3

Change in Profit Sharing Ratio Among the Existing Partners

LEARNING OBJECTIVES

After studying this Chapter, you should be able to understand :

- **Reconstitution of a Partnership Firm**
- **Sacrificing Ratio**
- **Gaining Ratio**
- **Goodwill : Meaning, Definition, Factors affecting the Value of Goodwill and nature of Goodwill**
- **Methods of Valuation of Goodwill**
- **When there is change in the profit sharing ratio of existing partners :**
  - **(i) Accounting Treatment of Goodwill**
  - **(ii) Accounting Treatment of Reserves and Accumulated Profits**
  - **(iii) Accounting for Revaluation of Assets and Liabilities**

Reconstitution of a Partnership Firm

Partnership is the result of an **agreement** between persons for sharing the profits of a business. Any change in the partnership agreement brings to an end the existing agreement and a new agreement comes into force. The change in the agreement results in changes in the relationship among the partners. In such a case, although the firm continues, it amounts to the reconstitution of the partnership firm. Reconstitution of the firm may happen in the following circumstances :

(*i*) **Change in the profit sharing ratio among the existing partners :** For example, *A* and *B* are partners in a firm sharing profits in the ratio of 2 : 1. In future, they decide to share profits in the ratio of 3 : 1. It amounts to reconstitution of the firm.

(*ii*) **Admission of a new partner :** For example, Charu and Dinesh are partners sharing profits equally. On April 1, 2019, they decided to admit Sudha as a new partner with 1/4th share. It results into reconstitution of the firm.

(*iii*) **Retirement of an existing partner :** For example, Babita, Gita and Sita are partners sharing profits in the ratio of 1 : 2 : 3. Sita Retires from the firm on March 31, 2019. It amounts to reconstitution of the firm.

(*iv*) **Death of a Partner :** For example, *P, Q* and *R* are partners in a firm sharing profits in the ratio of 4 : 3 : 2. *R* dies on March 31, 2019. *P* and *Q* decide to share future profits equally. It also amounts to reconstitution of the firm.

(*v*) **Amalgamation of two partnership firms :** For example, *A* and *B* are partners in a firm sharing profits in the ratio of 2 : 1. To eliminate competition they amalgamate their firm with the firm of *C* and *D* who are sharing profits in the ratio of 3 : 1. The new ratios for *A, B, C* and *D* are agreed at 2 : 1 : 3 : 1. It amounts to reconstitution of the firm of *A* and *B* on the one hand and the firm *C* and *D* on the other hand and a new reconstituted firm is formed.

Change in Profit Sharing Ratio Among the Existing Partners :

Sometimes the existing partners decide to change their profit sharing ratio. The change is necessiated due to the change in capital contribution or in active participation in management. As a result of change in profit sharing ratio, one or more of the existing partners may acquire extra share in profits at the cost of one or more of other partners. In such a case, in order to maintain equity among the partners, it is necessary to make adjustments for goodwill, revaluation of assets and liabilities, reserves, accumulated profits and losses etc. These adjustments are similar to those made at the time of admission or retirement of a partner.

Adjustments required at the time of change in the profit sharing ratio :

Various matters that need to be considered at the time of change in profit sharing ratio are :

(1) Determination of Sacrificing Ratio and Gaining Ratio
(2) Accounting for Goodwill
(3) Accounting Treatment of Reserves and Accumulated Profits
(4) Accounting for Revaluation of Assets and Liabilities
(5) Adjustment of Capitals

Sacrificing Ratio

Whenever there is a change in the profit sharing ratio, one or more of the existing partners have to surrender some of their old share in favour of one or more of other partners. The ratio of surrender of profit sharing ratio is called sacrificing ratio. It is calculated as follows :

Sacrificing Ratio = Old Ratio – New Ratio

The purpose of calculating sacrificing ratio is to determine the amount of compensation to be paid by the gaining partner (*i.e.,* the partner whose share has increased as a result of change) to the sacrificing partner (*i.e.,* the partner whose share has decreased as a result of change). Such compensation is usually paid on the basis of proportionate amount of goodwill.

Gaining Ratio

As a result of change in profit sharing ratio, one or more of the existing partners gain some portion of other partners share of profit. The ratio of gain of profit sharing ratio is called gaining ratio. It is calculated as follows :

Gaining Ratio = New Ratio – Old Ratio

ILLUSTRATION 1.

A and *B* were partners in a firm sharing profits and losses in the ratio of 2 : 1. With effect from 1st April, 2019 they agreed to share profits and losses equally. Calculate the individual partner's gain or sacrifice due to change in ratio.

SOLUTION :

Old Ratio of *A* and *B* = 2 : 1
New Ratio of *A* and *B* = 1 : 1
Sacrifice or Gain :

$$A = \frac{2}{3} - \frac{1}{2} = \frac{4-3}{6} = \frac{1}{6} \text{ (Sacrifice)}$$

$$B = \frac{1}{3} - \frac{1}{2} = \frac{2-3}{6} = \frac{1}{6} \text{ (Gain)}$$

A has sacrificed $\frac{1}{6}$th share whereas *B* has gained $\frac{1}{6}$th share.

ILLUSTRATION 2.

A, B and *C* were partners in a firm sharing profits and losses in the ratio of 3 : 2 : 1. The partners decide to share future profits and losses in the ratio of 2 : 2 : 1. Indicate each partner's gain or sacrifice due to change in ratio.

SOLUTION :

Old Ratio of *A, B* and *C* = 3 : 2 : 1
New Ratio of *A, B* and *C* = 2 : 2 : 1
Sacrifice or Gain :

$$A = \frac{3}{6} - \frac{2}{5} = \frac{15-12}{30} = \frac{3}{30} \text{ (Sacrifice)}$$

$$B = \frac{2}{6} - \frac{2}{5} = \frac{10-12}{30} = \frac{2}{30} \text{ (Gain)}$$

$$C = \frac{1}{6} - \frac{1}{5} = \frac{5-6}{30} = \frac{1}{30} \text{ (Gain)}$$

A has sacrificed $\frac{3}{30}$, *B* has gained $\frac{2}{30}$ and *C* has also gained $\frac{1}{30}$.

Goodwill

Meaning :— Goodwill means the 'good-name' or the reputation earned by a firm through the hardwork and honesty of its owners. If a firm renders good service to the customers, the customers who feel satisfied will come again and again and the firm will be able to earn more profits in future.

Thus, goodwill is the value of the reputation of a firm which enables it to earn higher profits in comparison to the normal profits earned by other firms in the same trade.

Definitions :

"The term goodwill is generally used to denote the benefit arising from connections and reputation." — *Lord Lindley*

"Goodwill is nothing more than the probability that the old customers will resort to the old place." — *Lord Eldon*

"Goodwill may be said to be that element arising from the reputation, connections or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets employed in the business." — *Spicer and Pegler*

Characteristics or Features of Goodwill :

1. **It is an intangible asset :—** Goodwill belongs to the category of intangible assets such as patents, trade marks, copy rights etc. It does not suffer wear and tear and as such the question of depreciation does not arise on it, as is the case of other assets.
2. **It is a valuable asset.**
3. **It is helpful in earning excess profits.**
4. **Its value is liable to constant fluctuations :—** While goodwill does not depreciate, its value is liable to constant fluctuations. It is always present as a silent asset in a business where there are super profits (*i.e.*, more than the normal) but declines in value with the decline in earnings.
5. **It is valuable only when entire business is sold :—** Goodwill cannot be sold in part. It can be sold with the entire business only. The only exception is at the time of admission and retirement of a partner.
6. **It is difficult to place an exact value on goodwill :—** This is because its value may fluctuate from time to time due to changing circumstances which are internal and external to business.

Nature of Goodwill :

Goodwill is an intangible asset since it has no physical existence and cannot be seen or touched. But it is not a fictitious asset because fictitious assets do not have a value whereas goodwill has a value in case of profit making concerns. It can be sold, though a sale will be possible along with the sale of entire business.

Origin of Goodwill
Or
Factors Affecting the Value of Goodwill

It is clear from the above, that the goodwill is the extra earning capacity of a business. Thus all factors which help a firm in earning profits affect the goodwill of the firm. Following factors affect the goodwill of a firm :

1. **Favourable Location of the Business :—** If the business is located at a convenient or prominent place, it will attract more customers and therefore will have more goodwill.

2. **Efficiency of Management :—** If the business is run by experienced and efficient management, its profits will go on increasing, which results in increase in the value of goodwill.

3. **The Longevity of the Business :—** An older business is better known to its customers, therefore it is likely to have more goodwill. When a business enterprise has built up good reputation over a period of time, the number of customers will be more in comparison to the customers of new entrants. Number of customers is an indicator of profit earning capacity of a business.

4. **Nature of Goods :—** If a business deals in goods of daily use, it will have steady profits as the demand for these goods will be stable. Such business will have more goodwill. But if it deals in fancy goods, its profits will be uncertain and as such the value of the goodwill will be less.

5. **Possession of Licence :—** If a firm holds an import licence, the goodwill of the firm will be more as it will be very difficult for other firms to enter this business in the absence of this licence.

6. **Monopolistic and other Rights :—** If a business enjoys monopoly market, it will have assured profits. Similarly, if it holds some special rights such as patents, trade marks, copyrights or concessions, etc., it will have more goodwill.

7. **Risk Involved :—** If there is more risk involved in the business, the value of the goodwill will be less.

8. **Trend of Profit :—** If the profits of a business are increasing continuously, the value of its goodwill will be more. If the profits are declining or if the profits are uncertain, the value of its goodwill will be less.

9. **Future Competition :—** The likelihood or possibility of increased competition in future would definitely reduce the value of Goodwill.

10. **Capital Required :—** The amount of capital required for a business will also influence the value of goodwill. If two business enterprises earn the same rate of profit, the business with lesser capital requirement shall enjoy more goodwill.

11. **Other Factors :—**
   (*i*) Good industrial relations
   (*ii*) Favourable Government regulations
   (*iii*) Stable political conditions
   (*iv*) Research and development efforts
   (*v*) Effective advertising to establish brand popularity
   (*vi*) Popularity of product in terms of quality

Classification of Goodwill :

Goodwill can be classified into two categories :

(1) Purchased Goodwill, and

(2) Self-Generated Goodwill or Inherent Goodwill

(1) **Purchased Goodwill :** Purchased goodwill is the goodwill which is acquired by making a payment. For example, when a business is purchased, the excess of purchase consideration over its net assets (*i.e.,* Assets – Liabilities) is referred to as purchased goodwill.

The following are the **important features** of purchased goodwill :

(*i*) It arises on purchase of a business.

(*ii*) It is recorded in the books of accounts because consideration is paid for it.

(*iii*) It is shown in the Balance Sheet as an asset.

(*iv*) It is amortised (*i.e.* depreciated) over its useful economic life.

(2) **Self-Generated Goodwill or Inherent Goodwill :** It is internally generated goodwill which arises from a number of characteristics or attributes which an on-going business possesses.

The following are the important features of Self-Generated goodwill :

(*i*) It is internally generated over a long period of time.

(*ii*) A true cost cannot be placed on this type of goodwill. Its valuation depends on the subjective judgement of the valuer.

(*iii*) As per Accounting Standard 26 (Ind AS-38) (Intangible Assets), it is not recorded in the books of accounts because consideration in money or money's worth has not been paid for it.

Need for the Valuation of Goodwill

The need for valuing the goodwill in partnership arises in the following circumstances :

1. When there is a change in the profit sharing ratio among the existing partners;
2. When a new partner is admitted;
3. When a partner retires or dies;
4. When the firm is sold; and
5. When the firm is amalgamated with another firm.

Methods of Valuation of Goodwill

It is very difficult to assess the value of goodwill, as it is an intangible asset. In case of sale of a business, its value depends on the mutual agreement between the seller and the purchaser of the business. Usually, there are three methods of valuing goodwill:

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

1. Average Profit Method :— This is a very simple and widely followed method of valuation of goodwill. In this method, goodwill is calculated on the basis of the number of past years profits. Average of such profits is multiplied by the agreed number of years (such as two or three) to find out the value of goodwill. Thus the formula is :

Value of Goodwill = Average Profit × Number of Years of purchase

Why average profits? A buyer always wants to estimate the future profits of a business. Future profits depend upon the average performance of the business in the past. Past profits indicate as to what profits are likely to accrue in the future. Therefore the past profits are averaged. But before calculating the average profits, the profits earned in the past must be adjusted in the light of future expectations and the following

factors should be taken into account while calculating the average profits :

(*i*) Abnormal income of a year should be deducted out of the net profit of that year.

(*ii*) Abnormal loss of a year should be added back to the net profit of that year.

(*iii*) Income from Investments should be deducted out of the net profits of that year, because this income is received from outside the business.

ILLUSTRATION 3.

Calculate goodwill of the firm on the basis of 3 year's purchase of the average profits of the last five years. The profits of the last five years were :

Year	*Amount (₹)*
2013-14	4,00,000
2014-15	5,00,000
2015-16	(60,000)
2016-17	1,50,000
2017-18	2,50,000

Additional Information :

(*i*) On 1st January, 2016, a fire broke out which resulted into a loss of goods of ₹3,00,000. A claim of ₹70,000 was received from the insurance company.

(*ii*) During the year ended 31st March, 2017 the firm received an unexpected tax refund of ₹80,000. *(C.B.S.E. 2019, Chennai)*

SOLUTION :

Total Profits of last 5 years :	₹
2013-14	4,00,000
2014-15	5,00,000
2015-16 (– ₹60,000 + Abnormal Loss ₹2,30,000)	1,70,000
2016-17	1,50,000
2017-18 (₹2,50,000 – Abnormal Gain ₹80,000)	1,70,000
	13,90,000

Average Profit = ₹13,90,000 ÷ 5 = ₹2,78,000

Goodwill = Average Profit × Number of Year's Purchase

= ₹2,78,000 × 3 = ₹8,34,000.

ILLUSTRATION 4.

A and *B* are partners sharing profits equally. They agree to admit *C* for equal share. For this purpose goodwill is to be valued at 150% of the average annual profits of the last 5 year's profits.

Profits were :

Year ended		₹	
31st March	2015	40,000	
”	2016	60,000	
”	2017	1,00,000	
”	2018	20,000	(Loss)
”	2019	1,50,000	

It was observed that :

(1) During the year ended 31st March 2016, an asset of the original cost of ₹2,00,000 with book value of ₹1,50,000 was sold for ₹1,24,000.

(2) On 1st April, 2017, 2 Computer's costing ₹1,00,000 were purchased and were wrongly debited to Travelling Expenses. Depreciation on Computers was to be charged @ 20% p.a. on written down value basis.

Calculate the value of goodwill.

SOLUTION :

Calculation of Adjusted Profits

Particulars	*2015*	*2016*	*2017*	*2018*	*2019*
	₹	₹	₹	₹	₹
Profits	40,000	60,000	1,00,000	(20,000)	1,50,000
Add : Loss on Sale of Asset		26,000			
Add : Cost of Computers wrongly charged to P & L A/c				1,00,000	
Less : Depreciation on Computers				(20,000)(1)	(16,000)(2)
Adjusted Profits	40,000	86,000	1,00,000	60,000	1,34,000

$$\text{Average Profit} = \frac{40,000 + 86,000 + 1,00,000 + 60,000 + 1,34,000}{5}$$

$$= \frac{4,20,000}{5} = ₹84,000$$

$$\text{Value of Goodwill} = 84,000 \times \frac{150}{100} = ₹1,26,000$$

Working Note :

(1) Depreciation on Computers for the year ended 31.3.2018 = 20% on ₹1,00,000 = ₹20,000

(2) Depreciation on Computers for the year ended 31.3.2019 : 20% on (₹1,00,000 – ₹20,000) = ₹16,000

ILLUSTRATION 5.

A and *B* are partners in a firm sharing profits and losses in the ratio of 2 : 1. They decide to take *C* into partnership for 1/5th share on 1st April 2017. For this purpose goodwill is to be valued at 80% of the average annual profits of the previous three or four years, whichever is higher.

The profits for the last four years are :

	₹
Year ending on 31st March 2014	98,000
Year ending on 31st March 2015	80,000
Year ending on 31st March 2016	76,000
Year ending on 31st March 2017	1,20,000

Calculate the value of Goodwill.

SOLUTION :

Calculation of Average Profits

Based on 3 year's Profits	₹	*Based on 4 year's profits*	₹
31st March 2015	80,000	31st March 2014	98,000
31st March 2016	76,000	31st March 2015	80,000
31st March 2017	1,20,000	31st March 2016	76,000
		31st March 2017	1,20,000
	2,76,000		3,74,000
Average Profit = 2,76,000 ÷ 3 = ₹92,000		Average Profit = 3,74,000 ÷ 4 = ₹93,500	

4 year's average profit is higher than 3 year's average profit. Hence, the value of goodwill will be 80% of ₹93,500 = ₹74,800.

ILLUSTRATION 6.

A and *B* are partners sharing profits and losses in the ratio of 3 : 2. They agree to take *C* into partnership for 1/3rd share. For this purpose, goodwill is to be valued at two year's purchase of the average profit of last four years which were as follows :

	₹
Year ending on 31st March 2014	50,000 (Profit)
Year ending on 31st March 2015	1,20,000 (Profit)
Year ending on 31st March 2016	1,80,000 (Profit)
Year ending on 31st March 2017	70,000 (Loss)

On 1st April, 2016 a Motor bike costing ₹50,000 was purchased and debited to travelling expenses account, on which depreciation is to be charged @ 20% p.a. calculate the value of goodwill.

SOLUTION :

Calculation of Average Profits :

	₹
31st March 2014	50,000 (Profit)
31st March 2015	1,20,000 (Profit)
31st March 2016	1,80,000 (Profit)
31st March 2017	30,000[(1)] (Loss)
	3,20,000

Average Profit = ₹3,20,000 ÷ 4 = ₹80,000

Goodwill = Average Profit × Number of year's purchase

= ₹80,000 × 2 = ₹1,60,000.

Note : (1) (*i*) Cost of Motor bike was wrongly debited to travelling expenses account. After rectification, the loss of 2017 will be reduced by ₹50,000.

(*ii*) Depreciation on Motor bike ₹10,000 (20% of 50,000) was not charged to Profit and Loss Account of 2017 which will increase the loss of 2017 by ₹10,000.

Hence, the final loss will be ₹70,000 – ₹50,000 + ₹10,000 = ₹30,000.

Weighted Average Profit Method :

This method is a modified version of average profit method. As per this method each year's profit is assigned a weight. The highest weight is attached to the profit of the most recent year. Thus, if profits are given for 2014, 2015, 2016 and 2017 and weighted average profit is to be calculated then weights will be assigned as follows :

2014 — 1; 2015–2; 2016—3; 2017—4.

Thereafter, each year's profit is multiplied by the weight assigned to it in order to find out the products and the total of products is then divided by the total of weights in order to calculate the weighted average profits. After this, the weighted average profit is multiplied by the agreed number of year's purchase to find out the value of goodwill. Thus, the formula is :

$$\text{Weighted Average Profit} = \frac{\text{Total of Products of Profits}}{\text{Total of Weights}}$$

$$\text{Goodwill} = \text{Weighted Average Profit} \times \text{Number of Year's of Purchase}$$

Weighted average profit method is considered better than the simple average profit method because it assigns more weightage to the profits of the latest year which is more likely to be earned in the future. This method is preferred when the profits over the past four or five years have been continuously rising or falling.

ILLUSTRATION 7.

The profits of a firm for the last five years were as follows :

Year ended 31st March	Profits (₹)
2011	43,000
2012	50,000
2013	52,000
2014	65,000
2015	85,000

You are required to calculate the value of goodwill on the basis of two year's purchase of weighted average profits. The weights to be used are :
2011 — 1; 2012 — 2; 2013 — 3; 2014 — 4; 2015 — 5.

SOLUTION :

Year ended 31st March	Profits (₹)	Weight	Products
2011	43,000	1	43,000
2012	50,000	2	1,00,000
2013	52,000	3	1,56,000
2014	65,000	4	2,60,000
2015	85,000	5	4,25,000
		15	9,84,000

$$\text{Weighted Average Profit} = \frac{9,84,000}{15} = ₹65,600$$

$$\text{Goodwill} = ₹65,600 \times 2 = ₹1,31,200$$

ILLUSTRATION 8.

It was agreed to calculate the value of goodwill of a firm at three years' purchase of the weighted average profits of the past four years. The appropriate weights to be used to each year ended on 31st March are : 2012 — 1; 2013 — 2; 2014 — 3; 2015 — 4.

The profits for these years ended on 31st March are : 2012 ₹20,200; 2013 ₹24,800; 2014 ₹20,000; and 2015 ₹30,000.

On a scrutiny of the accounts the following matters are revealed :—

(*i*) On 1st December, 2013 a major repair was made in respect of the plant incurring ₹6,000 which amount was charged to revenue. The paid sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method.

(*ii*) The closing stock for the year ending on 31st March 2013 was over-valued by ₹2,400.

(*iii*) To cover management cost an annual charge of ₹4,800 should be made for the purpose of goodwill valuation.

Compute the value of goodwill.

SOLUTION :

CALCULATION OF ADJUSTED PROFITS

Year Ending	31.3.2012	31.3.2013	31.3.2014	31.3.2015
	₹	₹	₹	₹
Profits	20,200	24,800	20,000	30,000
Less : Charge for Management Cost	4,800	4,800	4,800	4,800
	15,400	20,000	15,200	25,200
Add : Capital expenditure charged to revenue	—	—	6,000	—
	15,400	20,000	21,200	25,200
Less : Depreciation (not provided)	—	—	200[1]	580[1]
	15,400	20,000	21,000	24,620
Less : Over Valuation of Closing Stock	—	2,400	—	—
	15,400	17,600	21,000	24,620
Add : Over Valuation of Opening Stock	—	—	2,400	—
Adjusted Profits	15,400	17,600	23,400	24,620

CALCULATION OF WEIGHTED AVERAGE PROFITS

Year ending	Profits	Weight	Products
	₹		
31.3.2012	15,400	1	15,400
31.3.2013	17,600	2	35,200
31.3.2014	23,400	3	70,200
31.3.2015	24,620	4	98,480
		10	2,19,280

Weighted Average Profits = $\frac{2,19,280}{10} = 21,928$

Goodwill at 3 year's purchase = ₹21,928 × 3 = ₹65,784

Working Notes :

(1) Depreciation for the year ending 31st March, 2014 = 10% of ₹6,000 for 4 months

$$= 6{,}000 \times \frac{10}{100} \times \frac{4}{12} = ₹200.$$

(2) Depreciation for the year ending 31st March, 2015 = 10% of ₹5,800 *(i.e.*, 6,000 – 200)

$$= ₹5{,}800 \times \frac{10}{100} = ₹580.$$

(3) Closing Stock of 2013 automatically becomes the Opening Stock of 2014.

ILLUSTRATION 9.

Calculate the goodwill of a firm on the basis of two year's purchase of the weighted average profits of the last five years. Weights assigned to each year would be: 1, 2, 3, 4 and 5 respectively to the profits ended 31st March 2015, 2016, 2017, 2018 and 2019.

The Profits for these five years were :

Year ended	*31st March, 2015*	*31st March, 2016*	*31st March, 2017*	*31st March, 2018*	*31st March, 2019*
Profits (₹)	36,000	1,70,000	1,90,000	2,00,000	3,50,000

Scrutiny of books of accounts revealed the following :

(*i*) An abnormal loss of ₹50,000 was incurred during the year ended 31st March, 2015.

(*ii*) An abnormal gain of ₹30,000 was earned during the year ended 31st March, 2016.

(*iii*) Repairs to Car amounting to ₹40,000 was wrongly debited to Vehicles A/c on 1st January, 2018. Depreciation was charged on Vehicles @ 10% p.a. on Straight Line Method.

(*iv*) Closing Stock as on 31st March 2018 was undervalued by ₹50,000.

SOLUTION : Calculation of Adjusted Profits

Particulars	*31st March, 2015*	*31st March, 2016*	*31st March, 2017*	*31st March, 2018*	*31st March, 2019*
	₹	₹	₹	₹	₹
Profits	36,000	1,70,000	1,90,000	2,00,000	3,50,000
Add : Abnormal Loss	50,000				
Less : Abnormal Gain		(30,000)			
Less : Repair expenses that should have been debited to P & L A/c				(40,000)	
Add : Depreciation wrongly debited to P & L A/c (There should					

	have been no depreciation at all)				1,000(1)	4,000(2)
Add :	Closing Stock under-valued				50,000(3)	
Less :	Opening Stock under-valued					(50,000)(4)
	Adjusted Profits	86,000	1,40,000	1,90,000	2,11,000	3,04,000

Calculation of Weighted Average Profits :

Year ended	*Profits* (₹)	*Weight*	*Products* (₹)
31.3.2015	86,000	1	86,000
31.3.2016	1,40,000	2	2,80,000
31.3.2017	1,90,000	3	5,70,000
31.3.2018	2,11,000	4	8,44,000
31.3.2019	3,04,000	5	15,20,000
		15	33,00,000

$$\text{Weighted Average Profit} = \frac{33,00,000}{15} = ₹2,20,000$$

Goodwill = Weighted Average Profit × Number of Year's Purchase
= ₹2,20,000 × 2 = ₹4,40,000

Working Notes :

1. Depreciation for the year ended 31.3.2018 :
10% on ₹40,000 for 3 months = ₹1,000.
2. Depreciation for the year ended 31.3.2019 :
10% on ₹40,000 (Under Straight Line Method) = ₹4,000.
3. Closing Stock under-valued reduced the profits of the year ended 31.3.2018. Hence, it is to be added to profits.
4. Closing Stock of previous year becomes Opening Stock of next year. Since Closing Stock of the year ended 31.3.2018 was undervalued, it means Opening Stock as on 1.4.2018 is also under-valued as a result of which profit for the year ended 31.3.2019 is higher by ₹50,000. Hence, profits will have to be reduced by this amount.

