



Revision Notes for CBSE Class 12 Accountancy Chapter 2 Reconstitution of a Partnership Firm: Admission of a Partner

What are the modes of reconstitution of a partnership firm?

Under following circumstances, a partnership firm is reconstituted.

- Admission of a new partner
- Change in the profit sharing ratio among the existing partners
- Retirement of an existing partner
- Death of a partner

Here, admission of a partner will be discussed in detail

Rights acquired by newly admitted partner

Rights acquired by newly admitted partner are:

- (a) Right to share the assets of the partnership firm
- (b) Right to share the profits of the partnership firm.

Things to be considered at the time of admission of a partner

Following things are to be considered at the time of admission of a partner:

1. New profit sharing ratio;
2. Sacrificing ratio;
3. Valuation and adjustment of goodwill;
4. Revaluation of assets and Reassessment of liabilities;
5. Distribution of accumulated profits (reserves); and
6. Adjustment of partners' capitals.

New Profit Sharing Ratio

On the admission of a new partner, the old partners sacrifice a share of their profit in favour of the new partner. But, what will be the share of new partner and how he will acquire it from the existing partners is decided mutually among the old partners and the new partner. However, if nothing is specified as to how does the new partner acquire his share from the old partners; it may be assumed that he gets it from them in their profit sharing ratio. The profit sharing ratio among the old partners will change keeping in view their respective contribution to the profit sharing ratio of the incoming partner. Hence, new profit sharing ratio has to be adopted.

What is 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.

Mathematically,

$$\text{Sacrificing Ratio} = \text{Old share of profit} - \text{New share of profit}$$

What is 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 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.

Factors affecting the value of Goodwill

The factors affecting the value of goodwill are:

- **Nature of business-** If a business creates a positive impact and adds some changes to the society, their goodwill increases naturally.
- **Location:** If the business is centrally located or is at a place having heavy customer traffic, the goodwill tends to be high.
- **Efficiency of Management-** Effective management results into high productivity and cost efficiency, which ultimately brings profit and hence good will for the company.
- **Market Situation-** If you have a monopoly in the market or less competition, the tendency of more profit and hence more goodwill increases.
- **Special Advantages-** Business having advantages like import licences, low rate and assured supply of electricity, long-term contracts for supply of materials, well-known collaborators, patents, trademarks, etc. enjoy higher value of goodwill.

Need for valuation of Goodwill

The need for valuation of goodwill exists under following circumstances:

1. Change in the profit sharing ratio amongst the existing partners;
2. Admission of new partner;
3. Retirement of a partner;
4. Death of a partner; and
5. Dissolution of a firm involving sale of business as a going concern.
6. Amalgamation of partnership firms.

Methods of valuation of Goodwill

Methods of valuation of goodwill are as follows:

A) 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.

B) Super Profits Method- Under this method, the value of goodwill is calculated on the basis of excess profits instead of actual profits, since 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.

Mathematically,

$$\text{Normal Profits} = \frac{\text{Firm's Capital} \times \text{Normal Rate of Return}}{100}$$

C) Capitalisation Method- Under this method, the goodwill is calculated on the basis of two ways:

- (a) **Capitalisation of Average Profits-** Under this method, the value of goodwill is ascertained by deducting the actual firm's capital in the business from the capitalized 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) Capitalize the average profits on the basis of the normal rate of return to ascertain the capitalised value of average profits as follows:

$$\text{Average Profits} \times \frac{100}{\text{Normal Rate of Return}}$$

- (iii) Ascertain the actual firm's capital (net assets) by deducting outside liabilities from the total assets (excluding goodwill and fictitious assets).

Firms' Capital = Total Assets (excluding goodwill) – Outside Liabilities

Where outside Liabilities include both long term and short term Liabilities.

- (iv) Compute the value of goodwill by deducting net assets from the capitalised value of average profits, i.e. (ii) – (iii).

(b) Capitalisation by Super Profits- Goodwill can also be ascertained by capitalising the super profit directly. Under this method there is no need to work out the capitalised value of average profits. It involves the following steps.

- (i) Calculate capital of the firm, which is equal to total assets (excluding goodwill and fictitious assets) *minus outside liabilities*.
- (ii) Calculate normal profits on capital employed.
- (iii) Calculate average profit for past years, as specified.
- (ii) Calculate super profits by deducting normal profits from average profits.
- (iii) Multiply the super profits by the required rate of return multiplier, that is,

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

Journal Entries:

Treatment of Goodwill

(i) **When the new Partner brings goodwill in cash-** When the amount is paid by the new partner directly to the old partner's, no entry is passed but if it is passed through firm, the following entry is made:

- | | | |
|------|---|-----|
| (i) | Bank A/c | Dr. |
| | To Premium for Goodwill A/c | |
| | (Amount brought by new partner as premium) | |
| (ii) | Goodwill A/c | Dr. |
| | To Sacrificing Partners Capital A/c | |
| | (Individually)(Goodwill distributed among the existing partners' in their sacrificing ratio). | |

(ii) If it is credited to the new partner's capital account and then adjusted in favour of the existing partners in their sacrificing ratio

(i) Bank A/c Dr.
 To New Partner's Capital A/c
 (Amount brought by new partner for his share of goodwill).

