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Collegedunia NCERT Notes

The Ultimate NCERT Revision Guide for Class 12 Accountancy

Chapter 2: Reconstitution: Admission of a Partner

What this chapter covers: the six accounting adjustments triggered by admission of a new partner, new profit-sharing ratio, sacrificing ratio, goodwill valuation and treatment (premium, hidden, revaluation methods), Revaluation A/c for assets and liabilities, distribution of accumulated reserves and P&L, and adjustment of partners' capitals to the new ratio. Session 2026-27.

Contents

1 Introduction: What is Reconstitution?

A partnership firm is **reconstituted** whenever the relations among the existing partners change. The four main reconstitution events are:

1. **Admission** of a new partner (this chapter).
2. **Retirement** or death of a partner (Chapter 3).
3. **Change in profit-sharing ratio** among existing partners.
4. **Dissolution** of the firm (Chapter 4).

This chapter focuses on *admission*. On admission, the new partner joins on agreed terms; existing partners' shares fall; goodwill and asset values must be re-determined; reserves accumulated by old partners alone must be distributed; and capitals may need re-alignment.

2 The Six Adjustments at Admission

The Six Adjustments

1. **New Profit-Sharing Ratio** (new PSR for all partners including the incoming one).
2. **Sacrificing Ratio** (old partners' share given up to the new partner).
3. **Goodwill** valuation and treatment.
4. **Revaluation** of assets and liabilities (Revaluation A/c).
5. **Distribution of accumulated reserves and P&L** (in old PSR).
6. **Capital adjustment** to new ratio (if deed so requires).

2.1 Six-step admission sequence (visual)

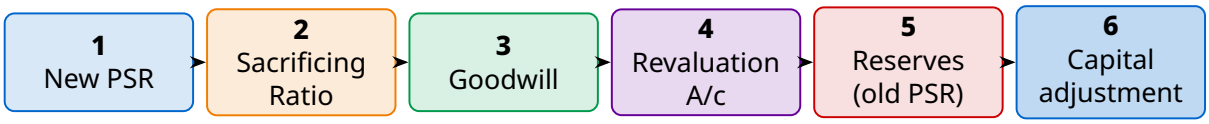

Figure 1: The six accounting adjustments triggered by admission, in the order you should attempt them. Steps 1 and 2 fix the ratios, step 3 settles goodwill, step 4 restates asset/liability values, step 5 distributes pre-existing reserves, and step 6 (if asked) equalises capitals.

Memory aid – "N-S-G-R-R-C"

New PSR, **S**acrificing Ratio, **G**oodwill, **R**evaluation, **R**eserves, **C**apitals. Run through this six-letter chant before drafting a full admission balance sheet, it prevents the most common 1-mark slip of skipping reserve distribution.

Quick Tip

In a 6-mark or 8-mark admission problem, the marking scheme usually allocates **1 mark per adjustment**. Skipping any of the six leaves marks on the table even if your arithmetic is right.

3 New Profit-Sharing Ratio

The new PSR is the ratio in which all partners (old + new) will share *future* profits.

3.1 Case A: New partner takes from old partners in old PSR (default)

If the question is silent on the source, default to old PSR. New old-partner share = old share $\times(1-$ new partner's share$)$.

Worked example. A and B share 3:2; admit C for 1/4. Remaining = 3/4. A's new = $3/5 \times 3/4 = 9/20$; B's = $2/5 \times 3/4 = 6/20$; C = $1/4 = 5/20$. New PSR = 9:6:5.

3.2 Case B: New partner takes a specific fraction from each old partner

Subtract the surrendered fraction from each old partner's old share directly.

Worked example. A and B share 3:2; C is admitted for 1/4 share, taking 1/8 from A and 1/8 from B.

- A's new = $3/5 - 1/8 = 24/40 - 5/40 = 19/40$.

- B's new = $2/5 - 1/8 = 16/40 - 5/40 = 11/40$.
- C's share = $1/4 = 10/40$.
- New PSR = 19:11:10.

3.3 Case C: New partner surrenders fractions of each old partner's share

Worked example. A and B share 3:2. C admitted; surrenders 1/3 of A's share and 1/4 of B's share.