2. Super Profit Method :— In this method goodwill is calculated on the basis of surplus (excess) profits earned by a firm in comparison to average profits earned by other firms. If a business has no anticipated excess earnings, it will have no goodwill. Such excess profits are called super profits and the goodwill is calculated on the basis of super profits. For example, if the normal rate of earning applicable in a particular type of business is 15% and if our firm is also engaged in the same type of business and we have invested ₹1,00,000 as capital and if we are earning ₹25,000 as profits, the Normal Profits at the rate of 15% on ₹1,00,000 should be ₹15,000, whereas, we are earning **Actual Profits** of ₹25,000. Therefore, ₹25,000 – ₹15,000 = ₹10,000 are **Super Profits.** Goodwill is calculated by multiplying the Super Profits by a reasonable number of years, such as two years purchase or three years purchase etc.

Thus the Formula is :

$$(i)\ \text{Normal Profit} = \frac{\text{Capital invested} \times \text{Normal rate of return}}{100}$$

(*ii*) Super Profit = Actual or Average profit – Normal profit

(*iii*) Goodwill = Super profit × No. of years purchased

ILLUSTRATION 10.

A firm earned net profits during the last seven years as follows :

2009	₹ 20,000 Profit	2010	₹ 70,000 Loss
2011	₹ 40,000 Loss	2012	₹2,50,000 Profit
2013	₹2,70,000 Profit	2014	₹3,00,000 Profit
2015	₹3,20,000 Profit		

The Capital invested in the firm is ₹12,00,000. Normal rate of return in the similar type of business is 10%. Calculate the value of goodwill on the basis of $2\frac{1}{2}$ years' purchases of average super profits earned during the above mentioned seven years.

SOLUTION :

(*i*) Actual Average Profit :

Total profits of last 7 years = ₹20,000 – ₹70,000 – ₹40,000 + ₹2,50,000 + ₹2,70,000 + ₹3,00,000 + ₹3,20,000

= ₹10,50,000

Average Profit = $\frac{10,50,000}{7}$ = ₹1,50,000

(*ii*) Normal Profit = Capital Invested × $\frac{\text{Normal rate of return}}{100}$

= 12,00,000 × $\frac{10}{100}$ = ₹1,20,000

(*iii*) Super Profit = Actual Average Profit – Normal Profit

= ₹1,50,000 – ₹1,20,000 = ₹30,000

(*iv*) Value of Goodwill = Super profit × Number of years purchased

= ₹30,000 × 2.5 = ₹75,000.

ILLUSTRATION 11.

A firm's average profits are ₹70,000. It includes an abnormal profit of ₹5,000. Capital invested in the business is ₹5,50,000 and the normal rate of return is 10%. Calculate goodwill at four times the super profit.

SOLUTION :

(*i*) Calculation of Actual Average Profit :

Average Profit	70,000
Less : Abnormal Profit	5,000
Actual Average Profit :	65,000

(*ii*) Normal Profits = Capital Invested × $\frac{\text{Normal Rate of Return}}{100}$

= 5,50,000 × $\frac{10}{100}$ = ₹55,000

(*iii*) Super Profit = Actual Average Profit – Normal Profit

= 65,000 – 55,000 = ₹10,000

(*iv*) Goodwill = Super Profit × Number of years purchased
= ₹10,000 × 4 = ₹40,000.

ILLUSTRATION 12.

The average Net Profits expected in the future by *ABC* Firm are ₹36,000 per year. The average capital employed in the business by the firm is ₹2,00,000. The rate of return expected from capital invested in this class of business is 10%. The remuneration of the partners is estimated to be ₹6,000 per annum. Find out the value of goodwill on the basis of two years' purchase of Super Profits.

SOLUTION :

(*i*) Actual Average Profit : ₹36,000 – ₹6,000 = ₹30,000

(*ii*) Normal Profit = Capital Invested × $\frac{\text{Normal Rate of Return}}{100}$

= ₹2,00,000 × $\frac{10}{100}$ = ₹20,000

(*iii*) Super Profit = Actual Average Profit – Normal Profit
= ₹30,000 – ₹20,000 = ₹10,000

(*iv*) Value of Goodwill = Super Profit × No. of year's Purchased
= ₹10,000 × 2 = ₹20,000.

ILLUSTRATION 13.

Average profits of a firm during the last few years are ₹80,000 and the normal rate of return in a similar business is 10%. If the goodwill of the firm is ₹1,00,000 at 4 year's purchase of super profit, find the capital employed by the firm.

(C.B.S.E. 2019)

SOLUTION :

Goodwill = Super Profit × 4 Year's Purchase

₹1,00,000 = Super Profit × 4

Super Profit = $\frac{₹1,00,000}{4}$ = ₹25,000

Normal Profit = Actual Average Profit – Super Profit
= ₹80,000 – ₹25,000 = ₹55,000

Capital Employed = Normal Profit × $\frac{100}{\text{Normal Rate of Return}}$

= ₹55,000 × $\frac{100}{10}$ = ₹5,50,000

ILLUSTRATION 14.

Amit and Kartik are partners sharing profits and losses equally. They decided to admit Saurabh for an equal share in the profits. For this purpose the goodwill of the firm was to be valued at four years' purchase of super profits.

The Balance Sheet of the firm on Saurabh's admission was as follows :

Liabilities		Amount	Assets	Amount
		₹		₹
Capitals :			Machinery	75,000
Amit	90,000		Furniture	15,000
Kartik	50,000	1,40,000	Stock	30,000
Reserve		20,000	Sundry Debtors	20,000
Loan		25,000	Cash	50,000
Sundry Creditors		5,000		
		1,90,000		1,90,000

The normal rate of return is 12% per annum. Average profits of the firm for the last four years was ₹30,000. Calculate Saurabh's share of goodwill.

(C.B.S.E. 2018, Comptt.)

SOLUTION :

Capital Employed in the Firm :

		₹
	Amit's Capital	90,000
+	Kartik's Capital	50,000
+	Reserve	20,000
		1,60,000

$$\text{Normal Profit} = \text{Capital Employed} \times \frac{\text{Normal Rate of Return}}{100}$$

$$= 1,60,000 \times \frac{12}{100} = ₹19,200$$

Super Profit = Average Profit – Normal Profit

= ₹30,000 – ₹19,200 = ₹10,800

Goodwill = ₹10,800 × 4 = ₹43,200

$$\text{Saurabh's Share of Goodwill} = ₹43,200 \times \frac{1}{3} = ₹14,400.$$

ILLUSTRATION 15.

On April 1, 2020 an existing firm had assets of ₹75,000 including cash of ₹5,000. The partner's capital accounts showed a balance of ₹60,000 and reserve constituted the rest. If the normal rate of return is 10% and the goodwill of the firm is valued at ₹24,000 at 4 year's purchase of super profits, find the average profits of the firm.

SOLUTION :

Goodwill = Super Profits × 4 year's purchase

24,000 = Super Profits × 4

$$\text{Super Profits} = \frac{24,000}{4} = ₹6,000$$

$$\text{Normal Profits} = \frac{\text{Capital employed}^{(1)} \times \text{Normal Rate of Return}}{100}$$

$$= 75,000 \times \frac{10}{100} = ₹7,500$$

Super Profits = Average Profits – Normal Profits

Hence, Average Profits = Super Profits + Normal Profits
= ₹6,000 + ₹7,500 = ₹13,500.

Note 1. Capital Employed (or Net Assets) = Assets – Liabilities. In this question, Assets are ₹75,000 and Liabilities nil. Hence, Capital Employed will be ₹75,000.

ILLUSTRATION 16.

On 1st April, 2020 an existing firm had assets of ₹2,00,000 including cash of ₹4,000. Its creditors amounted to ₹10,000 on that date. The partner's capital accounts showed a balance of ₹1,60,000 while the general reserve amounted to ₹30,000. If the normal rate of return is 15% and the goodwill of the firm is valued at ₹36,000 at 3 year's purchase of super profit, find the average profits of the firm.

SOLUTION :

Goodwill = Super Profits × 3 year's purchase

36,000 = Super Profits × 3

Super Profits = $\frac{36,000}{3}$ = ₹12,000

Capital Employed = Assets – Creditors
= ₹2,00,000 – ₹10,000 = ₹1,90,000.

OR

= Partner's Capital + General Reserve
= ₹1,60,000 + ₹30,000 = ₹1,90,000

Normal Profits = $\frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100}$

= ₹1,90,000 × $\frac{15}{100}$ = ₹28,500

Super Profits = Average Profits – Normal Profits

Hence, Average Profits = Super Profits + Normal Profits
= ₹12,000 + ₹28,500 = ₹40,500.

3. Capitalisation Method : Under this method, goodwill can be calculated in two ways :

(*i*) By capitalising the average profits, or

(*ii*) By capitalising the super profits.

(*i*) **Capitalisation of Average Profits Method :** Under this method first of all we calculate the average profits and then we assess the capital needed for earning such average profits on the basis of normal rate of return. Such capital is also called capitalised value of average profits. It is calculated as under :

Capitalised Value of Average Profits = Average Profits × $\frac{100}{\text{Normal Rate of Return}}$

If a firm earns a profit of ₹50,000 p.a. on an average basis and the normal rate of return is 10% p.a., the capitalised value of average profits will be :

$$50,000 \times \frac{100}{10} = ₹5,00,000$$

Goodwill is calculated by deducting the actual capital employed in business (*i.e.,* total tangible assets less outside liabilities on he date of valuation of Goodwill) from the capitalised value of average profits. If, in the above example, the actual

capital employed amount to ₹4,00,000, the goodwill will be valued at ₹1,00,000, *i.e.*, ₹5,00,000 – ₹4,00,000. There will be no goodwill if the actual capital employed in the business exceeds or equals the capitalised value of average profits.

ILLUSTRATION 17.

From the figures given below, calculate goodwill according to the capitalisation of Average Profits Method :

(*i*)	Actual Average Profits	= ₹72,000
(*ii*)	Normal Rate of Return	= 10%
(*iii*)	Assets	= ₹9,70,000
(*iv*)	Liabilities	= ₹4,00,000

SOLUTION :

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

$$= 72,000 \times \frac{100}{10} = ₹7,20,000$$

Capital Employed (*i.e.*, Net Assets as on the date of Valuation of Goodwill) = Assets – Liabilities

= ₹9,70,000 – ₹4,00,000 = ₹5,70,000.

Goodwill = Capitalised Value of Average Profits – Net Assets

= ₹7,20,000 – ₹5,70,000 = ₹1,50,000.

ILLUSTRATION 18.

Varun and Kuber are partners in a business. Balance in Capital and Current Accounts on 31st March, 2019 were :

	Capital Account	*Current Account*
Varun	₹5,00,000	₹80,000
Kuber	₹3,50,000	₹20,000 (Dr.)

Profits of the last five consecutive years ending 31st March were : 2015 ₹60,000; 2016 Loss ₹40,000; 2017 ₹1,30,000; 2018 ₹2,00,000 and 2019 ₹2,50,000.

General Reserve appeared in the books at ₹50,000.

If the normal rate of return is 10%, find the value of goodwill by Capitalisation of Average Profit Method.

SOLUTION :

$$\text{Average Profits} = \frac{60,000 - 40,000 + 1,30,000 + 2,00,000 + 2,50,000}{5} = ₹1,20,000$$

$$\text{Capitalised Value of Average Profits} = \text{Average Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

$$= 1,20,000 \times \frac{100}{10} = ₹12,00,000$$

Capital Employed = Capital Accounts + Current Accounts + General Reserve

= ₹5,00,000 + ₹3,50,000 + ₹80,000 – ₹20,000 + ₹50,000

= ₹9,60,000

Goodwill = Capitalised Value of Average Profits – Capital Employed
= ₹12,00,000 – ₹9,60,000 = ₹2,40,000.

(*ii*) **Capitalisation of Super Profit Method :** Under this method first of all we calculate the Super Profits and then we assess the capital needed for earning such super profits on the basis of normal rate of return. Such capital is actually the amount of goodwill. Following formula is used to calculate goodwill :

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

Super Profits are calculated in the same manner as calculated in super profits method.

ILLUSTRATION 19.

From the figures given in Illustration 17, calculate goodwill according to the Capitalisation of Super Profit Method.

SOLUTION :

Capital Employed = Assets – Liabilities
= ₹9,70,000 – ₹4,00,000 = ₹5,70,000

Super Profit = Average Profit – Normal Profit
= ₹72,000 – ₹57,000 (10% of ₹5,70,000)
= ₹15,000

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal rate of return}}$$

$$= 15{,}000 \times \frac{100}{10} = ₹1{,}50{,}000.$$

ILLUSTRATION 20 (A).

From the following information, calculate goodwill by (*i*) Capitalisation Method and (*ii*) at 3 year's purchase of super profits :

(*i*) Total Assets ₹10,00,000

(*ii*) External Liabilities ₹1,80,000

(*iii*) Normal Rate of Return 10%

(*iv*) Average Net Profit of last five years ₹1,00,000

SOLUTION :

(*i*) Goodwill as per Capitalisation Method :

Capital Employed (Net Assets) = Total Assets – External Liabilities
= ₹10,00,000 – ₹1,80,000 = ₹8,20,000

Normal Profit = 10% of ₹8,20,000 = ₹82,000

Super Profit = Average Profit – Normal Profit
= ₹1,00,000 – ₹82,000
= ₹18,000

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

$$= 18{,}000 \times \frac{100}{10} = ₹1{,}80{,}000$$

(*ii*) Goodwill as per 3 year's purchase of super profits :

Goodwill = Super Profit × Number of Year's purchased
= ₹18,000 × 3 = ₹54,000

ILLUSTRATION 20 (B).

The following information relates to a partnership firm :

(*a*) Profits for the last five years :

2012	₹ 80,000	2015	₹1,50,000
2013	₹1,00,000	2016	₹2,70,000
2014	₹2,00,000		

(*b*) Average Capital Employed is ₹5,00,000.

(*c*) Rate of normal profit 20%.

Find out the value of goodwill on the basis of :

(*i*) Three year's purchase of average profits

(*ii*) Three year's purchase of super profits.

(*iii*) Capitalisation of super profits.

SOLUTION : Average Profit :

Total Profits = ₹80,000 + ₹1,00,000 + ₹2,00,000 + ₹1,50,000 + ₹2,70,000
= ₹8,00,000

Average Profit = $₹\frac{8,00,000}{5}$ = ₹1,60,000

(*i*) On the basis of average profits :

Value of goodwill at 3 year's purchase of average profits :

₹1,60,000 × 3 = ₹4,80,000.

(*ii*) On the basis of super profits :

	₹
Average Profit	1,60,000
Less : Normal Profits 20% of ₹5,00,000	1,00,000
Super Profits	60,000

Value of goodwill at 3 year's purchase of super profits :

₹60,000 × 3 = ₹1,80,000.

(*iii*) On the basis of capitalisation of super profits :

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

$$= ₹60,000 \times \frac{100}{20} = ₹3,00,000.$$

Accounting Treatment of Goodwill when there is change in the profit sharing ratio of existing partners

A change in profit sharing ratio basically implies that one partner is purchasing from another partner, a share of profits previously belonging to the latter. The purchasing or gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill. In other words, the gaining partner should pay the

sacrificing partner that share of goodwill which is equal to the share gained by him. For example, suppose *X* and *Y* are sharing profits in the proportion of $\frac{4}{5} : \frac{1}{5}$. If it is decided that in future they will share profits in the proportion of $\frac{3}{5} : \frac{2}{5}$, it implies that *X* is selling $\frac{1}{5}$ th $(\frac{4}{5} - \frac{3}{5})$ share to *Y*. If the profits of the firm are ₹1,00,000 p.a. *X* will lose ₹20,000 and *Y* will gain ₹20,000 annually. This must be compensated by *Y* by paying to *X* an amount equal to $\frac{1}{5}$th of total value of goodwill of the firm. If the goodwill is valued at ₹2,50,000, *Y* must pay *X* $\frac{1}{5}$th of ₹2,50,000, *i.e.,* ₹50,000. Such an adjustment is made by passing an adjustment entry wherein *Y*'s Capital Account will be debited and *X*'s Capital Account will be Credited with ₹50,000.

ILLUSTRATION 21.

A, B and *C* are partners sharing profits and losses in the ratio of 5 : 4 : 1. It was decided that with effect from 1st April, 2016 the profit sharing ratio will be 9 : 6 : 5. Goodwill is to be valued at 2 year's purchase of average of 3 year's profits. The profits for 2013-14, 2014-15 and 2015-16 were ₹48,000, ₹42,000 and ₹60,000 respectively.

Pass the necessary journal entry for the treatment of goodwill.

SOLUTION :

Average Profits = ₹$\frac{48,000 + 42,000 + 60,000}{3}$ = ₹50,000.

Value of Goodwill at 2 year's purchase = ₹50,000 × 2 = ₹1,00,000.
Old Ratio of *A, B* and *C* = 5 : 4 : 1
New Ratio of *A, B* and *C* = 9 : 6 : 5

Sacrifice or Gain :

$A = \frac{5}{10} - \frac{9}{20} = \frac{10-9}{20} = \frac{1}{20}$ (Sacrifice)

$B = \frac{4}{10} - \frac{6}{20} = \frac{8-6}{20} = \frac{2}{20}$ (Sacrifice)

$C = \frac{1}{10} - \frac{5}{20} = \frac{2-5}{20} = \frac{3}{20}$ (Gain)

Since *A* has sacrificed, he will be credited by $\frac{1}{20}$ of ₹1,00,000 = ₹ 5,000

Since *B* has sacrificed, he will be credited by $\frac{2}{20}$ of ₹1,00,000 = ₹10,000

Since *C* has gained, he will be debited by $\frac{3}{20}$ of ₹1,00,000 = ₹15,000

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2016					
April 1	*C*'s Capital A/c	Dr.		15,000	
	To *A*'s Capital A/c				5,000
	To *B*'s Capital A/c				10,000
	(Adjustment for goodwill due to change in profit sharing ratio)				

ILLUSTRATION 22.

P, Q and *R* are partners sharing profits equally. They decided that in future *R* will get $\frac{1}{5}$th share in profits. On the day of change, firm's goodwill is valued at ₹3,00,000. Make the necessary journal entry.

SOLUTION :

Old Ratio of *P, Q* and *R* = $\frac{1}{3} : \frac{1}{3} : \frac{1}{3}$

New Ratio of *P, Q* and *R* = $\frac{2}{5} : \frac{2}{5} : \frac{1}{5}$

Sacrifice or Gain :

$$P = \frac{1}{3} - \frac{2}{5} = \frac{5-6}{15} = \frac{1}{15} \text{ (Gain)}$$

$$Q = \frac{1}{3} - \frac{2}{5} = \frac{5-6}{15} = \frac{1}{15} \text{ (Gain)}$$

$$R = \frac{1}{3} - \frac{1}{5} = \frac{5-3}{15} = \frac{2}{15} \text{ (Sacrifice)}$$

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	P's Capital A/c (1/15 of 3,00,000)	Dr.		20,000	
	Q's Capital A/c (1/15 of 3,00,000)	Dr.		20,000	
	To *R*'s Capital A/c (2/15 of 3,00,000)				40,000
	(*R* compensated by *P* and *Q* for the sacrifice made by him)				

ILLUSTRATION 23.

X and *Y* were partners sharing profits and losses in the ratio of 3 : 1. They decided that with effect from 1st April 2016, they would share profits and losses in the ratio of 5 : 3. The partnership deed provides that in the event of any change in profit sharing ratio, the goodwill should be valued at the total of two year's profits preceding the date the decision became effective. The profits for 2013-14, 2014-15 and 2015-16 were ₹60,000, ₹70,000 and ₹90,000 respectively. Pass the necessary Journal entry to give effect to the above arrangement.

SOLUTION :

Value of goodwill = ₹70,000 + ₹90,000 = ₹1,60,000

Calculation of Sacrifice or Gain :

Old Ratio 3 : 1

New Ratio 5 : 3

$$X = \frac{3}{4} - \frac{5}{8} = \frac{6-5}{8} = \frac{1}{8} \text{ (Sacrifice)}$$

$$Y = \frac{1}{4} - \frac{3}{8} = \frac{2-3}{8} = \frac{1}{8} \text{ (Gain)}$$

Since X has sacrificed, he will be credited from $\frac{1}{8}$ of ₹1,60,000 = ₹20,000

Since Y has gained, he will be debited from $\frac{1}{8}$ of ₹1,60,000 = ₹20,000

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2016 April 1	*Y*'s Capital A/c	Dr.		20,000	
	To *X*'s Capital A/c				20,000
	(Adjustment for goodwill due to change in profit sharing ratio)				

Accounting treatment of Reserves and Accumulated profits when there is change in the profit sharing ratio of existing partner's

Case (*i*) When Reserves and Accumulated Profits/Losses are to be transferred to Capital Accounts :

If, at the time of change in the profit sharing ratio, there are Reserves or Accumulated profits/losses existing in the books of the firm, these should be transferred to the Partner's Capital Accounts (if capitals are fluctuating) or to Current Accounts (if capitals are fixed) in their old profit sharing ratio. The reason for such transfer is that these reserves and accumulated profits/losses have come into existence before the change in profit sharing ratio and hence belong to the partners in their old profit sharing ratio. Following entries are passed for this purpose :

(*i*) **For Transfer of Reserves and Accumulated Profits :**

Reserve A/c	Dr.	
Profit & Loss A/c	Dr.	
Workmen's Compensation Reserve A/c	Dr.	(Excess of Reserve over Actual Liability)
Investment Fluctuation Reserve A/c	Dr.	(Excess of Reserve over difference between Book value and Market value)

To Old Partner's Capital or Current A/cs (in Old Ratio)

(*ii*) **For transfer of Accumulated Losses :**

Old Partner's Capital or Current A/cs	Dr. (in Old Ratio)
To Profit & Loss A/c	
To Deferred Revenue Expenditure A/c	(for example Advertisement Suspense A/c)

ILLUSTRATION 24.

X, Y and *Z* are partners sharing profits in the ratio of 4 : 3 : 2. From April 1, 2017, they decided to share the profits equally. On that date their books showed the following items :

	₹
Profit & Loss Account (Cr.)	1,20,000
General Reserve	45,000
Workmen Compensation Reserve	60,000
Advertisement Suspense Account (Dr.)	90,000

Record the necessary Journal entries.

SOLUTION :

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Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2017					
April 1	Profit & Loss A/c	Dr.		1,20,000	
	General Reserve A/c	Dr.		45,000	
	Workmen Compensation Reserve A/c	Dr.		60,000	
	To *X*'s Capital A/c (4/9)				1,00,000
	To *Y*'s Capital A/c (3/9)				75,000
	To *Z*'s Capital A/c (2/9)				50,000
	(Transfer of undistributed profit and general reserve on change in profit sharing ratio)				
April 1	*X*'s Capital A/c	Dr.		40,000	
	Y's Capital A/c	Dr.		30,000	
	Z's Capital A/c	Dr.		20,000	
	To Advertisement Suspense A/c				90,000
	(Transfer of Advertisement Suspense A/c on change in profit sharing ratio)				

ILLUSTRATION 25.

Babita, Kavita and Dinesh were partners in a firm. From 1st April, 2018 they decided to share the profits in the ratio of 2 : 3 : 5. On this date the Balance Sheet of the firm showed a balance of ₹60,000 in Contingency Reserve and debit balance of ₹1,20,000 in Profit and Loss Account. The Goodwill of the firm was valued at ₹3,60,000.

Pass necessary journal entries for the above transactions in the books of the firm. Also show your workings clearly. *(C.B.S.E. 2019, Chennai)*

SOLUTION : **Books of Babita, Kavita and Dinesh**

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Contingency Reserve A/c	Dr.		60,000	
	To Babita's Capital A/c				20,000
	To Kavita's Capital A/c				20,000
	To Dinesh's Capital A/c				20,000
	(Contingency reserve transferred in old ratio)				
	Babita's Capital A/c	Dr.		40,000	
	Kavita's Capital A/c	Dr.		40,000	
	Dinesh's Capital A/c	Dr.		40,000	
	To Profit and Loss A/c				1,20,000
	(Debit Balance of profit and loss a/c transferred in old ratio)				
	Dinesh's Capital A/c (5/30 of 3,60,000)	Dr.		60,000	
	To Babita's Capital A/c (4/30 of 3,60,000)				48,000
	To Kavita's Capital A/c (1/30 of 3,60,000)				12,000
	(Adjustment for goodwill)				

Calculation of Gaining/Sacrificing Ratio =

$$\text{Babita} = \frac{1}{3} - \frac{2}{10} = \frac{10-6}{30} = \frac{4}{30} \text{ (Sacrifice)}$$

$$\text{Kavita} = \frac{1}{3} - \frac{3}{10} = \frac{10-9}{30} = \frac{1}{30} \text{ (Sacrifice)}$$

$$\text{Dinesh} = \frac{1}{3} - \frac{5}{10} = \frac{10-15}{30} = \frac{5}{30} \text{ (Gain)}$$

Workmen Compensation Reserve :

This reserve is created out of firm's profits to pay compensation to employees. At the time of change in profit sharing ratio, it is treated as follows :

(1) **If there is no claim against Workmen Compensation Reserve :** In such a case, the entire amount of Workmen Compensation Reserve is credited to the Capital Accounts of partners in their old profit sharing ratio :
The Journal Entry passed is :

Workmen Compensation Reserve A/c Dr.
To Partner's Capital A/cs
(Workmen Compensation Reserve credited to partners Capital Accounts in their old profit sharing ratio)

(2) **If the claim for workmen compensation is lower than the amount of Workmen Compensation Reserve :** The amount of claim is credited to 'Provision for Workmen Compensation Claim A/c' and balance is credited to the Capital Accounts of partners in their old profit sharing ratio (Suppose Workmen Compensation Reserve is ₹50,000 and liability for claim is ₹20,000). The Journal Entry passed is :

Workmen Compensation Reserve A/c	Dr.	50,000		
To Provision for Workmen Compensation Claim A/c				20,000
To Partner's Capital A/cs				30,000

(Amount of claim transferred to liability and balance to partner's Capital Accounts in their old profit sharing ratio)

(3) **If the claim is equal to Workmen Compensation Reserve :** Entire amount of Workmen Compensation Reserve is transferred to Provision for Workmen Compensation Claim A/c :

Workmen Compensation Reserve A/c	Dr.			
To Provision for Workmen Compensation Claim A/c				

(Provision made for workmen compensation claim)

(4) **If the claim is more than the amount of Workmen Compensation Reserve:**

Entire amount of Workmen Compensation Reserve along with the excess claim is credited to 'Provision for Workmen Compensation Claim A/c'. The amount of excess claim is debited to 'Revaluation Account' because the loss must be borne by partners in their old profit sharing ratio. (Suppose Workmen Compensation Reserve is ₹50,000 and liability for claim is ₹60,000). The Journal entries passed are :

(*i*) Workmen Compensation Reserve A/c	Dr.	50,000		
Revaluation A/c	Dr.	10,000		
To Provision for Workmen Compensation Claim A/c				60,000

(Amount of claim debited to Workmen Compensation Reserve and Revaluation A/c)

(*ii*) Partners Capital A/cs	Dr.	10,000		
To Revaluation A/c				10,000

(Loss on revaluation transferred to capital accounts of partners in their old profit sharing ratio)

ILLUSTRATION 26.

