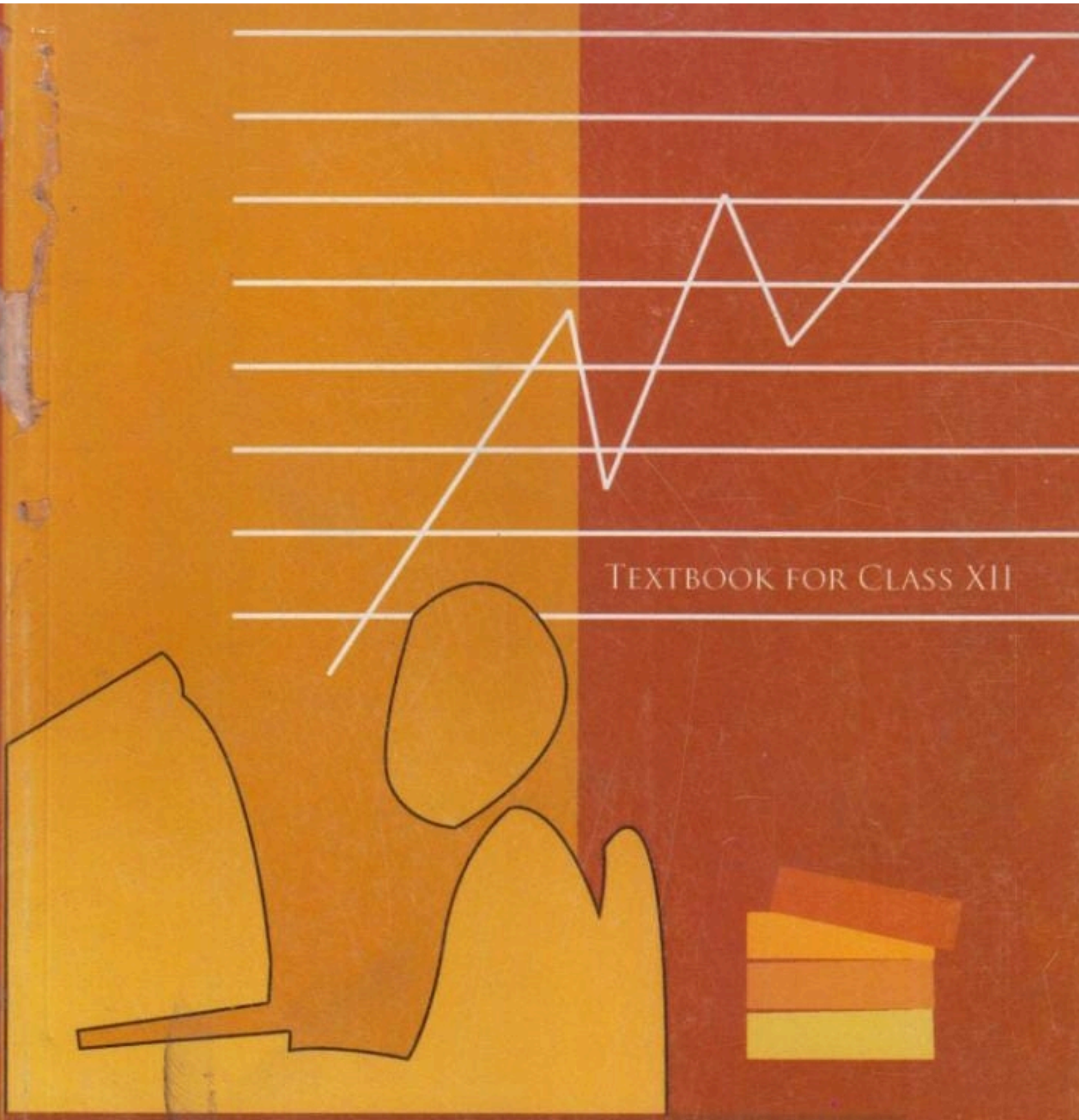

TEXTBOOK FOR CLASS XII

ACCOUNTANCY

COMPANY ACCOUNTS AND ANALYSIS OF FINANCIAL STATEMENTS

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CLASS - XII th COMMERCE

SUB - ACCOUNTANCY

Date - 26/07/2021 - 31/07/2021

Chapter - 3

Admission Of a Partner

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3.5 Goodwill

Goodwill is also one of the special aspects of partnership accounts which requires adjustment (also valuation if not specified) at the time of reconstitution of a firm viz., a change in the profit sharing ratio, the admission of a partner or the retirement or death of a partner.