(ii) New Partner's Capital A/c Dr.
 To Sacrificing Partner's Capital A/c's
 (Individually)
 (Goodwill brought by new partners distributed among the existing partners in their sacrificing ratio)

(iii) If the partners decide that the amount of premium for goodwill credited to their capital accounts should be retained in business, an additional entry is not passed. If, however, they decide to withdraw their amounts, (in full or in part) the following additional entry will be passed:

Existing Partner's Capital A/c (Individually) Dr.
 To Bank A/c
 (The amount of goodwill withdrawn by the existing partners)

(iv) **When the new partner does not bring goodwill in cash, partly or fully-** Here entries are made under two circumstances:

(a) **Goodwill does not exist in the books-** In this case, sacrificing partners are credited with their share of goodwill and new partner is debited by the amount of goodwill not brought by him.

Incoming (New) Partners Current A/c Dr.
 To Sacrificing Partners Capital A/c (individually)
 (Account of goodwill not brought in by new partner)

(b) **Goodwill exists in the books-** Goodwill appearing in the books will be written-off by debiting old partners' capital accounts in their old profit sharing ratio. Thereafter new value of goodwill will be given effect by crediting sacrificing partners' capital accounts and debiting new partners' current account.

The journal entries will be as under :-

(i) When the value of goodwill appears in the books and is written off
 Partners capital A/c (old) Dr. (In profit sharing ratio)
 To Goodwill A/c
 (Goodwill appearing in the books written-off)

(ii) For new value of goodwill :-
 Incoming partners' current A/c. Dr.
 To Sacrificing partners capital A/c. [In sacrificing ratio]
 (individually)

Hidden Goodwill

Sometimes the value of goodwill is not given at the time of admission of a new partner. In such a situation it has to be inferred from the arrangement of the capital and profit sharing ratio.

Adjustment for Accumulated Profits and Losses

Whenever the firm has accumulated profits and losses such as general reserves or reserves, the new partner is not entitled to any of these. These are distributed among the partners by transferring it to their capital current accounts in old profit sharing ratio. Similarly, if there are some accumulated losses in the form of a debit balance of profit and loss account and/or deferred revenue expenditure appearing in the balance sheet of the firm.

Revaluation of Assets and Reassessment of Liabilities

Whenever the assets or the company are understated or overstated, revaluation takes place. The gain or loss on revaluation of each asset and liability is transferred to this account and finally its balance is transferred to the capital accounts of the old partners in their old profit sharing ratio.

(i) For increase in the value of an asset

Asset A/c	Dr.	
To Revaluation A/c		(Gain)

(ii) For reduction in the value of an asset

Revaluation A/c	Dr.	
To Asset A/c		(Loss)

(iii) For appreciation in the amount of a liability

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

(iv) For reduction in the amount of a liability

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

(v) For an unrecorded asset

Asset A/c	Dr.	
To Revaluation A/c		(Gain)

(vi) For an unrecorded liability

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

(vii) For transfer of gain on Revaluation if credit balance

Revaluation A/c	Dr.	
To Old Partners Capital A/cs (individually)		(Old ratio)
viii) For transferring loss on revaluation		
Old partner's Capital A/cs (Individually)	Dr.	
To Revaluation A/c		(Old ratio)

Adjustment of Capitals

Sometimes, at the time of admission, the partners agree that their capitals should also be adjusted so as to be proportionate to their profit sharing ratio. In such a situation, if the capital of the new partner is given, the same can be used as a base for calculating the new capitals of the old partners. The capitals thus ascertained should be compared with their old capitals after all adjustments relating to goodwill reserves and revaluation of assets and liabilities, etc. have been made; and then the partner whose capital falls short, will bring in the necessary amount to cover the shortage and the partner who has a surplus, will withdraw the excess amount of capital.

Change in Profit Sharing Ratio among the Existing Partners

Sometimes, the partners of a firm decide to change their existing profit sharing ratio without any admission or retirement of a partner. This results in a gain of additional share in future profits of the firm for some partners while a loss of a part thereof for other partners. This is done by crediting sacrificing partner's and debiting gaining partner's with appropriate amounts.

