if specified.

(ii) Super Profit Method:

(a) Actual/Average Profit = Total Profits/No. of years

Normal Profit = Capital Invested x Normal Rate of Return/100

- (b) Where Capital Invested = Assets External Liabilities
- (c) Super Profit = Actual/Average Profit-Normal Profit
- (d) Value of Goodwill= Super profit x No. of years' purchase

(iii) Capitalization Method:

(a) Capitalization of actual/average method :

Value of Goodwill = Capitalized value of average profit - Actual capital employed (or Net Assets)

According to this method, the following steps should be adopted:

- (I) Actual/ Average profit is calculated in the same manner which has been explained earlier.
- (II) Capitalized value of actual/average profit = Actual/ Average Profit X 100/Normal rate of return
- (III) Actual capital employed (or Net Assets) = Total assets (excluding goodwill) minus outside liabilities.
- (b) Capitalization of Super Profit Method: As the name suggests, this method tries to assess the capital needed for earning the super profit. This capital is known as goodwill. Following formula can be used for calculating goodwill :

Value of goodwill = Super profit x 100/ Normal rate of return

B. CHANGE IN PROFIT SHARING RATIO AMONG THE EXISTING PARTNERS

In such a case, first sacrifice/gain share of partner (s) should be calculated, and then the following journal entry will be recorded:

(i) In case of effective profit :

Gaining Partner's Capital A/c

To Sacrificing Partner's Capital A/c

(gaining partner's share of profit transferred to sacrificing partner's capital a/c in their sacrificing ratio)

(ii) In case of effective loss :

Sacrificing Partner's Capital A/c

To Gaining Partner's Capital A/c

(sacrificing partner's share of profit transferred to gaining partner's share of profit in their gaining ratio)

We can say that sacrifice made by partners or gain received by partners will be adjusted through their capital accounts by making a single journal entry. It is also called capital adjustment on change of profit sharing ratio. In such a case a single journal entry is passed through capital transfer.

C. ADMISSION OF A PARTNER

Format: The format of revaluation account can be presented as follows:

Dr	•.

Revaluation A/c

Particulars Rs. Particulars Rs. To Decrease in value of assets By Increase in value of assets (Profit) **. .** (Loss) By Decrease in value of **.** . To Increase in value of Liabilities Liabilities(Profit) **. .** (Loss) By Unrecorded Assets (at an agreed To Unrecorded Liabilities (at an value) agreed value) By Loss transferred to Old Partner's To Profit transferred to Old Capital/Current A/c (in old ratio) **. .** Partner's Capital/Current A/c (in Total old ratio) Total

Dr.

Dr.

Cr.

Accounting Treatment of Accumulated Profits, Specific Funds and Accumulated Losses

(i)	Distribution of accumulated profits :						
	General Reserve A/c	Dr.					
	Reserve Fund A/c	Dr.					
	Profit & Loss A/c	Dr.					
	To Old Partners' Capital Current A/cs (undistributed profits and transferred to partners' a/cs in old ratio)						
(ii)	Distribution of specific funds :						
	Workmen's' Compensation Fund	Dr.					
	Investment Fluctuation Fund A/c	Dr.					
	Contingency Reserve A/c	Dr.					
	To Old Partners' Capital Current A/cs						
(iii)	Distribution of accumulated losses :						
	Old Partners' Capital Current A/cs	Dr.					
	To Profit & Loss A/c	Dr.					
	To Advertisement Expenses A/c						
	(undistributed losses and transferred to partners' a/cs in old ratio)						
Acc	ounting Treatment of Goodwill						
(a)	Premium for goodwill paid privately: When the premium for goodwill is paid to the old partners privately or directly or outside the business by the new partner ' <i>no journal entry'</i> is required in the books of the firm.						
(b)) Premium for goodwill brought in cash or kind: When new partner brings his share of premium for goodwill in cash or kind the following journal entries will be made :						
(i)	For amount of premium for goodwill brought in cash or kind :						
	Cash/Bank/Assets A/c	Dr.					
	To Premium for Goodwill A/c						
(ii)	Distribution of goodwill amongst sacrificing (old) partners in their sa	goodwill amongst sacrificing (old) partners in their sacrificing ratio:					
	Premium for Goodwill A/c	Dr.					
	To sacrificing (old) Partners' Capital/Current A/cs						
(iii)	Goodwill is withdrawn by sacrificing (old) partners (if any) :						
	Sacrificing (old) Partners' Capital/Current A/cs	Dr.					
	To Cash/Bank A/c						
(c)	Premium for goodwill not brought in cash: When the new pathering his share of premium for goodwill in cash, in such a situation h for goodwill can be adjusted through partners' capital accounts. The entry will be recorded :	rtner is not able to is share of premium he following journal					
		D					

