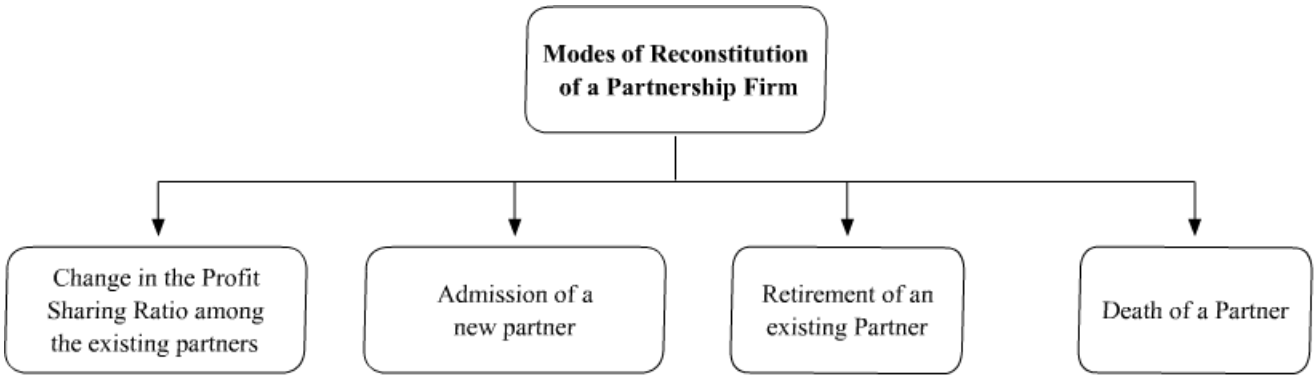
Reconstitution of a Partnership Firm- Admission of a Partner

❖ **Reconstitution of a Partnership Firm**

It implies a change in the existing agreement among the existing partners of a partnership firm.

❖ **Modes of Reconstitution of a Partnership Firm**



❖ **Admission of a New Partner**

According to the Partnership Act 1932, a new partner can be admitted with the consent of all the existing partners, unless otherwise stated in the partnership deed.

❖ **Adjustment at the time of Admission**

The following are the various items that need to be adjusted at the time of admission of a new partner.

- Profit Sharing Ratio
- Goodwill
- Revaluation of Assets and Liabilities
- Adjustment of Capital

❖ **Profit Sharing Ratio**

With the admission of a new partner, the old profit sharing ratio among the old partners changes. Therefore, the need arises to calculate the new profit sharing ratio of all the partners. The following are the different cases for calculation of new profit sharing ratio.

- When the new partner acquires his share from the existing partners in the old profit sharing ratio.
- When the new partner acquires his share from the existing partners in a specified ratio.
- When the existing partners surrender a fraction of their profit share to the new partner

❖ **Sacrificing Ratio**

It is defined as the ratio in which the existing partners sacrifice or surrenders their profit share in favour of the new partner.
It is calculated as:
Sacrificing Ratio = Old Profit Share – New Profit Share