P, Q and *R* sharing profits and losses in the ratio of 3 : 2 : 1, decide to share future profits and losses in the ratio of 4 : 3 : 2 with effect from 1st April, 2017. Following is an extract of their Balance Sheet as at 31st March, 2017 :

Liabilities	₹	*Assets*	₹
Workmen Compensation Reserve	60,000		

Show the accounting treatment under the following alternative cases :

Case (*i*) If there is no other information.

Case (*ii*) If a claim on account of workmen's compensation is estimated at ₹24,000.

Case (*iii*) If a claim on account of workmen's compensation is estimated at ₹60,000.

Case (*iv*) If a claim on account of workmen's compensation is estimated at ₹75,000.

SOLUTION : JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2017					
April 1	*Case (i)*				
	Workmen Compensation Reserve A/c	Dr.		60,000	
	To *P*'s Capital A/c				30,000
	To *Q*'s Capital A/c				20,000
	To *R*'s Capital A/c				10,000
	(Transfer of Workmen Compensation Reserve to partner's capital accounts in their old profit sharing ratio)				
	Case (ii)				
	Workmen Compensation Reserve A/c	Dr.		60,000	
	To Provision for Workmen Compensation Claim A/c				24,000
	To *P*'s Capital A/c				18,000
	To *Q*'s Capital A/c				12,000
	To *R*'s Capital A/c				6,000
	(Transfer of excess Workmen Compensation Reserve to partner's capital accounts in their old profit sharing ratio)				
	Case (iii)				
	Workmen Compensation Reserve A/c	Dr.		60,000	
	To Provision for Workmen Compensation Claim A/c				60,000
	(Provision made for Workmen Compensation Claim)				
	Case (iv)				
	Workmen Compensation Reserve A/c	Dr.		60,000	
	Revaluation A/c	Dr.		15,000	
	To Provision for Workmen Compensation Claim A/c				75,000
	(Provision created and shortfall charged to Revaluation Account)				
	P's Capital A/c	Dr.		7,500	
	Q's Capital A/c	Dr.		5,000	
	R's Capital A/c	Dr.		2,500	
	To Revaluation A/c				15,000
	(Transfer of loss on revaluation to partner's capital accounts in their old profit sharing ratio)				

ILLUSTRATION 27.

Mita, Gopal and Farhan were partners sharing profits and losses in the ratio 3 : 2 : 1. On 31st March, 2018 they decided to change the profit sharing ratio to 5 : 3 : 2. On this date, the Balance Sheet showed the following :

	₹
Deferred Advertisement Expenditure	30,000
Contingency Reserve	9,000
Workmen Compensation Reserve	48,000

A claim on account of workmen compensation of ₹60,000 was admitted. Goodwill was valued at ₹4,80,000. Pass the necessary journal entries for the above transactions in the books of the firm on its reconstitution.

SOLUTION :

Books of Mita, Gopal and Farhan

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2018	Mita's Capital A/c	Dr.		15,000	
Mar. 31	Gopal's Capital A/c	Dr.		10,000	
	Farhan's Capital A/c	Dr.		5,000	
	To Deferred Advertisement Exp A/c				30,000
	(Deferred Revenue Expense adjusted in old ratio)				
	Contingency Reserve A/c	Dr.		9,000	
	To Mita's Capital A/c				4,500
	To Gopal's Capital A/c				3,000
	To Farhan's Capital A/c				1,500
	(Contingency Reserve adjusted in old ratio)				
	Workmen Compensation Reserve A/c	Dr.		48,000	
	Revaluation A/c	Dr.		12,000	
	To Provision for Workmen Compensation Claim A/c				60,000
	(Provision created and shortfall met from Revaluation account)				
	Mita's Capital A/c	Dr.		6,000	
	Gopal's Capital A/c	Dr.		4,000	
	Farhan's Capital A/c	Dr.		2,000	
	To Revaluation A/c				12,000
	(Transfer of loss on revaluation)				
	Farhan's Capital A/c (1/30 of 4,80,000)	Dr.		16,000	
	To Gopal's Capital A/c				16,000
	(Adjustment for goodwill)				

Working Note : Calculation of Sacrifice or Gain :

Mita $= \frac{3}{6} - \frac{5}{10}$ = Nil

Gopal $= \frac{2}{6} - \frac{3}{10} = \frac{10-9}{30} = \frac{1}{30}$ Sacrifice

Farhan $= \frac{1}{6} - \frac{2}{10} = \frac{5-6}{30} = \frac{1}{30}$ Gain

Investment Fluctuation Reserve :

This reserve is created out of firm's profits to meet the fall in the market value of investments. At the time of change in profit sharing ratio, this reserve is treated as follows :

1. **When Book Value and Market Value of Investments is same :** In such a case, the entire amount of Investment Fluctuation Reserve is transferred to the Capital Accounts of partners in their old profit sharing ratio. The entry is :

Investment Fluctuation Reserve A/c Dr.
To Partner's Capital A/cs

2. **When Market value of Investments is less than the Book Value :** In such a case, the accounting treatment depends on the quantum of decrease. There may be three possibilities :

(*i*) **Fall in the value is Less Than Investment Fluctuation Reserve :** In such a case, Investment Fluctuation Reserve, to the extent of fall in value, is credited to Investments A/c and the balance is credited to Partner's Capital A/cs in their old profit sharing ratio. The entry is :

Investment Fluctuation Reserve A/c	Dr.
To Investments A/c	(Book Value – Market Value)
To Partner's Capital A/cs	(In old ratio)

(*ii*) **Fall in the value is Equal to Investment Fluctuation Reserve :** In such a case, entire amount of Investment Fluctuation Reserve is credited to Investments A/c. The entry is :

Investment Fluctuation Reserve A/c	Dr.
To Investments A/c	

(*iii*) **Fall in the value is More than Investment Fluctuation Reserve :** In such a case, entire amount of Investment Fluctuation Reserve, along with the amount of excess fall in value is credited to Investments A/c. The amount of excess fall is debited to Revaluation A/c because the loss must be borne by the partners in their old profit sharing ratio. The entries are :

(*i*)	Investment Fluctuation Reserve A/c	Dr.
	Revaluation A/c	Dr.
	To Investments A/c	
(*ii*)	Partner's Capital A/cs	Dr. (In old ratio)
	To Revaluation A/c	

3. **When Market Value of Investments is More than the Book value : In such a case three entries are passed :**

(*i*) Entire amount of Investment Fluctuation Reserve is credited to Partner's Capital A/cs :

Investment Fluctuation Reserve A/c	Dr.
To Partner's Capital A/cs	(In old ratio)

(*ii*) Increase in the value of Investments is debited to Investments A/c and credited to Revaluation A/c :

Investments A/c	Dr. (To bring the value of Investments to Market Value)
To Revaluation A/c	

(*iii*)

Revaluation A/c	Dr.
To Partner's Capital A/cs	(In old ratio)

ILLUSTRATION 28.

P, Q and *R* sharing profits and losses in the ratio of 3 : 2 : 1, decide to share profits and losses equally with effect from 1st April, 2017. Following is an extract of their Balance Sheet as at 31st March, 2017 :

Liabilities	₹	*Assets*	₹
Investment Fluctuation Reserve	30,000	Investments (At Cost)	5,00,000

Show the accounting treatment under the following alternative cases :

Case (*i*) If there is no other information.
Case (*ii*) If the market value of Investments is ₹5,00,000.
Case (*iii*) If the market value of Investments is ₹4,88,000.

Case (*iv*) If the market value of Investments is ₹4,46,000.
Case (*v*) If the market value of Investments is ₹5,06,000.

SOLUTION : JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2017					
April 1	*Case (i)*				
	Investment Fluctuation Reserve A/c	Dr.		30,000	
	To *P*'s Capital A/c				15,000
	To *Q*'s Capital A/c				10,000
	To *R*'s Capital A/c				5,000
	(Transfer of excess Investment Fluctuation Reserve to partner's capital accounts in their old profit sharing ratio)				
	Case (ii)				
	Same Solution as given in case (*i*)				
	Case (iii)				
	Investment Fluctuation Reserve A/c	Dr.		30,000	
	To Investments A/c (5,00,000 – 4,88,000)				12,000
	To *P*'s Capital A/c				9,000
	To *Q*'s Capital A/c				6,000
	To *R*'s Capital A/c				3,000
	(Transfer of excess Investment Fluctuation Reserve to partner's capital accounts in their old profit sharing ratio)				
	Case (iv)				
	Investment Fluctuation Reserve A/c	Dr.		30,000	
	Revaluation A/c	Dr.		24,000	
	To Investments A/c				54,000
	(Fall in the value of investments adjusted through investment fluctuation reserve and shortfall charged to Revaluation Account)				
	P's Capital A/c	Dr.		12,000	
	Q's Capital A/c	Dr.		8,000	
	R's Capital A/c	Dr.		4,000	
	To Revaluation A/c				24,000
	(Transfer of loss on revaluation to partner's capital accounts in their old profit sharing ratio)				
	Case (v)				
	Investment Fluctuation Reserve A/c	Dr.		30,000	
	To *P*'s Capital A/c				15,000
	To *Q*'s Capital A/c				10,000
	To *R*'s Capital A/c				5,000
	(Transfer of excess investments fluctuation reserve to Partners' Capital Accounts in their old profit-sharing ratio)				
	Investments A/c	Dr.		6,000	
	To Revaluation A/c				6,000
	(Value of investments brought up to market value)				

	Revaluation A/c	Dr.		6,000	
	To *P*'s Capital A/c				3,000
	To *Q*'s Capital A/c				2,000
	To *R*'s Capital A/c				1,000
	(Transfer of profit on revaluation in old profit sharing ratio)				

Case (*ii*) When Reserves and Accumulated Profits/Losses are not to be transferred to Capital Accounts :

If, in case of change in profit sharing ratio, there are reserves and accumulated profits appearing in the Balance Sheet and the partners decide to leave the reserves and accumulated profits undistributed, it will be necessary to pass an adjusting entry for the same. This is, because, at present the partners are entitled to share such reserves and profits in the old profit sharing ratio whereas in future they will be entitled to share such reserves and profits in the new profit sharing ratio. Hence, the gaining partner must compensate the sacrificing partner that share of reserves and profits which is proportionate to the share gained by him. For example, suppose *A* and *B* sharing profits in the ratio of 2 : 1 decide to share future profits in equal proportion. Reserves appearing in the Balance Sheet amount to ₹60,000 and the partners do not want to distribute them. In such a case at present *A* is entitled to ₹40,000 and *B* ₹20,000 of such reserves but in future, after the change in the profit sharing ratio, each would be entitled to ₹30,000. Hence, *B* must compensate *A* to the extent of ₹10,000. This amount is proportionate to the $\frac{1}{6}$ th share (*i.e.*, $\frac{1}{2} - \frac{1}{3}$) gained by him. The adjustment for this amount is usually made by passing an adjustment entry wherein *B*'s Capital Account will be debited and *A*'s Capital Account will be credited with ₹10,000.

ILLUSTRATION 29.

A and *B* are partners in a firm sharing profits in the ratio of 4 : 3. On March 31, 2016 their Balance Sheet showed a General Reserve of ₹35,000. On that date they decided to admit Sewak as a new partner and the new profit-sharing ratio will be 5 : 3 : 2. Record necessary journal entries in the books of the firm under the following circumstances :

(*i*) When they want to transfer the general reserve to their capital accounts.

(*ii*) When they don't want to transfer general reserve in their capital accounts but prefer to record an adjustment entry for the same.

SOLUTION :

***Alternative (i)* When General Reserve is transferred to Capital Accounts :**

JOURNAL

Date	*Particulars*		*L.F.*	*Dr. (₹)*	*Cr. (₹)*
2016					
March 31	General Reserve A/c	Dr.		35,000	
	To *A*'s Capital A/c				20,000
	To *B*'s Capital A/c				15,000
	(General reserve transferred to the Capital accounts of partners on the reconstitution of the firm)				

Alternative (*ii*) When General Reserve is not transferred to Capital Accounts :

Old Ratio of *A* and *B* = 4 : 3

New Ratio of *A*, *B* and Sewak= 5 : 3 : 2

Sacrifice or Gain :

$A = \frac{4}{7} - \frac{5}{10} = \frac{40-35}{70} = \frac{5}{70}$ (Sacrifice)

$B = \frac{3}{7} - \frac{3}{10} = \frac{30-21}{70} = \frac{9}{70}$ (Sacrifice)

Sewak = $\frac{2}{10}$ or $\frac{14}{70}$ (Gain)

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2016 March 31	Sewak's Capital A/c ($\frac{14}{70}$ of 35,000)	Dr.		7,000	
	To *A*'s Capital A/c ($\frac{5}{70}$ of 35,000)				2,500
	To *B*'s Capital A/c ($\frac{9}{70}$ of 35,000)				4,500
	(Adjustment for general reserve on the admission of Sewak)				

ILLUSTRATION 30.

X, Y and *Z* sharing profits and losses in the ratio of 1 : 2 : 2, decide to share future profits equally with effect from 1st April, 2016. On that date, Profit & Loss Account showed a credit balance of ₹1,20,000. Partners do not want to distribute the profit but prefer to record the change in the profit sharing ratio by passing an adjustment entry. You are required to give the adjusting entry.

SOLUTION :

Old Ratio of *X, Y* and *Z* $\frac{1}{5} : \frac{2}{5} : \frac{2}{5}$

New Ratio of *X, Y* and *Z* $\frac{1}{3} : \frac{1}{3} : \frac{1}{3}$

Sacrifice or Gain :

$X = \frac{1}{5} - \frac{1}{3} = \frac{3-5}{15} = \frac{2}{15}$ (Gain)

$Y = \frac{2}{5} - \frac{1}{3} = \frac{6-5}{15} = \frac{1}{15}$ (Sacrifice)

$Z = \frac{2}{5} - \frac{1}{3} = \frac{6-5}{15} = \frac{1}{15}$ (Sacrifice)

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2016					
April 1	*X*'s Capital A/c (2/15 of 1,20,000)	Dr.		16,000	
	To *Y*'s Capital A/c (1/15 of 1,20,000)				8,000
	To *Z*'s Capital A/c (1/15 of 1,20,000)				8,000
	(Adjustment for Profit and Loss Account balance on change in profit sharing ratio.)				

ILLUSTRATION 31.

A, B and *C* are partners sharing profits and losses in the ratio of 2 : 3 : 4. They decided to share future profits and losses in the ratio of 4 : 3 : 2. They also decided to record the effect of the following without affecting their book values :

	₹
General Reserve	40,000
Profit & Loss A/c	20,000
Advertisement Suspense A/c	15,000

You are required to give the necessary single journal entry.

SOLUTION :

Calculation of Net Effect of Accumulated Profits/Losses :

	₹
General Reserve	40,000
(+) Profit & Loss A/c	20,000
	60,000
(–) Advertisement Suspense A/c	15,000
Net Effect	45,000

Calculation of Sacrifice or Gain :

Old Ratio of *A, B* and *C* $\frac{2}{9} : \frac{3}{9} : \frac{4}{9}$

New Ratio of *A, B* and *C* $\frac{4}{9} : \frac{3}{9} : \frac{2}{9}$

Sacrifice or Gain :

A $\frac{2}{9} - \frac{4}{9} = \frac{2}{9}$ (Gain)

B $\frac{3}{9} - \frac{3}{9} = 0$

C $\frac{4}{9} - \frac{2}{9} = \frac{2}{9}$ (Sacrifice)

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	A's Capital A/c (2/9 of 45,000)	Dr.		10,000	
	To *C*'s Capital A/c (2/9 of 45,000)				10,000
	(Adjustment for general reserve, profit & loss account balance and advertisement suspense account on change in profit sharing ratio)				

ILLUSTRATION 32.

A, B, C and *D* are partners in a firm sharing profits and losses in the ratio of 2 : 2 : 1 : 1. They decided to share profits in future in the ratio of 4 : 3 : 2 : 1. For this purpose goodwill of the firm was valued at ₹1,80,000. There was also a reserve of ₹60,000 in the books of the firm.

Find out sacrifice and gaining ratio and pass necessary journal entry assuming that partners do not want to distribute the reserve.

SOLUTION :

		₹
Value of goodwill		1,80,000
Reserve		60,000
		2,40,000
Old Ratio of *A, B, C* and *D*	2 : 2 : 1 : 1	
New Ratio of *A, B, C* and *D*	4 : 3 : 2 : 1	

Sacrifice or Gain :

$$A = \frac{2}{6} - \frac{4}{10} = \frac{10-12}{30} = \frac{2}{30} \text{ (Gain)}$$

$$B = \frac{2}{6} - \frac{3}{10} = \frac{10-9}{30} = \frac{1}{30} \text{ (Sacrifice)}$$

$$C = \frac{1}{6} - \frac{2}{10} = \frac{5-6}{30} = \frac{1}{30} \text{ (Gain)}$$

$$D = \frac{1}{6} - \frac{1}{10} = \frac{5-3}{30} = \frac{2}{30} \text{ (Sacrifice)}$$

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	A's Capital A/c (2/30 of 2,40,000)	Dr.		16,000	
	C's Capital A/c (1/30 of 2,40,000)	Dr.		8,000	
	To *B*'s Capital A/c (1/30 of 2,40,000)				8,000
	To *D*'s Capital A/c (2/30 of 2,40,000)				16,000
	(Adjustment for goodwill and reserves on change in profit sharing ratio)				

ILLUSTRATION 33.

Divya and Pooja are partners in a firm, sharing profits and losses in the ratio of 3 : 2. On 31st March, 2015, their Balance Sheet was as under :

BALANCE SHEET OF DIVYA AND POOJA

as at 31st March, 2015

Liabilities	₹	Assets	₹
Sundry Creditors	9,800	Goodwill	16,000
General Reserve	23,400	Land and Building	20,000
Profit and Loss A/c	4,000	Investments	66,000

Investment Fluctuation Fund		12,600	Sundry Debtors	18,600
Capital A/cs :			Bills Receivables	7,400
Divya	60,000		Cash in Hand	11,100
Pooja	40,000	1,00,000	Advertisement Suspense A/c	10,700
		1,49,800		1,49,800

The partners decided that with effect from 1st April, 2015, they would share profits and losses equally.

For this purpose, they decided that :

(*a*) Investments to be valued at ₹60,000.

(*b*) Goodwill to be valued at ₹24,000.

(*c*) General Reserve not to be distributed between the partners.

You are required to :

(*i*) Pass journal entries

(*ii*) Prepare the revised Balance Sheet of the firm. *(I.S.C. 2016)*

SOLUTION :

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
	Profit and Loss A/c	Dr.		4,000	
	To Divya's Capital A/c				2,400
	To Pooja's Capital A/c				1,600
	(Profits distributed in the old ratio)				
	Investment Fluctuation Fund A/c	Dr.		12,600	
	To Investments A/c				6,000
	To Divya's Capital A/c				3,960
	To Pooja's Capital A/c				2,640
	(Loss on investments written off from Investment Fluctuation Fund)				
	Divya's Capital A/c	Dr.		9,600	
	Pooja's Capital A/c	Dr.		6,400	
	To Goodwill A/c				16,000
	(Purchased Goodwill written off)				
	Divya's Capital A/c	Dr.		6,420	
	Pooja's Capital A/c	Dr.		4,280	
	To Advertisement Suspense A/c				10,700
	(Advertisement suspense A/c written off)				
	Pooja's Capital A/c (Note 1)	Dr.		4,740	
	To Divya's Capital A/c				4,740
	(Adjustment for General Reserve and Goodwill)				

BALANCE SHEET OF DIVYA AND POOJA

as at 1st April, 2015

Liabilities	₹	*Assets*	₹
Sundry Creditors	9,800	Land and Building	20,000
General Reserve	23,400	Investments	60,000
Capital A/cs :		Sundry Debtors	18,600
Divya	55,080	Bills Receivables	7,400
Pooja	28,820	Cash in Hand	11,100
	1,17,100		1,17,100

Working Note :

1. Net Adjustment to be made :

	₹
General Reserve	23,400
Goodwill	24,000
	47,400

Sacrifice or Gain :

Old Ratio 3 : 2; New Ratio 1 : 1

Divya = $\frac{3}{5} - \frac{1}{2} = \frac{6-5}{10} = \frac{1}{10}$ Sacrifice

Pooja = $\frac{2}{5} - \frac{1}{2} = \frac{4-5}{10} = \frac{1}{10}$ Gain

Since Divya has sacrificed, she will be credited from $\frac{1}{10}$ of ₹47,400 = ₹4,740

Since Pooja has gained, she will be debited from $\frac{1}{10}$ of ₹47,400 = ₹4,740

2. CAPITAL ACCOUNTS

Particulars	*Divya*	*Pooja*	*Particulars*	*Divya*	*Pooja*
	₹	₹		₹	₹
To Goodwill A/c	9,600	6,400	By Balance b/d	60,000	40,000
To Advertisement			By Profit and Loss A/c	2,400	1,600
Suspense A/c	6,420	4,280	By Investment		
To Divya		4,740	Fluctuation Fund		
To Balance c/d	55,080	28,820	A/c	3,960	2,640
			By Pooja	4,740	
	71,100	44,240		71,100	44,240

Accounting for Revaluation of Assets and Liabilities when there is change in the profit sharing ratio of existing partners

Assets and liabilities of a firm must also be revalued at the time of change in profit sharing ratio of existing partners. The reason is that the realisable or actual value of assets and liabilities may be different from those shown in the Balance Sheet. It is possible that with the passage of time some of the assets might have appreciated in value while the value of certain other assets might have decreased and no record has been made of such changes in the books of accounts. Revaluation of assets and

liabilities becomes necessary because the change in the value of assets and liabilities belongs to the period prior to change in profit sharing ratio and hence must be shared by the partners in their old profit sharing ratio.

Revaluation of assets and liabilities may be given effect to in two different ways :

(*a*) When revised values are to be recorded in the books, and

(*b*) When revised values are not to be recorded in the books.

(a) When revised values are to be recorded in the books :

In such a case revaluation of assets and liabilities is done with the help of a new account called **'Revaluation Account.'** Sometimes this account is called as **'Profit & Loss Adjustment A/c'.** This account is a nominal account in nature. Therefore, if there is a loss due to revaluation, revaluation account is debited and if the revaluation results in a profit, the revaluation account is credited.

Following entries are passed for the purpose of revaluation :

(*i*) For decrease in the value of assets :

Revaluation A/c	Dr.	
To Assets A/c		
(Decrease in the value of assets)		

(*ii*) For increase in the value of assets :

Assets A/c	Dr.	
To Revaluation A/c		
(Increase in the value of assets)		

(*iii*) For increase in the value of liabilities :

Revaluation A/c	Dr.	
To Liabilities A/c		
(Increase in the value of liabilities)		

(*iv*) For decrease in the value of liabilities :

Liabilities A/c	Dr.	
To Revaluation A/c		
(Decrease in the value of liabilities)		

On the basis of above entries a Revaluation Account or P & L Adjustment A/c is prepared. If the credit side of this account is in excess, it reveals a profit and if the debit side is in excess, it will reveal a loss.

Such profit or loss will be divided between all the partners in their old profit sharing ratio. Following entries are passed for this purpose :

(*a*) When revaluation account shows profit :

Revaluation A/c	Dr.	
To Partner's Capital A/cs		
(Profit on revaluation credited to Partner's Capital A/cs)		

(*b*) Above entry is reversed when revaluation account shows loss :

Partner's Capital A/cs	Dr.	
To Revaluation A/c		
(Loss on revaluation debited to Partner's Capital A/cs)		

Proforma of Revaluation account is given below :

Dr. REVALUATION ACCOUNT Cr.

Particulars	₹	Particulars	₹
To Decrease in value of assets	.....	By Increase in value of assets	.....
To Increase in value of liabilities	.....	By Decrease in value of liabilities	.....
To Unrecorded liabilities	.....	By Unrecorded assets	.....
To Profit on Revaluation transferred to partner's capital/ current accounts (in old ratio)	.....	By Loss on Revaluation transferred to partner's capital/ current accounts (in old ratio)	.....
	.....		.....