New Partner's Capital A/c

To sacrificing (old) Partners' Capital/Current A/cs (For new partner's share of goodwill transferred to old partners in their sacrificing ratio)

- (d) Partly amount of goodwill brought in cash : When new partners brings only a part of his share of goodwill in cash, in such a situation the following journal entries will be passed :
 - (i) For bringing portion of share of goodwill (or premium)
 Cash/Bank A/c Dr.
 To Premium for Goodwill A/c
 (ii) For transferring goodwill to partners' accounts in their sacrificing rate
 - (ii) For transferring goodwill to partners' accounts in their sacrificing ratio : Premium for Goodwill A/c Dr. New Partners' Capital/Current/Loan A/c Dr. To sacrificing (old) Partners' Capital/Current A/cs

Adjustment of Partners' Capital

(i) Calculation of new partner's capital on the basis of old partners :

Step 1. Calculate the adjusted closing capitals of old partners (after all adjustments have been made)

Step 2. Calculate the total closing capital of new firm as under:

Total capital of new firm =

Combined adjusted closing capitals of old partners x Reciprocal of remaining share of profit of old partners.

Step 3. Calculate the proportionate capital of new partner as under:

New Partner's Capital = Total capital of the new firm x New partner's proportion of share of profit

(ii) Adjustment of old partners capital on the basis of new partner's capital: If the capital of a new partner is given, the same can be used as a base for calculating the new capital of the old partners. In such a situation, the following steps should be taken into consideration :

Step 1. Calculate total capital of new firm, *i.e.* New partner's capital x Reciprocal of proportion of share of profit of new partner.

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

Step 3. Calculate the adjusted closing capitals of old partners (*i.e.* after all adjustments have been made)

Step 4. Calculate the surplus/deficiency in each of old partner's capital account by comparing the new capital with their adjusted old capital which is adjusted through cash or transferred to their Current A/c.

- (iii) Adjustment of Surplus/Deficiency through cash : For this purpose, the following entries will be passed :
 - (a) If capital of old partners fall short (deficit) , bring in cash :

Cash/Bank A/c Dr.

To Partners' Capital A/c

(b) If capital of old partners has a surplus, withdraw cash : Partners' Capital A/c To Cash/Bank A/c

Dr.

(iv) Adjustment of Surplus/Deficiency through partner's current account: Surplus or deficit in partners' capital accounts may be transferred to newly opened partners' current account instead of actual cash to be paid off or brought in by the old partners. In that case, following entries will be passed :

(a) If the existing capital is more than his required capital (surplus)

Partners' Capital A/c

To Partner's Current A/c

(b) If the existing capital is less than his required capital (deficit)

Partner's Current A/c

Dr.

Dr.

To Partners' Capital A/c

If current account shows a credit balance, it is taken to the liabilities side of the balance sheet. However, if current account shows a debit balance, it is placed on the assets side of the balance sheet.

Format of Partners' Capital A/c

Particulars	А	В	С	Particulars	A	В	С
To Revaluation loss	хх	xx		By balance b/d	xx	xx	
To P & L A/c (Dr.)	xx	xx		By cash A/c			xx
To Advertisement Suspense	xx	xx		By premium A/c (cash	xx	xx	
A/c	xx	xx		goodwill)			
To Cash(premium withdrawn)			xx	By new partner's capital A/c	xx	xx	
To Sacrificing partners' capital				(non cash goodwill)			
A/c (non cash goodwill)	xx	xx		By revaluation			
To old goodwill	xx	xx	xx	Profit	xx	xx	
To balance c/d				By Reserves/workmen	xx	xx	
				compensation reserve/			
				Investment fluctuation fund			
				By P & L A/c (Cr.)	xx	xx	
	xx	xx	xx		xx	xx	xx