❖ **Goodwill**

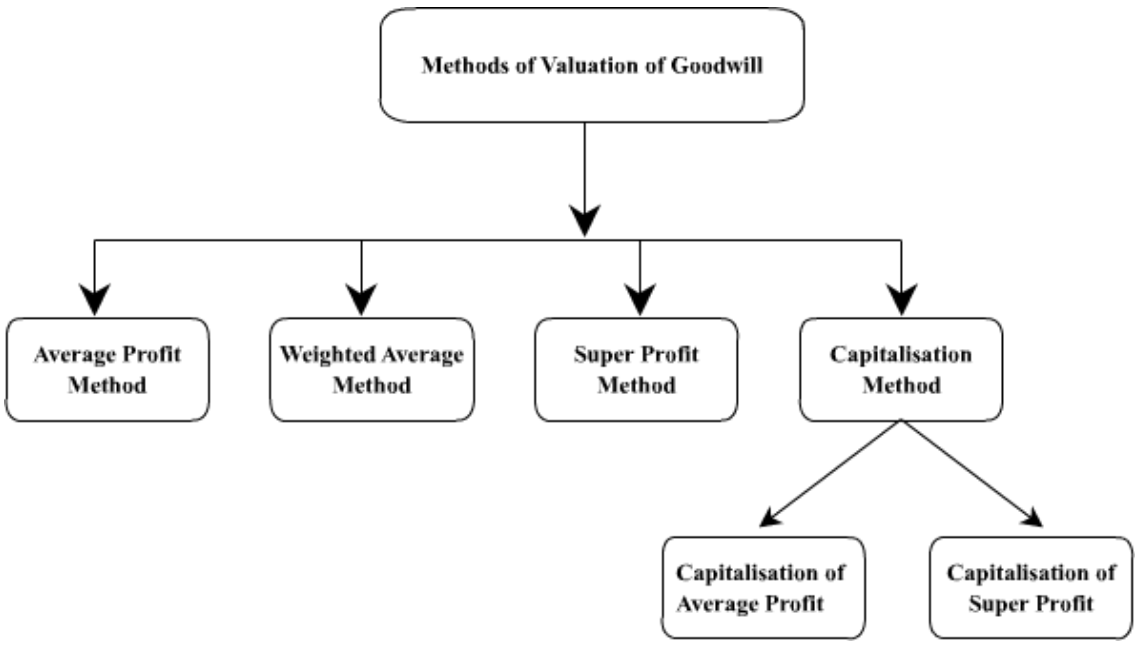
It is an intangible asset of a firm. It is the value of the firm's reputation and its good brand name in the market.

❖ **Factors Affecting Goodwill**

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

- ***Quality Products***: If a company produces product of the best quality and in large scale, then automatically the company earns more goodwill.
- ***Location***: If a business is located at an easily reachable and convenient place, then more number of consumers will be attracted again and again, which will lead to consistent increase in its sales and, therefore, the firm will earn higher goodwill.
- ***Management***: Efficient management leads to cost efficiency and increases productivity. If a firm's management is efficient, then superior quality products can be produced at lower cost. These can be sold at relatively lesser price. Superior quality at lower price enables a firm to earn higher goodwill.
- ***Market Structure***: If a firm is operating in a monopoly market with no close substitutes, then there will be more goodwill of the firm.
- ***Economies of Scale***: If a firm enjoys special advantages such as, continuous supply of power, fuel and raw materials at a low price and produces quality product at a large scale, then the firm enjoys higher value of goodwill.

❖ **Methods of Valuation of Goodwill**



❖ Formula for Valuation of Goodwill

Methods		Formula for Valuation of Goodwill
1	*Average Profit Method*	Goodwill = Average Profit × Number of Years Purchase $\text{Average Profit} = \frac{\text{Total Profit of Past Given Years} - \text{Loss (If any)}}{\text{No. of Years}}$
2	*Weighted Average Method*	Goodwill = Weighted Average Profit × Number of Years Purchase $\text{Weighted Average Profit} = \frac{\text{Total Products of Profit}}{\text{Total of Weights}}$
3	*Super Profit Method*	Goodwill = Super Normal Profit × Number of Years Purchase Super Normal Profit = Average Profit – Normal Profit $\text{Normal Profit} = \text{Average Capital Employed} \times \frac{\text{Normal Rate of Return}}{100}$ $\text{Average Capital Employed} = \frac{\text{Opening Capital Employed + Closing Capital Employed}}{2}$ Capital Employed = All Assets – Goodwill – Fictitious Assets – External Liabilities
4	*Capitalisation Method*	
(A)	*Capitalisation of Average Profit*	Goodwill = Capitalised Average Profit – Actual Capital Employed $\text{Capitalised value of Average Profit} = \text{Average Profit} \times \frac{100}{\text{Normal Rate of Return}}$
(B)	*Capitalisation of Super Profit*	$\text{Goodwill} = \text{Super Normal Profit} \times \frac{100}{\text{Normal Rate of Return}}$ Super Normal Profit = Average Profit – Normal Profit

❖ Treatment of Goodwill

Note: If in the question, goodwill already appears in the old Balance Sheet, then first of all this goodwill needs to be transferred (i.e. written-off) to the Old Partners' Capital A/c 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)

❖ Different Cases of Goodwill

Types of Cases	Journal Entries
When the new partner pays his share of goodwill privately to the old partners.	No Entry

