



CHAPTER - 02

CHANGE IN PROFIT SHARING RATIO AMONG THE EXISTING PARTNERS

Reconstitution of 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 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

- (1) **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
- (2) **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.
- (3) **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.
- (4) **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.
- (5) **Amalgamation of two partnership firms** For example A and B are partner 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 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 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 necessitated 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

$$\text{Gaining Ratio} = \text{New Ratio} - \text{Old Ratio}$$

Goodwill

Goodwill is good name or the reputation of the business, which is 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.

Features of Goodwill

- 1. It is an intangible asset:** Goodwill cannot be seen or touched, it does not have any physical existence, thus it belongs to the category of intangible assets such as patents, trademarks, copyrights, etc.
- 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 fluctuation, 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 or retirement of the 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 any 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.

Goodwill is divided into two categories.

- I. Purchased Goodwill:** Purchased goodwill means goodwill for which a consideration has been paid e.g. when business is purchased the excess of purchase consideration of its net assets i.e. (Assets – Liabilities) is the Purchased Goodwill. It is separately recorded in the books because as it is purchased by paying in form of cash or kind.

Characteristics

- (i)** It arises on purchase of a business or brand.
- (ii)** Consideration is paid for it so it is recorded in books.
- (iii)** Shown in balance sheet as an asset.
- (iv)** It is amortised (depreciated).
- (v)** Value is a subjective judgment & ascertained by agreement of seller & purchaser. It is approximate value and cannot be sold separately in the market or in parts.

II. Self-generated Goodwill also called as inherent goodwill. It is an internally generated goodwill which arises from a number of factors that a running business possesses due to which it is able to earn more profits in the future.

Purchased Goodwill	Self-generated Goodwill
<ul style="list-style-type: none">• Arise on purchase of a business• Paid, hence it is recorded in the books of account• Amortized• Subjective Value (Seller and Buyer)	<ul style="list-style-type: none">• Generated internally, over the years• Not recorded in the books (AS-26)• Subjective Value (Valuer)

Features

- (i)** It is generated internally over the years.
- (ii)** A true cost cannot be placed on this type of goodwill.
- (iii)** Value depends on subjective judgment of the value.
- (iv) As per Accounting Standard 26(Intangible Asset),** it is not recorded in the books of accounts because consideration in money or money's worth has not be paid for it.

Factors Affecting the Value of Goodwill

- 1. Efficient 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.
- 2. Quality of products:** If the firm is supplying good quality of products, then the customer will come again and again for the same and thus will create the goodwill and brand name for the same.
- 3. Location of business:** If the business is located at a convenient or prominent place, it will attract more customers and therefore will have more goodwill.
- 4. 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.
- 5. 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.
- 6. 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.

Need for Valuing Goodwill: Whenever the mutual rights of the partners changes the party which makes a sacrifice must be compensated. This basis of compensation is goodwill so we need to calculate goodwill.

Mutual rights change under following circumstances

1. When profit sharing ratio changes.
2. On admission of a partner
3. On Retirement or death of a partner
4. When amalgamation of two firms taken place
5. when partnership firm is sold.

Method 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. Capitalization method

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 years. Average of such profits is multiplied by the agreed number of years (such as two or three) to find out the value of goodwill.

Formula for calculation of goodwill

Goodwill = Average Profits × Number of years of purchase
 Number of years of purchase means for how many years the firm will earn the same amount of profits in future.

Average Profits = Total Profits/Number of years

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 profit share 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.

Weighted Average Profit Method: This method is a modified version of average profit method. In this Method each year's profit is assigned a weight. The highest weight is attached to profit of most recent year.

Eg: 2011-1, 2012-2, 2013-3, 2014-4.

Each year profits are multiplied by assigned weights. Products are added & divided by total number of weights. Weighted average is multiplied by agreed Number of years of Purchase.

$$\text{Weighted Average Profit:} = \frac{\text{Total Product of profits}}{\text{Total Weights}}$$

Goodwill = Weighted Average Profit × No. of years 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 future. This method is preferred when profits over the past years have been continuously rising or falling.

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. Super Profit are the excess of actual profit over normal profits. Where Normal profits are profits earned by similar business.

If a firm earns higher profit in comparison to normal profit (generally earned by other firms of same industry) then the difference is called Super Profit. Goodwill is calculated on the basis of Super profit due to future expectations of earning capacity of the firm.

Goodwill is calculated by the formula

Goodwill = Super Profit × Number of years of purchase

Super Profit = Average profit – Normal profits

Normal Profit = Investment (Capital Employed) × $\frac{\text{Normal rate of return}}{100}$

Capital Employed = Capital + Free Reserves – fictitious Assets (if any), or

All Assets – (Goodwill, fictitious assets and non-trade Investment) – Outsider's Liabilities

Capitalised Method Under this method, goodwill can be calculated in two ways:

(A) Capitalisation of Average Profit 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.

$$\text{Capitalised value of the firm} = \frac{\text{Average Profit} \times 100}{\text{Normal rate of return}}$$

Goodwill is calculated by deducting the actual capital employed in business from the capitalised value of average profits. There will be no goodwill if the actual capital employed in the business exceeds or equals the capitalised value of the average profits.

Net Assets or Capital employed = Total assets – Outside liabilities

Goodwill = Capitalized value of average profits – Capital Employed

(B) 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. Super profits are calculated in the same manner as calculated in super profits method.

Goodwill of the firm = Super Profits * 100 / Normal rate of return.

Goodwill

Goodwill refers to the difference between the fair or market value of the net assets of the partnership and their book value. An increase in the share of profit means the purchase of a share of profit from another partner by acquiring his or their share. The compensation paid by gaining a partner to sacrificing partner is known as "goodwill" or "premium for goodwill". This compensation is paid in their sacrificing ratio. Accounting treatment of goodwill:

Amount of compensation = Value of a firm's goodwill × share of profit gained

Entries to adjust Goodwill:

A. When goodwill is adjusted through partners' capital account :

(i) In the case of Fluctuating capital :

Gaining partner's Capital A/Cs

To Sacrificing partner's Capital A/Cs

(ii) In the case of Fixed capital :

Gaining a partner's Current A/Cs

To Sacrificing partner's Current A/Cs

Reserves and accumulated profits or losses

Accumulated earnings are the sum of a company's profits, retained earnings, earned surplus, or retained capital, after dividend payments, since the company's inception.

Accumulated losses refer to the advertisement expenditure and also previous year losses (if any) which have not been distributed among partners.

Following journal entries have to be made:

For transfer of reserves and accumulated profits :

Reserves A/c Dr.

Profit and loss A/c (Cr balance) Dr.

Workmen compensation A/c Dr.

Investment fluctuation reserve A/c Dr.

To All partner's capital/current A/cs

For transfer of accumulated losses:

All partners' capital/current A/cs Dr.

To Profit and loss A/c (Dr Balance)

To Deferred Revenue expenditure A/c (say, advertisement suspense A/c)

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 are sharing profits in the ratio of 2 : 1 and for future they 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.

Workmen compensation reserves (WCR)

Workmen Compensation reserve is a reserve besides free reserves to be paid for any mishappening and accident happen to workmen at the workplace. It may or may not arise or if arises claim may be equal to, higher or lower than the amount of reserve.

When a claim against WCR does not exist, the amount of Workmen compensation reserves is transferred to the partner's capital account in their old profit-sharing ratio.

The following entry is made:

Workmen compensation A/c Dr.

To Partner's capital/current A/c

(Being WCR is transferred to partner's cap/current a/c)

When a claim against WCR exist and claim = WCR

Workmen compensation reserve A/c Dr.

To provision for Workmen compensation claim A/c

When a claim against WCR exist and claim > WCR

(i) Workmen compensation reserve A/c Dr.

Revaluation A/c Dr.

To provision for Workmen compensation claim A/c

(ii) Partner's capital/current A/c Dr.

To Revaluation A/c

When a claim against WCR exist and claim < WCR

Workmen compensation reserve A/c Dr.

To provision for Workmen compensation claim A/c

To partner's capital/current A/cs

Investment Fluctuation Reserve (IFR)

Investment Fluctuation Reserve is a reserve created out of the profits to meet the fall in the market value of investments. Excess of Investment Fluctuation Reserve over the difference between book value and market value is credited to old partners in their old profit sharing ratio.

(i) When book value and market value are the same, the amount of IFR is transferred to Old partner's capital or Current Accounts in their old profit sharing ratio when the market value of the investment is less than the book value.