- A surrenders = $3/5 \times 1/3 = 1/5$. A's new = $3/5 - 1/5 = 2/5$.
- B surrenders = $2/5 \times 1/4 = 1/10$. B's new = $2/5 - 1/10 = 3/10$.
- C's share = $1/5 + 1/10 = 3/10$. New PSR (LCM 10): 4:3:3.

4 Sacrificing Ratio

Sacrificing Ratio

For each old partner:

$$\text{Sacrifice} = \text{Old Share} - \text{New Share}.$$

Express the sacrifices as a ratio. This drives the credit to old partners when the new partner brings in goodwill premium.

If the new partner acquires his share from old partners in their old PSR, the sacrificing ratio equals the old PSR.

4.1 Sacrificing ratio = Old − New (visual)

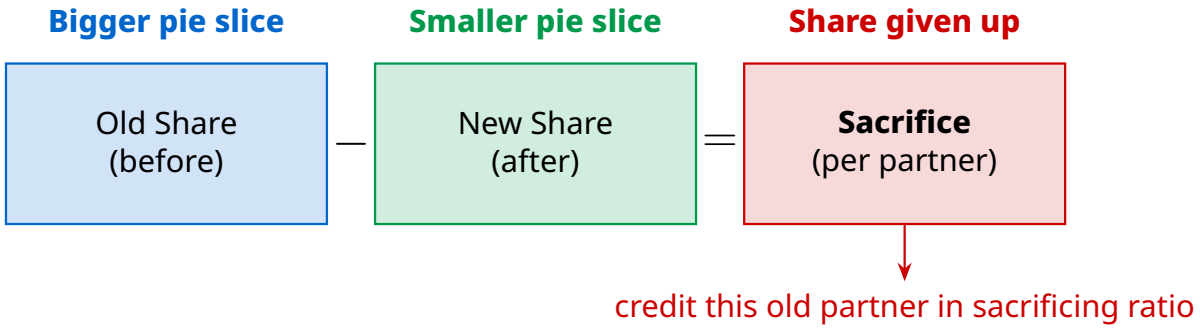

Figure 2: Each old partner's sacrifice is the shrinkage of his pie-slice from old PSR to new PSR. The sacrifices across old partners form the sacrificing ratio in which goodwill premium is credited.

5 Goodwill: Definition and Valuation

Goodwill is the most-tested topic of this chapter. Conceptually it is the price paid for a firm's earning capacity over and above what its tangible capital alone would generate. The four valuation methods NCERT discusses (Average Profit, Super Profit, Capitalisation, Weighted Average) give you alternative arithmetic routes to the same number; pick the one suggested by the question's data.

What is Goodwill?

Goodwill is the present value of a firm's future excess earnings (super profits) over normal earnings on its capital employed. It captures reputation, customer base, brand and other intangibles.

5.1 Four valuation methods at a glance

Average Profit

$G = \overline{P} \times n$

Simple, popular

Super Profit

$SP = \overline{P} - \text{Normal}$
$G = SP \times n$

Capitalisation

$G = \dfrac{\overline{P} \times 100}{r} - C_e$

Weighted Average

Recent years get higher weight

Figure 3: The four NCERT-listed goodwill methods. Average Profit and Weighted Average start from past earnings; Super Profit and Capitalisation reference the firm's capital employed and a normal rate of return.

5.2 AS-26 rule

Self-generated goodwill cannot be shown on the balance sheet. Only *purchased* goodwill (paid for in cash on acquisition) is recognised. Existing goodwill in the books of the old firm *must be written off* in old PSR before admission.

Common Mistake

A frequent slip: students write off the existing goodwill in the *new* ratio. AS-26 requires the write-off to be in the **old** ratio because the goodwill belonged to the old partners alone. Using the new ratio gifts a slice to the incoming partner before he has even paid for it.

Real-World Application

AS-26 is the Indian counterpart of IAS 38 "Intangible Assets". Indian audit firms apply the same self-generated-vs-purchased boundary when valuing intellectual property at start-up acquisitions, and it is also the rule that prevents a partnership from inflating its balance sheet with internally built brand value.

