1. Details of Module and its structure

Module Detail	
Subject Name	Accountancy
Course Name	Accountancy 03 (Class XII, Semester - 1)
Module Name/Title	Reconstitution of Partnership Firm-Admission of a Partner – Part 3
Module Id	leac_10303
Pre-requisites	Basic knowledge of Partnership - Fundamentals
Objectives	After going through this lesson, the learners will be able to understand recording of business transactions in the journal. • Accounting Treatment of Goodwill
Keywords	Accounting Treatment of Goodwill, Various Methods, Existing Goodwill - Treatment

2. Development Team

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1. Treatment of Goodwill

As stated earlier, the incoming partner who acquires his share in the profits of the firm from the existing partners brings in some additional amount to compensate them for loss of their share in super profits. It is termed as his share of goodwill (also called premium).

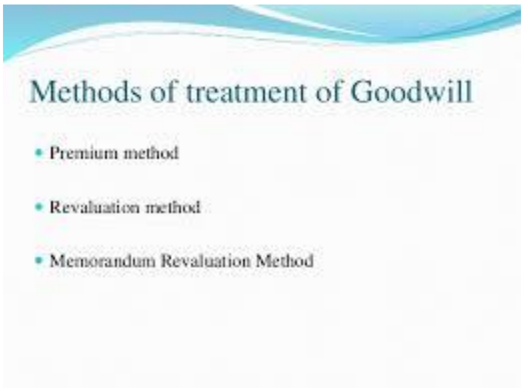
Alternatively, he may agree that goodwill account be raised in the books of the firm by giving the necessary credit to the old partners.

Thus, when a new partner is admitted, goodwill can be treated in two ways:

(1) By Premium Method, and

(2) By Revaluation Method.

(**3) By Memorandum Revaluation Method,**



Let us start our discussion by 1st Method-- Premium Method

Accounting Treatment of Goodwill on Admission of New Partner- Premium Method

There may be three situations related to treatment of goodwill(premium) at the time of admission of a new partner:

1) When the amount of goodwill (premium) is **paid privately;**

2) When the new partner **brings his share** of goodwill (premium) **inCash**;

3) When the new partner **does not bring his share** of goodwill(premium)**inCash**.

In that case, it has to be adjusted in Accounts.

All of these situations are discussed below:

1)When the amount of goodwill (premium) is paid privately: When the new partner pays the amount of goodwill in cash to the old (Sacrificing) partners privately outside the business**, no entries are required to be passed**

2) When new partner brings his share of goodwill (premium)in Cash (Premium method):

According to this method there are two alternatives:

a) Goodwill/premium brought in by the new partner is retained in the business*:*

If the new partner brings in his share of goodwill in cash and this amount is retained in the business, the amount is credited to the Capital Accounts of old partners in their sacrificing ratio. The following two entries are passed for this purpose:

i) Cash/Bank A/c. Dr.

To Premium A/c.

(For the amount of goodwill/premium brought in cash by new partner)

ii) Premium A/c. Dr.

To Sacrificing Partners' Capital A/c's

(For the amount of goodwill/premium transferred to old partners'(sacrificing) capital accounts in sacrificing ratio)

Alternatively, it is credited to the new partner's capital account and then adjusted in favour of the existing partners in sacrificing ratio. Journal entries will be as follows:

(i) Cash 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/cs (Individually)

(Goodwill brought by new partner shared by existing partners in sacrificing ratio)

An important observation

There can be a case that even an old partner may also gain on account of an admission of New partner. In that scenario, even that Gaining partner will also contribute to the sacrificing Partners and the above Entry no. (ii) will change like this

New Partner's Capital A/c Dr.

Gaining Partner Cap. A/c Dr.

To Sacrificing Partner's Capital A/cs (Individually)

(Goodwill brought by new partner and the Gaining partner share distributed among existing sacrificing partners in sacrificing ratio)

b) When Goodwill brought by new partner is withdrawn by the old partners Sometimes, the amount of goodwill brought in by new partner is withdrawn by the old partners. In this case, in addition to the two Journal entries explained above in (a) one more Journal entry is required to be passed:

Sacrificing Partner's Capital, A/c Dr.