3.5.1 Meaning of Goodwill

Over a period of time, a well-established business develops an advantage of good name, reputation and wide business connections. This helps the business to earn more profits as compared to a newly set up business. In accounting, the monetary value of such advantage is known as "goodwill".

It is as an intangible asset. In other words, goodwill is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits. It is generally observed that when a person pays for goodwill,

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he/she pays for something, which places him in the position of being able to earn super profits as compared to the profit earned by other firms in the same industry.

In simple words, goodwill can be defined as "the present value of a firm's anticipated excess earnings" or as "the capitalised value attached to the differential profit capacity of a business". Thus, goodwill exists only when the firm earns super profits. Any firm that earns normal profits or is incurring losses has no goodwill.

3.5.2 Factors Affecting the Value of Goodwill

The main factors affecting the value of goodwill are as follows:

1. *Nature of business:* A firm that produces high value added products or having a stable demand is able to earn more profits and therefore has more goodwill.
2. *Location:* If the business is centrally located or is at a place having heavy customer traffic, the goodwill tends to be high.
3. *Efficiency of management:* A well-managed concern usually enjoys the advantage of high productivity and cost efficiency. This leads to higher profits and so the value of goodwill will also be high.
4. *Market situation:* The monopoly condition or limited competition enables the concern to earn high profits which leads to higher value of goodwill.
5. *Special advantages:* The firm that enjoys special advantages like import licences, low rate and assured supply of electricity, long-term contracts for supply of materials, well-known collaborators, patents, trademarks, etc. enjoy higher value of goodwill.

3.5.3 Need for Valuation of Goodwill

Normally, the need for valuation of goodwill arises at the time of sale of a business. But, in the context of a partnership firm it may also arise in the following circumstances:

1. Change in the profit sharing ratio amongst the existing partners;
2. Admission of new partner;
3. Retirement of a partner;
4. Death of a partner; and
5. Dissolution of a firm involving sale of business as a going concern.
6. Amalgamation of partnership firms.

3.5.4 Methods of Valuation of Goodwill

Since goodwill is an intangible asset it is very difficult to accurately calculate its value. Various methods have been advocated for the valuation of goodwill of a partnership firm. Goodwill calculated by one method may differ from the goodwill

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calculated by another method. Hence, the method by which goodwill is to be calculated, may be specifically decided between the existing partners and the incoming partner.

The important methods of valuation of goodwill are as follows:

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

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3.5.4.1 *Average Profits Method*

Under this method, the goodwill is valued at agreed number of 'years' purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill, therefore, should be calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue.

For example, if the past average profits of a business works out at Rs. 20,000 and it is expected that such profits are likely to continue for another three years, the value of goodwill will be Rs. 60,000 (Rs. 20,000 × 3).

Illustration 9

The profit for the five years of a firm are as follows – year 2013 Rs. 4,00,000; year 2014 Rs. 3,98,000; year 2015 Rs. 4,50,000; year 2016 Rs. 4,45,000 and year 2017 Rs. 5,00,000. Calculate goodwill of the firm on the basis of 4 years purchase of 5 years average profits.

Solution

Year	*Profit (Rs.)*
2013	4,00,000
2014	3,98,000
2015	4,50,000
2016	4,45,000
2017	5,00,000
Total	**21,93,000**

$$\text{Average Profit} = \frac{\text{Total Profit of Last 5 Years}}{\text{No. of years}} = \text{Rs. } \frac{21,93,000}{5} = \text{Rs. } 4,38,600$$

Goodwill = Average Profits × No. of years purchased

= Rs. 4,38,600 × 4 = Rs. 17,54,400

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Illustration 10

The profits of firm for the five years are as follows:

Year	*Profit (Rs.)*
2012–13	20,000
2013–14	24,000
2014–15	30,000
2015–16	25,000
2016–17	18,000

Calculate the value of goodwill on the basis of three years' purchase of weighted average profits based on weights 1,2,3,4 and 5 respectively.