5.3 Method 1 – Average Profit Method

Average Profit Method

$$\text{Goodwill} = \text{Average Profit} \times \text{Years' Purchase}$$

Average profit usually computed over last 3 to 5 years; years' purchase is the multiplier (typically 2 to 4).

Example. Profits of last 5 years: 40k, 50k, 60k, 50k, 60k. Total = 260k; Avg = 52k. Goodwill (4 years' purchase) = 52k $\times$ 4 = Rs. 2,08,000.

5.4 Method 2 – Super Profit Method

Super Profit Method

Super Profit = Actual Average Profit $-$ Normal Profit, where Normal Profit = Capital Employed $\times$ Normal Rate / 100. Then: Goodwill = Super Profit $\times$ Years' Purchase.

Example. Capital Rs. 2,00,000; normal rate 15%; actual profit Rs. 48,000. Normal profit = $2{,}00{,}000 \times 15\% = 30{,}000$. Super profit = $48{,}000 - 30{,}000 = 18{,}000$. Goodwill (3 yrs) = $18{,}000 \times 3 =$ Rs. 54,000.

5.5 Method 3 – Capitalisation Method

Two sub-methods:

(a) Capitalisation of Average Profit. Goodwill = (Avg Profit $\times$ 100 / Normal Rate) $-$ Capital Employed.

(b) Capitalisation of Super Profit. Goodwill = Super Profit $\times$ 100 / Normal Rate.

Example. Capital Rs. 5,00,000; profit Rs. 1,50,000; normal rate 20%. Capitalised value = $1{,}50{,}000 \times 100/20 = 7{,}50{,}000$. Goodwill = $7{,}50{,}000 - 5{,}00{,}000 =$ Rs. 2,50,000.

5.6 Method 4 – Weighted Average Profit (advanced)

Recent years' profits are often more representative of the firm's current earning capacity than older years. The weighted average method captures this by assigning a larger weight to the most recent year and progressively smaller weights as we move backwards.

Weighted Average Profit

$$\text{Weighted Avg} = \frac{\sum(\text{Profit} \times \text{Weight})}{\sum \text{Weight}}$$

The numerator sums each year's profit times its weight; the denominator is the total of weights. Goodwill is then computed as Weighted Avg $\times$ Years' Purchase.

Worked example. Profits for 4 years: Rs. 80k, 90k, 1,00k, 1,20k with weights 1, 2, 3, 4. Numerator $= 80 + 180 + 300 + 480 = 1{,}040$ (thousands). Weights total $= 10$. Weighted average $= 1{,}04{,}000$. Goodwill (3 yrs' purchase) $= 3{,}12{,}000$.