(ii) If fall in value is less than the reserve, IFR, to the extent of fall in the value, is transferred to Investment Account and the balance is distributed among the old partners in their old profit sharing ratio

(iii) If the fall in value is equal to reserve, the amount of IFR is transferred to Investment Account and no amount is distributed among the old partners

(iv) If the fall in value is more than the reserve, the amount in excess of the amount of Investment Fluctuation Reserve is debited to Revaluation Account.

(v) When there is an increase in the market value of the investment, the entire reserve is distributed to old

partners in their old profit-sharing ratio and an increase in value is credited to Revaluation Account.

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

- (1) For decrease in the value of assets :**
 Revaluation A/c Dr.
 To Assets A/c
 (Decrease in the value of assets)
- (2) For increase in the value of assets:**
 Asset Ac Dr.
 To Revaluation A/c
 (Increase in the value of assets)
- (3) For increase in the value of liabilities**
 Revaluation A/c Dr.
 To Liabilities A/c
 (Increase in the value of liabilities)
- (4) 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 or loss will be 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/c Dr.
 To Revaluation A/c
 (Loss on Revaluation debited to Partner's Capital A/cs)

Proforma of Revaluation A/c

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Decrease in Value of Assets	xxxx	By Increase in Value of Assets	xxxx
To Increase in Value of Liabilities	xxxx	By Decrease in Value of Liabilities	xxxx
To Unrecorded Liabilities	xxxx	By Unrecorded Assets	xxxx
To Profit on Revaluation (Transfer to Old Partner's Capital A/c in Old Profit sharing Ratio)	xxxx	By Loss on Revaluation (Transfer to Old Partner's Capital A/c in Old Profit sharing Ratio)	xxxx
	xxxx		xxxx

Solved Examples

Q1. 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 of 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 $\frac{1}{30}$.

Q2. 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:

Years	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, 2018 the firm received an unexpected tax refund of ₹80,000.

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.

Q3. A firm earned net profits during the last seven years as follows:

2015	₹ 20,000 Profit	2016	₹ 70,000 Loss
2017	₹ 40,000 Loss	2018	₹ 2,50,000 Profit
2019	₹2,70,000 Profit	2020	₹3,00,000
2021	₹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:

$$\begin{aligned} \text{Total profits of last 7 years} &= ₹20,000 - ₹70,000 - ₹40,000 + ₹2,50,000 \\ &\quad + ₹2,70,000 + ₹3,00,000 + ₹3,20,000 \\ &= ₹10,50,000 \end{aligned}$$

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

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

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

(iii) Super 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.

Q4. 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 = Assets - Liabilities
(i.e., Net Assets as on the date of Valuation of Goodwill)
= ₹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.

Q5. From the figures given in Question 5, 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

Goodwill = Super Profit × $\frac{100}{\text{Normal rate of return}}$
= 15,000 × $\frac{100}{10}$ = ₹1,50,000

Q6. 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.

SOLUTIONS:

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 of Gain:

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

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

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

Q7. 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.

Journal

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)			

Q8. 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.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2017 April 1	<i>Case (i)</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 account in their old profit sharing ratio)			
	<i>Case (ii)</i> 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)			
	<i>Case (iii)</i> Workmen Compensation Reserve A/c	Dr.	60,000	
	To Provision for Workmen Compensation Claim A/c			60,000
	(Provision made for Workmen Compensation Claim)			
	<i>Case (iv)</i> 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)

Q9. 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, 2021. Following is an extract of their Balance Sheet as at 31st March, 2021:

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.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2021 April 1	<p><i>Case (i)</i> Investment Fluctuation Reserve A/c Dr. To P's Capital A/c To Q's Capital A/c To R's Capital A/c (Transfer of excess Investment Fluctuation Reserve to partner's capital accounts in their old profit sharing ratio)</p>		30,000	15,000 10,000 5,000
	<p><i>Case (ii)</i> Same Solution as given in case (i)</p>			
	<p><i>Case (iii)</i> Investment Fluctuation Reserve A/c Dr. To Investment A/c (5,00,000 - 4,88,000) To P's Capital A/c To Q's Capital A/c To R's Capital A/c (Transfer of excess Investment Fluctuation Reserve to partner's capital accounts in their old profit sharing ratio)</p>		30,000	12,000 9,000 6,000 3,000
	<p><i>Case (iv)</i> Investment Fluctuation Reserve A/c Dr. Revaluation A/c Dr. To Investments A/c (Fall in the value of investments adjusted through investment fluctuation reserve and shortfall charged to Revaluation Account)</p>		30,000 24,000	54,000
	<p>P's Capital A/c Dr. Q's Capital A/c Dr. R's Capital A/c Dr. To Revaluation A/c (Transfer of loss on revaluation to partner's capital accounts in their old profit sharing ratio)</p>		12,000 8,000 4,000	24,000
	<p><i>Case (v)</i> Investment Fluctuation Reserve A/c Dr. To P's Capital A/c To Q's Capital A/c To R's Capital A/c (Transfer of excess investments fluctuation reserve to Partners' Capital Accounts in their old profit-sharing ratio)</p>		30,000	15,000 10,000 5,000
	<p>Investments A/c Dr. To Revaluation A/c (Value of investments brought up to market value)</p>		6,000	6,000
	<p>Revaluation A/c Dr.</p>		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)	

Q10. 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, 2021. 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:

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

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

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

JOURNAL

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2021				
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.)			

Q11. 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.

SOLUTION:

JOURNAL of A, B and C

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

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 =

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

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

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

(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	<u>= (20,000)</u>
Total Capital of the firm				<u>1,20,000</u>

Since they share 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	<u>40,000</u>	<u>40,000</u>	<u>40,000</u>
Transferred to Current Accounts	<u>(Cr.) 60,000</u>	---	<u>(Dr.) 60,000</u>

QUESTIONS FOR PRACTICE

MCQ

- The profits for last 3 years were
1st year = ₹ 6,000 (including abnormal gain of ₹ 2,000)
2nd year = ₹ 4,000 (after charging abnormal loss of ₹ 3,000)
3rd year = ₹ 2,500 (including abnormal income of ₹ 1,500)
Calculate goodwill on the basis of 3 years' purchase of last 3 years profits and losses.
(a) ₹ 12,500
(b) ₹ 12,000
(c) ₹ 13,000
(d) ₹ 16,000
 - Capital employed in a business is ₹ 2,00,000. Normal rate of return on capital employed is 15%. During the year, the firm earned a profit of ₹ 48,000. Calculate goodwill on the basis of 3 years' purchase of super profit.
(a) ₹ 54,000
(b) ₹ 60,000
(c) ₹ 50,000
(d) None of these
 - A firm earns ₹ 1,20,000 as its annual profits. The normal rate of profit being 10%. Assets of firm are ₹ 14,40,000 and liabilities are ₹ 4,40,000. Find value of goodwill by capitalisation method.
(a) ₹ 4,00,000
(b) ₹ 2,80,000
(c) ₹ 2,00,000
(d) ₹ 3,60,000
 - Average profit of firm is ₹ 3,00,000. Total tangible assets in the firm are ₹ 28,00,000 and outside liabilities are ₹ 8,00,000. In same type of business, normal rate of return is 10% of capital employed. Calculate goodwill by capitalisation of super profit method.
(a) ₹ 14,00,000
(b) ₹ 16,00,000
(c) ₹ 18,00,000
(d) ₹ 10,00,000
 - 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
 - The goodwill of the firm is affected by
(a) Favourable location of the business
(b) Efficiency of management
(c) Risk Involved
(d) All of the above
 - The profits earned by a business over the last 5 years are ₹ 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
 - The net 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
 - Nature of Goodwill is
(a) Intangible asset
(b) Fictitious asset
(c) Long-term liability
(d) Current asset
 - 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 these
- (Q 11 and 12 are based on this information)**
A, B and C are partners sharing profits and losses in the ratio of 5 : 4 : 1. If, C acquires $\frac{1}{5}$ th share from A, then
- Calculate new profit sharing ratio.
(a) 5 : 4 : 2
(b) 5 : 4 : 1
(c) 3 : 4 : 3
(d) None of these
 - Calculate sacrificing ratio
(a) A sacrifice $\frac{1}{5}$
(b) B sacrifice $\frac{1}{5}$
(c) C sacrifice $\frac{1}{5}$
(d) None of these
 - Calculate net effect of revaluation when revised values are to be recorded in books.
(i) Stock is to be valued at 10% less (Book value ₹ 3,00,000).
(ii) Provision for bad debts is no more required, (Shown in balance sheet for ₹ 4,000).
(iii) An outstanding salary which is unrecorded of ₹ 16,000.
(a) ₹ 40,000 profit
(b) ₹ 42,000 profit
(c) ₹ 42,000 loss
(d) None of the above
 - 'A' and 'B' are partners in a firm. They share their profits and losses in the ratio of 3 : 2. They have decided that their new profits (losses) sharing ratio will be 1 : 1. At that time, their goodwill is valued at ₹

30,000. Calculate amount of goodwill which will be given by B to A.