When the new partner brings his share of goodwill in cash and the goodwill is retained in the business.	Cash/Bank A/c Dr. To Premium for Goodwill A/c (Amount of goodwill brought in by the new partner) Premium for Goodwill A/c Dr. To Sacrificing Partners' Capital A/c (Goodwill brought in by the new partner is transferred to the capital accounts of the old partners in their sacrificing ratio)
When the new partner brings his share of goodwill in cash and the goodwill is withdrawn by the old partners either fully or partly.	Cash/Bank A/c Dr. To Premium for Goodwill A/c (Amount of goodwill brought in by the new partner) Premium for Goodwill A/c Dr. To Sacrificing Partners' Capital A/c (Goodwill brought in by the new partner is transferred to the capital accounts of the old partners in their sacrificing ratio) Sacrificing Partners' Cap. A/c Dr. To Cash/Bank A/c (Amount of goodwill withdrawn by the old partners)
When the new Partners' brings his share of goodwill in part.	Cash/Bank A/c Dr. To Premium for Goodwill A/c (Amount of goodwill brought in by the new partner) Premium for Goodwill A/c Dr. (with the amount of Goodwill brought in by the new partner) New Partners' Capital A/c Dr. (with the amount of Goodwill **not** brought in) To Sacrificing Partners' Capital A/c
When the new partner is unable to bring his share of goodwill in cash at all.	New Partners' Capital A/c Dr. To Sacrificing Partners' Capital A/c (Sacrificing Partners' Capital Account credited with the amount of Goodwill **not** brought in by the new partner)
When the new partner brings his share of goodwill in kind - usually in form of Assets such as, machinery, land, debtors, etc.	**Assets** Debtors A/c Dr. Stock A/c Dr. Land A/c Dr. Machinery A/c Dr. To Premium for Goodwill A/c (Goodwill brought in form of assets by the new partner)

	Premium for Goodwill A/c Dr. To Sacrificing Partners' Capital A/c (Goodwill brought in by the new partner transferred to the old partners in their sacrificing ratio)

❖ **Treatment of Goodwill - Case 4 and Case 5 with Example**

A and B partners sharing profits and losses in the ratio 3:2. They admitted C for $\frac{1}{5}$th share.

Case 4: C was able to bring only Rs 15,000 as goodwill out of his share of Rs 40,000.
Case 5: C was not able to bring his share of goodwill of Rs 40,000.

Case 4:

Partners' Capital A/c

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
A's Capital A/c (JE2)			15,000	Goodwill A/c (JE1)	9,000	6,000	
B's Capital A/c (JE2)			10,000	C's Capital A/c (JE2)	15,000	10,000	

Journal Entries

JE1

Premium for Goodwill A/c Dr. 15,000

To A's Capital A/c $\left(15,000\times\frac{3}{5}\right)$ 9,000

To B's Capital A/c $\left(15,000\times\frac{2}{5}\right)$ 6,000

Share of C's Goodwill Transferred to the A and B in the sacrificing ratio of 3:2

JE2

C's Capital A/c Dr. 25,000

To A's Capital A/c $\left(25,000\times\frac{3}{5}\right)$ 15,000

To B's Capital A/c $\left(25,000\times\frac{2}{5}\right)$ 10,000

Goodwill **not** brought in by C credited to A's and B's Capital Accounts in their sacrificing ratio of 3:2)

Case 5:

C's Capital A/c	Dr.	40,000	
To A's Capital A/c $\left(40,000\times\frac{3}{5}\right)$			24,000
To B's Capital A/c $\left(40,000\times\frac{2}{5}\right)$			16,000

(Goodwill not brought in by C credited to A's and B's Capital Accounts in their sacrificing ratio of 3:2)

❖ **Revaluation Account- Revaluation of Assets and Liabilities at the time of Admission**

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	
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*
a) Furniture has depreciated by Rs 1,000.
b) Furniture has appreciated to Rs 10,000.
If the balance of Furniture in the Old Balance Sheet is Rs 6,000, then in the Revaluation Account the decrease in the value of furniture will be shown with Rs 1,000 **(for case (a))** and furniture will be shown with Rs 5,000 (Rs 6,000 – Rs 1,000) on the Assets side of the New Balance Sheet.