To Cash/Bank A/c

(For the amount of goodwill/premium with drawn by the old partners)

It must be noted that sometimes partners withdraw only ½ or ¼ amount of goodwill. In such case, entry should be passed with the withdrawn amount only.

Example

A and B are partners in a firm sharing profits and losses in the ratio of5:3. C is admitted in the firm for 1/5 share of profits. He brings in Rs. 20,000 as capital and Rs. 4,000 as goodwill. Give the necessary journal entries,

(a) When the amount of goodwill is retained in the business.

(b) When the amount of goodwill is fully withdrawn.

(c) When 50% of the amount of goodwill is fully withdrawn.

Solution

(a) When the amount of goodwill is retained in business

(i) Cash A/c Dr. 24,000

To C's Capital A/c 20,000

To Goodwill / Premium A/c 4,000

(Amount brought in by C as Capital and Goodwill)

(ii) Goodwill / Premium A/c Dr. 4,000

To A's Capital A/c 2,500

To B's Capital A/c 1,500

(Goodwill transferred to A and Bin the sacrificing ratio of 5:3)

Alternatively, the following entries may be recorded:

(i) Cash A/c Dr. 24,000

To C's Capital A/c 24,000

(ii) C's Capital A/c Dr 4,000

To A's Capital A/c 2,500

To B's Capital A/c 1,500

Note*:* Sacrificing ratio is the same as old profit sharing ratio, as New ratio is given and nothing else is mentioned.

(b) When the amount of goodwill is fully withdrawn.

(i) Cash A/c Dr. 24,000

To C's Capital A/c 20,000

To Goodwill / Premium A/c 4,000

(The amount brought in by C as Capital and Goodwill)

(ii) Goodwill / Premium A/c Dr. 4,000

To A's Capital A/c 2,500

To B's Capital A/c 1,500

(Goodwill transferred to A and B in the sacrificing ratio of 5:3)

(iii). A's Capital A/c Dr. 2,500

B's Capital A/c Dr. 1,500

To Cash A/c 4,000

(Cash withdrawn by A and B equal to their share of goodwill)

(c) When 50% of the amount of goodwill credited to existing partners is withdrawn.

Only 3rd Entry will change, as compared to the 2nd case

A Capital A/c Dr 1,250

B Capital A/c Dr 750

To Cash A/c 2,000

(Cash withdrawn for 50% of their share of goodwill)

When goodwill already exists in books:

If new partner brings his share of goodwill in cash, and if the Goodwill Account is already appearing in the books of the firm, then first of all the existing Goodwill Account will have to be written off.

For this purpose old Partners' Capital Accounts are debited in their old profit sharing ratio and Goodwill Account is credited. Thus, the following entry is passed to write off the existing goodwill:

Old Partner's Capital A/c Dr.

To Goodwill A/c

But, if it is decided that the goodwill may continue to appear in the books at its old value, the amount to be brought in by new partner will have to be proportionately reduced i.e., He will be required to bring cash only for this share of the excess of the agreed value of goodwill over the amount of goodwill already appearing in books

Let us take an example on this point,

Example A and B are partners with ratio of 3:2. Goodwill of the firm is valued at Rs. 20,000 and Mr. C who is admitted for 1/4 share brings in Rs. 5,000 as his share of goodwill. Suppose, goodwill already appearing in books at Rs.10,000 and there is a decision not to retain it.

Solution

Now, In this case, after crediting A and B for the amount of goodwill brought in by C, the following additional journal entry shall be recorded for writing off the existing amount of Old Goodwill.

A's Capital A/c Dr. 6,000
B's Capital A/c Dr. 4,000
To Goodwill A/c 10,000
(Goodwill written-off in old ratio)

However, if the partners decide to maintain the Goodwill Account as itis at 10,000, then the new partner is required to bring in goodwill only for the difference between its total value and the book value.