Solution

Year Ended 31st March	*Profit (Rs.)*	*Weight*	*Product*
2012–13	20,000	1	20,000
2013–14	24,000	2	48,000
2014–15	30,000	3	90,000
2015–16	25,000	4	1,00,000
2016–17	18,000	5	90,000
		15	3,48,000

$$\text{Weighted Average Profit} = \text{Rs. } \frac{3,48,000}{15} = \text{Rs. } 23,200$$

$$\text{Goodwill} = \text{Rs. } 23,200 \times 3 = \text{Rs. } 69,600$$

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Illustration 11

Calculate goodwill of a firm on the basis of three year' purchase of the weighted average profits of the last four years. The profit of the last four years were: 2012 Rs. 20,200; 2013 Rs. 24,800; 2014 Rs. 20,000 and 2015 Rs. 30,000. The weights assigned to each year are : 2012 – 1; 2013 – 2; 2014 – 3 and 2015 – 4.

You are supplied the following information:

1. On September 1, 2014 a major plant repair was undertaken for Rs. 6,000, which was charged to revenue. The said sum is to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method.
2. The Closing Stock for the year 2013 was overvalued by Rs. 2,400.
3. To cover management cost an annual charge of Rs. 4,800 should be made for purpose of goodwill valuation.

Solution

Calculation of Adjusted Profit	*2012* *Rs.*	*2013* *Rs.*	*2014* *Rs.*	*2015* *Rs.*
Given Profits	20,200	24,800	20,000	30,000
Less: Management Cost	4,800	4,800	4,800	4,800
Add: Capital Expenditure	15,400	20,000	15,200	25,200
Charged to Revenue	-	-	6,000	-
	15,400	20,000	21,200	25,200
Less: Unprovided Depreciation	-	-	200	580
	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 value of opening stock	-	-	2,400	-
Adjusted Profits	**15,400**	**17,600**	**23,400**	**24,620**

Calculation of weighted average profits:

(Rs.)

Year	*Profit*	*Weight*	*Product*
2012	15,400	1	15,400
2013	17,600	2	35,200
2014	23,400	3	70,200
2015	24,620	4	98,480
Total		**10**	**2,19,280**

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Weight Average Profit = Rs. $\frac{2,19,280}{10}$ = Rs. 21,928

Goodwill = Rs. 21,928 × 3 = Rs. 65,784

Notes to Solution

(i) Depreciation of 2014 = 10% of Rs. 6000 for 4 months
= Rs. 6000 × 10/100 × 4/12 = Rs. 200

(ii) Depreciation of 2015 = 10% of Rs. 6000 – Rs. 200 for one year
= Rs. 5800 × 10/100 + Rs. 580

(iii) Closing Stock of 2014 will become opening stock for the year 2015.

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3.5.4.3 *Capitalisation Method*

Under this method the goodwill can be calculated in two ways: (a) by capitalizing the average profits, or (b) by capitalising the super profits.

(a) *Capitalisation of Average Profits:* Under this method, the value of goodwill is ascertained by deducting the actual firm's capital (net assets) in the business from the capitalized value of the average profits on the basis of normal rate of return. This involves the following steps:

(i) Ascertain the average profits based on the past few years' performance.

(ii) Capitalize the average profits on the basis of the normal rate of return to ascertain the capitalised value of average profits as follows:

Average Profits × 100/Normal Rate of Return

(iii) Ascertain the actual firm's capital (net assets) by deducting outside liabilities from the total assets (excluding goodwill and ficticious assets).

Firms' Capital = Total Assets (excluding goodwill) – Outside Liabilities

(iv) Compute the value of goodwill by deducting net assets from the capitalised value of average profits, i.e. (ii) – (iii).

Illustration 14

A business has earned average profits of Rs. 1,00,000 during the last few years and the normal rate of return in a similar business is 10%. Ascertain the value of goodwill by capitalisation average profits method, given that the value of net assets of the business is Rs. 8,20,000.