- (a) ₹ 2,500
 (b) ₹ 2,400
 (c) ₹ 2,800
 (d) ₹ 3,000

15. 'B' and 'C' were partners sharing profits in the ratio of 3 : 2. They agreed to share their future profits in the ratio of 1 : 1. At that time, their books showed the following balances

Profit and Loss A/c (Cr) = ₹ 60,000

General Reserve = ₹ 40,000

Pass necessary entry at the time of change in profit sharing ratio.

- | | |
|-------------------------|-------------|
| (a) C's Capital A/c | Dr 1,00,000 |
| To B's Capital A/c | 1,00,000 |
| (b) General Reserve A/c | Dr 40,000 |
| To B's Capital A/c | 20,000 |
| To C's Capital A/c | 20,000 |
| (c) Profit and Loss A/c | Dr 60,000 |
| General Reserve A/c | Dr 40,000 |
| To B's Capital A/c | 1,00,000 |
| (d) Profit and Loss A/c | Dr 60,000 |
| General Reserve A/c | Dr 40,000 |
| To B's Capital A/c | 60,000 |
| To C's Capital A/c | 40,000 |

16. 'A', 'B' and 'D' are partners in a firm sharing profits (losses) in the ratio of 3 : 2 : 1. They change their ratio into 2 : 1 : 2 for future profits. At that time, their balance sheet shows the following balances Investment Fluctuation Reserve = ₹ 6,000 Investment = ₹ 25,000 Now, the market value of investments' is ₹ 22,000. Distribute investment fluctuation reserve among partners.

- | | |
|--|----------|
| (a) Investment Fluctuation Reserve A/c | Dr 6,000 |
| To A's Capital A/c | 3,000 |
| To B's Capital A/c | 2,000 |
| To D'S Capital A/c | 1,000 |
| (b) Investment Fluctuation Reserve A/c | Dr 6,000 |
| To A's Capital A/c | 6,000 |
| (c) A's Capital A/c | Dr 6,000 |
| To B's Capital A/c | 3,000 |
| To D'S Capital A/c | 3,000 |

- | | |
|--|----------|
| (d) Investment Fluctuation Reserve A/c | Dr 6,000 |
| To Investment A/c | 3,000 |
| To A's Capital A/c | 1,500 |
| To B's Capital A/c | 1,000 |
| To D'S Capital A/c | 500 |

17. Pass the journal entry to record the increase in the value of assets at the time of change in profit sharing ratio.

- | | |
|--------------------------|----|
| (a) Assets A/c | Dr |
| To Partners' Capital A/c | |
| (b) Revaluation A/c | Dr |
| To Assets A/c | |
| (c) Assets A/c | Dr |
| To Revaluation A/c | |
| (d) Liabilities A/c | Dr |
| To Revaluation A/c | |

18. The steps of treatment of goodwill at the time of change in profit sharing ratio are

- (i) Calculate compensation payable by gaining partner(s) to sacrificing partner(s).
 (ii) Pass the adjustment entry.

(iii) Calculate the share gained and share sacrificed.

The correct order is

- (a) (i), (iii), (ii)
 (b) (i), (ii), (iii)
 (c) (iii), (i), (ii)
 (d) (iii), (ii), (i)

19. If the claim on account of workmen's compensation is more than the workmen compensation reserve, which account(s) is/are debited initially?

- (a) Workmen compensation reserve
 (b) Revaluation account
 (c) Both (a) and (b)
 (d) None of the above

20. A and B are partners in a firm sharing profit and losses 2 : 3. With effect from 1st April, 2022, they decided to share profits and loss equally. What will be B's gain/sacrifice?

- (a) Gain 1/5
 (b) Sacrifice 1/5
 (c) Gain 1/10
 (d) Sacrifice 1/10

SUBJECTIVE QUESTIONS

1. Kumar, Gupta and Kavita were partners in a firm sharing profits and losses equally. The firm was engaged in the storage and distribution of canned juice and its godowns were located at three different places in the city. Each godown was being managed individually by Kumar, Gupta and Kavita. Because of increase in business activities at the godown managed by Gupta, he had to devote more time. Gupta demanded that his share in the profits of the firm be increased, to which Kumar and Kavita agreed. The new profit-sharing ratio was agreed to be 1 : 2 : 1. For this purpose, the goodwill of the firm was valued at two years' purchase of the average profits of last five years. The profits of the last five years were as follows:

Year	Profit (₹)
I	4,00,000

II	4,80,000
III	7,33,000
IV (Loss)	33,000
V	2,20,000

You are required to

(i) Calculate the goodwill of the firm.

(ii) Pass necessary Journal Entry for the treatment of goodwill on change in profit-sharing ratio of Kumar, Gupta and Kavita.

2. A business has earned average profits of ₹1,00,000 during the last few years and the normal rate of return in similar business is 10%. Find out the value of goodwill by:

(i) Capitalisation of Super Profit Method and

(ii) Super Profit Method if the goodwill is valued at 3 years' purchase of super profit. The assets of the business were ₹ 10,00,000 and its external liabilities ₹1,80,000.

3. The average profit earned by a firm is ₹ 80,000 which includes undervaluation of stock of ₹8,000 on an average basis. The capital invested in the business is ₹ 8,00,000 and the normal rate of return is 8%. Calculate goodwill of the firm on the basis of 7 times the super profit.

4. A partnership firm earned net profits during the last three years as follows:

Year	Net Profit (₹)
2008-2009	1,90,000
2009-2010	2,20,000
2010-2011	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 years' purchase of super profits earned on average basis during the above mentioned three years and (ii) by capitalisation method.

5. The goodwill of a firm was to be valued at two years' purchase of the average profits of the last three years. The profits were as under:

2014 - 15 : ₹ 20,000 (including an abnormal gain of ₹ 5,000)

2015 - 16 : ₹ 40,000 (after charging an abnormal loss of ₹ 10,000)

2016 - 17 : ₹ 40,000

Calculate the amount of goodwill.

6. A firm's profits for the last five years were ₹20,000; ₹30,000; ₹40,000; ₹50,000 and ₹60,000. Calculate the value of firm's goodwill on the basis of three years' purchase of weighted average profits after using weight of 1, 2, 3, 4 and 5 respectively.

7. The average net profits expected to a firm in future are ₹ 68,000 per year and capital invested in the business by the firm is ₹3,50,000. The rate of interest expected from capital invested in this class of business is 12%. The remuneration of the partners is estimated to be ₹ 8,000 for the year.

You are required to find out the value of goodwill on the basis of two years' purchase of super profits.

8. On 1st April, 2019 an existing firm had assets of ₹ 75,000 including cash of ₹ 5,000. The partners' capital accounts showed a balance of ₹ 60,000 and reserves constituted the rest. If the normal rate of return is 20% and the goodwill of the firm is valued at ₹ 24,000 at 4 years purchase of super profits, find the average profits of the firm.

9. Satish and Taruna were partners in a firm sharing profits and losses in the ratio of 3 : 2. From 1st April, 2018 they decided to share profits equally. On that date their Balance Sheet showed a credit balance of ₹ 35,000 in workmen compensation fund and ₹ 40,000 in general reserve. The goodwill of the firm on that date was valued at ₹ 50,000. The firm accepted a claim of ₹ 40,000 for workmen compensation.

Pass necessary journal entries for the above transactions on the reconstitution of the firm.

10. Raj, Shammi and Shashi are partners sharing profits and losses in the ratio of 5:3:2. They decided to share future profits and losses in the ratio 2 : 3 : 5 with effect from 1st April, 2017. Following items appear in the Balance Sheet as at 31st March, 2017:

General Reserve	₹1,50,000
Advertisement Suspense A/c (Dr.)	₹1,00,000
Contingencies Reserve	₹50,000
Profit and Loss Account (Dr.)	₹75,000

Pass necessary Journal entries.

Homework Questions

MCQ

1. The capital invested is ₹1,00,000. Calculate goodwill on 3.5 years purchase of super profits if a fair return on capital involved is 20% and average actual profits are ₹22,000.

