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Reconstitution of a Partnership Firm –Admission of a Partner

Illustration 21

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

Solution

Books of A and B
Journal

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
1.	Cash A/c	Dr.		25,000	
	To C's Capital A/c				25,000
	(Cash brought in by C as Capital)				
2.	Goodwill			18,000	
	To A's Capital A/c				9,000
	To B's Capital A/c				9,000
	(Goodwill raised at its full value)				
3.	A's Capital A/c	Dr.		8,000	
	B's Capital A/c	Dr.		6,000	
	C's Capital A/c	Dr.		4,000	
	To Goodwill A/c				18,000
	(Goodwill written-off)				

The net effect of the entries (2) and (3) above is that C's Capital account has been debited by Rs. 4,000 and A's Capital account and B's Capital account credited in their sacrificing ratio by Rs 1,000 (credit Rs 9,000 – debit Rs 8,000) and Rs 3,000 (credit Rs 9,000 – debit Rs 6,000) respectively, and goodwill will show nil balance.

Sometimes, the partners may decide not to show goodwill account anywhere in books (not even in the journal and ledger). In that case, for adjustment of goodwill, just one entry can be passed by debiting the new partner's capital account with his share of goodwill and crediting the old partners' capital accounts in their ratio of sacrifice. If in Illustration 21 we were to treat goodwill in this manner, the entry for goodwill would have been as follows:

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	C's Capital A/c Dr.		4,000	
	To A's Capital A/c			1,000
	To B's Capital A/c			3,000
	(Adjustment for C's share of goodwill)			

The above entry has the same effect on partners' capital accounts as journal entries (2) and (3).

Box I

Accounting standard 10 (AS–10) on "Accounting for Fixed Assets" in its Para 16 states that Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable either in cash or in shares or otherwise) which is excess of the net assets taken over, the excess is termed as goodwill'. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.

As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

In view of the provision in para 16 of the Accounting Standard 10 (AS-10), some experts feel that in case of admission, retirement or death of a partner or a change in profit sharing ratio among the partners, goodwill cannot be raised in the books of the firm, and all entries relating to goodwill on such occasions should be recorded in books of the firm directly through the partners' capital accounts only. This is stretching the interpretation of AS–10 too far. What this accounting standard implies is that normally goodwill should not be brought into books unless it is paid for, and whenever it is recorded it should be written- off over a period. Hence, crediting goodwill account with the amount brought in by the incoming partner for his share of goodwill and then transferring it to old partners' capital accounts by debiting goodwill account is quite in order. Similarly, when the incoming partner is unable to bring in the necessary amount for his share of goodwill, raising goodwill account at its agreed value by crediting the old partners in then old profit sharing ratio and then writing it off immediately by debiting it to all the partners (including the new partner) in the new profit sharing ratio is also acceptable as effectively it is tent amount to purchase of goodwill because new partner's capital account balance stands reduced by his share of goodwill. The same logic equally implies to the adjustments made for raising the goodwill account to its goodwill account when it already appears in the balance sheet. What is important is that in the normal course of raising goodwill as an asset should be avoided of and, if and when it is brought in to books, it should be written off in the shortest possible period.