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Admission of a Partner and Treatment of Goodwill

Admission of a partner occurs when a new partner joins an existing partnership firm with the consent of all existing partners. This process involves several accounting adjustments to reflect the new profit sharing arrangement and the financial position of the firm.

Rights acquired by the new partner:

- **Right to Share in Firm's Assets:** The new partner acquires a right to the firm's assets and liabilities proportional to the capital brought in.
- **Right to Share the Future Profits:** The new partner shares in the future profits of the firm, which requires modification of the existing profit sharing ratio among old partners.

Modification in Profit Sharing Ratio: When a new partner is admitted, the old partners sacrifice a part of their profit share. The profit sharing ratio is recalculated to accommodate the new partner's share.

New Profit Sharing Ratio: This is the ratio in which all partners, including the new partner, share the profits and losses of the firm after admission.

Cases for Calculating New Profit Sharing Ratio:

- **Case 1:** Only the new partner's share is given. The remaining profit is shared by old partners in their old ratio.
- **Case 2:** Old partners' and new partner's shares are given. New shares of old partners are calculated by deducting the new partner's share from their old shares.
- **Case 3:** Old partners have equal shares. New shares are calculated by deducting equal shares given to the new partner.
- **Case 4:** Surrendered shares by old partners are given. The new partner's share is the sum of surrendered shares, and old partners' shares are adjusted accordingly.

Sacrificing Ratio: The ratio in which old partners sacrifice their profit share in favor of the new partner. It is calculated by subtracting the new profit share from the old profit share of each old partner.

Example 1:

Ravi and Balveer share profits 7:3. Ravi sacrifices $\frac{2}{10}$ and Balveer $\frac{1}{10}$ in favor of Priya.

$$\text{Ravi's new share} = \frac{7}{10} - \frac{2}{10} = \frac{5}{10}$$

$$\text{Balveer's new share} = \frac{3}{10} - \frac{1}{10} = \frac{2}{10}$$

$$\text{Priya's share} = \frac{2}{10} + \frac{1}{10} = \frac{3}{10}$$

$$\text{New profit sharing ratio} = 5:2:3$$

Sacrificing ratio = 2:1

Key Terms:

- **Goodwill in Kind:** Goodwill brought in the form of assets instead of cash.
- **Hidden Goodwill:** Goodwill not directly disclosed but calculated based on partners' capitals.

Accounting Treatment of Goodwill

Goodwill represents the reputation and earning capacity of the firm. When a new partner is admitted, goodwill is revalued and accounted for as follows:

- If the new partner brings goodwill in cash through the firm, the firm debits cash and credits old partners' capital accounts in the sacrificing ratio.
- If goodwill is paid privately by the new partner, no entry is made in the firm's books.
- If the new partner cannot bring goodwill in cash, debit the new partner's current account and credit sacrificing partners' capital accounts.
- If goodwill is brought in part cash and part other means, appropriate debits and credits are made to cash, premium, and capital accounts.
- If goodwill is brought in kind, debit the asset account and credit premium account, then adjust premium against sacrificing partners' capital accounts.
- In case of hidden goodwill, debit new partner's capital account and credit sacrificing partners' capital accounts.

Revaluation of Assets, Liabilities and Treatment of Accumulated Profits and Losses

On admission of a new partner, assets and liabilities are revalued to reflect their current market values. The profit or loss on revaluation is transferred to old partners' capital or current accounts in their old profit sharing ratio.

Accumulated profits, losses, and reserves are also transferred to old partners' capital or current accounts in their old profit sharing ratio.

Example 2:

Ram and Mohan share profits 4:1. They admit Sohan for $\frac{1}{3}$ share. Profit & Loss Account shows a debit balance of ₹32,000 and reserves of ₹1,00,000.

Journal entries:

Particulars	Debit (₹)	Credit (₹)
Profit & Loss A/c	32,000	
Ram's Capital A/c		25,600
Mohan's Capital A/c		6,400
Reserve A/c		1,00,000
Ram's Capital A/c	80,000	
Mohan's Capital A/c	20,000	

Adjustment of Partners' Capital Accounts

Partners' capitals may be adjusted to be proportionate to their profit sharing ratio on admission of a new partner. This can be done in two ways:

1. Adjustment based on New Partner's Capital

Steps:

- Calculate total capital of the firm using new partner's capital and share.

- Calculate new capitals of all partners by dividing total capital by new profit sharing ratio.
- Prepare old partners' capital accounts after adjustments.
- Compare new capitals with old capitals to find surplus or deficiency.
- Adjust surplus or deficiency through cash/bank or current accounts.