(a) ₹2,000	(b) ₹6,000
(c) ₹ 7,000	(d) None of these
2. Goodwill can be

(a) Purchased	(b) Self-generated
(c) Both (a) and(b)	(d) None of these
3. A and B are partners in a firm sharing profits and losses in the ratio of 4:3. On March31,2021 their Balance Sheet showed a general reserve of ₹35,000. On that date they decide to Sewak as new partner and the new profit sharing ratio will be 5:3:2.What will be the journal entry if the firm does not to transfer general reserve in capital accounts but want to pass an adjustment entry.

(a) Sewak's Capital A/c	Dr.	7,000	
To A's Capital A/c		4,500	
To B's Capital A/c		2,500	
(b) Sewak's Capital A/c	Dr.	7,000	
To A's Capital A/c		2,500	
To B's Capital A/c		4,500	
(c) A's Capital A/c	Dr.	4,500	
B's Capital A/c	Dr.	2,500	
To Sewak's Capital A/c		7,000	
(d) A's Capital A/c	Dr.	2,500	
B's Capital A/c	Dr.	4,500	
To Sewak's Capital A/c		7,000	
4. Which of these can be a special advantage for firm that would help in generating goodwill?
 - (a) Import licences
 - (b) Long-term contracts for supply
 - (c) Patents
 - (d) All of the above
5. For a certain year, following financial information was obtained
 - Profits were ₹30,000.
 - A major plant repair was undertaken of ₹10,000 which was charged to revenue.
 - Closing stock of previous year was overvalued ₹ 10,000.
 - Calculate profit for the purpose of goodwill valuation.

(a) ₹10,000	(b) ₹20,000
(c) ₹ 30,000	(d) ₹50,000

6. Match the columns.

Column - I	Column- II
A. Intangible Asset	(i) Method of goodwill valuation
B. Nature of Business	(ii) Feature of Goodwill
C. Super Profit	(iii) Factor affecting goodwill

D. Self-generated	(iv) Type of goodwill
-------------------	-----------------------

- | | | | | |
|--|---|---|---|---|
| | A | B | C | D |
|--|---|---|---|---|
- (a) (iii) (ii) (iv) (i)
 - (b) (ii) (iii) (iv) (i)
 - (c) (iii) (ii) (i) (iv)
 - (d) (ii) (iii) (i) (iv)
7. The balance sheet of a partnership firm showed ₹20,000 debit balance of profit and loss account. Calculate the goodwill on 2 years purchase of average profits of last two years if the company earned ₹30,000 in profit the previous year.

(a) ₹30,000	(b) ₹20,000
(c) ₹10,000	(d) Can't say
 8. Find capitalised value of business from the following information

Annual Profit = ₹1,60,000
 Normal Rate of Profit =20%
 Assets (including cash) = ₹12,40,000
 Cash = ₹40,000
 Outside Liabilities = ₹2,00,000

(a) ₹ 8,00,000	(b) ₹32,00,000
(c) ₹10,40,00	(d) ₹9,00,000
 9. Find capital employed in business

Assets (including cash) = ₹12,28,000
 Cash = ₹2,28,000
 Liabilities = 12,00,000
 Partner's Capital = ₹6,00,000
 Reserves = Balance amount

(a) ₹10,28,000	(b) ₹8,00,000
(c) ₹6,00,000	(d) ₹8,28,000
 10. Find goodwill if Capitalised value of Business = ₹ 2,00,000

Net assets = ₹1,00,000
 Liabilities = ₹50,000
 Partner's Capital = ₹ 80,000

(a) ₹50,000	(b) ₹1,50,000
(c) ₹1,00,000	(d) ₹1,20,000
 11. A partnership firm earned average profits off ₹2,00,000 during the last few years and the normal rate of return in similar business is 10%. Find the value of goodwill by capitalisation of super profit method if assets and external liabilities of business are ₹ 20,00,000 and ₹3,60,000 respectively.

(a) ₹ 36,000	(b) ₹16,40,000
(c) ₹3,00,000	(d) ₹3,60,000
 12. A, B and C are partners sharing profits and losses in the ratio of 2:3:4. They decide 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 and Loss A/c(Cr.)	₹ 20,000
Advertisement Suspense A/c	₹ 15,000

Which of the following will be correct Journal entry to record the above adjustment.

- | | | |
|---------------------|-----|--------|
| (a) A's Capital A/c | Dr. | 10,000 |
| To C's Capital A/c | | 10,000 |
| (b) C's Capital A/c | Dr. | 10,000 |
| To A's Capital A/c | | 10,000 |
| (c) A's Capital A/c | Dr. | 5,000 |
| To C's Capital A/c | | 5,000 |
| (d) C's Capital A/c | Dr. | 5,000 |
| To A's Capital A/c | | 5,000 |

Direction: Read the following case study and answer question numbers 13 to 16 on the basis of the same. Rashid and Komal are partners in a firm. Over the years, they have built a legacy and reputation because of the kind of products that they sell. They believe that they should calculate the goodwill of firm for better future purposes. The accountants introduced them to the concept of goodwill by stating certain features of goodwill. On the basis of certain factors, the accountant laid certain guidelines for calculation of goodwill. The accountant then calculated the goodwill by taking into consideration the following facts about business The capital of partners are Rashid ₹ 30,000 and Komal ₹ 20,000

- During the last financial year, firm earned a profit of ₹ 15,000.
 - The normal rate of return on the business is 20%.
13. Which of these factors must have been taken by accountant to lay down guidelines for calculation of goodwill?
- (a) Location of business (b) Nature of business
(c) Market situation (d) All of the above
14. What is the capitalised value of business?
- (a) ₹ 1,50,000 (b) ₹75,000
(c) ₹5,00,000 (d) ₹ 25,000
15. What is the goodwill value by super profit method if goodwill is valued at 4 years purchase of super profits?
- (a) ₹ 5,000 (b) ₹75,000
(c) ₹ 20,000 (d) ₹ 25,000
16. What is the value of Goodwill by capitalisation method?
- (a) ₹ 5,000 (b) ₹ 75,000
(c) ₹ 20,000 (d) ₹ 25,000

Direction: Read the following case study and answer question numbers 17 to 21 on the basis of the same. Tony and Rony started a partnership firm, TR CDs to manufacture music CDs way back in 1990. Now since the music CDs are out of business, they plan to sell the business to one of the major content production houses in Mumbai. For the purpose of selling business, they reached to their accountant to calculate the goodwill and other financial advice. He suggested that since the CDs are very less in demand, their goodwill value will be hampered. Nonetheless, the framework for goodwill calculation was decided as follows 'The goodwill be valued at 4 years purchase of super profits. The following financial information was obtained at the end of this transaction.

- Assets ₹ 8,000
 - Creditors ₹ 1,000
 - Normal rate of return 10%
 - Goodwill of the firm ₹1,000
17. What type of goodwill is discussed in the passage from TR CDs perspective?

- | | |
|----------------------|-----------------------|
| (a) Purchased | (b) Self-generated |
| (c) Both (a) and (b) | (d) None of the above |

18. Which factor affecting the goodwill was highlighted by accountant?
- (a) Efficiency of management
(b) Market situation
(c) Nature of business
(d) Special advantages
19. What is the super profit of business?
- (a) ₹ 250 (b) ₹1,000
(c) ₹ 500 (d) ₹1,250
20. What is the normal profit of business?
- (a) ₹ 850 (b) ₹ 800
(c) ₹750 (d) ₹ 700
21. What is the average profit of business?
- (a) ₹ 450 (b) ₹700
(c) ₹ 750 (d) ₹950

Direction: (Q. No. 22 to 24) There are two statements marked as Assertion (a) and Reason (R). Read the statements and choose the appropriate option from the options given below

- (a) Both Assertion (a) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (a)
(b) Both Assertion (a) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (a)
(c) Assertion (a) is false, but Reason (R) is true
(d) Assertion (a) is true, but Reason (R) is false
22. **Assertion** (a) The factors which affect profits, also affect goodwill.
Reason (R) Profits are directly related to goodwill.
23. **Assertion** (a) Goodwill is considered as an intangible asset but not a fictitious asset.
Reason (R) Goodwill can neither be seen and touched nor it can be purchased or sold with any other asset.
24. **Assertion** (a) Self-generated goodwill is the internally generated or hard earned goodwill.
Reason (R) It arises due to continued hard work of the organisation, its better quality products, etc.
25. X and Y were partners sharing profits and losses in the ratio of 3:1. They decided that with effect from 1st April, 2021, 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 decision became effective. The profits for 2018-19, 2019-20, 2020-21 were ₹60,000, ₹70,000 and 90,000 respectively. Which of the following would be correct journal entry to the above arrangement.
- (a) Y's Capital A/c Dr. 20,000
To X's Capital A/c 20,000
(b) X's Capital A/c Dr. 20,000
To Y's Capital A/c 20,000
(c) Y's Capital A/c Dr. 10,000
To X's Capital A/c 10,000
(d) X's Capital A/c Dr. 10,000
To Y's Capital A/c 10,000

2. Sahil, Babita and Vishal are partners in a firm sharing profits and losses 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 passing a single journal entry.