Solution

Capitalised Value of Average Profits

$$\text{Rs. } \frac{1,00,000 \times 100}{10} = \text{Rs. } 10,00,000$$

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Goodwill = Capitalised value – Net Assets
= Rs. 10,00,000 – Rs. 8,20,000
= Rs.1,80,000

(b) *Capitalisation of Super Profits:* Goodwill can also be ascertained by capitalising the super profit directly. Under this method there is no need to work out the capitalised value of average profits. It involves the following steps.

(i) Calculate capital of the firm, which is equal to total assets (excluding goodwill and ficticious assets minus outside liabilities.

(ii) Calculate normal profits on capital employed.

(iii) Calculate average profit for past years, as specified.

(ii) Calculate super profits by deducting normal profits from average profits.

(iii) Multiply the super profits by the required rate of return multiplier, that is,

Goodwill = Super Profits × 100 Normal Rate of Return

In other words, goodwill is the capitalised value of super profits. The amount of goodwill worked out by this method will be exactly the same as calculated by capitalising the average profits.

For example, using the data given in illustration 14 where the average profits are Rs. 1,00,000 and the normal profits are Rs. 82,000 (10% of Rs. 8,20,000), the super profits worked out as Rs. 18,000 (Rs. 1,00,000 – Rs. 82,000), the goodwill will be calculated as follows.

$$\text{Rs. } 18{,}000 \times \frac{100}{10} = \text{Rs. } 1{,}80{,}000.$$

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Illustration 15

1. The goodwill of a firm is to be worked out at three years' purchase of the average profits of the last five years which are as follows:

Years	*Profits (Loss) (Rs.)*
2012	10,000
2013	15,000
2014	4,000
2015	(5,000)
2016	6,000

2. The capital of the firm is Rs. 1,00,000 and normal rate of return is 8%, the average profits for last 5 years are Rs. 12,000 and goodwill is to be worked out at 3 years' purchase of super profits.
3. Rama Brothers earn an average profit of Rs. 30,000 with a capital of Rs. 2,00,000. The normal rate of return in the business is 10%. Using capitalisation of super profits method work out the value the goodwill of the firm.

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Solution

1. Total Profits = Rs. 10,000 + Rs. 15,000 + Rs. 4,000 + Rs. 6,000 – Rs. 5,000
   = Rs. 30,000

   Average Profits = Rs. 30,000/5 = Rs. 6,000

   Goodwill = Average Profits × 3 = Rs. 6,000 × 3 = Rs.18,000
2. Average Profit = Rs. 12,000

   Normal Profit = Rs.1,00,000 × $\frac{8}{100}$ = Rs. 8,000

   Super Profit=Average Profit – Normal profit = Rs. 12,000 – Rs. 8,000
   = Rs. 4,000

   Goodwill=Super Profit × 3 = Rs. 4,000 × 3 = Rs. 12,000
3. Normal Profit= Rs. 2,00,000 × 10/100 = Rs. 20,000

   Super Profit = Average Profit – Normal Profit = Rs. 30,000 – Rs. 20,000
   = Rs. 10,000

   Goodwill=Super Profit × 100/Normal Rate of Return
   = 10,000 × 100/10 = Rs. 1,00,000.

3.5.5 Treatment of Goodwill

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

3.5.5.1 When the new Partner brings goodwill in cash.

The amount of premium brought in by the new partner is shared by the existing partners in their ratio of sacrifice. If this amount is paid to the old partners directly (privately) by the new partner, no entry is passed in the books of the firm. But, when the amount is paid through the firm, which is generally the case, the following journal entries are passed:

(i)	Bank A/c To Premium for Goodwill A/c (Amount brought by new partner as premium)	Dr.
(ii)	Goodwill A/c To Sacrificing Partners Capital A/c (Individually)(Goodwill distributed among the existing partners' in their sacrificing ratio).	Dr.

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

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(i)	Bank A/c To New Partner's Capital A/c (Amount brought by new partner for his share of goodwill).	Dr.
(ii)	New Partner's Capital A/c To Sacrificing Partner's Capital A/c's (Individually) (Goodwill brought by new partners distributed among the existing partners in their sacrificing ratio)	Dr.

