



INTRODUCTION

Indian Partnership Act, 1932

Sec. 4. Definition of "partnership", "partner", "firm" and "firm name".

"Partnership" is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.

Persons who have entered into partnership with one another are called individually "partners" and collectively a "firm", and the name under which their business is carried on is called the "firm name".

From the above definition of partnership, the essential elements of partnership can be understood as:

"Partnership" is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.

Merits of Partnership

The partnership form of business organisation enjoys the following advantages:

1. Ease of Formation: Partnership is simple to form, inexpensive to establish and easy to operate. No legal formalities are involved and no formal documents are to be prepared.

Only an agreement between two or more persons to carry on a lawful business is required. Even the registration of the firm is not compulsory. Similarly, a partnership can be dissolved easily at any time.

2. Larger Financial Resources: It is possible to collect a large amount of capital due to a number of partners. New partners can be admitted to raise further capital whenever necessary. Creditworthiness is also high because every partner is jointly and severally liable for all the debts of the firm.

3. Combined Abilities and Judgement: The skill and experience of all the partners are pooled together. Combined judgement of several persons helps to reduce errors of judgement.

The partners may be assigned duties according to their talent. Therefore, benefits of specialisation are available. Partners meet frequently and can take prompt decisions.

4. Direct Motivation: Ownership and management of business are vested in the same persons. There is direct relationship between effort and reward. Every partner is motivated to work hard and to ensure the success of the firm. Losses are shared and there is diffusion of risk.

5. Close Supervision: Every partner is expected to take personal interest in the affairs of the business. Different partners can maintain personal contacts with employees and customer's fear of unlimited liability makes the partners cautious and avoid reckless dealings. Management of partnership is cheaper when expert managers are not employed.

6. Flexibility of Operations: Partnership business is free from legal restrictions and Government control. Partners can make changes in the size of business, capital and managerial structure without any approval. The activities of partnership business can be adapted easily by changing conditions in the market.

7. Secrecy: A partnership firm is not required to publish its annual accounts. Audit of accounts is not essential and no reports are to be filed with the Government authorities. Therefore, the affairs of a partnership business can easily be kept secret and confidential.

8. Protection of Minority Interest: Management of partnership is democratic. Every partner has a right to be consulted and express his opinion.

All important decisions are taken with the mutual consent of all the partners. In case a partner is dissatisfied with the majority decisions, he can retire from the firm or give a notice for its dissolution.

9. Cooperation: Partnership encourages mutual cooperation and trust amongst people. Partners work in common for the benefit of all and do their level best to make the business prosperous. They can take more balanced decisions than one man.

10. Scope for Expansion: There are greater possibilities for expansion and growth of business. More partners can be taken in to meet the financial and managerial requirements of growing business.

Demerits of Partnership

A partnership suffers from the following limitations:

1. Limited Resources: There is a limit to the maximum number of partners in a firm. Therefore, it is not possible to collect huge financial resources. Borrowing capacity of partners is also limited. A partnership firm may not provide the required technical and administrative skills. There may be lack of professional management.

2. Unlimited Liability: Every partner is fully liable for the debts of partnership business. Fear of risk may restrict initiative and growth of business. Private properties of partners can also be taken up for business liabilities.

3. Uncertain Life: Partnership business suffers from instability. Insolvency, insanity, retirement and death of a partner may cause an abrupt end to business. Any partner can give a notice for dissolution of partnership.

4. Conflicts: Lack of confidence, unity and harmony among partners may lead to delayed decisions and inefficiency. Chances of conflict are high because every partner has an equal right to take part in the management of the firm.

5. Risk of Implied Authority: Every partner is an agent of the firm. A dishonest partner may cause a great loss to the firm. Other partners may suffer a heavy loss due to the dishonesty or negligence of one partner.

6. Restriction on Transfer of Interest: A partner cannot transfer or assign his share in the firm to a third party without the consent of other partners. He has, therefore, to lose the liquidity of his investment.

7. Reduced Public Confidence: A partnership firm does not enjoy high degree of public confidence and prestige. This is because it is free from legal formalities and Government restrictions. Its accounts are not published and public is not aware of exact position of the business.

Admission of a Partner

A new partner can be admitted only with the consent of all the existing partners. A new partner is not liable for any profit or loss occurred before his admission. Such a partner is called a new partner or incoming partner.

Purpose of Admission of a Partner:

1. For additional capital
2. For progress of the firm
3. For acquiring additional managerial skill
4. For reducing competition

Effect of Admission of a Partner: Admission of a new partner is a major event in a partnership business. A new admission can take place only with the unanimous consent of all the existing partners. New partners are admitted for several reasons. Additional capital contribution, fresh ideas more contacts etc. are some of the advantages in admitting a new partner. Following are the most important accounting aspects to be considered at the time of admission of a new partner.

1. Change in profit sharing ratio,
2. Accounting treatment of Goodwill,
3. Revaluation of assets and liabilities,
4. Treatment of reserves and accumulated profits/losses and
5. Adjustment of Capital Accounts.

1. Change in Profit Sharing Ratio: When a new partner comes into the business, old partner have to adjust his profit share from their portion. Thus, change in profit sharing ratio is the first accounting aspect to be considered on admission of a new partner. In academic accounting, change in profit sharing ratio can be presented in various ways:

The New Partner's Share is Mentioned without Specifying the Old Partner's Profit Sharing Arrangement. In this case, it is to be assumed that the profit available after paying the new partner's share is to be divided by the old partner's share in their old profit sharing ratio. In other words, even though the overall profit sharing ratio changes, the old ratio is still maintained between the old partners, within the new ratio.

Sacrificing Ratio

The ratio in which the old partners agree to sacrifice their share of profit in favour of the incoming partner is called sacrificing ratio. The sacrifice by a partner is equal to:

$$\text{Old Share of Profit} - \text{New Share of Profit}$$

2. Accounting Treatment of Goodwill: As stated earlier, the new partner is required to compensate the old partners for their loss of share in the super profits of the firm for which he brings in an additional amount known as premium or goodwill. This amount is shared by the existing partners in the ratio in which they forego their shares in favour of the new partner which is called sacrificing ratio.