3. Manoj, Pradeep and Mohit are sharing profits and losses in the ratio of 5 : 3 : 2. They decide to share future profits and losses in the ratio of 2 : 3 : 5 with effect from 1st April, 2019. They also decide to record the effect of the following accumulated profits, losses and reserves without affecting their book figures by passing a single entry:

	(₹)
General Reserve	12,000
Profit and Loss Account (Cr.)	48,000
Advertisement Suspense Account	24,000

Pass the necessary single adjusting entry.

4. Ayushi, Mansi and Deeksha share profits as 5 : 3 : 2. They decide to share their future profits as 4 : 3 : 3 with effect from 1st April, 2019. On this date, the following revaluations have taken place:

Particulars	Book Value (₹)	Revised Value (₹)
Investments	44,000	50,000
Plant and Machinery	50,000	40,000
Land & Building	80,000	1,00,000
Outstanding Expenses	11,200	12,000
Sundry Debtors	1,20,000	1,00,000
Trade Creditors	1,40,000	1,20,000

Pass the necessary adjustment entry to be made because of the above change in the values of assets and liabilities. However, old values will continue in the books.

5. Ramesh, Suresh and Dinesh are partners sharing profits and losses in the ratio of 4 : 3 : 2, decided to share the future profits and losses in the ratio of 2 : 3 : 4 with effect from 1st April, 2018. An extract of their Balance Sheet as at 31st March, 2018 is:

Liabilities	(₹)	Assets	(₹)
Workmen Compensation Reserve	1,80,000		

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 compensation is estimated at ₹90,000.

Case (iii) If a claim on account of workmen compensation is estimated at ₹ 1,98,000.

6. L, M and N are partners sharing profits and losses in the ratio of 4 : 3 : 2. They decide to share future profits and losses in the ratio of 2 : 3 : 4 with effect from 1st April, 2017. An extract of their Balance Sheet as at 31st March, 2017 is:

Liabilities	(₹)	Assets	(₹)
Investments Fluctuation Reserve	9,000	Investments (At cost)	1,00,000

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 ₹ 1,00,000

Case (iii) If the market value of investments is ₹95,500

Case (iv) If the market value of investments is ₹1,09,000

Case (v) If the market value of investments is ₹ 73,000.

7. From the following information, calculate the value of goodwill of the firm of Chander and Gupta:

(a) At 3 years purchase of average profits,

(b) At 3 years purchase of super profits,

(c) On the basis of capitalisation of super profits,

(d) On the basis of capitalisation of average profits,

(i) Average capital employed in the business ₹7,00,000.

- (ii) Net trading results of the firm for the past years = Profit 2014 – ₹ 1,47,600;
 Loss 2015 – ₹ 1,48,100; Profit 2016 – ₹ 4,48,700.
 (iii) Rate of interest expected from capital having regard to the risk involved 18%.
 (iv) Remuneration to each partner for his service ₹500 per month.

8. Ram, Mohan, Sohan and Hari were partners in a firm sharing profits in the ratio of 4 : 3 : 2 : 1. On 1st April, 2016, their Balance Sheet was as follows:

Balance Sheet of Ram, Mohan, Sohan and Hari
as at 1st April, 2016

Particulars	Amount(₹)	Particulars	Amount(₹)
Capitals		Fixed Assets	9,00,000
Ram 4,00,000		Current Assets	5,20,000
Mohan 4,50,000			
Sohan 2,50,000			
Hari <u>2,00,000</u>	13,00,000		
Workmen Compensation Reserve	1,20,000		
	<u>14,20,000</u>		<u>14,20,000</u>

From the above date, the partners decided to share the future profits in the ratio of 1 : 2 : 3 : 4. For this purpose, the goodwill of the firm was valued at ₹1,80,000. The partners also agreed for the following:

- (i) The Claim for Workmen Compensation has been estimated at ₹1,50,000.
 (ii) Adjust the capitals of the partners according to new profit sharing ratio by opening partners' current accounts.
 Prepare Revaluation Account, Partners' Capital Accounts and the Balance Sheet of the reconstituted firm.

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

Balance Sheet of Ashok, Bhim and Chetan as at 31st March, 2015

Liabilities	Amount (₹)	Assets	Amount (₹)
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 <u>50,000</u>	<u>3,50,000</u>		
	<u><u>5,50,000</u></u>		<u><u>5,50,000</u></u>

Ashok, Bhim and Chetan decided to share the future profits equally, w.e.f. 1st April, 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.

10. Why Reserves and Surplus are distributed at the time of reconstitution of the firm?

SOLUTION FOR PRACTICE QUESTIONS

SOLUTION FOR MCQ

1. (b)
$$\text{Average Profits} = \frac{\text{Total Operating Profits}}{\text{Number of Years}}$$

Average Profits = $\frac{(6,000 - 2,000) + (4,000 + 3,000) + (2,500 - 1,500)}{3}$

Goodwill = Average Profits × No. of years Purchase

2. (a) Goodwill = $4,000 \times 3 = ₹12,000$

Normal Profits = Capital Employed × Normal rate of return

$2,00,000 \times \frac{15}{100} = ₹30,000$

- Super Profits = Actual Average Profits - Super Profits = 48,000 - 30,000 = ₹18,000
 Goodwill = Super Profits × No. of years purchase = 18,000 × 3 = ₹54,000
3. (c) Capitalised value of firm = $\frac{1,20,000}{10} \times 100 = ₹12,00,000$
 Net assets = Total Assets - Total Liabilities = 14,40,000 - 4,40,000 = ₹10,00,000
 Goodwill = 12,00,000 - 10,00,000 = ₹2,00,000
4. (d) Capital Employed = 28,00,000 - 8,00,000 = ₹20,00,000
 Normal Profits = 20,00,000 × $\frac{10}{100} = ₹2,00,000$
 Super Profits = 3,00,000 - 2,00,000 = ₹1,00,000
 So Goodwill = 1,00,000 × $\frac{100}{10} = ₹10,00,000$
5. (a)
 6. (d)
 7. (b) Average profits of last 5 years = $\frac{12,000+13,000+14,000+18,000+(2000)}{5} = ₹11,000$
 Goodwill = 11,000 × 2 = ₹22,000
8. (b)
 Capital Employed = (85,000 - 5,000) - 30,000 = ₹50,000
 Normal Profits = 50,000 × $\frac{10}{100} = ₹5,000$
 Super profits = 8,000 - 5,000 = ₹3,000

$$\text{Goodwill} = 3,000 \times \frac{100}{10} = ₹30,000$$

9. (a)
 10. (b)
 11. (c)
 A's new share = $\frac{5}{10} - \frac{1}{5} = \frac{3}{10}$
 C's new share = $\frac{1}{10} + \frac{1}{5} = \frac{3}{10}$
 So new ratio = 3 : 4 : 3
12. (a)
 Only A's sacrifice has 1/5
13. (c)
 Loss on Revaluation = 30,000 + 16,000 - 4,000 = ₹42,000
14. (d)
 A's sacrifice or gain = $\frac{3}{5} - \frac{1}{2} = \frac{1}{10}$ (Sacrifice)
 B's sacrifice or gain = $\frac{2}{5} - \frac{1}{2} = \frac{-1}{10}$ (Gain)
 So B will give to A = $\frac{1}{10} \times 30,000 = ₹3,000$
15. (d)
 16. (d)
 17. (c)
 18. (c)
 19. (c)
 20. (d)
 B's sacrifice or gain = $\frac{3}{5} - \frac{1}{2} = \frac{1}{10}$ (Sacrifice)

SOLUTIONS FOR SUBJECTIVE QUESTIONS

1. (i) Calculation of Goodwill of the firm
 Average Profit = $\frac{₹(4,00,000+4,80,000+7,33,000-33,000+2,20,000)}{5} = ₹3,60,000$
 Goodwill of the firm = 2 × 3,60,000 = ₹ 7,20,000

(ii) **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Gupta's Capital A/c Dr.		1,20,000	
	To Kumar's Capital A/c			60,000
	To Kavita's Capital A/c			60,000
	(Being adjustment of goodwill among partners on change in profit sharing ratio)			

Working Notes: Calculation of Sacrifice/(Gain) of Partners due to change in Profit-sharing ratio:

Old ratio = 1 : 1 : 1

New ratio = 1 : 2 : 1

$$\text{Kumar's Sacrifice} = \frac{1}{3} - \frac{1}{4} = \frac{4-3}{12} = \frac{1}{12}$$

$$\text{Gupta's Gain} = \frac{1}{3} - \frac{2}{4} = \frac{4-6}{12} = \frac{-2}{12}$$

$$\text{Kavita's Sacrifice} = \frac{1}{3} - \frac{1}{4} = \frac{1}{12}$$

Calculation of Proportionate amount of goodwill adjusted among partners:

$$\text{Kumar} = 7,20,000 \times \frac{1}{12} = ₹60,000$$

$$\text{Gupta} = 7,20,000 \times \frac{2}{12} = ₹1,20,000$$

$$\text{Kavita} = 7,20,000 \times \frac{1}{12} = ₹60,000$$

2. (i) (a) Capital Employed = Assets -- External Liabilities = ₹10,00,000 - ₹1,80,000 = ₹8,20,000

(b) Normal Profit = Capital Employed × $\frac{\text{Normal Rate of Return}}{100}$
 = ₹8,20,000 × $\frac{10}{100} = ₹82,000$

(c) Super Profit = Actual Average Profit – Normal Profit = ₹ 1,00,000 – ₹82,000 = ₹18,000

As per Capitalisation Method,

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}} = 18,000 \times \frac{100}{10} = ₹1,80,000$$

(ii) As per Super Profit Method

$$\text{Goodwill} = \text{Super Profit} \times \text{No. of years' of purchase} = ₹18,000 \times 3 = ₹54,000.$$

3.

Average Profit = ₹80,000

Undervaluation of Stock = ₹8,000

Actual Average Profit = ₹80,000 + ₹8,000 (Note) = ₹88,000

Normal Profit = Capital Investment × Normal Rate of Return

$$= ₹8,00,000 \times \frac{8}{100} = ₹64,000$$

Super Profit = Actual Average Profit – Normal Profit

$$= ₹88,000 - ₹64,000 = ₹24,000$$

Goodwill = Super Profit × 7

$$= ₹24,000 \times 7 = ₹1,68,000$$

Note: Undervaluation of stock is added back to the profit as it reduces the profit.

4.

$$\text{Average Profit} = \frac{(1,90,000 + 2,20,000 + 2,50,000)}{3} = \frac{6,60,000}{3} = ₹2,20,000$$

Actual Average Profit = Average Profit – Remuneration = 2,20,000 – 1,00,000 = ₹1,20,000

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

$$= \frac{4,00,000}{100} \times 15 = ₹60,000$$

Super Profit = Actual Average Profit – Normal Profit

$$= 120,000 - 60,000 = ₹60,000$$

Goodwill = Super profit × No. of year's purchase

$$= 60,000 \times 2 = ₹1,20,000$$

(ii) Capitalisation Method:

Goodwill = Capitalised value of Average Profits – Actual Capital employed

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

$$= \frac{1,20,000}{15} \times 100 = ₹8,00,000$$

$$\text{Goodwill} = 8,00,000 - 4,00,000 = ₹4,00,000$$

5.

Year	Normalised Profits	(₹)
2014-2015	20,000 – 5,000 (abnormal gain)	15,000
2015-2016	40,000 + 10,000 (abnormal loss)	50,000
2016-2017		40,000
	Total	1,05,000

Average of normal profits = ₹1,05,000/3 = ₹35,000; Goodwill = ₹35,000 × 2 = ₹70,000

6.

Year	Profit (₹)	Weight	Product (₹)
I	20,000	1	20,000
II	30,000	2	60,000
III	40,000	3	1,20,000
IV	50,000	4	2,00,000
V	60,000	5	3,00,000
Total		15	7,00,000

$$\text{Weighted Average Profit} = \frac{\text{Total Product}}{\text{Total Weight}} = \frac{7,00,000}{15} = ₹46,667 \text{ (approx.)}$$

Goodwill = Weighted Avg. Profit × No. of Years' Purchase = 46,667 × 3 = ₹1,40,000 (approx.)

7.

(i) Average profit = ₹68,000 – ₹8,000 = ₹60,000

(ii) Normal profit = Capital employed × Normal rate of return / 100

$$= ₹3,50,000 \times \frac{12}{100} = ₹42,000$$

(iii) Super profit = Average profit – Normal profit

$$= ₹60,000 - 42,000 = ₹18,000$$

(iv) Value of goodwill = Super profit × No. of years' purchase

$$= ₹18,000 \times 2 = ₹36,000.$$

8.

(i) Calculation of Normal Profit:

$$\text{Normal Profit} = \text{Capital employed} \times \frac{\text{Normal Rate}}{100} = 75,000 \times \frac{20}{100} = ₹15,000$$

(ii) Calculation of Super Profit:

$$\text{Goodwill} = \text{Super profit} \times \text{No. of Years' Purchase}$$

$$₹ 24,000 = \text{Super Profit} \times 4$$

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

(iii) Calculation of Average Profit:

$$\text{Super Profit} = \text{Average Profit} - \text{Normal Profit}$$

$$₹6,000 = \text{Average Profit} - ₹ 15,000$$

$$\text{Average Profit} = ₹ 6,000 + ₹ 15,000 = ₹21,000.$$

9.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	Revaluation A/c Dr. Workmen Compensation Fund A/c Dr. To Provision for Claim for Workmen Compensation A/c (Being provision for claim for workmen compensation created and shortfall charged to Revaluation A/c)		5,000 35,000	40,000
	General Reserve A/c Dr. To Satish's Capital A/c To Taruna's Capital A/c (Being General Reserve transferred to Partners' Capital Accounts in old ratio)		40,000	24,000 16,000
	Taruna's Capital A/c Dr. To Satish's Capital A/c (Being goodwill adjusted, i.e., 50,000 × 1/10)		5,000	5,000
	Satish's Capital A/c Dr. Taruna's Capital A/c Dr. To Revaluation A/c (Being loss on Revaluation borne by partners)		3,000 2,000	5,000

10.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	General Reserve A/c Dr. Contingencies Reserves A/c Dr. To Raj's Capital A/c To Shammi's Capital A/c To Shashi's Capital A/c (Being reserves transferred to partners in their old profit sharing ratio)		1,50,000 50,000	1,00,000 60,000 40,000
	Raj's Capital A/c Dr. Shammi's Capital A/c Dr. Shashi's Capital A/c Dr. To Advertisement Suspense A/c To Profit and Loss A/c (Being balance of advertisement suspense and debit balance of profit and loss account transferred to partners in their old ratio)		87,500 52,500 35,000	1,00,000 75,000

SOLUTION FOR HOMEWORK QUESTIONS

SOLUTION FOR MCQ QUESTIONS

1. (c)

$$\text{Normal Profit} = 1,00,000 \times \frac{20}{100} = ₹20,000$$

$$\text{Super profits} = \text{Average profits} - \text{Normal Profits}$$

$$= 22,000 - 20,000 = ₹2,000$$

$$\text{Goodwill} = 2,000 \times 3,5 = ₹7,000$$

2. (c)

3. (b)

Old ratio of A and B = 4 : 3

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

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

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

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

So Sewak's Capital will be debited by $\frac{14}{70} \times 35,000 = 7,000$

and A's Capital will be credited by $\frac{5}{70} \times 35,000 = 2,500$

and B's Capital will be credited by $\frac{9}{70} \times 35,000 = 4,500$

4. (d)

5. (d)

	Amt (₹)
Profits	30,000
(+) Capital Expenditure	10,000
Opening Stock Overvalued	10,000
	50,000

6. (d)

7. (c)

$$\text{Average Profits} = \frac{(20,000) + 30,000}{2} = 5,000$$

$$\text{Goodwill} = 2 \times 5,000 = ₹10,000$$

8. (a)

$$\begin{aligned} \text{Total Capitalised value of firm} &= \frac{\text{Average Profits}}{\text{Normal rate of profits}} \times 100 \\ &= \frac{1,60,000}{20} \times 100 = ₹8,00,000 \end{aligned}$$

9. (a) Capital Employed = 12,28,000 - 2,00,000 = ₹10,28,000

10. (c)

$$\begin{aligned} \text{Goodwill} &= \text{Capitalised Value of Business} - \text{Net Assets} \\ &= 2,00,000 - 1,00,000 = ₹1,00,000 \end{aligned}$$