In other words, C will be required to bring in Rs. 2,500 only [1/4 of Rs. 10,000 (Rs 20,000 – Rs. 10,000)]. Which will be credited to old partners in their sacrificing ratio.
And no entry will be recorded for writing off the existing amount of goodwill.

Revaluation Method
This method is followed when the new partner does not bring in his share of goodwill in cash. In such a situation, the goodwill account is raised in the books of account by crediting the old partners in the old profit sharing ratio.

When goodwill account is to be raised in the books of account there are two possibilities,
(a) No goodwill appears in books at the time of admission, and
(b) Goodwill already exists in books at the time of admission.

Case (a) When no goodwill exists in the books*:*
At the time of the admission of a new partner, the goodwill account must be raised at its full value. This can be done by debiting goodwill account with its full value and crediting the Old partners' capital accounts in their Old profit sharing ratio. The journal entry will be:

Goodwill A/c Dr.
To Old Partners' Capitals A/c (individually)
(Being Goodwill raised at full value in the old ratio)
This goodwill will appear in the balance sheet of the firm at its full value.

Example
A and B are partners in a firm sharing profits and losses in the ratio of3:2. They decide to admit C for 1/5 share of profits, which he acquires equally from A and B. Goodwill is valued at Rs. 30,000. C brings in Rs. 16,000 as his capital but does not bring any amount for goodwill. No goodwill account exists in books of the firm. Goodwill account is to be raised at full value. Record the necessary journal entries.
Solution
1. Cash A/c Dr. 16,000
To C's Capital A/c 16,000
(Being Amount brought for capital)

2. Goodwill A/c Dr. 30,000
To A's Capital A/c 18,000

To B’s Capital A/c 12,000

(Being Goodwill raised at full value in old ratio)

Note: Now, Goodwill shall appear in the balance sheet at Rs. 30,000

Sometimes, a partner may bring in a part of his share of goodwill in Cash

Now in such a situation, after distributing the amount brought in for goodwill among the old partners in their sacrificing ratio, the **Goodwill account will be raised in the books based on the portion of premium not brought by the new partner**.

Let us take an example on this point

Example A and B are partners sharing profits in ratio of 3:1. They admit C as a new partner for**1/5**share in profits. C is to bring in Rs. 20,000 as his share of goodwill as the total value of goodwill is estimated at Rs. 1,00,000. But he is able to bring only Rs. 10,000 (half of what is due) on this account.

Solution

In this case, after crediting Old Partners with Rs. 10,000 to A and B capital accounts in their sacrificing ratio (3:1), Goodwill account will be raised by Rs. 50,000 (half of its total value) by crediting in their old profit sharing ratio.

(i) Cash A/c Dr.10,000

To Goodwill / Premium A/c 10,000

(ii) Goodwill / Premium A/c Dr.10,000

To A’s Capital A/c 7,500

To B’s Capital A/c 2,500

(iii) Goodwill A/c Dr.50,000

To A’s Capital A/c 37,500

To B’s Capital A/c 12,500

(Being Goodwill raised at remaining value in old ratio)

Case (b) When goodwill already exists in the books*:*

If the books already show some balance in the Goodwill Account, the adjustment for goodwill in the old partner’s capital accounts shall be made only for the difference between the agreed value of goodwill and the amount of goodwill appearing in books.

The amount of **goodwill appearing** in the books **may be less than its agreed value or it may be more than the agreed value**. **If it is less** than the agreed value, the difference between the agreed value of goodwill and the amount of goodwill appearing in the books will be **debited to goodwill account (i.e Raised) and credited to old partner's capital accounts in their old profit sharing ratio.**

Journal entry will be as under:

Goodwill A/c Dr.