The ratio is normally clearly given as agreed among the partners which could be the old ratio, equal sacrifice, or a specified ratio. The difficulty arises where the ratio in which the new partner acquires his share from the old partners is not specified. Instead, the new profit sharing ratio is given. In such a situation, the sacrificing ratio is to be worked out by deducting each partner's new share from his old share.

3. Revaluation of Assets and Liabilities: Revaluation of assets and liabilities is another major step prior to admission or retirement. Revaluation is important, as there are hidden profits or losses in the difference between book value and actual market

value of assets or liabilities. Revaluation is necessary whenever there is a change in profit sharing ratio, even without admission or retirement. The hidden profits or losses should be distributed in the ratio prior to change (old ratio). Revised values of assets and liabilities are brought into books by opening a temporary account called 'Revaluation account'. The purpose of revaluation account is to summarise effect of revaluation of assets and liabilities. Revaluation account represents the combined capital account of partners. Any gain on revaluation of asset or liabilities, which are to be credited to partners, will be credited in revaluation account. Similarly, any loss on revaluation will be debited in revaluation account instead of capital accounts. The revaluation account is closed by transferring its net balance to partner's capital accounts in the profit sharing ratio.

4. Treatment of Reserves and Accumulated Profits: Accumulated profits such as general reserve, credit balance in Profit & Loss account etc. will be transferred to the capital accounts of old partners in the old profit sharing ratio. Similarly, accumulated losses shall be transferred to the debit side of old partner's capital accounts. Therefore, these items will not appear in the new balance sheet.

5. Adjustment of Capital Accounts: When the partners change their profit sharing ratio at admission, retirement or any other reason, they also rearrange their capital accounts. Capital contribution is not essentially the basis of profit sharing. However, in most partnerships, capital contribution is considered as the major factor in determining profit sharing ratio. At the time of admission, capital contribution will be raised as an important condition. When a new partner is admitted for a certain share of profit for a certain amount of capital contribution, he would naturally expect the other also to maintain a capital balance matching with their profit share. Admission of a partner is not the only situation when a capital rearrangement is considered. Retirement, death or any other change in profit sharing ratio would prompt rescheduling the capital balances. The basic purpose of following 'Fixed capital method' is to maintain a steady capital ratio.

When capital is readjusted on the basis of new partner's capital contribution, the first step is to determine the revised capital balances of each partner. Readjustment in capital account is usually done by bringing in or taking out cash. Sometimes, in place of cash transactions, old partners may adjust their capital balances by transferring the excess or deficit in the capital accounts to their current accounts as a temporary measure. Once the capital balances are adjusted, current accounts can be settled in due course.

What are Partners and Their Kinds?

Meaning: Minimum of 2 persons are required to form a partnership and maximum of 10 persons in case of banking and 20 in case of others. These persons are individually known as 'Partners' and collectively known as 'Firm'.

Kinds of Partners

1. *Active Partners:* These are the persons who actively take part in the business, i.e., they are involved in day-to-day affairs of business. They take all the decisions.

2. *Sleeping Partners:* Sleeping partners are those partners who are not actively involved in the business, i.e., they do not take part in the day-to-day affairs of the business. But they do contribute capital and share profits and losses of the business like other partners.
3. *Nominal Partner:* He neither contributes capital nor takes part in the conduct of the business. He is a person with good reputation in the market and lends his name to the firm and makes outsiders believe that he is a partner of the firm.
4. *Partner in Profits Only:* He only shares profit but not the losses. The objective of having such partner is to make use of his capital and goodwill.
5. *Partner by Estoppel:* He is not a partner of a firm in actual. He neither contributes any capital nor share profits or losses of the business. He also does not take part in the conduct of the business. His role is to make the outsiders believe that he is a partner of the firm.
6. *Secret Partner:* As the name suggests, his name is not disclosed to the outsiders as a partner.
7. *Minor Partners:* According to Indian Partnership Act 1932, a minor, i.e., person below the age of 18 years cannot be a partner of the firm. However, with the mutual consent of all the partners, he can be admitted into the partnership for the benefits of the firm.

Rights and Obligations of Partners

All the rights and duties should be clearly defined in the Partnership Deed. If in any case, Partnership Deed is silent on some points, then in that case rights and obligations of the partners are governed by Partnership Act's provisions.

Rights of the Partners

1. Right to take part in the day-to-day affairs or management of the partnership.
2. If Partnership Deed is silent on the rate of interest on partner's loan, then the partner is entitled to the interest @ 6%.
3. Every partner of the firm has the right to check the books of accounts and records of business.
4. A partner has the right to be indemnified for the expenditure incurred by him to protect the firm from the loss.
5. A partner can use the property of the firm for the purpose of firm's business.
6. Right to retire from the firm in accordance with the terms and conditions of the Partnership Deed.
7. Every partner has the right to continue in the firm unless expelled according to the provisions of the deed.

8. On retirement, right to share profits in the firm earned with the help of partner's share in the firm or interest @ 6% p.a. until the amount due to retired partner is paid off.
9. Right to be consulted before taking important decisions.
10. Right to share the profits equally, in the absence of any agreement.
11. Right to receive interest on capital, if there are sufficient profits.
12. Every partner is co-owner of the firm.
13. Right to act independently in emergency situation to protect the firm from loss.
14. Right to inspect the entry of new partner.
15. Right to dissolve the firm with the consensus, i.e., mutual consent of all the partners. But in case, if partnership is at will, any partner can dissolve the firm by giving notice to other partners.

Duties and Obligations of Partners

1. Every partner of the partnership firm must act in the maximum interest of the firm.
2. Every partner must have mutual trust and confidence in other partners and they should act in faithful manner to each other and the firm.
3. Duty to render true accounts to fellow partners.
4. Duty to compensate the firm for the loss arising out of breach of trust and willful negligence.
5. A partner should not compete with the firm's business by starting his own business.
6. Obligation to share the loss equally in the absence of any agreement between the partners.
7. A partner must not apply firm's property for the accomplishment of his personal tasks.
8. Every partner must act within the scope of their authority.
9. A partner must not transfer his share without the mutual consent of his fellow partners.
10. Every partner must disclose any secret profit made by them.
11. A partner must not make secret profits by using firm's property, if he does so, he must surrender it to the firm.
12. In the absence of any previous contract between the partners, no partner is entitled to the salary.