❖ For case (b), in the Revaluation Account, the increase in the value of the furniture will be shown with the difference amount, i.e. with Rs 4,000 (Rs 10,000 – Rs 6,000) and the final value of furniture (i.e. Rs 10,000) will be shown on the Assets side of the New Balance Sheet.

❖ **Partners' Capital Account**

Partners' Capital A/c

Dr. **Cr.**

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

* 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. For example, if WCF appears on the Liabilities side of the Old Balance Sheet at Rs 6,000 and if in the adjustment, a claim of Workmen's Compensation of Rs 4,000 is given, then the excess amount of Rs 2,000 (i.e. Rs 6,000 – Rs 4,000) will be transferred to the credit side of the Old Partners' Capital Account in their old ratio. The amount of claim i.e. Rs 4,000 will be shown on the Liabilities side of the New Balance Sheet.
- 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 (which is brought in by the new partner) and may be withdrawn (either partly or fully) by the Old Partners'.

Note:

(1) If in the question, there are ***no adjustments related to WCF, IFF, Contingency Reserve***, then these are transferred to the Partners' Capital Account (with full value given in the question) among the old partners in their old profit sharing ratio.

(2) Reserves such as, Employees Provident Fund, Provision for Tax, Taxation Reserve, JLP Reserve and Depreciation Reserve are ***not*** transferred to the Partners' Capital Account and are shown on the Liability side of the New Firm's Balance Sheet.

❖ Treatment of JLP

Case I: *If no JLP appears in the Old Balance Sheet and is to be shown in the books of the new firm*

JLP A/c (with surrender value) Dr.
To Old Partners' Capital A/c
(JLP transferred to the Old partners' Capital A/c in Old ratio

And, JLP will be shown on the Assets side of the Balance sheet of the new firm.

Case II: *If JLP already appears in the Old Balance Sheet and is **not** to be shown in the books of the new firm.*

In this case, there is no need of any entry for transferring JLP to the Partners' Capital Account. However; if the partners decide not to show the JLP in the books of the new firm, then JLP is written-off among *all partners (including the new partner admitted)* with its surrender value in the new profit sharing ratio.

All Partners' Capital A/c (with surrender value) Dr.
To JLP A/c
(JLP written-off among all partners in new profit sharing ratio)

❖ **Adjustment of Capital of Partners**

Generally, on the eve of admission of a new partner, the partners agree that their capitals should be adjusted in the new profit sharing ratio. It is done through the following two ways:

- Adjustment of old partners' capital on the basis of new partners' capital.
- Adjustment of New Partners' Capital on the basis of old partners' capital (Proportionate Method)

❖ **Adjustment of Old Partners' Capital on the basis of New Partner's Capital**

The following are the steps involved in the adjustment of capital balances of the old partners on the basis of the capital balance 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. Let the difference of the total of the credit side and total of the debit side (Cr. – Dr.) of A' Capital Account be Rs 50,000 and that of B's Capital Account be Rs 75,000.

Step 2: Ascertain the new capitals of the old partners. This is done by dividing the new capital (say Rs 1,40,000) by the new profit sharing ratio (say 3:3:1)

$$\text{New Capital of A} = 1,40,000 \times \frac{3}{7} = \text{Rs } 60,000$$

$$\text{New Capital of B} = 1,40,000 \times \frac{3}{7} = \text{Rs } 60,000$$

Step 3: The new capital ascertained is written as 'Balance c/d' on the debit side of the Partners' Capital A/c.

Step 4: If the amount calculated in **Step 2** exceeds (lesser than) the amount calculated in **Step 1**, then the surplus/deficit is to be paid back/brought in by the individual partners'. In this example, A needs to bring in Rs 10,000 (as the New Capital of Rs 60,000 exceeds the Cr. – Dr. amount of Rs 50,000). On the other hand, B will be paid-off Rs 15,000 (as the Cr. – Dr. of Rs 75,000 exceeds the New Capital of Rs 60,000).