6 Treatment of Goodwill on Admission

6.1 Decision tree: which goodwill case am I in?

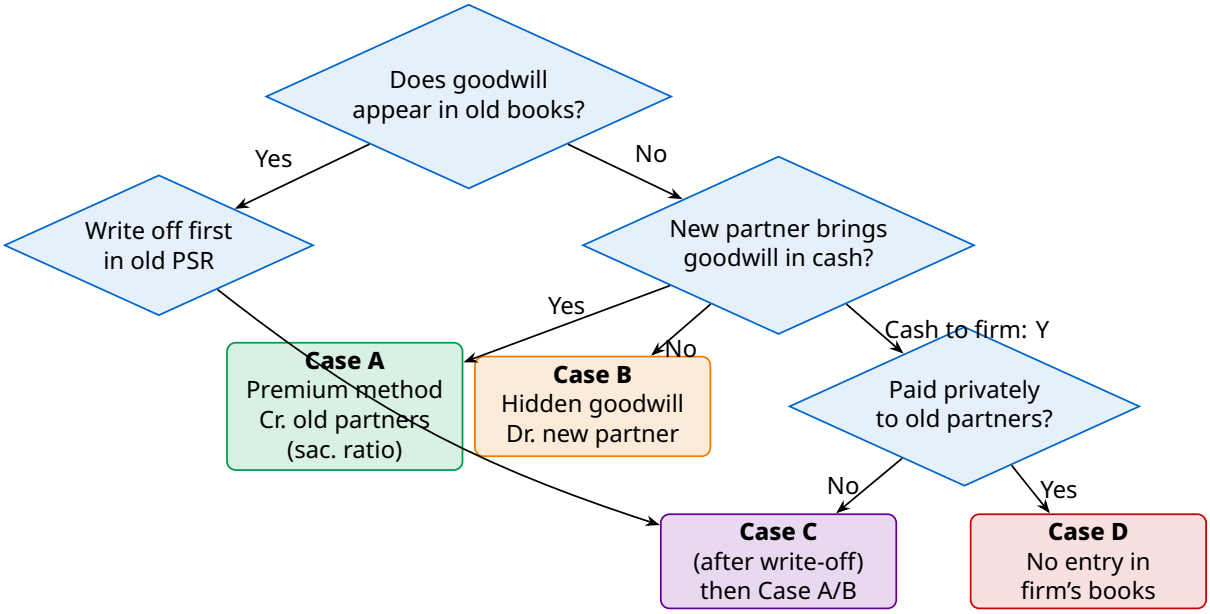

Figure 4: Four exam scenarios mapped to one decision tree. Read each clue ("goodwill in books", "brings cash", "paid privately") to land on the correct case before passing any entry.

6.2 Case A: New partner brings goodwill in cash

Two journal entries:

1. Cash / Bank A/c Dr.
   To Premium for Goodwill A/c
2. Premium for Goodwill A/c Dr.
   To Sacrificing Partners' Capital A/cs (in sacrificing ratio)

6.3 Case B: New partner unable to bring goodwill in cash (hidden goodwill method)

1. New Partner's Capital A/c Dr.
   To Sacrificing Partners' Capital A/cs (in sacrificing ratio)

Effect: new partner's capital is debited by his goodwill share; sacrificing partners' capitals credited.

6.4 Case C: Existing goodwill in old books

First, write it off:

- Old Partners' Capital A/cs (old PSR) Dr.
  To Goodwill A/c

Then proceed with Case A or B.

6.5 Case D: Goodwill paid privately

If the new partner pays goodwill directly to old partners outside the firm, *no entry* is passed in the firm's books for goodwill. Only the capital contribution is recorded.

Common Mistake

"Privately paid" goodwill produces ZERO entries in the firm's books. Many students still try to credit sacrificing partners; this is wrong and loses marks.

7 Revaluation Account

Quick Tip

The Revaluation A/c is sometimes called the "Profit and Loss Adjustment A/c" in older textbooks. Both names refer to the same account, do not lose a mark by treating them as separate items.

Revaluation A/c rules

- Increase in asset value $\Rightarrow$ Credit Revaluation A/c.
- Decrease in asset value $\Rightarrow$ Debit Revaluation A/c.
- Increase in liability $\Rightarrow$ Debit Revaluation A/c.
- Decrease in liability $\Rightarrow$ Credit Revaluation A/c.
- Unrecorded asset brought in $\Rightarrow$ Credit Revaluation.
- Unrecorded liability brought in $\Rightarrow$ Debit Revaluation.

- Net gain / loss transferred to old partners in *old PSR*.

Mnemonic – "**Asset up = credit; Liability up = debit**". The mirror also applies.