GOODWILL

Goodwill is also one of the special aspects of partnership accounts which requires adjustment (also valuation if not specified) at the time of reconstitution of a firm, viz., a change in the profit sharing ratio, the admission of a partner or the retirement or death of a partner.

Meaning of Goodwill

Over a period of time, a well-established business develops an advantage of good name, reputation and wide business connections. This helps the business to earn more profits as compared to a newly set up business. In accounting, the monetary value of such advantage is known as "goodwill".

It is regarded as an intangible asset. In other words, goodwill is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits. It is generally observed that when a person pays for goodwill, he/she pays for something, which places him in the position of being able to earn super profits as compared to the profit earned by other firms in the same industry.

In simple words, goodwill can be defined as "the present value of a firm's anticipated excess earnings" or as "the capitalised value attached to the differential profit capacity of a business". Thus, goodwill exists only when the firm earns super profits. Any firm that earns normal profits or is incurring losses has no goodwill.

Factors Affecting the Value of Goodwill

The main factors affecting the value of goodwill are as follows:

1. *Nature of Business*: A firm that produces high value added products or having a stable demand is able to earn more profits and therefore has more goodwill.
2. *Location*: If the business is centrally located or is at a place having heavy customer traffic, the goodwill tends to be high.
3. *Efficiency of Management*: A well-managed concern usually enjoys the advantage of high productivity and cost efficiency. This leads to higher profits and so the value of goodwill will also be high.
4. *Market Situation*: The monopoly condition or limited competition enables the concern to earn high profits which leads to higher value of goodwill.
5. *Special Advantages*: The firm that enjoys special advantages like import licences, low rate and assured supply of electricity, long-term contracts for supply of materials, well-known collaborators, patents, trademarks.

Methods of Valuation of Goodwill

1. Average Profits Method
2. Super Profits Method
3. Capitalisation Method.

Average Profits Method: Under this method, the goodwill is valued at agreed number of years' purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill, therefore, should be calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue.

For example, if the past average profits of a business works out at ₹ 20,000 and it is expected that such profits are likely to continue for another three years, the value of goodwill will be ₹ 60,000 (₹ 20,000 × 3).

Super Profits Method: The basic assumption in the average profits (simple or weighted) method of calculating goodwill is that if a new business is set up, it will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases an existing business has to pay in the form of goodwill a sum equal to the total profits he is likely to receive for the first 'few years'. But it is contended that the buyer's real benefit does not lie in total profits; it is limited to such amounts of profits which are in excess of the normal return on capital employed in similar business. Therefore, it is desirable to value goodwill on the basis of the excess profits and not the actual profits. The excess of actual profits over the normal profits is termed as super profits.

Normal Profit: $\text{Capital Employed} \times \text{Normal Rate of Return}/100$

Suppose an existing firm earns ₹ 18,000 on the capital of ₹ 1,50,000 and the normal rate of return is 10%. The Normal profits will work out at ₹ 15,000 ($1,50,000 \times 10/100$). The super profits in this case will be ₹ 3,000 (₹ 18,000 – ₹ 15,000). The goodwill under the super profit method is ascertained by multiplying the super profits by certain number of years' purchase. If, in the above example, it is expected that the benefit of super profits is likely to be available for 5 years in future, the goodwill will be valued at ₹ 15,000 ($3,000 \times 5$). Thus, the steps involved under the method are:

1. Calculate the average profit,
2. Calculate the normal profit on the capital employed on the basis of the normal rate of return,
3. Calculate the super profits by deducting normal profit from the average profits, and
4. Calculate goodwill by multiplying the super profits by the given number of years' purchase.

Capitalisation Methods: Under this method, the goodwill can be calculated in two ways: (a) by capitalising the average profits, or (b) by capitalising the super profits.

Capitalisation of Average Profits: Under this method, the value of goodwill is ascertained by deducting the actual capital employed (net assets) in the business from the capitalised value of the average profits on the basis of normal rate of return. This involves the following steps:

- (i) Ascertain the average profits based on the past few years' performance.
- (ii) Capitalise the average profits on the basis of the normal rate of return to ascertain the capitalised value of average profits as follows:
$$\text{Average Profits} \times 100 / \text{Normal Rate of Return}$$
- (iii) Ascertain the actual capital employed (net assets) by deducting outside liabilities from the total assets (excluding goodwill). $\text{Capital Employed} = \text{Total Assets (excluding goodwill)} - \text{Outside Liabilities}$.
- (iv) Compute the value of goodwill by deducting net assets from the capitalised value of average profits, i.e., (ii) – (iii).

Theory Questions

1. Explain the premium method of treatment of goodwill on admission of a new partner.
2. What is sacrificing ratio on admission of a partner?
3. Give two circumstances in which sacrificing ratio must be applied.
4. Why is there a need for revaluation of assets and liabilities of a firm, if there is an admission of a new partner?
5. Explain the treatment of goodwill on admission of a partner.
6. Explain various accounting steps involved in the admission of a new partner.
7. What is meant by super profit in the valuation of goodwill?
8. Explain with reason the treatment of reserves and surplus existing in the books of the firm on admission of a partner.

RECONSTITUTION OF PARTNERSHIP

Impact of Admission of a Partner

- K** Since a new partner gets his share of profit from old partners, he must compensate the old partners for the share sacrificed by them. The amount of compensation given by the new partner is known as goodwill.
- K** Assets and liabilities are revalued because the entire profit and loss due to their revaluation is divided amongst the old partners in their old profit sharing ratio. The new partner should not share such profit or loss because it belongs to the period prior to his admission.

K General Reserve A/c Dr.
 Profit & Loss A/c Dr.

To Old Partner's Capital A/c (in old ratio)

K When the circumstances premium for the goodwill in cash to the old partners privately outside the business, no entries are passed for it.

K Calculation of new profit sharing ratio:

Let total profit be = 1

Share given to Z = $1/3$

Remaining share = $1 - 1/3 = 2/3$

Now the old partners will share remaining profit in their old profit sharing ratio.