11. (d)

$$\text{Average Profits} = ₹2,00,000$$

$$\text{Capital Employed} = \text{Total Assets} - \text{External Liabilities} = 20,00,000 - 3,60,000 = ₹16,40,000$$

$$\text{Normal Profits} = \text{Capital Employed} \times \frac{\text{Normal rate of return}}{100} = 16,40,000 \times \frac{10}{100} = ₹1,64,000$$

$$\text{Super Profits} = \text{Average Profit} - \text{Normal Profit} = 2,00,000 - 1,64,000 = ₹36,000$$

$$\text{Goodwill} = \frac{\text{Super Profits}}{\text{Normal rate of return}} \times 100 = \frac{36,000}{10} \times 100 = ₹3,60,000$$

12. (a)

Calculation of Net effect of Accumulated Profits/Losses

	₹
General Reserve	40,000
(+) Profit and Loss A/c (Cr.)	20,000
(-) Advertisement Suspense A/c	(15,000)
Net effect	45,000

Calculation of Sacrifice or Gain:

Old ratio of A, B and C 2:3:4

New ratio of A, B and C 4:3:2

Sacrifice or Gain :

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

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

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

So A's Capital A/c will be debited by 10,000 i.e. $\frac{2}{9} \times 45,000 = 10,000$

and C's Capital A/c will be credited by 10,000 i.e. $\frac{2}{9} \times 45,000 = 10,000$

13. (d)

14. (b)

$$\begin{aligned} \text{Total Capitalised value of firm} &= \frac{\text{Average Profits}}{\text{Normal rate of return}} \times 100 \\ &= \frac{15,000}{20} \times 100 = ₹75,000 \end{aligned}$$

15. (c)

16. (d)

$$\begin{aligned} \text{Goodwill of the firm} &= \text{Total Capitalised Value of Business} - \text{Capital Employed} \\ &= 75,000 - 50,000 = ₹25,000 \end{aligned}$$

17. (b)

18. (c)

19. (a)

$$\begin{aligned} \text{Goodwill} &= \text{Super profits} \times \text{Number of year's purchase} \\ 1,000 &= \text{Super Profits} \times 4 \\ \text{Super Profits} &= ₹250 \end{aligned}$$

20. (d)

$$\begin{aligned} \text{Normal Profit} &= \text{Capital Employed} \times \frac{\text{Normal rate of return}}{100} \\ &= (8,000 - 1,000) \times \frac{10}{100} = ₹700 \end{aligned}$$

21. (d)

$$\begin{aligned} \text{Super Profit} &= \text{Average Profit} - \text{Normal Profit} \\ 250 &= \text{Average Profit} - \text{Normal Profit} \\ \text{Therefore, Average Profit} &= ₹950 \end{aligned}$$

22. (a)

23. (d)

24. (a)

25. (a)

26. (a) X's capital account would be credited with ₹1,00,000 i.e. $\frac{4}{9} \times 2,25,000 = 1,00,000$

27. (b)

28. (d) Profit on revaluation = 60,000 + 12,000 - 6,000 = 66,000

29. (c)

Dr.				Partner's Capital A/cs				Cr.
Particulars	Ashok	Bhim	Chetan	Particulars	Ashok	Bhim	Chetan	
To Ashok's Capital A/c	-	-	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	

30. (a)

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

$$\text{Bhim's Sacrifice or Gain} = \frac{2}{6} - \frac{1}{3} = \frac{1}{6} (\text{Nil})$$

$$\text{Chetan's sacrifice or gain} = \frac{1}{6} - \frac{1}{3} = \frac{-1}{6} (\text{Gain})$$

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 debited by 1/6th of ₹3,00,000 (Goodwill), i.e., ₹50,000

SOLUTION FOR SUBJECTIVE QUESTIONS

1.

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2018 April 1	Investments Fluctuation 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
	(Being transfer of excess I.F.R. to partners' capital A/cs in old ratio)			
	Investments A/c Dr.		12,000	
	To Revaluation A/c			12,000
	(Being value of investments brought upto market value)			
	Revaluation A/c Dr.		12,000	
	To P's Capital A/c			6,000
	To Q's Capital A/c			4,000
	To R's Capital A/c			2,000
	(Being transfer of profit on revaluation in old ratio)			

2. Calculation of sacrificing/gaining share of partners:

Sacrificing share = Old share - New share

$$\text{Sahil} = \frac{5}{11} - \frac{4}{9} = \frac{45-44}{99} = \frac{1}{99} \text{ (Sacrifice)}$$

$$\text{Babita} = \frac{4}{11} - \frac{3}{9} = \frac{36-33}{99} = \frac{3}{99} \text{ (Sacrifice)}$$

$$\text{Vishal} = \frac{2}{11} - \frac{2}{9} = \frac{18-22}{99} = \left(\frac{4}{99}\right) \text{ (Gain)}$$

Gaining Partner's Share of Profit to be adjusted = ₹29,700 (₹34,900 - ₹5,200) $\times \frac{4}{99} = ₹1,200$.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2019 April 1	Vishal's Capital A/c Dr.		1,200	
	To Sahil's Capital A/c (1,200 \times 1/4)			300
	To Babita's Capital A/c (1,200 \times 3/4)			900
	(Being net share of profit adjusted)			

3.	General Reserve	(₹) 12,000
	Add: Profit and Loss Account	<u>48,000</u>
		60,000
	Less: Advertisement Suspense Account	<u>24,000</u>
	Total amount to be adjusted	<u>36,000</u>

Old Ratio of Manoj, Pradeep and Mohit = 5:3:2

New Ratio of Manoj, Pradeep and Mohit = 2:3:5

Gaining Share = New Share - Old Share

$$\text{Manoj} = \frac{2}{10} - \frac{5}{10} = \frac{-3}{10} \text{ (sacrifice); Pradeep} = \frac{3}{10} - \frac{3}{10} = \text{Nil}$$

$$\text{Mohit} = \frac{5}{10} - \frac{2}{10} = \frac{3}{10} \text{ (gain)}$$

Mohit's share of profit to be adjusted = 36,000 $\times \frac{3}{10} = ₹10,800$

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
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2019 Apr. 1	Mohit's Capital A/c To Manoj's Capital A/c (Being profit adjusted between partners)	Dr.		10,800	10,800
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4. **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2019 Apr. 1	Deeksha's Capital A/c To Ayushi's Capital A/c (Being adjustment entry made)	Dr.	1,520	1,520

Working Note:

Particulars	Book Value (₹)	Revised Value (₹)	Profit/Loss (₹)
Investments	44,000	50,000	6,000
Plant and Machinery	50,000	40,000	(10,000)
Land & Building	80,000	1,00,000	20,000
Outstanding Expenses	11,200	12,000	(800)
Sundry Debtors	1,20,000	1,00,000	(20,000)
Trade Creditors	1,40,000	1,20,000	20,000
Total Profit on Revaluation			15,200

Old Ratio = 5 : 3 : 2, New Ratio = 4 : 3 : 3

Gaining Share = New Share - Old Share

$$\text{Ayushi} = \frac{4}{10} - \frac{5}{10} = \frac{-1}{10} \text{ (Sacrifice)}$$

$$\text{Mansi} = \frac{3}{10} - \frac{3}{10} = \text{Nil}$$

$$\text{Deeksha} = \frac{3}{10} - \frac{2}{10} = \frac{1}{10} \text{ (gain)}$$

$$\text{Deeksha's share of profit to be adjusted} = 15,200 \times \frac{1}{10} = ₹ 1,520.$$

5. **Journal**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2018 April 1 Case (i)	Workmen Compensation Reserve A/c To Ramesh's Capital A/c To Suresh's Capital A/c To Dinesh's Capital A/c (Being Workmen Compensation Reserve transferred to Partners' Capital A/cs in their old profit-sharing ratio)	Dr.	1,80,000	80,000 60,000 40,000
Case (ii)	Workmen Compensation Reserve A/c To Provision for Workmen Compensation Claim A/c To Ramesh's Capital A/c To Suresh's Capital A/c To Dinesh's Capital A/c (Being surplus of workmen compensation reserve transferred to Partners' Capital Accounts in their old profit-sharing ratio)	Dr.	1,80,000	90,000 40,000 30,000 20,000
Case (iii)	Workmen Compensation Reserve A/c Revaluation A/c To Provision for Workmen Compensation Claim A/c (Being provision created and shortfall charged to Revaluation Account)	Dr. Dr.	1,80,000 18,000	1,98,000
	Ramesh's Capital A/c Suresh's Capital A/c Dinesh's Capital A/c To Revaluation A/c (Being loss on revaluation transferred to Partners' Capital Accounts in their old profit-sharing ratio)	Dr. Dr. Dr.	8,000 6,000 4,000	18,000

6.