ILLUSTRATION 34.

A, B & C were partners in a firm sharing profits & losses in the ratio of 3 : 2 : 1. On March 31, 2017, their Balance Sheet was as follows:

BALANCE SHEET *as at March 31, 2017*

Liabilities		₹	Assets	₹
Capitals :			Fixed Assets	1,50,000
A	50,000		Current Assets	65,000
B	40,000			
C	30,000	1,20,000		
Reserve Fund		18,000		
Creditors		27,000		
Employees Provident Fund		50,000		
		2,15,000		2,15,000

From April 1, 2017, they decided to share future profits equally. For this purpose the followings were agreed upon:

(*i*) Goodwill of the firm was valued at ₹3,00,000.

(*ii*) Fixed Assets will be depreciated by 10%.

(*iii*) Expenses of ₹3,000 were paid by the firm for getting the value of fixed assets certified.

(*iv*) Capitals of the partners will be in proportion to their new profit sharing ratio. For this purpose Current Accounts will be opened.

Pass necessary Journal entries for the above transactions in the books of the firm.

(C.B.S.E. Sample Paper, 2018)

SOLUTION :

A, B and C

JOURNAL

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
2017				₹	₹
April 1	*C*'s Capital A/c (1/6 of 3,00,000)	Dr.		50,000	
	To *A*'s Capital A/c				50,000
	(Treatment of goodwill due to change in profit sharing ratio)				

April 1	Reserve Fund A/c	Dr.	18,000	
	To *A*'s Capital A/c			9,000
	To *B*'s Capital A/c			6,000
	To *C*'s Capital A/c			3,000
	(Reserve Fund transferred to partners' capital accounts in their old profit sharing ratio)			
April 1	Revaluation A/c	Dr.	15,000	
	To Fixed Assets A/c			15,000
	(Decrease in the value of fixed assets)			
April 1	Revaluation A/c	Dr.	3,000	
	To Bank A/c			3,000
	(Expenses for revaluation of fixed assets)			
April 1	*A*'s Capital A/c	Dr.	9,000	
	B's Capital A/c	Dr.	6,000	
	C's Capital A/c	Dr.	3,000	
	To Revaluation A/c			18,000
	(Loss on revaluation transferred to partners' capital accounts)			
April 1	*A*'s Capital A/c	Dr.	60,000	
	To *A*'s Current A/c			60,000
	(*A*'s excess capital credited to his Current Account)			
April 1	*C*'s Current A/c	Dr.	60,000	
	To *C*'s Capital A/c			60,000
	(*C*'s deficit capital debited to his Current Account)			

Working Notes :

(1) Old Ratio of *A*, *B* and *C* = 3 : 2 : 1
New Ratio of *A*, *B* and *C* = 1 : 1 : 1

Sacrifice or Gain =

A : $\frac{3}{6} - \frac{1}{3} = \frac{3-2}{6} = \frac{1}{6}$ Sacrifice

B : $\frac{2}{6} - \frac{1}{3}$ = Nil

C : $\frac{1}{6} - \frac{1}{3} = \frac{1-2}{6} = \frac{1}{6}$ Gain

(2) Adjusted balance of Capital Accounts :

					₹
A	:	₹50,000 + ₹50,000	+ ₹9,000 – ₹9,000	=	1,00,000
B	:	₹40,000	+ ₹6,000 – ₹6,000	=	40,000
C	:	₹30,000 – ₹50,000	+ ₹3,000 – ₹3,000	=	(20,000)
Total Capital of the Firm					1,20,000

Since they share profits equally, each partner's Capital should be:

$$1,20,000 \times \frac{1}{3} = ₹40,000$$

	A	B	C
	₹	₹	₹
Existing Capitals	1,00,000	40,000	(–) 20,000
Required Capital	40,000	40,000	40,000
Transferred to Current Accounts	(Cr.) 60,000	—	(Dr.) 60,000

ILLUSTRATION 35.

Ashok, Bhim and Chetan were partners in a firm sharing profits in the ratio of 3 : 2 : 1. Their Balance Sheet as at 31-3-2015 was as follows :

Balance Sheet of Ashok, Bhim and Chetan
as at 31-3-2015

Liabilities		₹	*Assets*	₹
Creditors		1,00,000	Land	1,00,000
Bills Payable		40,000	Building	1,00,000
General Reserve		60,000	Plant	2,00,000
Capitals :			Stock	80,000
Ashok	2,00,000		Debtors	60,000
Bhim	1,00,000		Bank	10,000
Chetan	50,000	3,50,000		
		5,50,000		5,50,000

Ashok, Bhim and Chetan decided to share the future profits equally, w.e.f., April 1, 2015. For this it was agreed that :

(*i*) Goodwill of the firm be valued at ₹3,00,000.

(*ii*) Land be revalued at ₹1,60,000 and building be depreciated by 6%.

(*iii*) Creditors of ₹12,000 were not likely to be claimed and hence be written off.

Prepare Revaluation Account, Partners' Capital Accounts and Balance Sheet of the reconstituted firm. *(C.B.S.E. 2016)*

SOLUTION :

Dr. REVALUATION ACCOUNT Cr.

Particulars		₹	*Particulars*	₹
To Building A/c		6,000	By Land A/c	60,000
To Profit on Revaluation transferred to :			By Creditors A/c	12,000
Ashok's Capital A/c	33,000			
Bhim's Capital A/c	22,000			
Chetan's Capital A/c	11,000	66,000		
		72,000		72,000

Dr. PARTNER'S CAPITAL ACCOUNTS Cr.

Particulars	*Ashok*	*Bhim*	*Chetan*	*Particulars*	*Ashok*	*Bhim*	*Chetan*
	₹	₹	₹		₹	₹	₹
To Ashok's Capital A/c[1]	—	—	50,000	By Balance b/d	2,00,000	1,00,000	50,000
To Balance c/d	3,13,000	1,42,000	21,000	By General Reserve	30,000	20,000	10,000
				By Revaluation A/c	33,000	22,000	11,000
				By Chetan's Capital A/c	50,000	—	—
	3,13,000	1,42,000	71,000		3,13,000	1,42,000	71,000

BALANCE SHEET
as at 1st April, 2015

Liabilities		₹	*Assets*	₹
Creditors		88,000	Land	1,60,000
Bills Payable		40,000	Building	94,000
Capitals :			Plant	2,00,000
Ashok	3,13,000		Stock	80,000
Bhim	1,42,000		Debtors	60,000
Chetan	21,000	4,76,000	Bank	10,000
		6,04,000		6,04,000

Working Notes :

(1) Ashok's Sacrifice/Gain $= \frac{3}{6} - \frac{1}{3} = \frac{1}{6}$ (Sacrifice);

Bhim's Sacrifice/Gain $= \frac{2}{6} - \frac{1}{3} =$ Nil

Chetan's Sacrifice/Gain $= \frac{1}{6} - \frac{1}{3} = \frac{1}{6}$ (Gain)

Chetan has gained, so his Capital Account will be debited by 1/6th of ₹3,00,000 (Goodwill), *i.e.*, ₹50,000

Ashok has sacrificed, so his Capital Account will be credited by 1/6th of ₹3,00,000 (Goodwill), *i.e.*, ₹50,000

ILLUSTRATION 36.

A, B, C and *D* were partners in a firm sharing profits in the ratio of 3 : 2 : 3 : 2. On 1.4.2016, their Balance Sheet was as follows :

BALANCE SHEET of *A, B, C* and *D*
as on 1.4.2016

Liabilities	₹	*Assets*	₹
Capitals :		Fixed Assets	8,25,000

A	2,00,000		Current Assets	3,00,000
B	2,50,000			
C	2,50,000			
D	3,10,000	10,10,000		
Sundry Creditors		90,000		
Workmen Compensation Reserve		25,000		
		11,25,000		11,25,000

From the above date the partners decided to share the future profits in the ratio of 4 : 3 : 2 : 1. For this purpose the goodwill of the firm was valued at ₹2,70,000. It was also considered that :

(*i*) The claim against Workmen Compensation Reserve has been estimated at ₹30,000 and fixed assets will be depreciated by ₹25,000.

(*ii*) Adjust the capitals of the partners according to the new profit sharing ratio by opening Current Accounts of the partners.

Prepare Revaluation Account, Partners' Capital Accounts and the Balance Sheet of the reconstituted firm. *(C.B.S.E. 2017, Outside Delhi)*

Dr. REVALUATION ACCOUNT Cr.

Particulars	*Amount*	*Particulars*		*Amount*
	₹			₹
To Provision for Workmen's Compensation Claim A/c	5,000	By Loss on Revaluation transferred to :		
To Fixed Assets A/c	25,000	*A*'s Capital A/c	9,000	
		B's Capital A/c	6,000	
		C's Capital A/c	9,000	
		D's Capital A/c	6,000	30,000
	30,000			30,000

Dr. PARTNER'S CAPITAL ACCOUNTS Cr.

Particulars	*A*	*B*	*C*	*D*	*Particulars*	*A*	*B*	*C*	*D*
	₹	₹		₹		₹	₹		₹
To Revaluation	9,000	6,000	9,000	6,000	By Balance b/d	2,00,000	2,50,000	2,50,000	3,10,000
To Sundries (Goodwill)	27,000	27,000			By Sundries (Goodwill)			27,000	27,000
To Balance c/d	1,64,000	2,17,000	2,68,000	3,31,000					
	2,00,000	2,50,000	2,77,000	3,37,000		2,00,000	2,50,000	2,77,000	3,37,000
To *C*'s Current A/c					By Balance b/d	1,64,000	2,17,000	2,68,000	3,31,000
(Balancing figure)			72,000		By *A*'s Current A/c				
To *D*'s Current A/c					(Balancing figure)	2,28,000			
(Balancing figure)				2,33,000	By *B*'s Current A/c				
To Balance c/d[2]	3,92,000	2,94,000	1,96,000	98,000	(Balancing figure)		77,000		
	3,92,000	2,94,000	2,68,000	3,31,000		3,92,000	2,94,000	2,68,000	3,31,000

BALANCE SHEET
as at 1-4-2016

Liabilities		*Amount*	*Assets*		*Amount*
		₹			₹
Provision for Workmen's Compensation Claim		30,000	Fixed Assets		8,00,000
Sundry Creditors		90,000	Current Assets		3,00,000
Capital Accounts :			Current Accounts :		
A	3,92,000		*A* (Dr.)	2,28,000	
B	2,94,000		*B* (Dr.)	77,000	3,05,000
C	1,96,000				
D	98,000	9,80,000			
Current Accounts :					
C (Cr.)	72,000				
D (Cr.)	2,33,000	3,05,000			
		14,05,000			14,05,000

Working Notes :

(1) Adjustment for Goodwill : (Old Ratio – New Ratio)

A : $\frac{3}{10} - \frac{4}{10} = \frac{1}{10}$ Gain

B : $\frac{2}{10} - \frac{3}{10} = \frac{1}{10}$ Gain

C : $\frac{3}{10} - \frac{2}{10} = \frac{1}{10}$ Sacrifice

D : $\frac{2}{10} - \frac{1}{10} = \frac{1}{10}$ Sacrifice

Since *A* has gained he will be debited by $\frac{1}{10}$ of 2,70,000 = 27,000

Since *B* has gained he will be debited by $\frac{1}{10}$ of 2,70,000 = 27,000

Since *C* has sacrificed he will be credited by $\frac{1}{10}$ of 2,70,000 = 27,000

Since *D* has sacrificed he will be credited by $\frac{1}{10}$ of 2,70,000 = 27,000

(2) Adjustment of Capitals :

Total Capital of the firm = 1,64,000 + 2,17,000 + 2,68,000 + 3,31,000
= 9,80,000

A's Capital in the new firm = $\frac{4}{10}$ of 9,80,000 = 3,92,000

B's Capital in the new firm = $\frac{3}{10}$ of 9,80,000 = 2,94,000

C's Capital in the new firm = $\frac{2}{10}$ of 9,80,000 = 1,96,000

D's Capital in the new firm = $\frac{1}{10}$ of 9,80,000 = 98,000

ILLUSTRATION 37.

A, B and *C* are partners sharing profits and losses in the ratio of 5 : 3 : 2. From 1st April, 2018, they dedide to share future profits and losses equally. Their Balance Sheet as at 31st March, 2018 stood as follows :

Liabilities		₹	*Assets*		₹
Sundry Creditors		50,000	Land and Buildings		4,00,000
Salaries Payable		25,000	Computers		60,000
Outstanding Expenses		20,000	Stock		2,00,000
General Reserve		50,000	Sundry Debtors	3,00,000	
Workmen Compensation Reserve		70,000	*Less :* Provision for		
Capital Accounts :			doubtful debts	25,000	2,75,000
A	4,00,000		Cash at Bank		30,000
B	2,50,000		Cash in Hand		10,000
C	1,50,000	8,00,000	Advertisement Suspense		40,000
		10,15,000			10,15,000

Partners agreed that :

(*i*) Value of Land and Building be increased to ₹5,00,000 and stock be decreased by ₹20,000.

(*ii*) Provision for doubtful debts to be written back, since all debtors are good.

(*iii*) Out of salaries payable, ₹15,000 was not payable.

(*iv*) Outstanding expenses are to be written back, being not payable.

(*v*) A provision for Workmen Compensation Claim be made for ₹30,000.

(*vi*) Goodwill is valued at ₹60,000.

(*vii*) *B* was to carry out the work for reconstitution of the firm at a remuneration (including expenses) of ₹10,000. Expenses paid by *B* amounted to ₹4,000.

Pass journal entries and prepare Revaluation Account.

SOLUTION :

Journal of *A, B* and *C*

Date	*Particulars*		*L.F.*	*Dr. (₹)*	*Cr. (₹)*
2018					
April 1	General Reserve A/c	Dr.		50,000	
	To *A*'s Capital A/c				25,000
	To *B*'s Capital A/c				15,000
	To *C*'s Capital A/c				10,000
	(Transfer of general reserve in old profit sharing ratio)				
"	Workmen Compensation Reserve A/c	Dr.		70,000	
	To Provision for Workmen Compensation Claim A/c				30,000
	To *A*'s Capital A/c				20,000
	To *B*'s Capital A/c				12,000
	To *C*'s Capital A/c				8,000
	(Excess of Workmen Compensation Reserve transferred in old profit sharing ratio)				

"	*A*'s Capital A/c	Dr.		20,000	
	B's Capital A/c	Dr.		12,000	
	C's Capital A/c	Dr.		8,000	
	To Advertisement Suspense A/c				40,000
	(Transfer of accumulated loss in old profit sharing ratio)				
"	Land & Buildings A/c	Dr.		1,00,000	
	Provision for Doubtful Debts A/c	Dr.		25,000	
	Salaries Payable A/c	Dr.		15,000	
	Outstanding Expenses A/c	Dr.		20,000	
	To Revaluation A/c				1,60,000
	(Increase in the value of assets and decrease in liabilities)				
"	Revaluation A/c	Dr.		20,000	
	To Stock A/c				20,000
	(Decrease in the value of stock)				
"	Revaluation A/c	Dr.		10,000	
	To *B*'s Capital A/c				10,000
	(Remuneration payable to *B*)				
"	Revaluation A/c	Dr.		1,30,000	
	To *A*'s Capital A/c				65,000
	To *B*'s Capital A/c				39,000
	To *C*'s Capital A/c				26,000
	(Transfer of gain on revaluation in old profit sharing ratio)				
"	*B*'s Capital A/c ($\frac{1}{30}$ of ₹60,000)[1]	Dr.		2,000	
	C's Capital A/c ($\frac{4}{30}$ of ₹60,000)	Dr.		8,000	
	To *A*'s Capital A/c ($\frac{5}{30}$ of ₹60,000)				10,000
	(Adjustment for goodwill on change in profit sharing ratio)				

Dr. REVALUATION ACCOUNT Cr.

Particulars		₹	*Particulars*	₹
To Stock A/c		20,000	By Land & Building A/c	1,00,000
To *B*'s Capital A/c		10,000	By Provision for Doubtful	
To Gain on Revaluation			Debts A/c	25,000
transferred to :			By Salaries Payable A/c	15,000
A's Capital A/c	65,000		By Outstanding Expenses A/c	20,000
B's Capital A/c	39,000			
C's Capital A/c	26,000	1,30,000		
		1,60,000		1,60,000

Working Note (1) :

Calculation of Sacrifice or Gain :

Old Ratio — 5 : 3 : 2 New Ratio — 1 : 1 : 1

$A = \frac{5}{10} - \frac{1}{3} = \frac{15-10}{30} = \frac{5}{30}$ Sacrifice

$B = \frac{3}{10} - \frac{1}{3} = \frac{9-10}{30} = \frac{1}{30}$ Gain

$C = \frac{2}{10} - \frac{1}{3} = \frac{6-10}{30} = \frac{4}{30}$ Gain

ILLUSTRATION 38.

Parth, Raman and Zaisha are partners in a firm manufacturing furniture. They have been sharing profits and losses in the ratio of 5 : 3 : 2. From 1st April, 2017 they decided to share future profits and losses in the ratio of 2 : 5 : 3. Their Balance Sheet showed a debit balance of ₹4,000 in Profit & Loss Account; balance of ₹36,000 in General Reserve and a Balance of ₹12,000 in Workmen's Compensation Reserve. It was agreed that—

(*i*) The goodwill of the firm be valued at ₹76,000.

(*ii*) The Stock (book value of ₹40,000) was to be depreciated by 8%.

(*iii*) Creditors amounting to ₹900 were not likely to be claimed.

(*iv*) Claim on account of Workmen's Compensation amounted to ₹20,000.

(*v*) Investments (book value ₹38,000) were revalued at ₹40,000.

Pass necessary Journal entries for the above. *(C.B.S.E. 2018 Comptt.)*

SOLUTION :

Books of the Parth, Raman and Zaisha

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2017					
April 1	Parth's Capital A/c	Dr.		2,000	
	Raman's Capital A/c	Dr.		1,200	
	Zaisha's Capital A/c	Dr.		800	
	To P & L A/c				4,000
	(Debit balance of P & L A/c distributed in old ratio)				
"	General Reserve A/c	Dr.		36,000	
	To Parth's Capital A/c				18,000
	To Raman's Capital A/c				10,800
	To Zaisha's Capital A/c				7,200
	(General Reserve distributed in old ratio)				
"	Revaluation A/c	Dr.		8,000	
	Workmen Compensation Reserve A/c	Dr.		12,000	
	To Provision for Workmen Compensation Claim A/c				20,000
	(Liability created for workmen compensation claim)				

"	Revaluation A/c Dr. To Stock A/c (Decrease in value of stock)		3,200	3,200
"	Investments A/c Dr. Creditors A/c Dr. To Revaluation A/c (Increase in value of investments and amount not likely to be claimed by creditors)		2,000 900	2,900
"	Parth's Capital A/c Dr. Raman's Capital A/c Dr. Zaisha's Capital A/c Dr. To Revaluation A/c[(1)] (Loss on Revaluation transferred in old ratio)		4,150 2,490 1,660	8,300
"	Raman's Capital A/c (2/10 of 76,000) Dr. Zaisha's Capital A/c (1/10 of 76,000) Dr. To Parth's Capital A/c (3/10 of 76,000) (Adjustment for goodwill on account of change in profit sharing ratio)		15,200 7,600	22,800

Working Notes :

		₹
(1)	Revaluation A/c Debited with ₹8,000 + ₹3,200	11,200
	Revaluation A/c Credited with	2,900
	Therefore, Loss on Revaluation	8,300

(2) Calculation of Sacrifice or Gain

Old Ratio 5 : 3 : 2

New Ratio 2 : 5 : 3

Parth : $\frac{5}{10} - \frac{2}{10} = \frac{3}{10}$ Sacrifice

Raman : $\frac{3}{10} - \frac{5}{10} = \frac{2}{10}$ Gain

Zaisha : $\frac{2}{10} - \frac{3}{10} = \frac{1}{10}$ Gain

ILLUSTRATION 39.

L, M and *N* were partners in a firm sharing profits in the ratio of 2 : 3 : 5. From 1st April, 2018 they decided to share the profits in the ratio of 1 : 2 : 2. On this date, the Balance Sheet showed a credit balance of ₹1,17,000 in General Reserve and a debit balance of ₹35,000 in Profit and Loss account. The goodwill of the firm was valued at ₹5,00,000. The revaluation of assets and reassessment of liabilities resulted into a gain of ₹30,000.

Pass necessary journal entries for the above transactions on the reconstitution of the firm. *(C.B.S.E. 2019, Rajasthan)*

SOLUTION :

Books of *L, M* and *N*

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2018					
April 1	General Reserve A/c	Dr.		1,17,000	
	To *L*'s Capital A/c				23,400
	To *M*'s Capital A/c				35,100
	To *N*'s Capital A/c				58,500
	(General Reserve transferred in old ratio)				
	L's Capital A/c	Dr.		7,000	
	M's Capital A/c	Dr.		10,500	
	N's Capital A/c	Dr.		17,500	
	To Profit & Loss A/c				35,000
	(Debit balance of Profit & Loss A/c transferred in old ratio)				
	M's Capital A/c (1/10 of 5,00,000)	Dr.		50,000	
	To *N*'s Capital A/c				50,000
	(Adjustment for Goodwill)				
	Revaluation A/c	Dr.		30,000	
	To *L*'s Capital A/c				6,000
	To *M*'s Capital A/c				9,000
	To *N*'s Capital A/c				15,000
	(Gain on revaluation transferred in old ratio)				

Working Note :

Calculation of Sacrifice or Gain =

$L = \frac{2}{10} - \frac{1}{5} = \text{Nil}$

$M = \frac{3}{10} - \frac{2}{5} = \frac{1}{10}$ Gain

$N = \frac{5}{10} - \frac{2}{5} = \frac{1}{10}$ Sacrifice

ILLUSTRATION 40.

A, B and *C* are partners sharing profits and losses in the ratio of 3 : 3 : 2. Their balance sheet as at 31st March 2019 was as follows :

Liabilities		₹	Assets	₹
Sundry Creditors		24,000	Cash at Bank	37,000
General Reserve		36,000	Sundry Debtors	44,000
Capital Accounts :			Stock	1,20,000
A	2,00,000		Machinery	1,59,000
B	1,50,000		Building	2,00,000
C	1,50,000	5,00,000		
		5,60,000		5,60,000

Partners decided that with effect from 1st April 2019, they would share profits and losses in the ratio of 4 : 3 : 2. It was agreed that :

(*i*) Stock be valued at ₹1,10,000.

(*ii*) Machinery is to be depreciated by 10%.

(*iii*) A provision for doubtful debts is to be made on debtors @ 5%.

(*iv*) Building to be appreciated by 20%.

(*v*) A liability for ₹2,500 included in sundry creditors is not likely to arise.

Partners agreed that the revised values are to be recorded in the books. They do not, however want to distribute the general reserve. You are required to prepare journal entries, capital accounts of the partners and the revised balance sheet.

SOLUTION :

JOURNAL

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2019				
April, 1	Revaluation A/c Dr.		28,100	
	To Stock A/c			10,000
	To Machinery A/c			15,900
	To Provision for Doubtful Debts A/c			2,200
	(Decrease in the value of assets and provision made for doubtful debts)			
	Building A/c Dr.		40,000	
	Sundry Creditors A/c Dr.		2,500	
	To Revaluation A/c			42,500
	(Increase in the value of building and decrease in creditors)			
	Revaluation A/c Dr.(1)		14,400	
	To *A*'s Capital A/c			5,400
	To *B*'s Capital A/c			5,400
	To *C*'s Capital A/c			3,600
	(The transfer of profit on revaluation to the capital accounts of partners in old ratio)			
	A's Capital A/c Dr.(2)		2,500	
	To *B*'s Capital A/c			1,500
	To *C*'s Capital A/c			1,000
	(The adjustment for general reserve on change in profit sharing ratio)			

Workings : (1)

Dr. REVALUATION ACCOUNT Cr.

Particulars	₹	Particulars	₹
To Stock A/c	10,000	By Building A/c	40,000
To Machinery A/c	15,900	By Sundry Creditors A/c	2,500
To Provision for doubtful debts A/c	2,200		
To Profit on Revaluation			

transferred to :			
A's Capital A/c (3/8)	5,400		
B's Capital A/c (3/8)	5,400		
C's Capital A/c (2/8)	3,600		
	42,500		42,500

(2) Adjustment for General Reserve :

Old Ratio of *A, B* and *C* 3 : 3 : 2

New Ratio of *A, B* and *C* 4 : 3 : 2

Sacrifice or Gain :

$$A = \frac{3}{8} - \frac{4}{9} = \frac{5}{72} \text{ (Gain)}$$

$$B = \frac{3}{8} - \frac{3}{9} = \frac{3}{72} \text{ (Sacrifice)}$$

$$C = \frac{2}{8} - \frac{2}{9} = \frac{2}{72} \text{ (Sacrifice)}$$

Since *A* has gained, he will be debited from $\frac{5}{72}$ of General Reserves of ₹36,000 = ₹2,500

Since *B* has sacrificed, he will be credited from $\frac{3}{72}$ of General Reserves of ₹36,000 = ₹1,500

Since *C* has sacrificed, he will be credited from $\frac{2}{72}$ of General Reserves of ₹36,000 = ₹1,000

Dr. CAPITAL ACCOUNTS Cr.