Hence,

X's share = $3/4$ of $2/3 = 6/12$ or $3/4 * 2/3 = 6/12$

Y's share = $1/4$ of $2/3 = 2/12$ or $1/4 * 2/3 = 2/12$

Z's share = $1/3$

Thus, the new profit sharing ratio of X, Y and Z will be:

$$= 6/12 : 2/12 : 1/3$$

$$= (6 : 2 : 4)/12$$

$$= 6 : 2 : 4 \text{ or } 3 : 1 : 2$$

K Share of profit given to C = $1/5$

Share acquired by C from A = $1/2$ of $1/5 = 1/10$

Share acquired by C from B = $1/2$ of $1/5 = 1/10$

Therefore,

A's new share after surrendering $1/10$ in C's favour

$$= 3/4 - 1/10 = (15 - 2)/20$$

$$= 13/20$$

B's new share after surrendering $1/10$ in C's favour

$$= 1/4 - 1/10 = (5 - 2)/20$$

$$= 3/20$$

C's share = $1/10 + 1/10 = 2/10$

Therefore, new share

$$= 13/20 : 3/20 : 2 : 10$$

$$= (13 : 3 : 4)/20$$

$$= 13 : 3 : 4$$

K Share of profit given to 'C' = $\frac{1}{3}$ share

$$\text{Share acquired by C from A} = \frac{1}{3} * \frac{2}{3} = \frac{2}{9}$$

$$\text{Share acquired by C from B} = \frac{1}{3} * \frac{1}{3} = \frac{1}{9}$$

$$\text{A's new share after surrendering} = \frac{2}{9} = \frac{2}{3} - \frac{2}{9} = \frac{(6 - 2)}{9} = \frac{4}{9}$$

$$\text{B's new share after surrendering} = \frac{1}{9} = \frac{1}{3} - \frac{1}{9} = \frac{(3 - 1)}{9} = \frac{2}{9}$$

$$\text{C's share} = \frac{1}{3}$$

Therefore, new profit sharing ratio

$$= \frac{4}{9} : \frac{2}{9} : \frac{1}{3}$$

$$= (4 : 2 : 3)/9 \text{ or } 4 : 2 : 3$$

X : Y – 3 : 1, Z admitted

$$X = \frac{1}{3} * \frac{3}{4} = \frac{1}{4} \text{ (X surrender } \frac{1}{3} \text{ of his share)}$$

$$Y = \frac{1}{4} * \frac{1}{4} = \frac{1}{16} \text{ (Y surrender } \frac{1}{4} \text{ of his share)}$$

$$\text{Therefore, Z's share} = \frac{1}{4} + \frac{1}{16} = \frac{(4 + 1)}{16} = \frac{5}{16}$$

New profit sharing ratio:

$$X = \frac{3}{4} - \frac{1}{4} = \frac{2}{4}$$

$$Y = \frac{1}{4} - \frac{1}{16} = \frac{(4 - 1)}{16} = \frac{3}{16}$$

$$Z = \frac{5}{16}$$

Therefore, $\frac{2}{4} : \frac{3}{16} : \frac{5}{16}$

$$= (8 : 3 : 5)/16$$

$$= 8 : 3 : 5$$

K Old profit sharing ratio of P = $\frac{5}{8}$

New profit sharing ratio of P = $\frac{4}{9}$

P's sacrificing ratio = old ratio – new ratio

$$= \frac{5}{8} - \frac{4}{9} = \frac{(45 - 32)}{72} = \frac{13}{72}$$

Old profit sharing ratio of Q = $\frac{3}{8}$

New profit sharing ratio of Q = $\frac{3}{9}$

Q's sacrificing ratio = old ratio – new ratio

$$= \frac{3}{8} - \frac{3}{9} = \frac{(27 - 24)}{72} = \frac{3}{72}$$

Sacrificing ratio = $\frac{13}{72} : \frac{3}{72}$ or 13 : 3

K Profit distributed equally.

(i) For writing off the Goodwill A/c already appearing in the books:

Old Partner's Capital A/c	Dr. (in old ratio)
To Goodwill A/c	

Premium for Goodwill A/c	Dr.	10,000	
To A's Capital A/c			5,000
To B's Capital A/c			5,000
(Being the amount of goodwill transferred to old partners in sacrificing ratio)			

Working Note: Calculation of sacrificing ratio:

Sacrificing ratio = Old ratio – New ratio

Thus, A's sacrifice ratio = $4/7 - 3/7 = 1/7$

B's sacrifice ratio = $3/7 - 2/7 = 1/7$

As, C has not made any sacrifice, therefore he will not be entitled to any amount of goodwill brought in by new partner.

A and B have sacrificed in equal proportion, therefore they will get equal share in the goodwill brought in by D.

Illustrations 2: The Balance sheet of Krishna and Suresh is given below. They share profits and losses in the ratio of 3 : 2.

Balance Sheet

Liabilities	₹	Assets	₹
Capital:		Plant	30,000
Krishna	30,000	Patent	5,000
Suresh	20,000	Furniture	3,000
General Reserve	5,000	Stock	16,000
Creditors	15,000	Debtors	15,000
Joint Life Policy	7,000	Joint Life Policy Investment	7,000
		Cash	1,000
77,000		77,000	

They take Mohan into partnership on following terms:

- (i) Mohan shall bring ₹ 14,000 in cash for goodwill share and capital for future $1/5^{\text{th}}$ share in profits.
- (ii) Depreciation on plant and machinery amounted to ₹ 5,000.
- (iii) Patents were appreciated by ₹ 8,000.
- (iv) Valuation of goodwill of the firm was to be made at twice the average profit of last 4 years and profits were ₹ 10,000, ₹ 9,000, ₹ 8,000 and ₹ 13,000.

Prepare Revaluation Account, Partner's Capital Account and Opening Balance Sheet for the firm.