Journal entries for deficiency or surplus:

- **Deficiency:** Debit Cash/Bank A/c and credit partner's capital account.
- **Surplus:** Debit partner's capital account and credit Cash/Bank A/c.

2. Adjustment based on Old Partners' Capitals

Steps:

- Prepare old partners' capital accounts after adjustments.
- Calculate total capital of the firm as combined adjusted capital of old partners divided by their combined profit share.
- New partner's capital equals his share of total capital.
- If goodwill is not brought in cash, debit new partner's capital account.

Example 3:

Geet and Preet share profits 7:3. Meet is admitted for $\frac{1}{4}$ share, bringing ₹4,30,000 capital and ₹25,000 goodwill premium. The balance sheet shows various assets and liabilities.

Adjustments agreed:

- Land and Building appreciated by 20%.
- Machinery depreciated by 10%.
- Workmen's Compensation Fund liability is ₹50,000.
- Capitals adjusted based on Meet's capital.

Revaluation Account and Partners' Capital Accounts are prepared to record these adjustments.

New profit sharing ratio:

$$\text{Geet} = \frac{3}{4} \times \frac{7}{10} = \frac{21}{40}$$

$$\text{Preet} = \frac{3}{4} \times \frac{3}{10} = \frac{9}{40}$$

$$\text{Meet} = \frac{10}{40}$$

New ratio = 21:9:10

Capital brought in for 1/4 share = ₹4,30,000

Total capital of firm = ₹4,30,000 × 4 = ₹17,20,000

Cash balance after adjustments = ₹5,45,000

Practice Set

Level 1 – Easy

- Define admission of a partner and explain the rights acquired by the new partner.
- Calculate the new profit sharing ratio if a new partner is admitted for 1/5 share and old partners share profits equally.

Level 2 – Moderate

- Ravi and Sohan share profits 3:2. Sohan is admitted for $\frac{1}{4}$ share. Calculate new profit sharing ratio and sacrificing ratio.
- Pass journal entries for goodwill when a new partner brings goodwill in cash through the firm.

Level 3 – Challenging

- Geet and Preet share profits 7:3. Meet is admitted for $\frac{1}{4}$ share, bringing ₹4,30,000 capital and ₹25,000 goodwill premium. Prepare Revaluation Account and Partners' Capital Accounts after adjustments.
- Explain the adjustment of partners' capitals based on new partner's capital with a numerical example.

Answer Key

Level 1:

Admission of a partner is when a new partner joins with consent of all existing partners. The new partner acquires rights to share in assets and future profits.

If new partner's share is $\frac{1}{5}$ and old partners share equally, old partners share = $\frac{4}{5}$ equally = $\frac{2}{5}$ each. New ratio = $\frac{2}{5} : \frac{2}{5} : \frac{1}{5} = 2:2:1$.

Level 2:

Old ratio = 3:2

New partner's share = $\frac{1}{4}$

Remaining share = $\frac{3}{4}$

Old partners' new shares = $\frac{3}{4} \times \frac{3}{5} = \frac{9}{20}$ and $\frac{3}{4} \times \frac{2}{5} = \frac{6}{20}$

New ratio = $\frac{9}{20} : \frac{6}{20} : \frac{5}{20} = 9:6:5$

Sacrificing ratio = Old share - New share = $(\frac{3}{5} - \frac{9}{20}) : (\frac{2}{5} - \frac{6}{20}) = (\frac{12}{20} - \frac{9}{20}) : (\frac{8}{20} - \frac{6}{20}) = 3:2$

Journal entry for goodwill brought in cash:

Cash A/c	Dr.	To Old Partners' Capital A/c (in sacrificing ratio)
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Level 3:

Refer to Example 3 for detailed ledger accounts and balance sheet preparation.

Adjustment of partners' capitals based on new partner's capital involves calculating total capital using new partner's capital and share, then adjusting old partners' capitals accordingly. Surplus or deficiency is adjusted through cash or current accounts.

Quick Reference

- **Admission of Partner:** Consent of all partners, new profit sharing ratio, adjustment of capitals.
- **Goodwill Treatment:** Cash brought in or adjusted through capital/current accounts.
- **Revaluation:** Assets and liabilities revalued, profit/loss shared by old partners.
- **Capital Adjustment:** Based on new partner's capital or old partners' capitals.

Glossary

- **Admission of Partner:** Entry of a new partner into the firm.
- **Goodwill:** Intangible asset representing firm's reputation.
- **Profit Sharing Ratio:** Ratio in which partners share profits and losses.
- **Sacrificing Ratio:** Ratio in which old partners give up profit share.
- **Revaluation Account:** Account to record changes in asset and liability values.
- **Capital Account:** Account showing partner's investment in the firm.

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