Particulars	*A*	*B*	*C*	*Particulars*	*A*	*B*	*C*
	₹	₹	₹		₹	₹	₹
To *B*'s Capital A/c	1,500			By Balance b/d	2,00,000	1,50,000	1,50,000
To *C*'s Capital A/c	1,000			By Revaluation A/c	5,400	5,400	3,600
To Balance c/d	2,02,900	1,56,900	1,54,600	By *A*'s Capital A/c		1,500	1,000
	2,05,400	1,56,900	1,54,600		2,05,400	1,56,900	1,54,600

BALANCE SHEET

as at 1st April 2019

Liabilities		₹	*Assets*		₹
Sundry Creditors		21,500	Cash at Bank		37,000
General Reserve		36,000	Sundry Debtors	44,000	
Capital Accounts :			*Less* : Provision for doubtful debts	2,200	41,800
A	2,02,900		Stock		1,10,000
B	1,56,900		Machinery		1,43,100
C	1,54,600	5,14,400	Building		2,40,000
		5,71,900			5,71,900

When revised values are not to be recorded in the books :

ILLUSTRATION 41.

Continuing Illustration 40, the partners agreed that the revised values of assets and liabilities are not to be recorded in the books and they also do not want to distribute the general reserve. You are required to record the change by passing a single journal entry with necessary working note. Also prepare the revised balance sheet.

SOLUTION :

Workings :

		₹
Loss due to decrease in the value of Stock	10,000	
Loss due to decrease in the value of Machinery	15,900	
Loss due to provision for doubtful debts	2,200	28,100
Profit due to increase in the value of Building	40,000	
Profit due to decrease in Sundry Creditors	2,500	42,500
Profit on Revaluation		14,400
+ General Reserve		36,000
		50,400

Old Ratio of *A*, *B* and *C* 3 : 3 : 2

New Ratio of *A*, *B* and *C* 4 : 3 : 2

Sacrifice or Gain :

$A = \frac{3}{8} - \frac{4}{9} = \frac{5}{72}$ (Gain) $\quad 50{,}400 \times \frac{5}{72} = 3{,}500$ (Dr.)

$B = \frac{3}{8} - \frac{3}{9} = \frac{3}{72}$ (Sacrifice) $\quad 50{,}400 \times \frac{3}{72} = 2{,}100$ (Cr.)

$C = \frac{2}{8} - \frac{2}{9} = \frac{2}{72}$ (Sacrifice) $\quad 50{,}400 \times \frac{2}{72} = 1{,}400$ (Cr.)

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2019					
April 1	*A*'s Capital A/c	Dr.		3,500	
	To *B*'s Capital A/c				2,100
	To *C*'s Capital A/c				1,400
	(The adjustment for revaluation of assets and liabilities and for general reserve on change in profit sharing ratio)				

BALANCE SHEET

as at 1st April 2019

Liabilities		₹	Assets	₹
Sundry Creditors		24,000	Cash at Bank	37,000
General Reserve		36,000	Sundry Debtors	44,000
Capital Accounts			Stock	1,20,000
A	1,96,500		Machinery	1,59,000
B	1,52,100		Building	2,00,000
C	1,51,400	5,00,000		
		5,60,000		5,60,000

ILLUSTRATION 42.

Brijesh, Charu and Dilip are partners sharing profits and losses in the ratio of 3 : 2 : 1. Their balance sheet as at 31st March, 2016 was as follows :

Liabilities		₹	*Assets*		₹
Creditors		87,000	Cash		30,000
Reserves		42,000	Debtors	62,000	
Profit & Loss A/c (Profits)		21,000	*Less* : Provision for doubtful debs	2,000	60,000
Capital Accounts :			Stock		1,80,000
Brijesh	3,00,000		Furniture		30,000
Charu	3,00,000		Plant		2,00,000
Dilip	50,000	6,50,000	Building		3,00,000
		8,00,000			8,00,000

The partners agreed that from 1st April, 2016 they will share profits and losses in the ratio of 4 : 4 : 1. They agreed that :

(*i*) Stock is to be valued at 20% less.

(*ii*) Provision for doubtful debts to be increased by ₹1,500.

(*iii*) Furniture is to be depreciated by 20% and plant by 15%.

(*iv*) ₹3,500 are outstanding for salaries.

(*v*) Building is to be valued at ₹3,50,000.

(*vi*) Goodwill is valued at ₹45,000.

Partners do not want to record the altered values of assets and liabilities in the books and want to leave the reserves and profits undisturbed.

You are required to pass a single journal entry to give effect to the above. Also prepare the revised balance sheet.

SOLUTION :

Workings :

	₹	
Loss due to decrease in the value of Stock	36,000	
Loss due to provision for doubtful debts	1,500	
Loss due to decrease in the value of Furniture	6,000	
Loss due to decrease in the value of Plant	30,000	
Loss due to unrecorded liability (*i.e.*, Outstanding salary)	3,500	77,000
Profit due to increase in the value of Building		50,000
Loss on Revaluation		(–) 27,000
Adjustment for Reserves		(+) 42,000
Adjustment for Profit & Loss A/c (Profits)		(+) 21,000
Adjustment for Goodwill		(+) 45,000
		(+) 81,000

Old Ratio of Brijesh, Charu and Dilip	3 : 2 : 1
New Ratio of Brijesh, Charu and Dilip	4 : 4 : 1

Sacrifice or Gain :

Brijesh	$= \frac{3}{6} - \frac{4}{9} = \frac{1}{18}$ (Sacrifice)	$81,000 \times \frac{1}{18} =$ ₹4,500 (Cr.)
Charu	$= \frac{2}{6} - \frac{4}{9} = \frac{2}{18}$ (Gain)	$81,000 \times \frac{2}{18} =$ ₹9,000 (Dr.)
Dilip	$= \frac{1}{6} - \frac{1}{9} = \frac{1}{18}$ (Sacrifice)	$81,000 \times \frac{1}{18} =$ ₹4,500 (Cr.)

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2016					
April 1	Charu's Capital A/c	Dr.		9,000	
	To Brijesh's Capital A/c				4,500
	To Dilip's Capital A/c				4,500
	(The adjustment for revaluation of assets and liabilities and for reserves, profits and goodwill on change in profit sharing ratio)				

BALANCE SHEET
as at 1st April, 2016

Liabilities		₹	Assets		₹
Creditors		87,000	Cash		30,000
Reserves		42,000	Debtors	62,000	
Profit & Loss A/c (Profits)		21,000	*Less* : Provision for		
Capital Accounts :			doubtful debts	2,000	60,000
Brijesh	3,04,500		Stock		1,80,000
Charu	2,91,000		Furniture		30,000
Dilip	54,500	6,50,000	Plant		2,00,000
			Building		3,00,000
		8,00,000			8,00,000

ILLUSTRATION 43.

Shanker, Babita and Vishal are partners in a firm in the ratio of 5 : 4 : 2. On 1st April, 2019 they decided to share profits in future in the ratio of 4 : 3 : 2. On this date general reserve was ₹34,900 and loss on revaluation of assets and liabilities was ₹5,200. It was decided that adjustment should be made without altering the figures of assets and liabilities in the Balance Sheet. Make adjustment by a single journal entry.

SOLUTION :

		₹
General Reserve		34,900
(–) Loss on Revaluation		5,200
		29,700
Old Ratio of Shanker, Babita and Vishal	5 : 4 : 2	
New Ratio of Shanker, Babita and Vishal	4 : 3 : 2	

Sacrifice or Gain :

Shanker $= \frac{5}{11} - \frac{4}{9} = \frac{1}{99}$ (Sacrifice) $\quad 29{,}700 \times \frac{1}{99} =$ 300 (Cr.)

Babita $= \frac{4}{11} - \frac{3}{9} = \frac{3}{99}$ (Sacrifice) $\quad 29{,}700 \times \frac{3}{99} =$ 900 (Cr.)

Vishal $= \frac{2}{11} - \frac{2}{9} = \frac{4}{99}$ (Gain) $\quad 29{,}700 \times \frac{4}{99} =$ 1,200 (Dr.)

JOURNAL

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2019				
April 1	Vishal's Capital A/c Dr.		1,200	
	To Shanker's Capital A/c			300
	To Babita's Capital A/c			900
	(The adjustment for general reserve and loss on revaluation of assets and liabilities on change in profit sharing ratio)			

ILLUSTRATION 44.

A, B and *C* were partners in a firm sharing Profits in the ratio of 2 : 2 : 1. Their Balance Sheet as at March 31, 2019 was as follows :

BALANCE SHEET OF FIRM *A, B* AND *C*
as at March 31, 2019

Liabilities		Amount	Assets	Amount
		₹		₹
Creditors		30,000	Land	85,000
Bills Payable		20,000	Building	50,000
Outstanding Expenses		25,000	Plant	1,00,000
General Reserve		50,000	Stock	40,000
Capital :			Debtors	25,000
A	50,000		Cash	5,000
B	60,000			
C	70,000	1,80,000		
		3,05,000		3,05,000

From April 1, 2019 the partners decided to share profits in the ratio of 1 : 2 : 3. For this purpose it was agreed that :

(*i*) The goodwill of the firm should be valued at ₹60,000.

(*ii*) Land should be revalued at ₹1,00,000. Building should be depreciated by 6%.

(*iii*) Creditors amounting to ₹3,000 were not to be paid.

You are required to :

(*i*) Record the necessary journal entries to give effect to the above agreement.

(*ii*) Prepare the capital accounts of the partners.

(*iii*) Prepare the balance sheet of the reconstituted firm.

Partners decide that 'General Reserve' will be transferred to Capital Accounts whereas revised values of assets and liabilities are not to be recorded in the books.

SOLUTION :

Workings :

		₹
	Profit due to increase in the value of Land	15,000
	Profit due to decrease in Creditors	3,000
		18,000
(–)	Loss due to decrease in the value of Building	3,000
	Profit on Revaluation	15,000
(+)	Adjustment for Goodwill	60,000
		75,000

Old Ratio of *A, B* and *C* 2 : 2 : 1

New Ratio of *A, B* and *C* 1 : 2 : 3

Sacrifice or Gain :

$A = \frac{2}{5} - \frac{1}{6} = \frac{7}{30}$ (Sacrifice) $75{,}000 \times \frac{7}{30} = ₹17{,}500$

$B = \frac{2}{5} - \frac{2}{6} = \frac{2}{30}$ (Sacrifice) $75{,}000 \times \frac{2}{30} = ₹\ 5{,}000$

$C = \frac{1}{5} - \frac{3}{6} = \frac{9}{30}$ (Gain) $75{,}000 \times \frac{9}{30} = ₹22{,}500$

(*i*) JOURNAL

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2019 April 1	General Reserve A/c Dr.		50,000	
	To *A*'s Capital A/c			20,000
	To *B*'s Capital A/c			20,000
	To *C*'s Capital A/c			10,000
	(General Reserve transferred to partner's capital accounts due to change in profit sharing ratio)			
	C's Capital A/c Dr.		22,500	
	To *A*'s Capital A/c			17,500
	To *B*'s Capital A/c			5,000
	(The adjustment for revaluation of assets and liabilities and goodwill on change in profit sharing ratio)			

(*ii*)

Dr. CAPITAL ACCOUNTS Cr.

Particulars	*A*	*B*	*C*	Particulars	*A*	*B*	*C*
	₹	₹	₹		₹	₹	₹
To *A*'s Capital A/c	—	—	17,500	By Balance b/d	50,000	60,000	70,000
To *B*'s Capital A/c	—	—	5,000	By General Reserve	20,000	20,000	10,000
To Balance c/d	87,500	85,000	57,500	By *C*'s Capital A/c	17,500	5,000	—
	87,500	85,000	80,000		87,500	85,000	80,000

(*iii*)

BALANCE SHEET

as at April 1, 2019

Liabilities		Amount	Assets	Amount
		₹		₹
Creditors		30,000	Land	85,000
Bills Payable		20,000	Building	50,000
Outstanding Expenses		25,000	Plant	1,00,000
Capitals :			Stock	40,000
A	87,500		Debtors	25,000
B	85,000		Cash	5,000
C	57,500	2,30,000		
		3,05,000		3,05,000

VERY SHORT ANSWER QUESTIONS

(Questions Carrying 1 Mark)

Remembering (Knowledge based)

Q. 1. What is meant by reconstitution of partnership firm? *(C.B.S.E. 2014)*

Ans. Partnership is the result of agreement and any change in existing agreement brings to an end the existing agreement and a new agreement comes into force. It amounts to reconstitution of the firm.

Q. 2. State any three circumstances other than (*i*) admission of a new partner; (*ii*) retirement of a partner and (*iii*) death of a partner, when need for valuation of goodwill of a firm may arise. *(C.B.S.E. 2016)*

Ans. In addition to admission, retirement and death of a partner, the need for valuation of goodwill may arise in the following circumstances :

(*i*) Change in the profit sharing ratio amongst the existing partners.

(*ii*) Dissolution of a firm involving sale of business as a going concern.

(*iii*) Amalgamation of partnership firms.

Q. 3. What is meant by change in profit-sharing ratio?

Ans. A change in profit sharing ratio implies purchase of share of profit by one or more partners from other partner or partners.

Q. 4. What is Sacrificing Ratio? *(C.B.S.E. 2014, C)*

Ans. The ratio in which one or more of the existing partners surrender some of their old share in favour of one or more of other partners is called sacrificing ratio. Sacrificing ratio is computed by deducting the new ratio from the old ratio.

Q. 5. What is the formula for calculating sacrificing ratio?

Ans. Sacrificing Ratio = Old Ratio – New Ratio.

Q. 6. What is meant by Sacrificing Partners?

Ans. The partners whose shares have decreased as a result of change in profit sharing ratio are called 'Sacrificing Partners'.

Q. 7. Give two circumstances in which sacrificing ratio may be applied.

Ans. (*i*) At the time of admission of a new partner.
(*ii*) At the time of change in profit sharing ratio of existing partners.

Q. 8. Define Gaining Ratio.

Ans. The ratio in which one or more partners gain some portion of other partners share of profit is called gaining ratio. It is calculated by deducting old ratio from the new ratio.

Q. 9. Give the formula for calculating Gaining Ratio of a partner in a partnership firm.

Ans. Gaining Ratio = New Ratio – Old Ratio.

Q. 10. What is meant by Gaining Partners?

Ans. The partners whose shares have increased as a result of change in profit sharing ratio are called 'Gaining Partners'.

Q. 11. Give two circumstances in which gaining ratio may be applied.

Ans. (*i*) At the time of retirement of a partner.
(*ii*) At the time of change in profit sharing ratio of existing partners.

Q. 12. Define Goodwill.

Ans. Goodwill is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits earned by other similar firms belonging to the same type of industry.

Q. 13. Give two characteristics of Goodwill.

Ans. (*i*) It is an intangible asset not a fictitious asset. It is a valuable asset.
(*ii*) It is helpful in earning excess profits.

Q. 14. Name any two factors affecting goodwill of a partnership firm.

Ans. (*i*) Favourable Location of the Business.
(*ii*) Efficiency of Management.

Q. 15. How the goodwill is valued under the average profits method?

Ans. Under this method normal past profits of the business for a number of years are totalled and average is calculated. Goodwill is then calculated by multiplying the average profits by agreed number of years purchase (such as two or three).

Q. 16. What is meant by Super Profits?

Ans. Super Profit is the excess of actual average profits over normal profits.

Q. 17. How the goodwill is valued under the super profits method?

Ans. Under this method, first, super profits are calculated by deducting normal profit from the average profit and then goodwill is calculated by multiplying the super profits by the given number of year's purchase.

Q. 18. How the goodwill is valued under the Capitalisation of Average Profits method? *(C.B.S.E. 2012, C, Set 2)*

Ans. First of all, Capitalised value of Average Profits is calculated as per the following formula :

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

Thereafter, Goodwill is calculated as follows :

Goodwill = Capitalised Value of Average Profits – Capital Employed

Q. 19. Enumerate two main steps involved in valuing the goodwill according to super profit method. *(C.B.S.E. 2012 C, Set 1 & 3)*

Ans. (*i*) Ascertain super profits by subtracting normal profits from average profits. (*ii*) Calculate goodwill by multiplying super profits with number of years' purchase.

Q. 20. How the goodwill is valued under the Capitalisation of Super Profit method?

Ans. $\text{Goodwill} = \frac{\text{Super Profit} \times 100}{\text{Normal Rate of Return}}$

Q. 21. State the ratio in which the partners share profits or losses on revaluation of assets and liabilities, when there is a change in profit sharing ratio amongst existing partners? *(C.B.S.E. 2013)*

Ans. In Old Profit Sharing Ratio.

Q. 22. How are the accumulated profits and losses distributed when there is change in profit sharing ratio amongst existing partners?

Ans. Accumulated profits are credited to the Capital Accounts of all the partners in their old profit sharing ratio and accumulated losses are debited to their Capital Accounts in old profit sharing ratio.

Understanding

Q. 23. Why is 'Goodwill' considered an 'Intangible Asset' but not a 'Fictitious Asset'?

Ans. Goodwill cannot be seen or touched, it can only be felt. Hence, it is treated as an intangible asset. But it is not a fictitious asset because fictitious assets do not have a value whereas goodwill has a value and it can be purchased or sold with any other asset.

Q. 24. How does the factor 'Location' affect the goodwill of a firm?

Ans. Better location will attract more customers resulting in increase in sales and profits which in turn will result in increase in the value of goodwill.

Q. 25. How does the factor 'Efficiency of Management' affect the goodwill of a firm?

Ans. If the manager is capable and competent, the firm will earn high profits which will increase the value of goodwill.

Q. 26. How does the factor 'quality of product' affect the goodwill of a firm?

Ans. Better quality of product will increase the sales and profits which will increase the value of goodwill.

Q. 27. How does the market situation affect the value of goodwill of a firm? *(C.B.S.E. 2011)*

Ans. The monopoly condition or limited competition enables the concern to earn high profits which leads to higher value of goodwill.

Q. 28. How does the nature of business affect the value of goodwill of a firm?
(C.B.S.E. 2011, Outside Delhi)

Ans. A firm which produces goods having a stable demand will be able to earn more profits and hence will have more goodwill.

Q. 29. Distinguish between average profits and super profits.

Ans. Average profit is the average of the profits of past few years whereas super profit is the excess of average profits over normal profits.

Q. 30. When there is change in the profit sharing ratio amongst existing partners, does it require adjustment for goodwill?

Ans. Yes. Because the gaining partner will be acquiring a part of future profits which otherwise would belong to the sacrificing partner. Hence, the gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill.

Q. 31. When there is change in profit sharing ratio amongst existing partners, should the assets and liabilities be revalued?

Ans. Yes. Because the profit or loss on revaluation should by credited or debited to the accounts of the partners in their old profit sharing ratio.

Q. 32. What is the nature of 'Revaluation Account'?

Ans. Revaluation Account is a nominal account in nature.

Q. 33. Why are ''Reserves & Surplus'' distributed at the time of reconstitution of the firm?

Ans. These belong to old partners. As such, these should be distributed among them.

Q. 34. Anant, Gulab and Khushbu were partners in a firm sharing profits in the ratio of 5 : 3 : 2. From 1.4.2014, they decided to share the profits equally. For this purpose the goodwill of the firm was valued at ₹2,40,000.

Pass necessary journal entry for the treatment of goodwill on change in the profit sharing ratio of Anant, Gulab and Khushbu. *(C.B.S.E. 2015, All India)*

Ans. JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2014					
April 1	Gulab's Capital A/c (1/30 of ₹2,40,000)	Dr.		8,000	
	Khushbu's Capital A/c (4/30 of ₹2,40,000)	Dr.		32,000	
	To Anant's Capital A/c (5/30 of ₹2,40,000)				40,000
	(Adjustment of goodwill on change in profit sharing ratio)				

Working Note :

Old Ratio 5 : 3 : 2

New Ratio 1 : 1 : 1

Sacrifice or Gain :

Anant $: \frac{5}{10} - \frac{1}{3} = \frac{15 - 10}{30} = \frac{5}{30}$ Sacrifice

Gulab : $\frac{3}{10} - \frac{1}{3} = \frac{9-10}{30} = \frac{1}{30}$ Gain

Khushbu : $\frac{2}{10} - \frac{1}{3} = \frac{6-10}{30} = \frac{4}{30}$ Gain

Q. 35. Give the accounting entry for an unrecorded liability in case of reconstitution of partnership firm. *(C.B.S.E. 2019, Delhi)*

Ans. Revaluation A/c Dr.
To Sundry Liabilities
(Unrecorded liability now recorded)

Q. 36. Give the accounting entry for unrecorded assets in case of reconstitution of a partnership firm. *(C.B.S.E. 2019, Delhi)*

Ans. Sundry Assets Dr.
To Revaluation A/c
(Unrecorded assets recorded)

SHORT ANSWER QUESTIONS

(Questions Carrying 3 Marks)

Remembering (Knowledge based)

Q. 1. Mention the occasions on which reconstitution of partnership firm can take place.

Q. 2. What adjustments are required at the time of reconstitution of a partnership firm?

Ans. Following adjustments are required at the time of reconstitution of a partnership firm :

(*i*) Determination of Sacrificing Ratio and Gaining Ratio

(*ii*) Accounting for Goodwill.

(*iii*) Accounting Treatment of Reserves and Accumulated Profits

(*iv*) Accounting for Revaluation of Assets and Liabilities.

(*v*) Adjustment of Capitals.

Q. 3. Who should compensate whom in case of a change in profit sharing ratio of existing partners.

Q. 4. Give any three features of goodwill.

Q. 5. Write any four factors which affect the goodwill of a partnership firm.

Q. 6. On what occasions does the need for valuation of goodwill arise?

Q. 7. Explain any two methods of valuation of goodwill.

Q. 8. What is meant by number of years' purchase at the time of valuation of goodwill?

Q. 9. Explain capitalisation method of goodwill valuation with the help of imaginary figures.

Q. 10. Distinguish between average profit and super profit method of valuation of goodwill.

Q. 11. How will you deal with goodwill when there is change in the profit sharing ratio among the existing partners? Illustrate with the help of imaginary figures.

Q. 12. How will you deal with reserves and accumulated profits at the time of change in the profit sharing ratio among the existing partners?

Q. 13. Is it necessary to revalue the assets and liabilities if there is a change in profit sharing ratio of the existing partners? Give reason.

Understanding

Q. 14. Why are reserves and accumulated profits credited to the partner's capital accounts in case of change in profit sharing ratio amongst the existing partners?

Ans. Reserves and accumulated profits are credited to the capital accounts of all partners in their old profit sharing ratio because they have been set apart out of the profits earned in the period before change. If they are not adjusted at present, they will get adjusted later in their new profit sharing ratio which will result in loss to the sacrificing partner and gain to the gaining partner.

Application based

Q. 15. Anand and Vikas were partners in a firm sharing profits and losses in the ratio of 2 : 1. With effect from 1st April, 2019, they agreed to share the profits equally. On that date, the Balance Sheet of the firm showed ₹75,000 as Workmen Compensation Reserve against which there was no liability. Vikas expressed his opinion that it should be credited to the Capital accounts equally. However, Anand was of the opinion that it should be credited to the Capital accounts in the ratio of 2 : 1. Anand was able to convince Vikas. Explain what argument must have been put forward by Anand to which Vikas agreed?

Ans. Anand would have given the argument that Workmen Compensation Reserve was created out of profits when their profit sharing ratio was 2 : 1. Hence, it should be credited in the old profit sharing ratio.

Q. 16. Priya and Rani were partners in a firm sharing profits and losses in the ratio of 2 : 1. With effect from 1st April, 2019, they agreed to share the profits equally. They prepared a Revaluation Account on this date and an unrecorded asset (Motorbike) worth ₹40,000 was found not to have been recorded in the books. Priya was of the view that it should be Credited to Revaluation Account whereas Rani was of the view that it should be Credited to the Capital accounts in equal proportion. Rani agreed to the viewpoint of Priya. Explain what argument must have been put forward by Priya to which Rani agreed?

Ans. Priya would have given the argument that unrecorded asset belonged to the old firm when the profit sharing ratio was 2 : 1. Hence it should be Credited to Revaluation Account so that the profit on account of this asset could be shared in 2 : 1.

Q. 17. Chaman and Dinesh were partners in a firm sharing profits in 3 : 1. With effect from 1st April, 2019, they agreed to share the profits in 2 : 1. They prepared a Revaluation Account on this date and it was found that an unrecorded liability towards the salary of an employee of ₹50,000 existed. Dinesh was of the view that it should be debited to Revaluation Account whereas Chaman was of the view that it should be recorded in the books of accounts at the time of its payment. Chaman agreed to the viewpoint of Dinesh. Explain what argument must have been put forward by Dinesh to which Chaman agreed?

Ans. Dinesh must have given the argument that liability towards salaries related to the old firm when the profit sharing ratio was 3 : 1. Hence, it should be debited to Revaluation Account so that the loss on account of this liability could be borne in 3 : 1. If it was recorded at the time of actual payment, the partners will bear the loss in 2 : 1.

PRACTICAL QUESTIONS

(Question Nos. 1 to 44 are strictly in the serial order of Illustrations)

Sacrificing and Gaining Ratio :

Q. 1. (*a*) *X* and *Y* were partners in a firm sharing profits in the ratio of 5 : 3. With effect from 1st April, 2019 they agreed to share profits equally. Calculate the individual partner's gain or sacrifice due to change in ratio.

[**Ans.** *X* sacrifices and *Y* gains $\frac{1}{8}$th share.]

(*b*) *A* and *B* were in partnership sharing profits equally. With effect from 1st April, 2019 they agreed to share profits in the ratio of 4 : 3. Calculate the individual partner's gain or sacrifice due to change in ratio.

[**Ans.** *A* gains and *B* sacrifices $\frac{1}{14}$th share.]

Q. 2. (*a*) *A, B* and *C* were in partnership sharing profits in the ratio of 4 : 3 : 1. The partners agreed to share future profits in the ratio of 5 : 4 : 3. Calculate each partner's gain or sacrifice due to change in ratio.