Solution:

Dr.		Revaluation Account		Cr.	
Particulars	Amt	Particulars	Amt		
To Plant	5,000	By Patents	8,000		
To Profit Transferred to Capital Account:					
Krishna	1,800				
Suresh	<u>1,200</u>				
	8,000				8,000

Dr.			Capital Account			Cr.	
Particulars	Krishna	Suresh	Mohan	Particulars	Krishna	Suresh	Mohan
To Bal c/d	41,400	27,600	10,000	By Bal b/d	30,000	20,000	10,000
				By Reserves	3,000	2,000	
				By Revaluation A/c	1,800	1,200	
				By Joint Life Policy	4,200	2,800	
				By Cash A/c (Goodwill)	2,400	1,600	
	41,400	27,600	10,000		41,400	27,600	10,000

Opening Balance Sheet

Liabilities	Amount	Assets	Amount
Creditors	15,000	Plant & Machinery	25,000
Capital:		Patents	13,000
Krishna	41,400	Furniture	3,000
Suresh	27,600	Stock	16,000
Mohan	<u>10,000</u>	Debtors	15,000
	79,000	Joint Life Policy	7,000
		Cash	15,000
	94,000		94,000

Working Notes:

1. Valuation of Goodwill:

Average profit = $(10,000 + 9,000 + 8,000 + 13,000)/4 = ₹ 10,000$

Goodwill at 2 years purchase = $10,000 * 2 = ₹ 20,000$

Mohan's share of goodwill = $20,000 * 1/5 = ₹ 4,000$

Mohan's capital = $14,000 - 4,000$
= $10,000$

2. Entry for joint life policy:

Joint Life Policy A/c	Dr.	7,000	
To Krishna's Capital A/c			4,200
To Suresh's Capital A/c			2,800

Illustration 3: A and B are partners sharing in the ratio of 2/3 and 1/3. Balance Sheet of their firm is as below:

Balance Sheet

Liabilities			Assets	
Capital:			Debtors	40,000
A	40,000		Less: R.D.D.	<u>3,600</u>
B	<u>30,000</u>	70,000	Stock	20,000
Reserve Fund		12,000	Building	25,000
Creditors		20,000	Machinery	31,000
Bank Overdraft		15,000	Typewriter	2,600
			Patent	2,000
		1,17,000		1,17,000

Mr. C was admitted as partner on the following terms:

- He will get 1/6th share in future profit for which he brings goodwill in cash ₹ 10,000.
- R.D.D. is reduced to ₹ 1,600 whereas machinery was appreciated by ₹ 2,600.
- Patents were fully written off.
- Discount on creditors were provided at ₹ 400.

Prepare Revaluation A/c, Partner's Capital A/c and Opening Balance Sheet for the firm.

Solution:

Dr.		Revaluation Account		Cr.	
Particulars	Amt (₹)	Particulars	Amt (₹)		
To Patents	2,000	By Provision for Doubtful Debts	2,000		
To Profit Transferred to:		By Machinery	2,600		
A	2,000	By Provision for Discount on Creditors	400		
B	1,000				
	5,000				5,000

Dr.		Capital Account				Cr.	
Particulars	A (₹)	B (₹)	C (₹)	Particulars	A (₹)	B (₹)	C (₹)
				By Balance b/d	40,000	30,000	
				By Reserve Fund	8,000	4,000	
				By Revaluation A/c	2,000	1,000	
				By Premium for Goodwill A/c	10,000		
To Balance c/d	60,000	35,000	19,000	By Bank			19,000
	60,000	35,000	19,000		60,000	35,000	19,000

Opening Balance Sheet

Liabilities	Amt (₹)	Assets	Amt (₹)
Sundry Creditors	20,000	Bank	14,000
Less: Provision:	<u>400</u>	Sundry Debtors	40,000
Capitals:		Less: Provision:	<u>1,600</u>
A	60,000	Stock	20,000
B	35,000	Building	25,000
C	19,000	Machinery	33,600
		Typewriter	2,600
	1,33,600		1,33,600

Working Notes:

- Sacrifice Ratio = Old Ratio – New Ratio
 Sacrifice by A = old $\frac{2}{3}$ – new $\frac{3}{6}$ = $\frac{1}{6}$
 Sacrifice by B = old $\frac{1}{3}$ – new $\frac{2}{6}$ = 0

Since B has not made any sacrifice, the ratio amount of premium for goodwill brought in by C will be credited to A.

2. C's capital is not given in the question. He will bring in capital proportionate to his share of profits. C is given $\frac{1}{6}$ th share of profits, balance $\frac{5}{6}$ th is shared by A and B. Total capital of A and B after all adjustments is ₹ 60,000 + 35,000 = 95,000.

Thus, for $\frac{5}{6}$ th share of profits, the capital = 95,000.

Then total capital of the firm = 95,000 * $\frac{6}{5}$ = ₹ 1,14,000.

Therefore, C's capital for $\frac{1}{6}$ th share profits = 1,14,000 * $\frac{1}{6}$ = ₹ 19,000.

3. Calculation of balance at bank:

Amount of cash brought in by C as goodwill = 10,000

Amount of cash brought in by C as capital = 19,000

29,000

(-) Bank overdraft 15,000

Balance at bank 14,000

Illustration 4: A, B, C and D are the partners sharing profits and losses in 6 : 5 : 3 ratio. Balance Sheet is given as below:

Liabilities	Amt (₹)	Assets	Amt (₹)
Creditors	18,900	Debtors	26,460
Bills Payable	6,300	Land & Building	45,150
General Reserve	10,500	Furniture	7,350
Capital:		Stock	29,400
A	35,400	Cash	7,140
B	29,850		
C	14,550		
	1,15,500		1,15,500

D was admitted as partner on the following terms:

- (i) He shall get $\frac{1}{8}$ th share in business future profit for which he should bring goodwill ₹ 14,070 and capital ₹ 14,700 in cash.
- (ii) Debtors are raised by ₹ 2,000 whereas provision for repairs were made at ₹ 1,320.
- (iii) Furniture were depreciated by ₹ 920.
- (iv) Partners decided to write off goodwill from book amounting to ₹ 5,250 as well as to withdraw cash amounting to ₹ 7,060.

Prepare Revaluation Account, Partner's Capital Account and Opening Balance Sheet for the firm. Also pass necessary journal entries.