To Old Partners' Capital A/c

(Goodwill raised to its agreed value)

Example

Ram and Rahim are partners in a firm sharing profits and losses in the ratio of3:2. Rahul is admitted into partnership for 1/3 share in profits. He brings in Rs. 10,000 as capital, but is not in a position to bring any amount for his share of goodwill which has been valued at Rs. 30,000. Give necessary journal entries when the goodwill appears at Rs 15,000 in the books

Solution

Cash A/c Dr. 10,000

To Rahul's Capital A/c 10,000

(Amount brought by Rahul as capital)

Goodwill Dr. 15,000

To Ram's Capital A/c 9,000

To Rahim's Capital A/c 6,000

(Goodwill raised to its agree value)

If, however, it is **more** than the agreed value, the difference will be **debited to the old partners' capital accounts in their old profits sharing ratio and credited to the goodwill account**. (**Written off**)

Journal entry will be as under:

Old Partners' Capital A/c Dr.

To Goodwill A/c

(Goodwill brought down to its agreed value)

Example

Ram and Rahim are partners in a firm sharing profits and losses in the ratio of3:2. Rahul is admitted into partnership for 1/3 share in profits. He brings in Rs. 10,000 as capital, but is not in a position to bring any amount for his share of goodwill which has been valued at Rs. 30,000. Give necessary journal entries when the goodwill appears at Rs. 36,000 in the books

Solution

Cash A/c Dr. 10,000

To Rahul's Capital 10,000

(Amount brought by Rahul as capital)

Ram's Capital A/c Dr. 3,600

Rahim's Capital A/c Dr. 2,400

To Goodwill A/c 6,000

(Goodwill brought down to its agreed value)

Normally, when goodwill is raised in the books of the firm, it is shown in the balance sheet. If, however, the partners decide that after necessary adjustments have been made in the old partners' capital accounts, the goodwill should not appear in the firm's balance sheet, then it has to be written off. This is done by

Capital a/c (All partners) (including new) Dr.

To Goodwill account

(in New profit sharing ratio).

The net effect of such treatment will be that the new partner's capital account stands debited to the extent of his share of goodwill and the old partners' capital accounts credited in the ratio of their sacrifice, and the Goodwill shows nil balance in the Balance sheet.

Example

A and B are Equal partners. They admit C into partnership and the new ratio is fixed as 4:3:2. C is unable to bring anything for goodwill but brings Rs 25,000 as capital. Goodwill of the firm is valued at Rs 18,000. Give necessary journal entries assuming that the partners do not want goodwill to appear in the Balance Sheet.

Solution

1.Cash A/c Dr. 25,000

To C's Capital A/c 25,000

(Cash brought in by C as Capital)

2.Goodwill 18,000

To A's Capital A/c 9,000

To B's Capital A/c 9,000

(Goodwill raised at its full value)

3.A’s Capital A/c Dr. 8,000
B’s Capital A/c Dr. 6,000
C’s Capital A/c Dr. 4,000
To Goodwill A/c 18,000
(Goodwill written-off)

Just see the net effect of the entries (2) and (3).

C’s Capital account has been debited by Rs. 4,000 and A’s Capital account and B’s Capital account credited in their sacrificing ratio by Rs 1,000 (credit Rs 9,000 – debit Rs 8,000) and Rs 3,000 (credit Rs 9,000 – debit Rs 6,000) respectively, and goodwill will show nil balance.

Sometimes, the partners may decide not to show goodwill account any wherein books (not even in the journal and ledger). In that case, for adjustment of goodwill, just one entry can also be passed:

New partner’s capital account Dr. (with his share of goodwill)
To Old partners’ capital accounts
(in their ratio of sacrifice).

If in the EXAMPLE given above we were to treat goodwill in this manner, then the entry for goodwill would have been as follows:

C’s Capital A/c Dr. 4,000
To A’s Capital A/c 1,000
To B’s Capital A/c 3,000
(Adjustment for C’s share of goodwill)

The above entry has the same effect on partners’ capital a/c’s as journal entries (2) and (3).

It is important to mention here that in the normal course Raising of goodwill as an Asset should be avoided and, if and when it is brought in to books, it should be written off in the shortest possible period (As a matter of Financial Prudence), because it is a Non-productive asset.