7.1 Revaluation A/c rule visualised

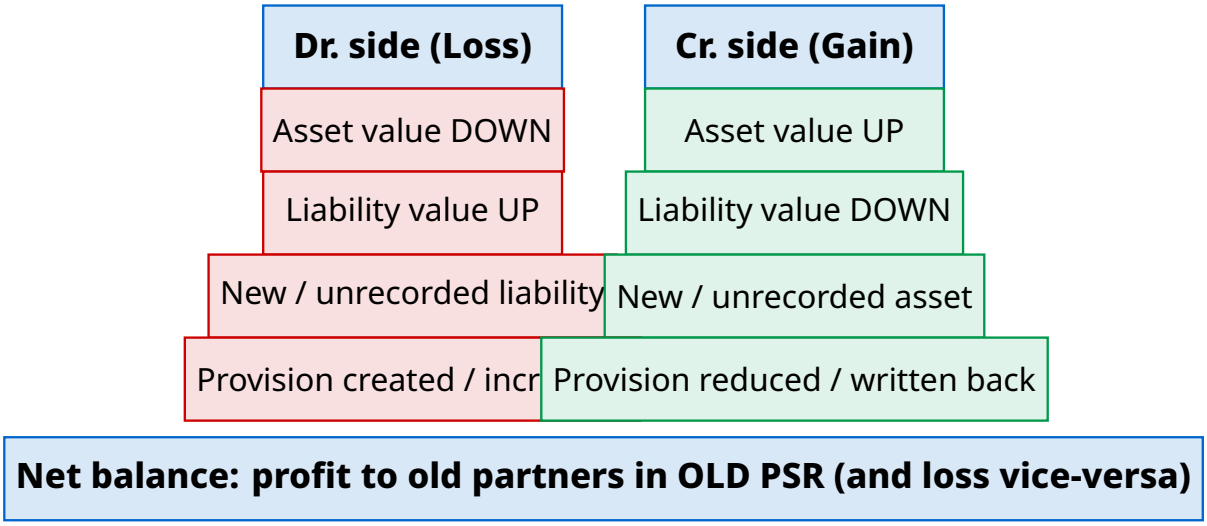

Figure 5: Two-column rule for Revaluation A/c. Every item the question gives belongs on one side: read whether the change increases or decreases the line, then read whether the line is an asset or a liability.

8 Distribution of Reserves and Accumulated Profits / Losses

Reserves (general reserve, contingency reserve, workmen compensation reserve, etc.) and accumulated P&L (credit balance = profit; debit balance = loss) appearing on the date of admission belong only to the old partners. Distribute them in *old* PSR before admission.

Journal entries:

- For credit-side items (Reserve, Cr. P&L):
  General Reserve A/c Dr.
  P&L A/c Dr.
  To Old Partners' Capital A/cs (old PSR)
- For debit-side items (Dr. P&L = accumulated loss):
  Old Partners' Capital A/cs (old PSR) Dr.
  To P&L A/c

Common Mistake

Reserves and the credit balance of P&L A/c are pre-admission profits, they belong only to the old partners. Distributing them in the *new* PSR is a textbook error that gifts a windfall to the incoming partner.

Real-World Application

When a new junior partner is admitted into an Indian law or CA firm, the firm's general reserve (often built up over a decade) is transferred to the seniors before he joins. The incoming partner therefore sees a "cleaner" balance sheet on day one, exactly the discipline NCERT codifies here.

9 Capital Adjustment to the New Ratio

If the deed requires capitals in the new PSR:

9.1 Method 1 – Based on new partner's capital

New partner's capital is given. Compute total capital of the firm:

$$\text{Total Capital} = \frac{\text{New Partner's Capital}}{\text{New Partner's Share}}.$$

Then each old partner's required capital = Total Capital $\times$ his new share. Adjust the difference (current capital after all other adjustments minus required capital) through cash or current accounts.

9.2 Method 2 – Total capital given

Total capital is specified. Compute each partner's required capital using his new share; adjust differences.