Solution:**Journal**

	Particulars	Amt. Dr. `	Amt. Cr. `
(i)	General Reserve A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Being general reserve transferred to Old Partner's Capital A/cs)	10,500	4,500 3,750 2,250
(ii)	Revaluation A/c Dr. To Furniture A/c To Provision for Repairs A/c (Being reduction in the value of assets and a provision made for o/s repair bills)	2,240	920 1,320
(iii)	Debtors A/c Dr. To Revaluation A/c (Being amount receivable from an old customer)	2,000	2,000
(iv)	Land & Building A/c Dr. To Revaluation A/c (Being increase in the value of land and building)	9,760	9,760
(v)	Revaluation A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Being transfer of profit on revaluation to Old Partner's Capital A/cs)	9,520	4,080 3,400 2,040
(vi)	A's Capital A/c Dr. B's Capital A/c Dr. C's Capital A/c Dr. To Goodwill A/c (Being goodwill appearing in the books written off)	2,250 1,875 1,125	5,250
(vii)	Cash A/c Dr. To D's Capital A/c To Premium for Goodwill A/c (Being the amount brought in cash by D being ` 14,700 for capital and ` 14,070 for goodwill)	28,770	14,070 14,700

(viii)	Premium for Goodwill A/c	Dr.	14,070	
	To A's Capital A/c			6,030
	To B's Capital A/c			5,025
	To C's Capital A/c			3,015
	(Being goodwill brought in by 'D' credited to old partners capital A/c)			
(ix)	A's Capital A/c	Dr.	3,660	
	B's Capital A/c	Dr.	3,400	
	To Cash A/c			7,060
	(Being cash withdrawn by A and B)			
(x)	Cash A/c	Dr.	1,320	
	To C's Capital A/c			1,320
	(Being cash brought in by C)			

Dr. Revaluation Account Cr.

Particulars	Amt (₹)	Particulars	Amt (₹)
To Furniture A/c	920	By Debtor's A/c	2,000
To Provision for Repairs	1,320	By Land and Building A/c	9,760
To Profit Transferred to Capital A/c:			
A	4,080		
B	3,400		
C	<u>2,040</u>		
	11,760		11,760

Dr. Capital Account Cr.

Particulars	A (₹)	B (₹)	C (₹)	D (₹)	Particulars	A (₹)	B (₹)	C (₹)	D (₹)
To Goodwill	2,250	1,875	1,125	14,700	By Balance b/d	35,400	29,850	14,550	14,700
To Balance c/d	47,760	40,150	20,730		By General Reserve A/c	4,500	3,750	2,250	
					By Revaluation A/c	4,080	3,400	2,040	
					By Cash A/c	6,030	5,025	3,015	
					By Premium for Goodwill A/c				
	50,010	42,025	21,855	14,700		50,010	42,025	21,855	14,700

To Cash A/c	3,660	3,400	22,050	14,700	By Balance c/d	47,760	40,150	20,730	14,700
To Balance c/d	44,100	36,750			By Cash A/c (Balancing Fig.)			1,320	
	47,760	40,150	22,050	14,700		47,760	40,150	22,050	14,700

Balance Sheet as on....

Liabilities	Amt (`)	Assets	Amt (`)
Creditors	18,900	Cash	24,920
Bills Payable	6,300	Debtors	28,460
Provision for Repairs	1,320	Stock	29,400
Capital:		Furniture	6,430
A	44,100	Land and Building	54,910
B	36,750		
C	22,050		
D	<u>14,700</u>		
	1,17,600		
	<u>1,44,120</u>		<u>1,44,120</u>

New profit sharing ratio will be calculated as under:

Share given to D = $1/8$

Balance of profits = $1 - 1/8 = 7/8$

A's new share = $7/8 * 6/14 = 3/8$

B's new share = $7/8 * 5/14 = 5/16$

C's new share = $7/8 * 3/14 = 3/16$

D's share = $1/8$

A : B : C : D = $3/8 : 5/16 : 3/16 : 1/8 = 6/16 : 5/16 : 3/16 : 2/16$

D brought in ` 14,700 as capital according to his $1/8^{\text{th}}$ share of profit. Therefore, according to D's capital, the total capital of the new firm will be:

= $14,700 * 8/1 = ` 1,17,600$

Therefore, A's Capital in new firm = $1,17,600 * 6/16 = ` 44,100$

B's Capital in new firm = $1,17,600 * 5/16 = ` 36,750$

C's Capital in new firm = $1,17,600 * 3/16 = ` 22,050$

D's Capital in new firm = $1,17,600 * 2/16 = ` 14,700$

Illustration 5 (Dr. Balance in P & L A/c: R.D.D. adjusted in General Reserve):
The Balance Sheet of Sohan and Madan as on 31st Dec. 2006 is set out below. They share Profits and Losses in the ratio of 2 : 1.

Balance Sheet

Liabilities	Amt (₹)	Assets	Amt (₹)
Sohan's Capital	40,000	Building	20,000
Madan's Capital	30,000	Furniture	6,000
General Reserve	24,000	Stock	12,000
Creditors	16,000	Debtors	60,000
		Cash	6,000
		Profit & Loss A/c	6,000
	1,10,000		1,10,000

They agreed to admit Priya as a partner into the firm on the following terms:

- (i) Priya to bring ₹ 12,000 as capital and ₹ 9,000 as a goodwill which is to be retained in the business. He will be entitled to 1/4th share of profits of the firm.
- (ii) 50% of General Reserves are to remain as Reserve for Doubtful Debts.
- (iii) Furniture is to be depreciated by 5%.
- (iv) Stock is to be revalued at ₹ 13,000.
- (v) Creditors of ₹ 1,000 are not likely to claim and hence should be written off.
- (vi) Rent of ₹ 400 due not received has not been recorded in the books.

Prepare Profit and Loss Adjustment Account, Partner's Capital Account and Balance Sheet of the firm after admission of Priya.

Solution:

Dr.		Profit and Loss Adjustment Account		Cr.	
Particulars	₹	Particulars	₹		
Decrease in Assets		Increase in Assets			
To Furniture (6,000 × 5%)	300	By Stock (13,000 – 12,000)	1,000		
To Profit on Revaluation		Decrease in Liabilities			
Sohan (2/3)	1,400	By Creditors	1,000		
Madan (1/3)	<u>700</u>	By O/s Rent	400		
	2,100				
	2,400				2,400

Dr. Capital Accounts Cr.