[**Ans.** *A* sacrifices $\frac{2}{24}$, *B* sacrifices $\frac{1}{24}$ and *C* gains $\frac{3}{24}$.]

(*b*) Mahesh, Naresh and Om were partners sharing profits in the ratio of 2 : 3 : 4. With effect from 1st April, 2016 they agreed to share profits in the ratio of 1 : 2 : 3. Calculate each partner's gain or sacrifice due to change in ratio.

[**Ans.** Mahesh sacrifices and Om gains $\frac{1}{18}$th share.]

Valuation of Goodwill — Average Profit Method :

Q. 3. The goodwill of a firm is valued at 4 years' purchase of average profits of last five years. The profits of the last five years were :

Year		*Profit (₹)*
2013-14	:	2,00,000

2014-15 : (3,00,000)
2015-16 : 4,50,000 (including an abnormal gain of ₹50,000)
2016-17 : 3,50,000 (after charging an abnormal loss of ₹90,000)
2017-18 : 2,60,000

Calculate the amount of goodwill.

[**Ans.** Goodwill ₹8,00,000]

Q. 4. *X* purchased the business of *Y* from 1st April, 2019. For this purpose goodwill is to be valued at 100% of the average annual profits of the last four years. The profits shown by *Y*'s business for the last four years were :

Year ended			*(₹)*	
31st March,	2016	Profit	1,00,000	(after debiting loss of stock by fire ₹50,000)
,,	2017	Loss	1,50,000	(includes voluntary retirement compensation paid ₹80,000)
,,	2018	Profit	1,50,000	
,,	2019	Profit	2,00,000	

Verification of books of accounts revealed the following :

(*i*) During the year ended 31st March, 2017, a machine got destroyed in accident and ₹60,000 was written off as loss in Profit & Loss Account.

(*ii*) On 1st July 2017, Two Computers costing ₹40,000 each were purchased and were debited to Travelling Expenses Account on which depreciation is to be charged @ 10% p.a. on Straight Line Method.

Calculate the value of goodwill.

[**Ans.** Goodwill ₹1,39,000.]

Hint. Profit for the year ended 31st March 2018 ₹2,24,000 and for 2019 ₹1,92,000.

Q. 5. *A, B* and *C* are partners in a firm sharing profits and losses in the ratio of 3 : 2 : 1. They decide to take *D* into partnership for 1/4th share on 1st April, 2017. For this purpose, goodwill is to be valued at 3 times the average annual profits of the previous four or five years whichever is higher. The agreed profits for goodwill purpose of the past five years are as follows :

	₹
Year ending on 31st March 2013	1,30,000
Year ending on 31st March 2014	1,20,000
Year ending on 31st March 2015	1,50,000
Year ending on 31st March 2016	1,10,000
Year ending on 31st March 2017	2,00,000

Calculate the value of Goodwill.

[**Ans.** Goodwill ₹4,35,000]

Q. 6. *A, B* and *C* are partners sharing profits and losses equally. They agree to admit *D* for equal share. For this purpose goodwill is to be valued at 3 year's purchase of average profits of last 5 years which were as follows :

	₹
Year ending on 31st March 2013	60,000 (Profit)

Year ending on 31st March 2014	1,50,000 (Profit)
Year ending on 31st March 2015	20,000 (Loss)
Year ending on 31st March 2016	2,00,000 (Profit)
Year ending on 31st March 2017	1,85,000 (Profit)

On 1st October, 2016 a computer costing ₹40,000 was purchased and debited to office expenses account on which depreciation is to be charged @25% p.a. Calculate the value of goodwill.

[**Ans.** Goodwill ₹3,66,000.]

Hint : Adjusted profit of 2017 will be : ₹1,85,000 + ₹40,000 – Depreciation ₹5,000 = ₹2,20,000.

Q. 7. The profits earned by a firm during the last four years were as follows :

Year ended 31st March	*Profits (₹)*
2013	80,000
2014	1,00,000
2015	1,10,000
2016	1,50,000

Calculate the value of goodwill on the basis of three year's purchase of weighted average profits. Weights to be used are 1, 2, 3 and 4 respectively to the profits for 2013, 2014, 2015 and 2016.

[**Ans.** Goodwill ₹3,63,000.]

Q. 8. Following information is available about the business of a firm :

(*i*) Profits : In 2013, ₹40,000; In 2014, ₹50,000; In 2015, ₹60,000, (*ii*) Non-recurring income of ₹1,000 is included in the profits of 2014, (*iii*) Profits of 2013 have been reduced by ₹6,000 because goods were destroyed by fire, (*iv*) Goods have not been insured but it is thought to insure them in future. The insurance premium is estimated at ₹400 per year, (*v*) Reasonable remuneration of the proprietor of business is ₹6,000 per year, but it has not been taken into account for calculation of above mentioned profits, (*vi*) Profits of 2015 include ₹5,000 income on investment.

Goodwill is agreed to be valued at two year's purchase of the weighted average profits of the past three years. The appropriate weights to be used are :—

2013 :— 1; 2014 :—2; 2015 :—3.

[**Ans.** Value of Goodwill ₹90,200.]

Q. 9. Calculate the value of goodwill on the basis of three year's purchase of the weighted average profits of the last five years. Profits to be weighted 1, 2, 3, 4 and 5, the greatest weightage to be given to last year. Profits of the last five years were :

Year ended			*(₹)*	
31st March,	2015 :	Profit	80,000	
''	2016 :	Profit	1,05,000	(after considering abnormal loss of ₹41,500)
''	2017 :	Loss	20,000	(after considering abnormal gain of ₹40,000)
''	2018 :	Profit	1,80,000	
''	2019 :	Profit	2,00,000	

Books of Accounts of the firm revealed that :

(*i*) Closing Stock as on 31st March, 2015 was overvalued by ₹40,000.

(*ii*) Repairs to Machinery ₹60,000 were wrongly debited to Machinery Account on 1st July, 2017. Depreciation was charged on Machinery @ 20% p.a. on diminishing balance method.

[**Ans.** Value of Goodwill ₹3,60,000.]

Hint : Weighted Profit for the year ended 31st March 2018 ₹5,16,000 and 2019 ₹10,51,000.

Super Profit Method :

Q. 10. A firm earned profits of ₹80,000, ₹1,00,000, ₹1,20,000 and ₹1,80,000 during 2010-11, 2011-12, 2012-13 and 2013-14 respectively. The firm has capital investment of ₹5,00,000. A fair rate of return on investment is 15% p.a. Calculate goodwill of the firm based on three years' purchase of average super profits of last four years. *(C.B.S.E. Sample Question Paper, 2015)*

[**Ans.** Goodwill ₹1,35,000]

Q. 11. Capital invested in a firm is ₹3,00,000. Normal rate of return is 10%. Average profits of the firm are ₹41,000 (after an abnormal loss of ₹2,000). Calculate goodwill at five times the super profits.

[**Ans.** Goodwill ₹65,000.]

Q. 12. The capital of the firm of Anuj and Benu is ₹10,00,000 and the market rate of interest is 15%. Annual salary to the partners is ₹60,000 each. The profit for the last three years were ₹2,80,000, ₹3,80,000 and ₹4,20,000. Goodwill of the firm is to be valued on the basis of two years purchase of last three years average super profits. Calculate the goodwill of the firm. *(C.B.S.E. 2019, M.P.)*

[**Ans.** Goowill ₹1,80,000]

Q. 13. Find out the capital employed from the following information :

Normal rate of return :		12%
Profits : 2017-18	₹	80,000
2018-19	₹	1,30,000
2019-20	₹	1,56,000
Goodwill valued at 3 years purchase of Super Profits	₹	1,50,000

[**Ans.** Capital Employed ₹6,00,000]

Q. 14. *A* and *B* are partners. They admit *C* for $\frac{1}{4}$th share in profits. For this purpose goodwill is to be valued at three year's purchase of super profits.

Following information is provided to you :

	₹
A's Capital	5,00,000
B's Capital	4,00,000
General Reserve	1,50,000
Profit & Loss A/c (Cr.)	30,000
Sundry Assets	12,00,000

The normal rate of return is 15% p.a. Average Profits are ₹2,00,000 per year. You are required to calculate *C*'s share of goodwill.

[**Ans.** *C*'s share of goodwill ₹28,500.]

Hint. Sundry Assets will be ignored.

Q. 15. On 1st April, 2014, a firm had assets of ₹1,00,000 excluding stock of ₹20,000. Partners' Capital Accounts showed a balance of ₹60,000. The current liabilities were ₹10,000 and the balance constituted the reserve. If the normal rate of return is 8%, the 'Goodwill' of the firm is valued at ₹60,000 at four years purchase of super profit, find the average profit of the firm. *(C.B.S.E. 2015, Comptt.)*

[**Ans.** Average Profit ₹23,800.]

Hint : Capital Employed = Total Assets – Current Liabilities
= ₹1,20,000 – ₹10,000 = ₹1,10,000

Q. 16. On April 1st 2020, an existing firm had assets of ₹5,00,000 including cash of ₹20,000. the firm had a General Reserve of ₹90,000, partner's capital accounts showed a balance of ₹3,80,000 and creditors amounted to ₹30,000. If the normal rate of return is 20% and the goodwill of the firm is valued at ₹64,000 at 4 year's purchase of super profit, find the average profits of the firm.

[**Ans.** ₹1,10,000.]

Capitalisation Method :

Q. 17. The average profits of a firm is ₹48,000. The total assets of the firm are ₹8,00,000. Value of other liabilities is ₹5,00,000. Average rate of return in the same business is 12%.

Calculate goodwill from capitalisation of average profits method.

[**Ans.** ₹1,00,000.]

Hint : Capital Employed = Assets – Liabilities.

Q. 18. Anupma, Purnima and Ruchika are partners in a business. Balances in their Capital and Current Accounts as on 31st March, 2019 were :

	Capital Account (₹)	*Current Account* (₹)
Anupma	6,00,000	60,000 (Dr.)
Purnima	5,00,000	30,000 (Dr.)
Ruchika	5,00,000	10,000 (Cr.)

The firm earned an average profit of ₹2,40,000. If the normal rate of return is 12%, find the value of goodwill by Capitalisation of Average Profit Method.

[**Ans.** Value of Goodwill ₹4,80,000]

Q. 19. Calculate the value of goodwill according to capitalisation of Super Profits Method in the previous Q. 17.

[**Ans.** ₹1,00,000]

Q. 20. The following information relates to a partnership firm :

(*a*) Profits/Losses for the last six years :

1st year	₹20,000 Profit	4th year	₹60,000 Profit
2nd year	₹60,000 Profit	5th year	₹50,000 Profit
3rd year	₹10,000 Loss	6th year	₹72,000 Profit

(*b*) Average Capital Employed is ₹2,00,000.

(*c*) Rate of normal profit is 15%.

Find out the value of goodwill on the basis of :

(*i*) Four year's purchase of average profits.

(*ii*) Four year's purchase of super profits.

(*iii*) Capitalisation of super profits.

[**Ans.** (*i*) On the basis of average profits ₹1,68,000
(*ii*) On the basis of super profits ₹ 48,000
(*iii*) On the basis of capitalisation of super profits ₹ 80,000.]

Accounting Treatment of Goodwill when there is change in the profit sharing ratio of existing partners

Q. 21. *A* and *B* are partners sharing profits and losses in the ratio of 3 : 1. It was decided that with effect from 1st April, 2015 the profit sharing ratio will be 5 : 3. Goodwill is to be valued at 2 year's purchase of average of 3 year's profits. The profits for the years ending 31st March 2013, 2014 and 2015 were ₹36,000, ₹32,000 and ₹40,000 respectively.

Pass the necessary journal entry for the treatment of goodwill.

[**Ans.** Debit *B* by ₹9,000 and Credit *A* by ₹9,000.]

Q. 22. *P, Q* and *R* are partners sharing profits equally. They decided that in future *R* will get 1/7 share in profits. On the day of change, firm's Goodwill is valued at ₹42,000. Give Journal Entries arising on account of change in profit sharing ratio.

[**Ans.** Debit *P* and *Q* by ₹4,000 each and credit *R* by ₹8,000.]

Hint.: New Ratios $\frac{3}{7} : \frac{3}{7} : \frac{1}{7}$. *P* and *Q* gain $\frac{2}{21}$ each and *R* sacrifices $\frac{4}{21}$.

Q. 23. *A, B* and *C* were partners sharing profits and losses in the ratio of 7 : 3 : 2. From 1st April 2015, they decided to share profits and losses in the ratio of 8 : 4 : 3. Goodwill is to be valued at the average of three year's profits preceding the date of change in profit sharing ratio. The profits for the years ending 31st March 2012, 2013, 2014 and 2015 were ₹52,000, ₹48,000, ₹60,000 and ₹90,000 respectively. Give the necessary journal entry.

[**Ans.** Value of Goodwill ₹66,000; Debit *B* by ₹1,100 and *C* by ₹2,200; Credit *A* by ₹3,300.]

Accounting Treatment of Reserves and Accumulated Profits when there is change in the profit sharing ratio of existing partners

Q. 24. *A* and *B* are partners in a firm sharing profits in the ratio of 3 : 2. They decided to share profits in the ratio of 3 : 4 w.e.f., April 1, 2016. On that date there was a credit balance of ₹70,000 in their Profit and Loss Account. Pass the necessary journal entry assuming that partners decide to distribute the profits.

[**Ans.** Credit *A*'s Capital A/c by ₹42,000 and *B*'s Capital A/c by ₹28,000.]

Q. 25. *A, B* and *C* are partners sharing profits and losses in the ratio of 1 : 2 : 3. From April 1, 2016, they decided to share the profits in the ratio of 2 : 3 : 4. On that date, Profit and Loss Account disclosed a debit balance of ₹90,000. Record the necessary journal entry for the distribution of the balance in the Profit and Loss Account.

[**Ans.** Debit *A*'s Capital A/c by ₹15,000, *B*'s Capital A/c by ₹30,000 and *C*'s Capital A/c by ₹45,000.]

Q. 26. *A* and *B* sharing profits and losses in the ratio of 2 : 3, decide to share future profits and losses equally with effect from 1st April, 2016. An extract of their Balance Sheet as at 31st March, 2016 is as follows :

Liabilities	₹	*Assets*	₹
Workmen Compensation Reserve	40,000		

Show the accounting treatment under the following alternative cases :

Case (*i*) If there is no other information.

Case (*ii*) If a claim on account of workmen's compensation is estimated at ₹25,000.

Case (*iii*) If a claim on account of workmen's compensation is estimated at ₹40,000.

Case (*iv*) If a claim on account of workmen's compensation is estimated at ₹50,000.

[**Ans.** Case (*i*) Cr. *A*'s Capital A/c by ₹16,000 and *B*'s Capital A/c by ₹24,000

Case (*ii*) Cr. *A*'s Capital A/c by ₹6,000 and *B*'s Capital A/c by ₹ 9,000

Case (*iii*) Entire amount of Workmen Compensation Reserve will be Credited to Provision for Workmen Compensation A/c

Case (*iv*) Loss on Revaluation ₹10,000; Debit *A*'s Capital A/c by ₹4,000 and *B*'s Capital A/c by ₹6,000.

Q. 27. *P, Q* and *R* were partners in a firm sharing profits in the ratio of 1 : 1 : 2. On 31st March, 2018, their balance sheet showed a debit balance of ₹9,000 in the profit and loss account and a Workmen Compensation Reserve of ₹64,000. From 1st April, 2018 they decided to share profits in the ratio of 2 : 2 : 1. For this purpose it was agreed that :

(*a*) Goodwill of the firm was valued at ₹4,00,000.

(*b*) A claim on account of workmen compensation of ₹30,000 was admitted.

Pass necessary journal entries on reconstitution of the firm.

(C.B.S.E. 2019, M.P.)

[**Ans.** Adjustment for Goodwill : Debit *P* and *Q* by ₹60,000 each and credit *R* by ₹1,20,000. Excess Workmen Compensation Reserve ₹34,000 Credited to partner's capital accounts in old ratio.]

Q. 28. *A, B* and *C* sharing profits and losses in the ratio of 4 : 3 : 2, decide to share profits and losses in the ratio of 2 : 3 : 4 with effect from 1st April, 2016. Following is an extract of their Balance Sheet as at 31st March, 2016 :

Liabilities	₹	*Assets*	₹
Investment Fluctuation Reserve	54,000	Investments (At Cost)	6,00,000

Show the accounting treatment under the following alternative cases :

Case (*i*) If there is no other information.
Case (*ii*) If the market value of Investments is ₹6,00,000.
Case (*iii*) If the market value of Investments is ₹5,91,000.
Case (*iv*) If the market value of Investments is ₹5,28,000.
Case (*v*) If the market value of Investments is ₹6,60,000.

[**Ans.** Case (*i*) and (*ii*) : Credit *A*'s Capital A/c by ₹24,000, *B*'s Capital A/c by ₹18,000 and *C*'s Capital A/c by ₹12,000.

Case (*iii*) : Credit *A*'s Capital A/c by ₹20,000, *B*'s Capital A/c by ₹15,000 and *C*'s Capital A/c by ₹10,000.

Case (*iv*) : Loss on Revaluation ₹18,000.
Debit *A*'s Capital A/c by ₹8,000, *B*'s Capital A/c by ₹6,000 and *C*'s Capital A/c by ₹4,000.

Case (*v*) : Entire amount of Investment Fluctuation Reserve credited to partner's capital accounts in 4 : 3 : 2 and profit on revaluation ₹60,000 also credited to partner's capital accounts in 4 : 3 : 2.

Q. 29. *A* and *B* are partners in a firm sharing profits in the ratio of 3 : 2. On March 31, 2016, their Balance Sheet showed a general reserve of ₹54,000. On that date they decided to admit *C* as a new partner. The new profit sharing ratio between *A, B* and *C* will be 4 : 3 : 2. Record the necessary journal entry in the books of the firm under the following circumstances :

(*i*) When they want to transfer the general reserve in their capital accounts.

(*ii*) When they don't want to transfer general reserve in their capital accounts and prefer to record an adjustment entry for the same.

[**Ans.** (*i*) Dr. General Reserve by ₹54,000
Cr. *A*'s Capital A/c by ₹32,400
Cr. *B*'s Capital A/c by ₹21,600
(*ii*) Dr. *C*'s Capital A/c by ₹12,000
Cr. *A*'s Capital A/c by ₹ 8,400
Cr. *B*'s Capital A/c by ₹ 3,600]

Q. 30. *A, B* and *C* are partners sharing profits equally. From 1st April, 2017, they decided to share profits in the ratio of 3 : 4 : 5. On that date, Profit and Loss Account showed a credit balance of ₹90,000. Partners do not want to distribute the Profit and Loss Account balance but prefer to record the change by an adjustment entry. You are required to give the adjusting entry.

[**Ans.** Debit *C* and Credit *A* by ₹7,500.]

Q. 31. *X, Y* and *Z* were sharing profits and losses in the ratio of 5 : 3 : 2. They decided to share future profits and losses in the ratio of 2 : 3 : 5 with effect from 1.4.2017. They decided to record the effect of the following, without effecting their

book values :—

(*i*) Profit and Loss Account ₹24,000
(*ii*) Advertisement Suspense Account ₹12,000

Pass the necessary adjusting entry.

[**Ans.** Debit *Z* by ₹3,600 and Credit *X* by ₹3,600.]

Q. 32 (A). *A, B, C* and *D* are partners in a firm sharing profits and losses in the ratio of 2 : 2 : 1 : 1. They decided to share future profits and losses in the ratio of 3 : 2 : 2 : 3. For this purpose goodwill of the firm valued at ₹1,50,000. There was also a reserve of ₹60,000 in the books of the firm.

Find out sacrifice ratio and gaining ratio and pass necessary journal entry assuming that reserve is not to be distributed.

[**Ans.** Debit *C* by ₹7,000 and *D* by ₹28,000; Credit *A* by ₹7,000 and *B* by ₹28,000.]

Q. 32 (B). Arun and Varun were in partnership sharing profits in the ratio of 2 : 3. With effect from 1st May 2016 they agreed to share profits in the ratio of 1 : 2. For this purpose the goodwill of the firm is to be valued at two year's purchase of the average profits of last three years, which were ₹1,50,000, ₹1,40,000 and ₹2,20,000 respectively. Reserves appear in the books at ₹1,10,000. Partners do not want to distribute the reserves. You are required to give effect to the change by passing a single journal entry.

[**Ans.** Debit Varun and Credit Arun by ₹30,000.]

Q. 33. *X, Y* and *Z* are partners sharing profits and losses in the ratio of 7 : 5 : 4. Their balance sheet as at 31st March 2016 stood as follows :

Liabilities		₹	*Assets*	₹
Capital Accounts :			Sundry Assets	6,00,000
X	2,00,000			
Y	1,50,000			
Z	1,20,000	4,70,000		
General Reserve		75,000		
Profit & Loss A/c (Profits)		15,000		
Creditors		40,000		
		6,00,000		6,00,000

Partners decided that with effect from 1st April 2016, they will share profits and losses in the ratio of 3 : 2 : 1. For this purpose goodwill of the firm was valued at ₹1,50,000. The partners do not want to distribute the general reserve and profits.

Pass a single journal entry to record the change and prepare a revised balance sheet.

[**Ans.** Debit *X* by ₹15,000 and *Y* by ₹5,000; Credit *Z* by ₹20,000. Total of Balance Sheet ₹6,00,000.]

Accounting for Revaluation of Assets and Liabilities when there is change in the profit sharing ratio of existing partners.

Q. 34. *A, B & C* were partners in a firm sharing profits & losses in the ratio of 2 : 2 : 1. On March 31, 2018, their Balance Sheet was as follows :

BALANCE SHEET
as at March 31, 2018

Liabilities		₹	*Assets*	₹
Capitals :			Land & Building	3,00,000
A	2,00,000		Stock	1,60,000
B	1,50,000		Debtors	80,000
C	90,000	4,40,000	Cash at Bank	10,000
General Reserve		40,000		
Creditors		70,000		
		5,50,000		5,50,000

From April 1, 2018, they decided to share future profits in the ratio of 1 : 2 : 3. For this purpose the following were agreed upon :

(*i*) Goodwill of the firm was valued at ₹4,50,000.

(*ii*) Land & Building will be appreciated by 20%.

(*iii*) Capitals of the partners will be in proportion to their new profit sharing ratio. For this purpose Current Accounts will be opened.

Pass necessary Journal entries for the above transactions in the books of the firm.

[**Ans.**

	A (₹)	*B* (₹)	*C* (₹)
Existing Capital	3,45,000	2,20,000	(–) 25,000
Required Capital	90,000	1,80,000	2,70,000
Transferred to Current Accounts	(Cr.) 2,55,000	(Cr.) 40,000	(Dr.) 2,95,000]

Q. 35. *A, B* and *C* are partners in a firm sharing profits in the ratio of 3 : 2 : 1. Their Balance Sheet as at 31st March, 2017 is as under :

Liabilities		₹	*Assets*	₹
Sundry Creditors		2,00,000	Premises	3,00,000
General Reserve		1,20,000	Machinery	1,80,000
Capitals :			Stock	1,20,000
A	3,00,000		Debtors	2,50,000
B	1,50,000		Bank	20,000
C	1,00,000	5,50,000		
		8,70,000		8,70,000

From 1st April, 2017, the partners agreed to share future profits in the ratio of 4 : 3 : 3 and make the following adjustments :

(*i*) Premises will be appreciated by 10% and stock by ₹10,000.

(*ii*) A provision for doubtful debts is to be made on debtors @4%.

(*iii*) Sundry Creditors be reduced by ₹15,000.

(*iv*) Machinery will be depreciated by 5%.

(*v*) Goodwill of the firm is valued at ₹48,000.

Prepare Revaluation Account, Partner's Capital Accounts and Balance Sheet of the reconstituted firm.

[**Ans.** Profit on Revaluation ₹36,000; Balance of Capital Accounts : *A* ₹3,82,800, *B* ₹2,03,600 and *C* ₹1,19,600; Balance Sheet Total ₹8,91,000.]

Hint : *A* Sacrifices $\frac{3}{30}$, *B* Sacrifices $\frac{1}{30}$ and *C* gains $\frac{4}{30}$th share.

Q. 36. *S, T, U* and *V* were partners in a firm sharing profits in the ratio of 4 : 3 : 2 : 1. On 1-4-2016 their Balance Sheet was as follows :

BALANCE SHEET OF *S, T, U* AND *V*
as at 1-4-2016

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
Capitals :			Fixed Assets	4,40,000
S	2,00,000		Current Assets	2,00,000
T	1,50,000			
U	1,00,000			
V	50,000	5,00,000		
Sundry Creditors		80,000		
Workmen Compensation Reserve		60,000		
		6,40,000		6,40,000

From the above date partners decided to share the future profits in 3 : 1 : 2 : 4 ratio. For this purpose the goodwill of the firm was valued at ₹90,000. The partners also agreed for the following :

(*i*) The claim for workmen compensation has been estimated at ₹70,000.

(*ii*) To adjust the capitals of the partners according to new profit sharing ratio by opening partners current accounts.