If the partners decide that the amount of premium for goodwill credited to their capital accounts should be retained in business, an additional entry is not passed. If, however, they decide to withdraw their amounts, (in full or in part) the following additional entry will be passed:

Existing Partner's Capital A/c (Individually) To Bank A/c (The amount of goodwill withdrawn by the existing partners)	Dr.

Illustration 16

Sunil and Dalip are partners in a firm sharing profits and losses in the ratio of 5:3. Sachin is admitted in the firm for 1/5th share of profits. He brings in Rs. 20,000 as capital and Rs. 4,000 as his share of goodwill by cheque. Give the necessary journal entries,

(a) When partners decided to retain goodwill in business.
(b) When the amount of goodwill is fully withdrawn.
(c) When 50% of the amount of goodwill is withdrawn.

Solution

(a) When the amount of goodwill credited to existing partners is retained in business,

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Books of Sunil and Dalip
Journal

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
(i)	Bank A/c	Dr.		24,000	
	To Sachin's Capital A/c				20,000
	To Premium for Goodwill A/c				4,000
	(The amount brought in by Sachin as Capital and Goodwill)				
(ii)	Premium for Goodwill A/c	Dr.		4,000	
	To Sunil's Capital A/c				2,500
	To Dalip's Capital A/c				1,500
	(Goodwill transferred to Sunil and Dalip in the ratio of 5:3)				

Alternatively,

(i)	Cash A/c	Dr.	24,000	
	To Sachin's Capital A/c			24,000
(ii)	Sachin's Capital A/c	Dr	4,000	
	To Sunil's Capital A/c			2,500
	To Dalip's Capital A/c			1,500

Note: It assumed that the sacrificing ratio is the same as old profit sharing ratio.

(b) When the amount of goodwill credited to existing partners is fully withdrawn.

Journal

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
1.	Same as in (a) above				
2.	Same as in (a) above.				
3.	Sunil's Capital A/c	Dr.		2,500	
	Dalip's Capital A/c	Dr.		1,500	
	To Bank A/c				4,000
	(Cash withdrawn by Sunil and Dalip equal to their share of goodwill)				

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

Journal

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
1.	Same as in (a) above.				
2.	Same as in (a) above				
3.	Sunil's Capital A/c	Dr.		1,250	
	Dalip's Capital A/c	Dr.		750	
	To Cash A/c				2,000
	(Cash withdrawn for 50% of their share of goodwill)				

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Illustration 17

Vijay and Sanjay are partners in a firm sharing profits and losses in the ratio of 3:2. They admitted Ajay into partnership with 1/4 share in profits. Ajay brings in Rs. 30,000 for capital and the requisite amount of premium in cash. The goodwill of the firm is valued at Rs. 20,000. The new profit sharing ratio is 2:1:1. Vijay and Sanjay withdraw their share of goodwill. Give necessary journal entries.

Solution

(a) Ajay will bring Rs. 5,000 (1/4 of Rs. 20,000) as his share of goodwill (premium)

(b) Sacrificing Ratio is 2:3 as calculated below:

For Vijay, old ratio is 3/5 and the new ratio is 2/4, hence, his sacrificing ratio is

$$= \frac{3}{5} - \frac{2}{4} = \frac{12-10}{20} = \frac{2}{20}$$

For Sanjay, old ratio is 2/5 and the new ratio is 1/4, hence, his sacrificing ratio is $= \frac{2}{5} - \frac{1}{4} = \frac{8-5}{20} = \frac{3}{20}$

Books of Vijay and Sanjay
Journal

Date	*Particulars*		*L.F.*	*Debit (Rs.)*	*Credit (Rs.)*
1.	Bank A/c	Dr.		35,000	
	To Ajay's Capital A/c				30,000
	To Premium for Goodwill A/c				5,000
	(The amount of capital and goodwill brought by Ajay)				
2.	Premium for Goodwill A/c	Dr.		5,000	
	To Vijay's Capital A/c				2,000
	To Sanjay's Capital A/c				3,000
	(the amount of goodwill brought by Ajay shared by Vijay and Sanjay in their sacrificing ratio)				
3.	Vijay's Capital A/c	Dr.		2,000	
	Sanjay's Capital A/c	Dr.		3,000	
	To Bank A/c				5,000
	(Cash withdrawn by Vijay and Sanjay for their share of goodwill)				