Particulars	Sohan	Mohan	Priya	Particulars	Sohan	Mohan	Priya
To Profit & Loss A/c (Loss)	4,000	2,000	–	By Balance b/d	40,000	30,000	–
To Balance c/d	51,400	35,700	12,000	By General Reserves trd. (1/2)	8,000	4,000	–
				By Profit & Loss Adjustment (Profit)	1,400	700	
				By Goodwill Raised	6,000	3,000	
				By Cash/Bank A/c	–	–	12,000
	55,400	37,700	12,000		55,400	37,700	12,000

Balance Sheet as on 31-12-2006

Liabilities		Amt (₹)	Assets		Amt (₹)
Capital:			Fixed Assets:		
Sohan	51,400		Land & Building		20,000
Mohan	35,700		Furniture	6,000	
Priya	12,000	99,100	Less: Depreciation	300	5,700
Other Liabilities:			Current Assets:		
Creditors	16,000		Stock	12,000	
Less: Adjustment	1,000	15,000	Add: Adjustment	1,000	13,000
			Debtors	60,000	
			Less: R.D.D. (From Gen Res.)	12,000	48,000
			O/s Rent		400
			Cash/Bank		27,000
		11,4100			11,4100

Working Notes:

- (i) Sacrifice ratio for goodwill adjustment

Goodwill adjusted in the sacrifice ratio of 2 : 1 (i.e., the Old PSR between the old partners).

Dr.		Goodwill Account		Cr.
Particulars	₹	Particulars	₹	
To Capital Accounts (raised)		By Cash (amount brought in)	9,000	
S (2/3)	6,000			
M (1/3)	3,000			
	9,000			9,000

Dr.		Cash/Bank Account		Cr.
Particulars	₹	Particulars	₹	
To Balance b/d	6,000	By Balance c/d	27,000	
To Goodwill (brought in)	9,000			
To Capital (brought in)	12,000			
	27,000			27,000

Illustration 6: (Goodwill – Average Profit Method: Revaluation Loss): Ranade and Kanade were partners and shared the profits in the ratio of 3/5th and 2/5th. On 31st December, 2004, their Balance Sheet was as follows:

Balance Sheet as on 31st December, 2004

Liabilities	₹	Assets	₹
Sundry Creditors	15,000	Bank	250
Reserve Fund	5,000	Sundry Debtors	22,500
Capital Accounts:		Less: R.D.D.	250
Ranade	36,000	Stock	8,500
Kanade	24,000	Investments	12,000
		Plant	15,000
		Building	22,000
	80,000		80,000

On 1st January, 2005, Mr. Hegade was admitted to partnership on the following terms.

- (i) He should bring ₹ 18,650 as his capital for his 1/5th share.
- (ii) Valuation of the goodwill of the firm was to be made at twice the average profit of the last three years. The profits were as follows: 2004 – ₹ 16,000, 2003 – ₹ 27,000 and 2002 – ₹ 24,500. Hegade is to bring the goodwill in cash equal to his share.

- (iii) Before admitting Hegade, R.D.D. was to be raised upto ₹ 500 only.
 (iv) Closing stock was to be valued at ₹ 7,500.
 (v) Appreciate Building by 5%.

Prepare Profit and Loss Adjustment Account, Capital Accounts of the Partners and Balance Sheet of the new firm.

Solution:

Dr.		Profit and Loss Adjustment Account		Cr.	
Particulars	₹	Particulars	₹		
Decrease in Assets		Increase in Assets			
To Debtors (Increase in RDD)	250	By Building (22,000 × 5%)		1,100	
To Stock (8,500 – 7,500)	1,000	By Loss on Revaluation			
		R (3/5)	90		
		K (2/5)	<u>60</u>	150	
	1,250				1,250

Dr.		Capital Account				Cr.	
Particulars	R	K	H	Particulars	R	K	H
To P & L Adj. A/c (loss)	90	60	–	By Balance b/d	36,000	24,000	–
To Balance c/d	44,310	29,540	18,650	By Reserve Fund	3,000	2,000	–
				By Goodwill Raised	5,400	3,600	–
				By Cash/Bank (brought in)			18,650
	44,400	29,600	18,650		44,400	29,600	18,650

Balance Sheet as at 1-1-2005

Liabilities		Amt (₹)	Assets		Amt (₹)
Capital:			Fixed Assets:		
R	44,310		Buildings	22,000	
K	29,540		<i>Add:</i> Adjustment	1,100	23,100
H	18,650	92,500	Plant		15,000
Other Liabilities:			Investments		12,000
Creditors		15,000	Current Assets:		
			Stock	8,500	
			<i>Add:</i> Adjustment	1,000	7,500

		Debtors	22,500	
		Less: R.D.D.	500	22,000
		Cash/Bank		27,900
	1,07,500			1,07,500

Working Notes:

(i) Sacrifice ratio for goodwill adjustment

Goodwill adjusted in the sacrifice ratio 3 : 2 (which is the same as their old PSR between the old Partners)

Dr.		Goodwill Account		Cr.	
Particulars		Particulars			
To Capital Accounts (raised)		By Cash (amount brought in)			9,000
Ranade (3/5)	5,400				
Kanade (2/5)	3,600				
	9,000				9,000

Dr.		Cash/Bank Account		Cr.	
Particulars		Particulars			
To Balance b/d	250	By Balance c/d			27,900
To Goodwill (brought in)	9,000				
To Capital (brought in)	18,650				
	27,900				27,900

Illustration 7 (Decrease in Liability): Aditi and Anita are partners in a firm sharing profit and losses equally. Their Balance Sheet as on 31st December, 2002 was as follows:

Balance Sheet as on 31st December, 2002

Liabilities		Assets	
Capitals:		Cash	800
Aditi	12,000	Stock	8,000
Anita	10,000	Sundry Debtors	7,200
General Reserve	1,000	Loose Tools	3,000
Sundry Creditors	15,000	Furniture	2,000
Bills Payable	2,000	Motor Van	7,000
		Plant & Machinery	12,000
	40,000		40,000

They agreed to admit Ashwini as a new partner on 1st January, 2003 on the following terms:

- (i) She shall have 1/4 share in future profits.
- (ii) She shall bring ₹ 8,000 as her capital.
- (iii) She shall bring ₹ 4,000 as her goodwill.
- (iv) Motor van is to be depreciated by 10% and stock is revalued at ₹ 7,000.
- (v) Plant and Machinery is to be appreciated by 20%.
- (vi) An amount of ₹ 1,200 included in creditors is no longer a liability and hence, required to be property adjusted.

Prepare (1) Profit and Loss adjustment Account, (2) Partner's Capital Accounts and (3) Balance Sheet of new firm.