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2017 April 1				
Case (i)	Investments Fluctuation Reserve A/c To L's Capital A/c To M's Capital A/c To N's Capital A/c (Being balance of investments fluctuation reserve transferred to partners' capital accounts)	Dr.	9,000	4,000 3,000 2,000
Case (ii)	Same Solutions as given in Case (i).			
Case (iii)	Investments Fluctuation Reserve A/c To Investments A/c To L's Capital A/c To M's Capital A/c To N's Capital A/c (Being excess of investments fluctuation reserve transferred to partners' Capital Accounts in their old profit-sharing ratio)	Dr.	9,000	4,500 2,000 1,500 1,000
Case (iv)	Investments Fluctuation Reserve A/c To L's Capital Ac To M's Capital A/c To N's Capital A/c (Being excess of investments fluctuation reserve transferred to partners' Capital Accounts in their old profit-sharing ratio)	Dr.	9,000	4,000 3,000 2,000
	Investment A/c To Revaluation A/c (Being the value of investments brought up to market value)	Dr.	9,000	9,000
	Revaluation A/c To L's Capital A/c To M's Capital A/c To N's Capital A/c (Being profit on revaluation transferred to capital A/cs)	Dr.	9,000	4,000 3,000 2,000
Case (v)	Investment Fluctuation Reserve A/c Revaluation A/c To Investment A/c (Being fall in market value of investments adjusted through investments fluctuation reserve and shortage charged to revaluation account)	Dr. Dr.	9,000 18,000	27,000
	L's Capital A/c M's Capital A/c N's Capital A/c To Revaluation A/c (Being the transfer of loss on revaluation to partner's capital accounts)	Dr. Dr. Dr.	8,000 6,000 4,000	18,000

Note : The market value of investment is assumed to be ₹1,00,000 for case (i).

7. (i) Calculation of Average Maintainable Profits and Super Profit:

	(₹)
Total Profits (₹1,47,600 - ₹1,48,100 + ₹4,48,700)	4,48,200
Average Profit, i.e., ₹4,48,200 ÷ 3	1,49,400
Less: Remuneration of 2 partners @ ₹500 p.m. (2 × 500 × 12)	<u>12,000</u>
Average Profit (maintainable)	1,37,400
Less: Normal Profit = $7,00,000 \times \frac{18}{100}$	<u>1,26,000</u>
Super Profit	<u>11,400</u>

(ii) Calculation of Value of Goodwill:

(a) At 3 years' purchase of average profits:

Average maintainable profits × No. of years' purchase = ₹1,37,400 × 3 = ₹4,12,200

(b) At 3 years' purchase of super profits:

Super profits × No. of years' Purchase = ₹ 11,400 × 3 = ₹ 34,200

(c) On the basis of capitalisation of super profits:

Super Profit × $\frac{100}{\text{Normal rate of return}} = ₹ 11,400 \times \frac{100}{18} = ₹ 63,333$

(d) On the basis of capitalisation of average profits:

Average maintainable Profit × $\frac{100}{\text{Normal rate of return}} = ₹ 1,37,400 \times \frac{100}{18} = ₹ 7,63,333$

Less: Actual Capital employed = ₹ 7,00,000

Goodwill = ₹ 63,333

8. Dr. **Revaluation Account** Cr.

Particulars	(₹)	Particulars	(₹)
To Claim for Workmen Compensation	30,000	By Loss on revaluation transferred to Partners' Capital A/cs:	
		Ram	12,000
		Mohan	9,000
		Sohan	6,000
		Hari	3,000
	<u>30,000</u>		<u>30,000</u>

Dr. **Partner's Capital Accounts** Cr.

Particulars	Ram (₹)	Mohan (₹)	Sohan (₹)	Hari (₹)	Particulars	Ram (₹)	Mohan (₹)	Sohan (₹)	Hari (₹)
To Revaluation A/c	12,000	9,000	6,000	3,000	By Balance b/d	4,00,000	4,50,000	2,50,000	2,00,000
To Ram's Capital A/c	--	--	--	54,000	By Sohan's Capital A/c	--	18,000	--	--
To Mohan's Capital A/c	--	--	18,000	--	By Hari's Capital A/c	54,000	--	--	--
To Partner's Current A/cs	3,15,000	2,05,000	--	--	By Partners' Current A/cs	--	--	1,55,000	3,65,000
To Balance c/d	1,27,000	2,54,000	3,81,000	5,08,000					
	<u>4,54,000</u>	<u>4,68,000</u>	<u>4,05,000</u>	<u>5,65,000</u>		<u>4,54,000</u>	<u>4,68,000</u>	<u>4,05,000</u>	<u>5,65,000</u>

Balance Sheet of Ram, Mohan, Sohan and Hari

as at 1st April, 2016

Liabilities	(₹)	Assets	(₹)
Partners' Capital A/cs:		Fixed Assets	9,00,000
Ram	1,27,000	Current Assets	5,20,000
Mohan	2,54,000	Partners' Current A/cs:	
Sohan	3,81,000	Sohan	1,55,000
Hari	5,08,000	Hari	3,65,000
Claim for Workmen Compensation	1,50,000		
Partners' Current A/cs:			
Ram	3,15,000		
Mohan	2,05,000		
	<u>19,40,000</u>		<u>19,40,000</u>

Working Notes:

	Ram	Mohan	Sohan	Hari
Old Ratio =	4 :	3 :	2 :	1
New Ratio =	1 :	2 :	3 :	4

Sacrificing Ratio = Old Ratio – New Ratio

$$\text{Ram} = \frac{4}{10} - \frac{1}{10} = \frac{3}{10} \text{ (Sacrifice)}$$

$$\text{Mohan} = \frac{2}{10} - \frac{2}{10} = \frac{1}{10} \text{ (Sacrifice)}$$

$$\text{Sohan} = \frac{3}{10} - \frac{3}{10} = \left(\frac{1}{10}\right) \text{ (gain)}$$

$$\text{Hari} = \frac{1}{10} - \frac{4}{10} = \left(\frac{3}{10}\right) \text{ (gain)}$$

Goodwill = ₹1,80,000

$$\text{Ram's Sacrifice} = 1,80,000 \times \frac{3}{10} = ₹ 54,000$$

$$\text{Mohan's Sacrifice} = 1,80,000 \times \frac{1}{10} = ₹18,000$$

$$\text{Sohan's gain} = 1,80,000 \times \frac{1}{10} = ₹18,000$$

$$\text{Hari's gain} = 1,80,000 \times \frac{3}{10} = ₹54,000$$

Journal Entry for Adjustment of Goodwill

Sohan's Capital A/c	Dr.	₹ 18,000	
Hari's Capital A/c	Dr.	₹ 54,000	
To Ram's Capital A/c			₹ 54,000
To Mohan's Capital A/c			₹ 18,000

9.

Dr. **Revaluation Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Building A/c	6,000	By Land A/c	60,000
To Partners' Capital A/cs: (transfer of profit)		By Creditors A/c	12,000
Ashok	33,000		
Bhim	22,000		
Chetan	<u>11,000</u>		
	66,000		
	<u>72,000</u>		<u>72,000</u>

Dr. **Partner's Capital Accounts** Cr.

Particulars	Ashok (₹)	Bhim (₹)	Chetan (₹)	Particulars	Ashok (₹)	Bhim (₹)	Chetan (₹)
To Ashok's Capital A/c	—	—	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 Revaluation A/c	33,000	22,000	11,000
				By General Reserve A/c	30,000	20,000	10,000
				By Chetan's Capital A/c	50,000	—	—
	<u>3,13,000</u>	<u>1,42,000</u>	<u>71,000</u>		<u>3,13,000</u>	<u>1,42,000</u>	<u>71,000</u>

Balance Sheet
as at 1st April, 2015

Liabilities	Amount (₹)	Assets	Amount (₹)
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	<u>21,000</u>	Bank	10,000
	<u>4,76,000</u>		
	<u><u>6,04,000</u></u>		<u><u>6,04,000</u></u>

Working Notes:

1. Calculation for Sacrifice or Gain

$$\text{Ashok} = \frac{3}{6} - \frac{1}{3} = \frac{1}{6} \text{ (Sacrifice)}$$

$$\text{Bhim} = \frac{2}{6} - \frac{1}{3} = \text{Nil}$$

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

2. Calculation of share of goodwill to be adjusted:

$$\text{Goodwill} = 3,00,000 \times \frac{1}{6} = ₹50,000$$

10. 'Reserves and Surplus' belong to old partners as they are created out of past profits. Hence they are distributed among old partners in old-profit sharing ratio at the time of reconstitution of the firm.