Note: Alternatively, journal entries (1) and (2) could be as follows:

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Books of Vijay and Sanjay
Journal

Date	*Particulars*		*L.F.*	*Debit (Rs.)*	*Credit (Rs.)*
1.	Bank A/c	Dr.		35,000	
	To Ajay's Capital A/c				35,000
	(Ajay brought in Rs. 30,000 for capital and Rs. 5,000 as goodwill)				
2.	Ajay's Capital A/c	Dr.		5,000	
	To Vijay's Capital A/c				2,000
	To Sanjay's Capital A/c				3,000
	(Amount of goodwill brought in by Ajay shared by Vijay and Sanjay in their sacrificing in the ratio of 2:3)				

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3.5.5.3 *Hidden Goodwill*

Sometimes the value of goodwill is not given at the time of admission of a new partner. In such a situation it has to be inferred from the arrangement of the capital and profit sharing ratio. Suppose, A and B are partners sharing profits equally with capitals of Rs. 45,000 each. They admitted C as a new partner for one-third share in the profit. C brings in Rs. 60,000 as his capital. Based on the amount brought in by C and his share in profit, the total capital of the newly constituted firm works out to be Rs.1,80,000 (Rs. 60,000 × 3). But the actual total capital of A, B and C works out as Rs. 1,50,000 (Rs. 45,000 + Rs. 45,000 + Rs. 60,000). Hence, it can be inferred that the difference is on account of goodwill i.e., Rs. 30,000 (Rs. 1,80,000 – Rs. 1,50,000). Which is to be shared equally (old ratio) by A and B. This shall raise their capital accounts to Rs. 60,000 each and total capital of the firm to Rs. 1,80,000. In this, C's Current account will be debited by Rs. 10,000 (his share of goodwill) and A and B's Capital accounts credited by Rs. 5,000 each.

Illustration 22

Hem and Nem are partners in a firm sharing profits in the ratio of 3:2. Their capitals were Rs. 80,000 and Rs. 50,000 respectively. They admitted Sam on Jan. 1, 2017 as a new partner for 1/5 share in the future profits. Sam brought Rs. 60,000 as his capital. Calculate the value of goodwill of the firm and record necessary journal entries on Sam's admission, if:

(a) Sam brings his share of goodwill
(b) Sam does not bring his share of goodwill

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Solution

(a) Sam brings his share of goodwill

Books of Hem, Nem and Sam
Journal

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
1.	Bank A/c Dr. To Sam's Capital A/c To Premium for Goodwill A/c (Amoun brought by Sam as Capital and Premium for goodwill)		82,000	 60,000 22,000
2.	Premium for goodwill A/c Dr. To Hem's Capital A/c To Nem's Capital A/c (Premium for goodwill credited to sacrificing partners' capital account in their sacrificing ratio)		22,000	 13,200 8,800

(b) Sam does not bring his share of goodwill

Books of Hem, Nem and Sam
Journal

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
1.	Bank A/c Dr. To Sam's Capital A/c (Cash brought by Sam for his capital)		60,000	 60,000
2.	Sam's Current A/c Dr. To Hem's Capital A/c To Nem's Capital A/c		22,000	 13,200 8,800

Working Notes :

Value of Firm's goodwill
Sam's Capital = Rs. 60,000

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Sam's Share	=	1/5
Total capital of Firm	=	Rs. 60,000 x 5 = Rs. 3,00,000
Hem + Nem + Sam	=	Rs. 80,000 + Rs. 50,000 + Rs. 60,000
	=	Rs. 1,90,000
Goodwill of the firm	=	Rs. 3,00,000 - Rs. 1,90,000 = Rs. 1,10,000
Sam's Share	=	Rs. 1,10,000 x 1/5 = Rs. 22,000

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