Solution:

Dr.		Profit and Loss Adjustment Account		Cr.	
Particulars		Particulars			
Decrease in Assets:		Increase in Assets:			
To Motor Van (7,000 × 10%)	700	By Plant & Machinery (12,000 × 20%)		2,400	
To Stock (8,000 – 7,000)	1,000	Decrease in Liability:			
To Profit on Revaluation		By Creditors		1,200	
Aditi (1/2) 950					
Anita (1/2) <u>950</u>	1,900				
	3,600				3,600

Dr.			Capital Account			Cr.	
Particulars	Aditi	Anita	Ashwini	Particulars	Aditi	Anita	Ashwini
To Balance c/d	15,450	13,450	8,000	By Balance b/d	12,000	10,000	
				By Gen. Reserve	500	500	
				By P&L Adj. (Profit)	950	950	
				By Goodwill Raised			
				By Cash (brought in)	2,000	2,000	8,000
	15,450	13,450	8,000		15,450	13,450	8,000

Balance Sheet as at 1-1-2003

Liabilities		Amt (₹)	Assets		Amt (₹)
Capital:			Fixed Assets:		
Aditi	15,450		Plant & Machinery	12,000	
Anita	13,450		Add: Adjustment	2,400	14,400
Ashwini	8,000	36,900	Motor Van	7,000	
Other Liabilities			Less: Adjustment	700	6,300
Sundry Creditors	15,000		Furniture		2,000
Less: Adjustment	1,200	13,800	Current Assets:		
Bills Payable		2,000	Stock	8,000	
			Less: Adjustment	1,000	7,000
			Debtors		7,200
			Loose Tools		3,000
			Cash		12,800
		52,700			52,700

Working Notes:

- (i) Sacrifice ratio for goodwill adjustment

Goodwill adjusted in the sacrifice ratio 1 : 1 (which is the same as their old PSR between old partners).

Dr.	Goodwill Account		Cr.
Particulars	₹	Particulars	₹
To Capital Accounts (raised):		By Cash (amount brought in)	4,000
Aditi (1/2)	2,000		
Anita (1/2)	2,000		
	4,000		4,000

Dr.	Capital Account		Cr.
Particulars	₹	Particulars	₹
To Balance b/d	800	By Balance c/d	12,800
To Goodwill (brought in)	4,000		
To Capital (brought in)	8,000		
	12,800		12,800

Illustration 8 (50% Goodwill Withdrawn by Partners): Sagar and Pankaj are partners in a firm, sharing profits and losses in the ratio of 3 : 2 respectively. Their Balance Sheet as on 31st December, 2005 was as under:

Balance Sheet as on 31st December, 2005

Liabilities	₹	Assets	₹
Sundry Creditors	7,000	Cash at Bank	8,000
Sagar's Capital	32,000	Sundry Debtors	14,000
Pankaj's Capital	22,000	Land and Building	25,000
General Reserve	12,000	Stock	10,000
		Plant and Machinery	12,000
		Furniture and Fixtures	4,000
	73,000		73,000

On 1st January, 2006, they admit Atul in the partnership. The terms being that:

- (i) He shall pay ₹ 10,000 as his share of goodwill. 50% amount of Goodwill shall be withdrawn by the old partners.
- (ii) He shall bring ₹ 12,000 as his capital for 1/4 share in future profit.
- (iii) For the purpose of Atul's admission, it was agreed that assets be revalued as follows:
 - (a) Land and Building is to be valued at ₹ 30,000.
 - (b) Plant and Machinery to be valued at ₹ 10,000.
 - (c) Stock valued at ₹ 12,000 and furniture and fixtures at ₹ 2,000.
 - (d) A provision at 5% to be made for Doubtful Debts on Debtors.

Prepare Profit and Loss Adjustment Account, Partner's Capital Accounts and Balance Sheet of the new firm.

Solution:

Dr.	Profit and Loss Adjustment Account	Cr.	
Particulars	₹	Particulars	₹
Decrease in Assets		Increase in Assets	
To Plant & Machinery (12,000 – 10,000)	2,000	By Land & Building (30,000 – 25,000)	5,000
To Furniture & Fixtures (4,000 – 2,000)	2,000	By Stock (12,000 – 10,000)	2,000

To Debtors (Increase in R.D.D.) (14,000 × 5%)		700		
To Profit on Revaluation				
Sagar (3/5)	1,380			
Pankaj (2/5)	<u>920</u>	2,300		
		7,000		7,000

Dr.

Capital Account

Cr.

Particulars	Sagar	Pankaj	Atul	Particulars	Sagar	Pankaj	Atul
To Goodwill (50% withdrawn)	3,000	2,000	-	By Balance b/d	32,000	22,000	
To Balance c/d	43,580	29,720	12,000	By Gen. Reserve	7,200	4,800	
				By P & L Adj. (Profit)	1,380	920	
				By Goodwill Raised			
				By Cash/Bank (brought in)	6,000	4,000	12,000
	46,580	31,720	12,000		46,580	31,720	12,000

Balance Sheet as on 1-1-2006

Liabilities		Amt (₹)	Assets		Amt (₹)
Capital:			Fixed Assets:		
Sagar	43,580		Land & Buildings	25,000	
Pankaj	29,720		<i>Add:</i> Adjustment	5,000	30,000
Atul	12,000	85,300	Plant & Machinery	12,000	
Others Liabilities:			<i>Less:</i> Depreciation	2,000	10,000
Sundry Creditors		7,000	Furniture	4,000	
			<i>Less:</i> Depreciation	2,000	2,000
			Current Assets:		
			Stock	10,000	
			<i>Add:</i> Adjustment	2,000	12,000
			Debtors	14,000	
			<i>Less:</i> R.D.D.	700	13,300
			Cash/Bank		25,000
		92,300			92,300

Working Notes:

(i) Sacrifice ratio for goodwill adjustment

Goodwill adjusted in the sacrifice ratio 3 : 2 (which is the same as their Old PSR between the old partners).

Dr.		Goodwill Account		Cr.	
Particulars	₹	Particulars	₹		
To Capital Accounts (raised)		By Cash (amount brought in)	10,000		
Sagar (3/5)	6,000				
Pankaj (2/5)	4,000				
	10,000				10,000

Dr.		Cah/Bank Account		Cr.	
Particulars	₹	Particulars	₹		
To Balance b/d	8,000	By Capital (Goodwill)			
To Goodwill (brought in)	10,000	Sagar	3,000		
To Capital (brought in)	12,000	Pankaj	2,000		
		By Balance c/d	25,000		
	30,000				30,000

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