For A New Capital (Rs 60,000) > Cr – Dr (Rs 50,000) {so, A will bring Rs 10,000 in cash }

For B New Capital (Rs 60,000) < Cr – Dr. (Rs 75,000) {so, B will be paid-off Rs 15,000 in cash}

Partners' Capital Account

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
Cash (Amount paid back to B)		15,000		Cash (Amount brought in by A)	10,000		
Balance c/d (New Capital Balances)	60,000	60,000	20,000				

❖ **Adjustment of New Partners' Capital on the basis of old partners' capital – (Proportionate Method)**

Note: In this case, the capital of the new partner is *not mentioned in the question*, for example, C is to bring in proportionate capital. The following are the steps involved in adjusting the capital of the new partner on the basis of the old partners.

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.
Let the difference of the total of the credit side and total of the debit side (Cr. – Dr.) of A' Capital Account be Rs 50,000 and that of B's Capital Account be Rs 76,000

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

Step 3: Calculate the Proportionate Capital of the new partner by the formula:
Proportionate Capital of the New Partner = Total Capital of the Old Partners × Reciprocal of the combined New Shares of Old Partners' × Share of New Partner

$$= (50,000 + 76,000) \times \text{ Reciprocal of } \left(\frac{3}{7} + \frac{3}{7}\right) \times \frac{1}{7}$$

$$= 1,26,000 \times \frac{7}{6} \times \frac{1}{7}$$

$$= \text{Rs } 21,000$$

Step 4: This amount is written as '**Cash/Bank**' on the credit side of the New Partner's Capital Account.

Partners' Capital Account

Dr. **Cr.**

Particulars	A	B	C	Particulars	A	B	C
Balance c/d	50,000	76,000		Cash/Bank (C's Proportionate Capital)			21,000

❖ **Cash Account-** Usually, Cash Account is presented in the Working Notes, but it can also be shown after Partners' Capital Account and before preparing Balance Sheet.

Format of 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 withdrawal of goodwill brought in by New Partner/ Withdrawal of goodwill already appearing in the old books)	
Balance c/d*		Balance c/d#	

* 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.

** If Bank Overdraft is given on the Liabilities side of the Old 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 (after the admission of the new partner).

Format of Balance Sheet

Dr. **Cr.**

Liabilities	Amount Rs	Assets	Amount Rs
Bank Overdraft		Cash in Hand	
Creditors		Cash at Bank	
General Reserve		Debtors	
Contingency Reserve		*Less*: Provisions for	
Depreciation Reserve		Doubtful Debts	
Workmen's Compensation Fund		Bills Receivable	
Investment Fluctuation Fund		Stock	
Machinery Replacement Reserve		Land and Building	

Employee Provident Fund Provision for Tax JLP Reserve Bills Payable Profit and Loss A/c – (Profit) Capitals: A B C		Plant and Machinery JLP Profit and Loss A/c – (Loss)	
	*		○

Note: The equality of * and ○ ensures the arithmetical accuracy of the solution.

❖ **Hidden Goodwill**

In case of Hidden Goodwill, the value of Goodwill is not mentioned at the time of admission of a new partner.

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 as elaborated in the following steps.

Step 1: Calculate the total capital of the new firm. If the new partner is admitted for $\frac{1}{4}$th share and brings Rs 50,000 as capital, then the total capital of the new firm should be

$$\text{Rs } 50,000 \times \frac{4}{1} = \text{Rs } 2,00,000$$

Step 2: Calculate the existing capital balances of all the partners (including the capital of the new partner).

Step 3: Add the existing capital balances of all the partners (including the new partner).

Step 4: If the capital balances of A, B and C are Rs 70,000, Rs 60,000 and Rs 50,000 respectively, then the total capital of the firm is Rs 1,80,000 (i.e. Rs 70,000 + Rs 60,000 + Rs 50,000)

Step 5: Calculate the value of Hidden Goodwill by subtracting the existing capital balances of all the partners (i.e. the amount ascertained in the **Step 4**) from the total capital of the firm (amount ascertained in the **Step 1**).

That is, Hidden Goodwill = Total Capital of the Firm – Sum of the Capital Balances of the all partners.

So, Hidden Goodwill = Rs 2,00,000 – Rs 1,80,000 = Rs 20,000

Step 6: Share of Goodwill of the New Partner (C) is calculated as:

C's Share of Goodwill = Firm's Goodwill × C's Profit Share

$$= \text{Rs } 20,000 \times \frac{1}{4} = \text{Rs } 5,000$$