Prepare Revalution Account, Partners' Capital Accounts and the Balance Sheet of the reconstituted firm. *(C.B.S.E. 2017, Delhi)*

[**Ans.** Loss on Revaluation ₹10,000;

Capital A/cs : *S* ₹1,47,000; *T* ₹49,000; *U* ₹98,000; *V* ₹1,96,000;

Current A/cs : *S* (Cr.) ₹58,000; *T* (Cr.) ₹1,16,000; *V* (Dr.) ₹1,74,000; B/S Total ₹8,14,000]

Q. 37. *P, Q* and *R* were partners sharing profits in the ratio of 1 : 3 : 2. Following was their Balance Sheet as at 31st March, 2018 :

Liabilities	₹	*Assets*	₹
Sundry Creditors	2,80,000	Land and Building	5,00,000

Outstanding Expenses		15,000	Investments	
Workmen Compensation Reserve		60,000	(Market Value ₹1,10,000)	1,25,000
Investment Fluctuation Reserve		45,000	Stock	2,20,000
Capital Accounts :			Sundry Debtors	3,20,000
P	2,00,000		Bank Balance	1,60,000
Q	5,00,000		Advertisement Suspense	75,000
R	3,00,000	10,00,000		
		14,00,000		14,00,000

On 1st April, 2018 they decided to share future profits in the ratio of 4 : 6 : 5. It was agreed that :

(*i*) Claim for Workmen Compensation has been estimated at ₹1,00,000.

(*ii*) A motor cycle valued at ₹30,000 was unrecorded and is now to be recorded in the books.

(*iii*) Outstanding expenses were not payable anymore.

(*iv*) Value of stock be increased to ₹2,90,000.

(*v*) A provision for doubtful debts be created @ 5% on Sundry Debtors.

(*vi*) Goodwill is valued at ₹1,00,000.

(*vii*) The work of reconstitution was assigned to firm's auditors. They were paid ₹20,000 for this work.

Pass journal entries and prepare Revaluation Account.

[**Ans.** Gain on Revaluation ₹39,000.]

Q. 38. *A, B* and *C* are partners sharing profits and losses in the ratio of 2 : 2 : 1. From 1st April, 2019 they decided to share future profits and losses equally.

Following balances appeared in their books :

	₹
Profit and Loss A/c (Cr.)	20,000
Advertisement Suspense A/c (Dr.)	15,000
Workmen Compensation Reserve	60,000

It was agreed that :

(*i*) Goodwill should be valued at two year's purchase of super profits. Firm's average profits. Firm's average profits are ₹75,000. Capital invested in the business is ₹6,00,000 and normal rate of return is 10%.

(*ii*) Furniture (book value of ₹50,000) be reduced to ₹30,000.

(*iii*) Computers (book value of ₹40,000) be reduced by ₹10,000.

(*iv*) Claim on account of Workmen's Compensation amounted to ₹50,000.

(*v*) Investments (book value of ₹30,000) were revalued at ₹25,000.

Pass necessary journal entries for the above.

[**Ans.** Adjustment for Goodwill : Dr. *C* by ₹4,000 and Cr. *A* and *B* by ₹2,000 each; Revaluation Loss ₹35,000.]

Q. 39. Aman, Bobby and Chandani were partners in a firm sharing profits and losses in the ratio of 5 : 4 : 1. From 1st April, 2018 they decided to share profits equally. The revaluation of assets and re-assessment of liabilities resulted in a loss of ₹5,000. The goodwill of the firm on its reconstitution was valued at ₹1,20,000. The firm had a balance of ₹20,000 in General Reserve.

Showing your workings clearly pass necessary journal entries on the reconstitution of the firm. *(C.B.S.E. 2019, M.P.)*

[**Ans.** Adjustment for Goodwill : Dr. Chandani by ₹28,000 and Cr. Aman by ₹20,000 and Bobby by ₹8,000.]

Q. 40. *X* and *Y* are partners sharing profits and losses in the ratio of 4 : 3. Their Balance Sheet as at 31st March, 2016 stood as follows :

Liabilities		₹	*Assets*	₹
Sundry Creditors		28,000	Cash	20,000
Reserve		42,000	Sundry Debtors	1,20,000
Capital Accounts :			Stock	1,40,000
X	2,40,000		Fixed Assets	1,50,000
Y	1,20,000	3,60,000		
		4,30,000		4,30,000

They decided that with effect from 1st April, 2016, they will share profits and losses in the ratio of 2 : 1. For this purpose they decided that :

(*i*) Fixed assets are to be depreciated by 10%.

(*ii*) A provision of 6% be made on debtors for doubtful debts.

(*iii*) Stock be valued at ₹1,90,000.

(*iv*) An amount of ₹3,700 included in creditors is not likely to be claimed.

Partners decided to record the revised values in the books. However, they do not want to disturb the reserves. You are required to prepare journal entries, capital accounts of the partners and the revised balance sheet.

[**Ans.** Profit on Revaluation ₹31,500; Adjustment for Reserve : Dr. *X* by ₹4,000 and Cr. *Y* by ₹4,000; Capitals *X* ₹2,54,000 and *Y* ₹1,37,500 ; Balance Sheet Total ₹4,57,800.]

Q. 41. *P*, *Q* and *R* are in partnership sharing profits and losses in the ratio of 5 : 4 : 3. On 31st March 2019, their balance sheet was as follows :

Liabilities		₹	*Assets*	₹
Sundry Creditors		50,000	Cash at Bank	40,000
Outstanding Expenses		5,000	Sundry Debtors	2,10,000
General Reserve		75,000	Stock	3,00,000
Capital Accounts :			Furniture	60,000
P	4,00,000		Plant & Machinery	4,20,000
Q	3,00,000			
R	2,00,000	9,00,000		
		10,30,000		10,30,000

It was decided that with effect from 1st April 2019, the profit sharing ratio will be 4 : 3 : 2. For this purpose the following revaluations were made :

(*i*) Furniture be taken at 80% of its value.

(*ii*) Stock be appreciated by 20%.

(*iii*) Plant & Machinery be valued at ₹4,00,000.

(*iv*) Create provision for doubtful debts for ₹10,000 on debtors.

(*v*) Outstanding expenses be increased by ₹3,000.

Partners agreed that altered values are not to be recorded in the books and they also do not want to distribute the general reserve.

You are required to post a single journal entry to give effect to the above. Also prepare the revised Balance Sheet.

[**Ans.** Profit on Revaluation ₹15,000. Adjustment for Revaluation and General Reserve : Debit *P* by ₹2,500 and Credit *R* by ₹2,500. Balance Sheet Total ₹10,30,000.]

Q. 42. *L, M* and *N* are partners sharing profits and losses in equal proportion. On 31st March 2016, their balance sheet was as follows :

Liabilities		₹	*Assets*		₹
Creditors		58,000	Cash		8,000
Reserve and Surplus		42,000	Debtors	75,000	
Capital Accounts :			*Less* : Provision for		
L	2,00,000		Doubtful debts	3,000	72,000
M	1,00,000		Stock		1,80,000
N	80,000	3,80,000	Fixed Assets		2,20,000
		4,80,000			4,80,000

The partners decided that with effect from 1st April 2016, they will share profits and losses in the ratio of 4 : 2 : 1. For this purpose goodwill is to be valued at 2 year's purchase of the average profits of the last four years, which were :

	₹	
Year ending 31st March 2013	20,000	(Loss)
Year ending 31st March 2014	48,000	(Profit)
Year ending 31st March 2015	60,000	(Profit)
Year ending 31st March 2016	80,000	(Profit)

They further agreed that :

(*i*) Provision for doubtful debts be increased by ₹2,000.

(*ii*) Stock be appreciated by 20% and fixed assets be depreciated by 10%.

(*iii*) Creditors be taken at ₹49,000.

Partners do not desire to record the revised values of assets and liabilities in the books. They also desire to leave the reserve and surplus undisturbed.

You are required to give effect to the change in profit sharing ratio by passing a single journal entry. Also prepare the revised balance sheet.

[**Ans.** Value of Goodwill ₹84,000; Profit on Revaluation ₹21,000; Adjustment entry : Debit *L* by ₹35,000 and Credit *M* and *N* by ₹7,000 and ₹28,000 respectively. Total of Balance Sheet ₹4,80,000.]

Q. 43. Amit, Archit and Akshat are partners in a firm in the ratio of 3 : 2 : 1. On 1st April, 2019 they decided to share the profits in future in the ratio of 7 : 5 : 4. On this date General Reserve is ₹38,000 and profit on revaluation of assets and liabilities being ₹34,000. It was decided that adjustment should be made without altering the figures in the Balance Sheet. Make adjustment by one single journal entry.

[**Ans.**

Akshat's Capital A/c	Dr.	6,000	
To Amit's Capital A/c			4,500
To Archit's Capital A/c			1,500]

Q. 44. Anshu, Anju and Anupma are partners in a firm sharing profit in the ratio of 2 : 2 : 1. Their Balance Sheet as at March 31, 2019 was as follows :

BALANCE SHEET
as at March 31, 2019

Liabilities		₹	*Assets*	₹
Creditors		65,000	Land	2,00,000
Bills Payable		7,000	Building	80,000
General Reserve		48,000	Plant	1,60,000
Capital :			Stock	2,10,000
Anshu	2,40,000		Debtors	50,000
Anju	2,00,000		Cash	20,000
Anupma	1,60,000	6,00,000		
		7,20,000		7,20,000

Anshu, Anju and Anupma decided to share the profit equally, w.e.f. April 1, 2019. For this purpose it was agreed that :

(*i*) The goodwill of the firm should be valued at ₹60,000.

(*ii*) Land should be revalued at ₹3,00,000 and building and plant should be depreciated by 5%. Stock be valued at ₹2,25,000.

(*iii*) Creditors amounting to ₹2,000 were not likely to be claimed and hence should be written off. You are required to :

(*a*) Record the necessary journal entries to give effect to the above agreement, without opening revaluation account;

(*b*) Prepare the capital accounts of the partners; and

(*c*) Prepare the balance sheet of the firm after reconstitution.

Partners decide that General Reserve is to be transferred to Capital Accounts whereas revised values of assets and liabilities are not to be recorded in the books.

[**Ans.** Capitals : Anshu ₹2,70,200; Anju ₹2,30,200 and Anupma ₹1,47,600. Balance Sheet Total ₹7,20,000.

ADDITIONAL QUESTIONS

Valuation of Goodwill

Q. 45. The average profit earned by a firm is ₹75,000 which includes undervaluation of stock of ₹5,000 on an average basis. The capital invested in the business is ₹7,00,000 and the normal rate of return is 7%. Calculate goodwill of the firm on the basis of 5 times the super profit. *(C.B.S.E. 2015, Comptt.)*

[**Ans.** Adjusted Profit ₹80,000; Goodwill ₹1,55,000.]

Q. 46. Calculate the value of goodwill as on 1st April, 2015, on the basis of $2\frac{1}{2}$ year's purchase of the average profits of the last five years. The profits and losses for the years ending 31st March were: 2010 ₹80,000; 2011 ₹1,00,000; 2012 Loss ₹30,000; 2013 ₹1,70,000; 2014 ₹1,60,000 and 2015 ₹1,80,000. You are informed that the profits of the year ending 31st March 2014 included profit on sale of a fixed asset amounting to ₹50,000 and the profits for the year 2015 were effected by a loss due to fire amounting to ₹20,000.

[**Ans.** ₹2,75,000.]

Hint. Profit for the year 2010 will be ignored.

Q. 47. Calculate the value of goodwill at 2 year's purchase of the average profits of the last 3 years. The profit for the first year was ₹50,000, for second year twice the profit of first year and for the third year one and half times the profit of the second year.

[**Ans.** ₹2,00,000]

Q. 48. A firm earns a profit of ₹37,000 per year. In the same business a 10% return is generally expected. The total assets of the firm are ₹4,00,000. The value of other liabilities is ₹90,000. Find out the value of goodwill.

[**Ans.** Goodwill ₹60,000.]

Q. 49. An existing firm had assets of ₹4,00,000 including cash of ₹15,000. The partner's capital accounts showed a balance of ₹3,00,000 and reserves constituted the rest. If the normal rate of return is 12% and the goodwill of the firm is valued at ₹50,000 at $2\frac{1}{2}$ year's purchase of super profits, find the average profits of the firm.

[**Ans.** ₹68,000]

Q. 50. An existing firm had assets of ₹4,00,000 including cash of ₹15,000. Its creditors amounted to ₹20,000 on that date. The partner's capital accounts showed a balance of ₹3,00,000 and reserves amounted to ₹80,000. If the normal rate of return is 10% and the goodwill of the firm is valued at ₹75,000 at 3 year's purchase of super profits, find the average profits of the firm.

[**Ans.** ₹63,000.]

Q. 51. A partnership firm earned net profits during the last three years as follows:

Years	*Net Profit* ₹
2007-2008	1,90,000

2008-2009	2,20,000
2009-2010	2,50,000

The capital employed in the firm throughout the above mentioned period has been ₹4,00,000. Having regard to the risk involved, 15% is considered to be a fair return on the capital. The remuneration of all the partners during this period is estimated to be ₹1,00,000 per annum.

Calculate the value of goodwill on the basis of (*i*) two year's purchase of super profits earned on average basis during the above mentioned three years and (*ii*) by capitalisation of average profits method. *(C.B.S.E. 2011, Outside Delhi)*

[**Ans.** (*i*) As per Super Profits ₹1,20,000.
(*ii*) As per Capitalisation of Average Profits ₹ 4,00,000.]

Q. 52. Average profit of the firm is ₹3,00,000. Total assets of the firm are ₹24,00,000 whereas Partner's Capital is ₹20,00,000. If normal rate of return in a similar business is 12% of the capital employed, what is the value of goodwill by Capitalisation of Super Profit?

[**Ans.** Value of Goodwill ₹5,00,000]

Q. 53. The following information relates to a partnership firm :

(*a*) Sundry Assets of the firm ₹6,80,000. Outside Liabilities ₹60,000.

(*b*) Profits and losses for the past years : Profit 2013 ₹50,000; Loss 2014 ₹10,000; Profit 2015 ₹1,64,000 and Profit 2016 ₹1,80,000.

(*c*) The normal rate of return in a similar type of business is 12%.

Calculate the value of goodwill on the basis of :

(*i*) Three year's purchase of average profits.

(*ii*) Three year's purchase of super profits.

(*iii*) Capitalisation of average profits, and

(*iv*) Capitalisation of super profits.

[**Ans.** (*i*) ₹2,88,000; (*ii*) ₹64,800; (*iii*) ₹1,80,000 and (*iv*) ₹1,80,000]

Accounting Treatment of Goodwill :

Q. 54. *X, Y* and *Z* are partners sharing profits in the ratio of 5 : 4 : 1. It is now agreed that they will share future profits in the ratio of 3 : 3 : 4. Goodwill is valued at ₹1,00,000. You are required to pass a single journal entry for the treatment of goodwill.

[**Ans.** Debit *Z* by ₹30,000 and Credit *X* and *Y* by ₹20,000 and ₹10,000 respectively.]

Q. 55. Charu and Dinesh have been sharing profits in the ratio of 3 : 1. The net profits for the past four years have been ₹60,000; ₹50,000; ₹90,000 and ₹1,20,000 respectively. It is now agreed that in future Dinesh is to have 2/5th share in profits and for that purpose goodwill is to be valued on the basis of $2\frac{1}{2}$ year's purchase of average profits of the past four years. Give journal entry for the treatment of goodwill.

[**Ans.** Debit Dinesh by ₹30,000 and Credit Charu by ₹30,000.]

Q. 56. *A, B* and *C* are partners sharing profits in the ratio of 5 : 3 : 2. It is now agreed that they will share profits in the ratio of 5 : 4 : 3. Goodwill is valued at ₹1,20,000. Pass a single journal entry for the treatment of goodwill.

[**Ans.** Debit *B* by ₹4,000 and *C* by ₹6,000; Credit *A* by ₹10,000.]

Q. 57. *P, Q* and *R* are partners sharing profits and losses in the ratio of 5 : 3 : 2. From 1st April, 2016, they decide to share profits and losses in equal proportions. The partnership deed provides that in the event of any change in profit sharing ratio, the goodwill should be valued at three year's purchase of the average of five year's profits. The profits and losses of the preceding five years ending 31st March are :

Profits : 2012 : ₹60,000, 2013 : ₹1,50,000, 2014 : ₹1,70,000, 2015 : ₹1,90,000.

Loss : 2016 : ₹70,000.

Give the necessary journal entry to record the above change.

[**Ans.** Debit *Q* by ₹10,000 and *R* by ₹40,000 and Credit *P* by ₹50,000.]

Q. 58. *A* and *B* have been carrying on business in partnership with fixed capitals of ₹2,40,000 and ₹1,20,000 respectively and sharing profits in the same proportion. They decided that with effect from April 1, 2016 they would share profits and losses in the ratio of 3 : 2. For this purpose goodwill is to be valued at three year's purchase of the average of preceding three year's profits. The profits for the years ending 31st March were 2013 : ₹75,000; 2014 : ₹60,000; 2015 ₹80,000 and 2016 ₹1,30,000. Give the necessary journal entry.

[**Ans.** Value of Goodwill ₹2,70,000, Debit *B*'s Current A/c by ₹18,000 and Credit *A*'s Current A/c by ₹18,000.]

Note : Since the capitals are fixed, adjustment will be made through current accounts.

Accounting Treatment of Reserves and Accumulated Profits

Q. 59. *A, B* and *C* were partners in a firm sharing profits in the ratio of 1 : 3 : 2. They decided that with effect from 1st April, 2016, they will share profits in the ratio of 4 : 6 : 5. For this purpose the goodwill of the firm is valued at the total of preceding three year's profits. The profits were :

	₹	
2011-12	40,000	
2012-13	10,000	(Loss)
2013-14	80,000	(Loss)
2014-15	1,20,000	
2015-16	1,40,000	

Reserves and Profits appeared in the balance sheet at ₹40,000 and ₹30,000 respectively. Partners do not want to distribute the reserves and profits appearing in the balance sheet. Pass a single journal entry to record the change.

[**Ans.** Debit *A* and Credit *B* by ₹25,000.]

Accounting for Revaluation of Assets and Liabilities :

Q. 60. *X, Y* and *Z* are partners sharing profits and losses in the ratio of 5 : 3 : 2. Their position as at 31st March 2019 was as follows :

Liabilities		₹	*Assets*		₹
Sundry Creditors		44,000	Cash in Hand		8,000
Outstanding Expenses		10,000	Cash at Bank		22,000
Capitals :			Debtors	56,000	
X	2,80,000		*Less* : Provision	6,000	50,000
Y	2,80,000		Stock		2,80,000
Z	1,00,000	6,60,000	Machinery		1,54,000
			Building		2,00,000
		7,14,000			7,14,000

It was decided that with effect from 1st April 2019, profit and loss sharing ratio will be 3 : 3 : 1. They agreed on the following terms :

(*i*) Goodwill of the firm be valued at two year's purchase of the average super profits of last three years. Average profits of the last three years are ₹1,08,000, while the normal profits may be taken at ₹66,000.

(*ii*) Provision on debtors be reduced by ₹2,000.

(*iii*) Value of stock be increased by 10% and machinery be valued at ₹1,00,000.

(*iv*) An item of ₹3,000 included in sundry creditors is not likely to be claimed.

Partners do not want to record the altered values of assets and liabilities in the books. Pass an entry to give effect to the above and prepare the revised balance sheet.

[**Ans.** Loss on Revaluation ₹21,000; Value of Goodwill ₹84,000. Debit *Y* by ₹8,100 and Credit *X* and *Z* by ₹4,500 and ₹3,600 respectively. Total of Balance Sheet ₹7,14,000.]

Q. 61. The following is the balance sheet of a firm as at 31st March, 2019 :

Liabilities		₹	*Assets*	₹
Capital Accounts :			Building	6,50,000
A	4,00,000		Plant and Machinery	5,00,000
B	4,00,000		Stock	3,00,000
C	3,00,000		Debtors	2,40,000
D	3,00,000	14,00,000	Bills Receivable	10,000
Reserves		1,50,000	Cash at bank	20,000
Profit & Loss A/c (Profits)		90,000		
Creditors		80,000		
		17,20,000		17,20,000

On 1st April, 2019, the assets and liabilities were revalued as under :

	₹
Building	8,00,000
Plant and Machinery	3,20,000
Stock	2,60,000
Creditors	84,000

A provision of 5% was required on debtors. Goodwill of the firm is valued at ₹1,70,000. Partners agreed that from 1st April, 2019 they will share profits in the ratio of 4 : 3 : 2 : 1 instead of their former ratio of 5 : 4 : 2 : 1. They do not want to record

the revised values of assets and liabilities in the books. They also do not want to disturb the reserves and Profit & Loss A/c.

Pass a single journal entry to give effect to the above.

[**Ans.** Loss on Revaluation ₹86,000; Debit *C* by ₹10,800 and *D* by ₹5,400; Credit *A* by ₹5,400 and *B* by ₹10,800.]

Q. 62. Dinesh, Ramesh and Suresh are partners in a firm sharing profits and losses in the ratio of 3 : 3 : 2. From 1st April, 2018 they decided to share the future profits equally. On this date, the General Reserve showed a balance of ₹1,60,000; Revaluation of fixed assets resulted into a gain of ₹1,02,000 and stock resulted into a loss of ₹22,000. On this date the goodwill of the firm was valued at ₹3,60,000.

Pass necessary journal entries for the above transactions on reconstitution of the firm. *(C.B.S.E. 2019, Chennai)*

[**Ans.** Adjustment for Goodwill : Dr. Suresh by ₹30,000 and Cr. Dinesh and Ramesh by ₹15,000 each.]

Q. 63. Hari, Kunal and Uma are partners in a firm sharing profits and losses in the ratio of 5 : 3 : 2. From 1st April, 2018 they decided to share future profits and losses in the ratio of 2 : 5 : 3. Their Balance Sheet showed a balance of ₹75,000 in the Profit and Loss Account and a balance of ₹15,000 in Investment Fluctuation Fund. For this purpose, it was agreed that :

(*i*) Goodwill of the firm was valued at ₹3,00,000.

(*ii*) That investments (having a book value of ₹50,000) were valued at ₹35,000.

(*iii*) That stock having a book value of ₹50,000 be depreciated by 10%.

Pass the necessary journal entries for the above in the books of the firm.
(C.B.S.E. 2019, Rajasthan)

[**Ans.** Loss on Revaluation ₹5,000.]

Hint (*i*) P & L Balance of ₹75,000 will be distributed in old ratio.

(*ii*) Entry for decrease in the value of Investments :

Investment Fluctuation Fund A/c	Dr.	15,000	
To Investments A/c			15,000

There will be no effect of decrease in the value of investments on Revaluation A/c

QUESTIONS BASED ON INCOMPLETE INFORMATION

(Strictly as per Sample Paper Issued by CBSE)

Problem 1.

A, B and *C* were partners sharing profits and losses in the ratio of 7 : 5 : 4. From 1st April, 2016, they decided to share profits and losses in the ratio of 3 : 2 : 1. You are required to fill up the following journal entry :

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Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2016					
April 1	*A*'s Capital A/c	Dr.		—	
	B's Capital A/c	Dr.		—	
	To *C*'s Capital A/c				7,200
	(Adjustment for goodwill due to change in profit sharing ratio)				

Problem 2.

A, B and *C* are partners sharing profit and loss in the ratio of 2 : 5 : 5. From 1st January, 2019, they decided to share profit and loss in the ratio of 3 : 5 : 7.

You are required to fill up the following journal entry :

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2019				₹	₹
Jan. 1	*A*'s Capital A/c	Dr.		—	
	C's Capital A/c	Dr.		90,000	
	To *B*'s Capital A/c				—
	(Adjustment for goodwill due to change in profit sharing ratio)				

Solution to Problem 1 :

Old Ratio of *A, B* and *C* = 7 : 5 : 4

New Ratio of *A, B* and *C* = 3 : 2 : 1

Sacrifice or Gain =

$$A = \frac{7}{16} - \frac{3}{6} = \frac{21-24}{48} = \frac{3}{48} \text{ (Gain)}$$

$$B = \frac{5}{16} - \frac{2}{6} = \frac{15-16}{48} = \frac{1}{48} \text{ (Gain)}$$

$$C = \frac{4}{16} - \frac{1}{6} = \frac{12-8}{48} = \frac{4}{48} \text{ (Sacrifice)}$$

JOURNAL

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2016					
April 1	*A*'s Capital A/c	Dr.		5,400	
	B's Capital A/c	Dr.		1,800	
	To *C*'s Capital A/c				7,200
	(Adjustment for goodwill due to change in profit sharing ratio)				

Working Note :

C's Capital A/c is credited with ₹7,200 and he has sacrificed $\frac{4}{48}$ share.

Hence, the total value of goodwill must be : ₹7,200 × $\frac{48}{4}$ = ₹86,400

A's share $\frac{3}{48}$ of ₹86,400 = ₹5,400

B's share $\frac{1}{48}$ of ₹86,400 = ₹1,800

Answer to Problem 2.

A's Capital A/c	Dr.	60,000	
C's Capital A/c	Dr.	90,000	
To *B*'s Capital A/c			1,50,000

OBJECTIVE TYPE QUESTIONS

(A) State Whether the following statements are True or False :

1. Change in profit sharing ratio of existing partners does not amount to reconstitution of the partnership firm.
2. Old Ratio – Sacrificing Ratio = New Ratio
3. Gaining Ratio = New Ratio – Old Ratio
4. Any change in existing agreement of partnership results in reconstitution of a firm.
5. Unrecorded assets are recorded in existing partner's capital accounts.
6. At the time of change in profit sharing ratio among existing partners, an unrecorded liability is credited to Revaluation Account.
7. Sacrificing Ratio = New Ratio – Old Ratio
8. Goodwill is a fictitious asset.
9. Revaluation account is a nominal account.
10. General Reserve Account always shows credit balance.
11. Recording of unrecorded assets on the reconstitution of partnership firm is a gain to the existing partners.
12. At the time of change in profit sharing ratio, profit on Revaluation Account is credited to existing partner's capital accounts in old ratio.
13. Average Profit – Normal Profit = Super Profit
14. Capital Employed × Normal Rate of Return = Normal Profit
15. Goodwill is a Current Asset.
16. Goodwill is not a fictitious asset.
17. Goodwill is a saleable asset.
18. Normal Profit – Actual Profit = Super Profit

19. Goodwill is a valuable asset.
20. Losses are ignored while calculating the average profit.
21. Goodwill exists only when a firm earns more profits than normal profits.

(B) Fill in the Blanks :

1. Goodwill is an ..... asset, but not a ..... asset.
2. Super profit is the excess of ..... over the normal profits.
3. Following two main steps are involved in valuing the goodwill under the ..... method :
   (*i*) Calculate super profit
   (*ii*) Multiply super profit by number of years purchase
4. Under weighted average method it is considered better to give a ..... Weightage to the profit to the recent years.
5. The person who purchases a running business of the firm must pay in the form of ..... a sum which is equal to the profits he is likely to receive for the first few years.
6. Under ..... method the goodwill can be calculated by deducting the actual capital employed from the capitalized value of the average profits.
7. The Goodwill of firm ₹3,60,000 valued at three year's purchase of super profit. If capital employed is ₹4,00,000 and Normal rate of return is 10% per annum, the amount of average profit will be .....
8. Revaluation Account is prepared at the time of .....
9. Revaluation Account is a ..... account.
10. Revaluation Account shows ..... in the value of assets and liabilities.
11. In the case of downward revaluation of an asset, Revaluation Account is .....
12. In the case of upward revaluation of a liability, Revaluation Account is .....
13. In the Balance Sheet prepared after the new Partnership Deed, the assets and liabilities are shown at ..... if Revaluation Account is prepared.
14. In valuation of Goodwill, the Weighted Average Profit Method is preferred over average method when there is a ..... in profits.
15. Change in profit sharing ratio of existing partners amounts to ..... of partnership firm.
16. Revaluation of assets on the reconstitution of partnership firm becomes necessary because their present values may be different from their ..... values.
17. Tangible Trading Assets – Trading Liabilities = ...
18. Goodwill = Super Profit $\times \frac{100}{\text{.....}}$

19. Goodwill = Capitalised value of Average Profits (–) .....

20. Average Profit = $\frac{\text{.....}}{\text{Number of years}}$

21. Goodwill is an intangible and ..... asset of a business.

22. Goodwill is a ..... which arises due to connection and reputation of a business.

23. If average profits of a firm are ₹86,000, normal rate of return is 10% and goodwill at five times of super profits is ₹1,30,000, capital employed will be .....

24. If average profits of a firm are ₹74,000, normal rate of return is 10%, goodwill is valued at ₹1,20,000, capital employed will be .....

(C) Matching Questions :

1. Match the following in case of Change in Profit Sharing Ratio :

(*i*)	Ratio in which Partners share profit & losses before reconstitution of firm	(*a*)	New profit sharing ratio
(*ii*)	Ratio in which Partners surrender their share of profit in favour of other partner's	(*b*)	Gaining Ratio
(*iii*)	Ratio in which all the Partners share the future profit and losses	(*c*)	Sacrificing Ratio
(*iv*)	Ratio in which Partners acquire the share from other	(*d*)	Old Ratio

2. Identify the factors affecting the value of goodwill :

(*i*)	Stable demand	(*a*)	Favourable location
(*ii*)	Increased number of customers over a period of time	(*b*)	Longevity of business
		(*c*)	Goods of Daily use
		(*d*)	Risk involved

3. Identify weight for the past years while calculating goodwill by weighted average profit :

(*i*)	2017	(*a*)	1
(*ii*)	2019	(*b*)	2
(*iii*)	2020	(*c*)	3
(*iv*)	2018	(*d*)	4
		(*e*)	5

4. Match the following items :

(*i*)	Old Ratio – New Ratio	(*a*)	Gaining Ratio
(*ii*)	Goodwill	(*b*)	Fixed Asset
(*iii*)	General Reserve	(*c*)	Credit Balance
(*iv*)	New Ratio – Old Ratio	(*d*)	Sacrificing Ratio

5. Match the following items :

(*i*)	Goodwill which is acquired by making a payment	(*a*)	Inherent goodwill
(*ii*)	Goodwill which arises from favourable location	(*b*)	Purchased goodwill
(*iii*)	Goodwill which arises due to efficiency of management		

6. Match the following items :

(*i*)	If goodwill is valued at ₹1,20,000 at 4 years purchase of super profit; normal return is 10% and average profits are ₹50,000, capital employed will be	(*a*)	₹8,00,000
		(*b*)	₹2,00,000
		(*c*)	₹5,00,000

7. In case of change in profit sharing ratio among existing partners :

(*i*)	General Reserve will be distributed in	(*a*)	Sacrificing/Gaining Ratio
(*ii*)	Advertisement Suspense will be debited to Partners' Capital A/cs in	(*b*)	Old Ratio
(*iii*)	Goodwill valued will be adjusted in	(*c*)	New Ratio

8. Match the following items :

(*i*)	Revaluation A/c is opened	(*a*)	At the time of retirement
(*ii*)	Sacrificing Ratio	(*b*)	At the time of death
(*iii*)	Valuation of Goodwill	(*c*)	At the time of admission
		(*d*)	At the time of reconstitution of partnership firm

(D) Multiple Choice Questions :

Choose the Best Alternate :

1. Sacrificing Ratio :
   (A) New Ratio – Old Ratio (B) Old Ratio – New Ratio
   (C) Old Ratio – Gaining Ratio (D) Gaining Ratio – Old Ratio

2. Gaining Ratio :
   (A) New Ratio – Sacrificing Ratio (B) Old Ratio – Sacrificing Ratio
   (C) New Ratio – Old Ratio (D) Old Ratio – New Ratio

3. *A* and *B* were partners in a firm sharing profit or loss euqally. With effect from 1st April, 2019 they agreed to share profits in the ratio of 4 : 3. Due to change in profit sharing ratio, *A*'s gain or sacrifice will be :
   (A) Gain $\frac{1}{14}$ (B) Sacrifice $\frac{1}{14}$
   (C) Gain $\frac{4}{7}$ (D) Sacrifice $\frac{3}{7}$

4. *A* and *B* were partners in a firm sharing profit or loss equally. With effect from 1st April, 2019 they agreed to share profits in the ratio of 4 : 3. Due to change in profit sharing ratio, *B*'s gain or sacrifice will be :
   (A) Gain $\frac{1}{14}$ (B) Sacrifice $\frac{1}{14}$
   (C) Gain $\frac{4}{7}$ (D) Sacrifice $\frac{3}{7}$

5. *A* and *B* were partners in a firm sharing profit or loss in the ratio of 3 : 5. With effect from 1st April, 2019, they agreed to share profits or losses equally. Due to change in profit sharing ratio, *A*'s gain or sacrifice will be :
   (A) Gain $\frac{3}{8}$ (B) Gain $\frac{1}{8}$
   (C) Sacrifice $\frac{3}{8}$ (D) Sacrifice $\frac{1}{8}$

6. *A* and *B* were partners in a firm sharing profits and losses in the ratio of 2 : 1. With effect from 1st January, 2019 they agreed to share profits and losses equally. Individual partner's gain or sacrifice due to change in the ratio will be :
   (A) Gain by *A* $\frac{1}{6}$; Sacrifice by *B* $\frac{1}{6}$ (B) Sacrifice by *A* $\frac{1}{6}$; Gain by *B* $\frac{1}{6}$
   (C) Gain by *A* $\frac{1}{2}$; Sacrifice by *B* $\frac{1}{2}$ (D) Sacrifice by *A* $\frac{1}{2}$; Gain by *B* $\frac{1}{2}$

7. *A* and *B* share profits and losses in the ratio of 3 : 2. With effect from 1st January, 2019, they agreed to share profits equally. Sacrificing ratio and Gaining Ratio will be :
   (A) Sacrifice by *A* $\frac{1}{10}$; Sacrifice by *B* $\frac{1}{10}$

(B) Gain by $A \frac{1}{10}$; Gain by $B \frac{1}{10}$

(C) Sacrifice by $A \frac{1}{10}$; Gain by $B \frac{1}{10}$

(D) Gain by $A \frac{1}{10}$; Sacrifice by $B \frac{1}{10}$

8. *A* and *B* were partners in a firm sharing profit or loss in the ratio of 3 : 1. With effect from Jan. 1, 2019 they agreed to share profit or loss in the ratio of 2 : 1. Due to change in profit-loss sharing ratio, *B*'s gain or sacrifice will be :

(A) Gain $\frac{1}{12}$ (B) Sacrifice $\frac{1}{12}$

(C) Gain $\frac{1}{3}$ (D) Sacrifice $\frac{1}{3}$

9. *A, B* and *C* were partners sharing profit or loss in the ratio of 7 : 3 : 2. From Jan. 1, 2019 they decided to share profit or loss in the ratio of 8 : 4 : 3. Due to change in the profit-loss sharing ratio, *B*'s gain or sacrifice will be :

(A) Gain $\frac{1}{60}$ (B) Sacrifice $\frac{1}{60}$

(C) Gain $\frac{2}{60}$ (D) Sacrifice $\frac{3}{60}$

10. *X, Y* and *Z* are partners in a firm sharing profits and losses in the ratio of 5 : 3 : 2. The partners decide to share future profits and losses in the ratio of 3 : 2 : 1. Each partner's gain or sacrifice due to change in the ratio will be :

(A) *X* Sacrifice $\frac{1}{30}$; *Y* Gain $\frac{1}{30}$; *Z* Nil

(B) *X* Gain $\frac{1}{30}$; *Y* Nil; *Z* Sacrifice $\frac{1}{30}$

(C) *X* Nil; *Y* Sacrifice $\frac{1}{30}$; *Z* Gain $\frac{1}{30}$

(D) *X* Nil; *Y* Gain $\frac{1}{30}$; *Z* Sacrifice $\frac{1}{30}$

11. *A, B* and *C* were partners in a firm sharing profits and losses in the ratio of 3 : 2 : 1. The partners decide to share future profits and losses in the ratio of 2 : 2 : 1. Each partner's gain or sacrifice due to change in ratio will be :

(A) Sacrifice $A \frac{3}{30}$; Gain $B \frac{2}{30}$; Gain $C \frac{1}{30}$

(B) Gain $A \frac{2}{30}$; Gain $B \frac{1}{30}$; Sacrifice $C \frac{3}{30}$

(C) Sacrifice $A \frac{3}{30}$; Gain $B \frac{1}{30}$; Gain $C \frac{2}{30}$

(D) Gain $A \frac{1}{30}$; Gain $B \frac{1}{15}$; Sacrifice $C \frac{1}{10}$

12. *A, B* and *C* were partners in a firm sharing profits and losses in the ratio of 4 : 3 : 2. The partners decide to share future profits and losses in the ratio of 2 : 2 : 1. Each partner's gain or sacrifice due to change in the ratio will be :

(A) Sacrifice *A* $\frac{2}{45}$; Sacrifice *B* $\frac{1}{45}$; Gain *C* $\frac{3}{45}$

(B) Gain *A* $\frac{2}{45}$; Sacrifice *B* $\frac{3}{45}$; Gain *C* $\frac{1}{45}$

(C) Sacrifice *A* $\frac{2}{45}$; Gain *B* $\frac{3}{45}$; Sacrifice *C* $\frac{1}{45}$

(D) Gain *A* $\frac{2}{45}$; Gain *B* $\frac{1}{45}$; Sacrifice *C* $\frac{3}{45}$

13. *A, B* and *C* were partners in a firm sharing profits in 4 : 3 : 2 ratio. They decided to share future profits in 4 : 3 : 1 ratio. Sacrificing ratio and gaining ratio will be :

(A) *A* Sacrifice $\frac{4}{72}$; *B* Sacrifice $\frac{3}{72}$; *C* Gain $\frac{7}{72}$

(B) *A* Gain $\frac{3}{72}$; *B* Gain $\frac{4}{72}$; *C* Sacrifice $\frac{7}{72}$

(C) *A* Sacrifice $\frac{3}{72}$; *B* Sacrifice $\frac{4}{72}$; *C* Gain $\frac{7}{72}$

(D) *A* Gain $\frac{4}{72}$; *B* Gain $\frac{3}{72}$; *C* Sacrifice $\frac{7}{72}$

14. *X, Y* and *Z* were partners sharing profits in the ratio 2 : 3 : 4 with effect from 1st January, 2019 they agreed to share profits in the ratio 3 : 4 : 5. Each partner's gain or sacrifice due to change in the ratio will be :

(A) *X* Gain $\frac{1}{36}$; *Y* Nil; *Z* Sacrifice $\frac{1}{36}$

(B) *X* Sacrifice $\frac{1}{36}$; *Y* Nil; *Z* Gain $\frac{1}{36}$

(C) *X* Gain $\frac{1}{36}$; *Y* Sacrifice $\frac{1}{36}$; *Z* Nil

(D) *X* Sacrifice $\frac{1}{36}$; *Y* Gain $\frac{1}{36}$; *Z* Nil

15. *X, Y* and *Z* were in partnership sharing profits in the ratio 4 : 3 : 1. The partners agreed to share future profits in the ratio 5 : 4 : 3. Each partner's gain or sacrifice due to change in ratio will be :

(A) *X* Sacrifice $\frac{2}{24}$; *Y* Sacrifice $\frac{1}{24}$; *Z* Gain $\frac{3}{24}$

(B) *X* Gain $\frac{2}{24}$; *Y* Gain $\frac{1}{24}$; *Z* Sacrifice $\frac{3}{24}$

(C) *X* Sacrifice $\frac{1}{24}$; *Y* Sacrifice $\frac{2}{24}$; *Z* Gain $\frac{3}{24}$

(D) *X* Sacrifice $\frac{2}{24}$; *Y* Gain $\frac{3}{24}$; *Z* Sacrifice $\frac{1}{24}$

16. *A, B* and *C* are equal partners in the firm. It is now agreed that they will share the future profits in the ratio 5 : 3 : 2. Sacrificing ratio and gaining ratio of different partners will be :

(A) *A* Sacrifice $\frac{5}{30}$; *B* Gain $\frac{1}{30}$; *C* Gain $\frac{4}{30}$

(B) *A* Gain $\frac{5}{30}$; *B* Sacrifice $\frac{4}{30}$; *C* Sacrifice $\frac{1}{30}$

(C) *A* Gain $\frac{5}{30}$; *B* Sacrifice $\frac{1}{30}$; *C* Sacrifice $\frac{4}{30}$

(D) *A* Sacrifice $\frac{5}{30}$; *B* Gain $\frac{4}{30}$; *C* Gain $\frac{1}{30}$

HOTS

17. Which of the following is True in relation to goodwill?

(A) Goodwill is a fictitious asset

(B) Goodwill is a current asset

(C) Goodwill is a wasting asset

(D) Goodwill is an intangible asset

18. The excess amount which the firm can get on selling its assets over and above the saleable value of its assets is called :

(A) Surplus (B) Super profits

(C) Reserve (D) Goodwill

HOTS

19. Which of the following is NOT true in relation to goodwill?

(A) It is an intangible asset (B) It is fictitious asset

(C) It has a realisable value (D) None of the above

20. When Goodwill is not purchased goodwill account can :

(A) Never be raised in the books

(B) Be raised in the books

(C) Be partially raised in the books

(D) Be raised as per the agreement of the partners

HOTS

21. The Goodwill of the firm is NOT affected by :

(A) Location of the firm (B) Reputation of firm

(C) Better customer service (D) None of the above

(CPT; June 2011)

22. Capital employed by a partnership firm is ₹5,00,000. Its average profit is ₹60,000. The normal rate of return in similar type of business is 10%. What is the amount of super rofits?

(A) ₹50,000 (B) ₹10,000

(C) ₹6,000 (D) ₹56,000

(C.S. Foundation, Dec., 2012)

23. Weighted average method of calculating goodwill is used when :

(A) Profits are not equal (B) Profits show a trend

(C) Profits are fluctuating (D) None of the above

(CPT; June 2009)

24. The profits earned by a business over the last 5 years are as follows : ₹12,000; ₹13,000; ₹14,000; ₹18,000 and ₹2,000 (loss). Based on 2 years purchase of the last 5 years profits, value of Goodwill will be :

(A) ₹ 23,600 (B) ₹ 22,000

(C) ₹1,10,000 (D) ₹1,18,000

25. The average profit of a business over the last five years amounted to ₹60,000. The normal commercial yield on capital invested in such a business is deemed to be 10% p.a. The net capital invested in the business is ₹5,00,000. Amount of goodwill, if it is based on 3 years purchase of last 5 years super profits will be :

(A) ₹1,00,000 (B) ₹1,80,000

(C) ₹ 30,000 (D) ₹1,50,000

HOTS

26. Under the capitalisation method, the formula for calculating the goodwill is :

(A) Super profits multiplied by the rate of return

(B) Average profits multiplied by the rate of return

(C) Super profits divided by the rate of return

(D) Average profits divided by the rate of return *(CPT; Dec. 2011)*

27. Total assets of a firm including fictitious assets of ₹5,000 are ₹85,000. The net liabilities of the firm are ₹30,000. The normal rate of return is 10% and the average profits of the firm are ₹8,000. Calculate the goodwill as per capitalisation of super profits.

(A) ₹20,000 (B) ₹30,000

(C) ₹25,000 (D) None of these

28. Total Capital employed in the firm is ₹8,00,000, reasonable rate of return is 15% and Profit for the year is ₹12,00,000. The value of goodwill of the firm as per capitalization method would be :

(A) ₹82,00,000 (B) ₹12,00,000

(C) ₹72,00,000 (D) ₹42,00,000

(C.S. Foundation, June 2013)

29. The average capital employed of a firm is ₹4,00,000 and the normal rate of return is 15%. The average profit of the firm is ₹80,000 per annum. If the remuneration of the partners is estimated to be ₹10,000 per annum, then on the basis of two years purchase of super-profit, the value of the Goodwill will be :

(A) ₹10,000 (B) ₹20,000

(C) ₹60,000 (D) ₹80,000

30. A firm earns ₹1,10,000. The normal rate of return is 10%. The assets of the firm amounted to ₹11,00,000 and liabilities to ₹1,00,000. Value of goodwill by capitalisation of Average Actual Profits will be :

(A) ₹2,00,000 (B) ₹ 10,000
(C) ₹ 5,000 (D) ₹1,00,000

(C.S. Foundation Dec., 2012)

31. Capital invested in a firm is ₹5,00,000. Normal rate of return is 10%. Average profits of the firm are ₹64,000 (after an abnormal loss of ₹4,000). Value of goodwill at four times the super profits will be :

(A) ₹ 72,000 (B) ₹ 40,000
(C) ₹2,40,000 (D) ₹1,80,000

32. *P* and *Q* were partners sharing profits and losses in the ratio of 3 : 2. They decided that with effect from 1st January, 2019 they would share profits and losses in the ratio of 5 : 3. Goodwill is valued at ₹1,28,000. In adjustment entry :

(A) Cr. *P* by ₹ 3,200; Dr. *Q* by ₹ 3,200
(B) Cr. *P* by ₹37,000; Dr. *Q* by ₹37,000
(C) Dr. *P* by ₹37,000; Cr. *Q* by ₹37,000
(D) Dr. *P* by ₹ 3,200 Cr. *Q* by ₹ 3,200

33. *A, B* and *C* are partners sharing profits in the ratio of 4 : 3 : 2 decided to share profits equally. Goodwill of the firm is valued at ₹10,800. In adjusting entry for goodwill :

(A) *A*'s Capital A/c Cr. by ₹4,800; *B*'s Capital A/c Cr. by ₹3,600; *C*'s Capital A/c Cr. by ₹2,400.
(B) *A*'s Capital A/c Cr. by ₹3,600; *B*'s Capital A/c Cr. by ₹3,600; *C*'s Capital A/c Cr. by ₹3,600.
(C) *A*'s Capital A/c Dr. by ₹1,200; *C*'s Capital A/c Cr. by ₹1,200;
(D) *A*'s Capital A/c Cr. by ₹1,200; *C*'s Capital A/c Dr. by ₹1,200

34. *A, B* and *C* were partners sharing profits and losses in the ratio of 7 : 3 : 2. From 1st January, 2019 they decided to share profits and losses in the ratio of 8 : 4 : 3. Goodwill is ₹1,20,000. In Adjustment entry for goodwill :

(A) Cr. *A* by ₹6,000; Dr. *B* by ₹2,000; Dr. C by ₹4,000
(B) Dr. *A* by ₹6,000; Cr. *B* by ₹2,000; Cr. C by ₹4000
(C) Cr. *A* by ₹6,000; Dr. *B* by ₹4,000; Dr. C by ₹2,000
(D) Dr. *A* by ₹6,000; Cr. *B* by ₹4,000; Cr. C by ₹2,000

35. *P, Q* and *R* were partners in a firm sharing profis in 5 : 3 : 2 ratio. They decided to share the future profits in 2 : 3 : 5. For this purpose the goodwill of the firm was valued at ₹1,20,000. In adjustment entry for the treatment of goodwill due to change in the profit sharing ratio :

(A) Cr. *P* by ₹24,000; Dr. *R* by ₹24,000
(B) Cr. *P* by ₹60,000; Dr. *R* by ₹60,000
(C) Cr. *P* by ₹36,000; Dr. *R* by ₹36,000
(D) Dr. *P* by ₹36,000; Cr. *R* by ₹36,000

36. *A, B* and *C* are partners in a firm sharing profits in the ratio of 3 : 4 : 1. They decided to share profits equally w.e.f. 1st April, 2019. On that date the Profit and Loss Account showed the credit balance of ₹96,000. Instead of closing the Profit and Loss Account, it was decided to record an adjustment entry reflecting the change in profit sharing ratio. In the journal entry :

(A) Dr. *A* by ₹ 4,000; Dr. *B* by ₹16,000; Cr. *C* by ₹20,000

(B) Cr. *A* by ₹ 4,000; Cr. *B* by ₹16,000; Dr. *C* by ₹20,000

(C) Cr. *A* by ₹16,000; Cr. *B* by ₹ 4,000; Dr. *C* by ₹20,000

(D) Dr. *A* by ₹16,000; Dr. *B* by ₹ 4,000; Cr. *C* by ₹20,000

HOTS

37. *A, B* and *C* are partner sharing profits in the ratio of 1 : 2 : 3. On 1-4-2019 they decided to share the profits equally. On the date there was a credit balance of ₹1,20,000 in their Profit and Loss Account and a balance of ₹1,80,000 in General Reserve Account. Instead of closing the General Reserve Account and Profit and Loss Account, it is decided to record an adjustment entry for the same. In the necessary adjustment entry to give effect to the above arrangement :

(A) Dr. *A* by ₹50,000; Cr. *B* by ₹50,000

(B) Cr. *A* by ₹50,000; Dr. *B* by ₹50,000

(C) Dr. *A* by ₹50,000; Cr. *C* by ₹50,000

(D) Cr. *A* by ₹50,000; Dr. *C* by ₹50,000

HOTS

38. *X, Y* and *Z* are partners in a firm sharing profits in the ratio 4 : 3 : 2. Their Balance Sheet as at 31-3-2019 showed a debit balance of Profit & Loss A/c ₹1,80,000. From 1-4-2019 they will share profits equally. In the necessary journal entry to give effect to the above arrangement when *X, Y* and *Z* decided not to close the Profit & Loss Acccount :

(A) Dr. *X* by ₹20,000; Cr. *Z* by ₹20,000

(B) Cr. *X* by ₹20,000; Dr. *Z* by ₹20,000

(C) Dr. *X* by ₹40,000; Cr. *Z* by ₹40,000

(D) Cr. *X* by ₹40,000; Dr. *Z* by ₹40,000

HOTS

39. Arun and Varun are partners sharing profits in the ratio of 4 : 3. Their Balance Sheet showed a balance of ₹56,000 in the General Reserve Account and a debit balance of ₹14,000 in Profit and Loss Account. They now decided to share the future profits equally. Instead of closing the General Reserve Account and Profit and Loss Account, it is decided to pass an adjustment entry for the same. In adjustment entry :

(A) Dr. Arun by ₹3,000; Cr. Varun by ₹3,000

(B) Dr. Arun by ₹5,000; Cr. Varun by ₹5,000

(C) Cr. Arun by ₹5,000; Dr. Varun by ₹5,000

(D) Cr. Arun by ₹3,000; Dr. Varun by ₹3,000

HOTS

40. *X, Y* and *Z* are partners in a firm sharing profits in the ratio of 3 : 2 : 1. They decided to share future profits equally. The Profit and Loss Account showed a Credit balance of ₹60,000 and a General Reserve of ₹30,000. If these are not to be shown in balance sheet, in the journal entry :

(A) Cr. *X* by ₹15,000; Dr. *Z* by ₹15,000

(B) Dr. *X* by ₹15,000; Cr. *Z* by ₹15,000

(C) Cr. *X* by ₹45,000; Cr. *Y* by ₹30,000; Cr. *Z* by ₹15,000

(D) Cr. *X* by ₹30,000; Cr. *Y* by ₹30,000; Cr. *Z* by ₹30,000

41. *X, Y* and *Z* are partners sharing profits and losses in the ratio 5 : 3 : 2. They decide to share the future profits in the ratio 3 : 2 : 1. Workmen compensation reserve appearing in the balance sheet on the date if no information is available for the same will be :

(A) Distributed to the partners in old profit sharing ratio

(B) Distributed to the partners in new profit sharing ratio

(C) Distributed to the partners in capital ratio

(D) Carried forward to new balance sheet without any adjustment

42. Any change in the relationship of existing partners which results in an end of the existing agreement and enforces making of a new agreement is called

(A) Revaluation of partnership.

(B) Reconstitution of partnership.

(C) Realization of partnership.

(D) None of the above. *(C.B.S.E. Sample Paper, 2015)*

[See answers at the end of the book]