9.3 Two-method visual: capital adjustment on admission

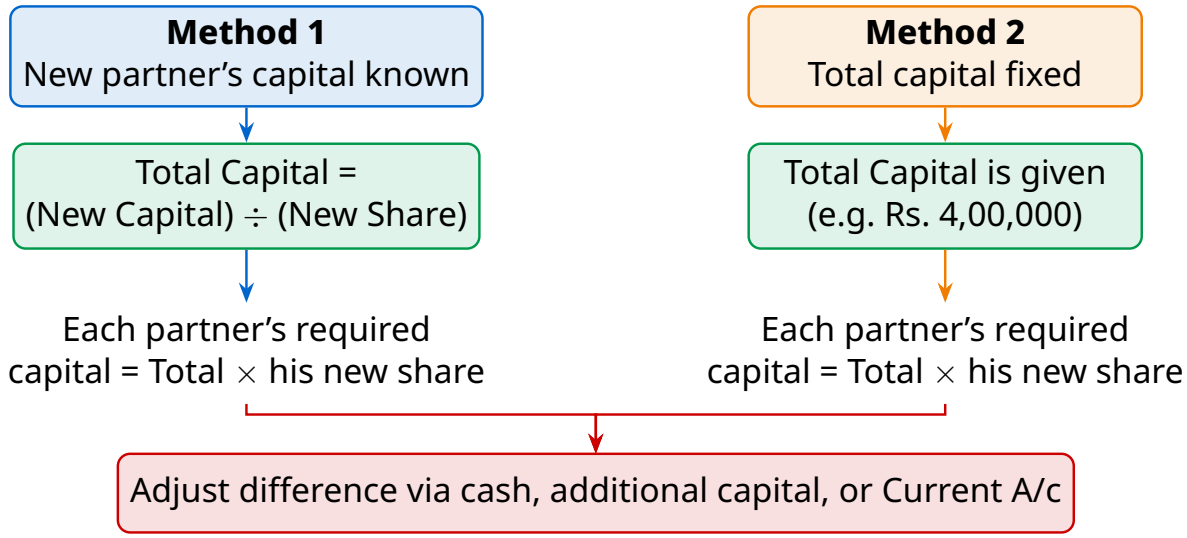

Figure 6: Both methods produce the same final shape, each continuing partner is brought to "Total Capital × his new share". The only difference is where the Total Capital number comes from.

10 Detailed Worked Examples

10.1 Worked Example 1 – New PSR (Default Source)

A and B share 3:2. Admit C for 1/4. Find new PSR.

Remaining = $1 - 1/4 = 3/4$. A's new = $3/5 \times 3/4 = 9/20$; B's = $2/5 \times 3/4 = 6/20$; C = $5/20$. **New PSR = 9:6:5**.

10.2 Worked Example 2 – Sacrificing Ratio Computation

Sandeep and Navdeep share 5:3. Admit C with new PSR 4:2:1. Find sacrificing ratio.

LCM(8, 7) = 56. Sandeep: old $35/56$, new $32/56$, sacrifice $3/56$. Navdeep: old $21/56$, new $16/56$, sacrifice $5/56$. **Sacrificing Ratio = 3:5**.

10.3 Worked Example 3 – Goodwill by Average Profit

5-yr profits: 40k, 50k, 60k, 50k, 60k. 4 yrs' purchase. Total = 260k. Avg = 52k. Goodwill = 52k × 4 = **Rs. 2,08,000**.

10.4 Worked Example 4 – Goodwill by Super Profit

Capital 2,00,000; rate 15%; profit 48,000. Normal = $30{,}000$. Super = $18{,}000$. Goodwill (3 yrs) = $54{,}000$. **Rs. 54,000**.

10.5 Worked Example 5 – Goodwill by Capitalisation

Capital 5,00,000; profit 1,50,000; rate 20%. Capitalised value = $7{,}50{,}000$. Goodwill = $7{,}50{,}000 - 5{,}00{,}000 =$ **Rs. 2,50,000**.

10.6 Worked Example 6 – Revaluation A/c

Adjustments on admission: building up by 20k, stock down by 5k, creditors up by 3k, new provision for doubtful debts 2k.

Revaluation A/c:

Dr.	Rs.	Cr.	Rs.
Stock A/c (decrease)	5,000	Building A/c (increase)	20,000
Creditors A/c (increase)	3,000		
Provision for D.D.	2,000		
Profit to old partners (old PSR)	10,000		
Total	**20,000**	**Total**	**20,000**

11 CBSE Previous-Year Questions – Solved

11.1 CBSE 2024 (5-mark)

Q. P and Q share 3:1. Admit R for 1/5 with capital Rs. 40,000 and goodwill Rs. 8,000. Pass journal entries.

Solution.

1. Cash/Bank A/c Dr. 48,000 ; To R's Capital A/c 40,000; To Premium for Goodwill A/c 8,000.
2. Premium for Goodwill A/c Dr. 8,000; To P's Capital A/c 6,000; To Q's Capital A/c 2,000 (sacrificing ratio = old 3:1).

11.2 CBSE 2023 (6-mark)

Q. A and B share 2:1; admit C for 1/4. Revaluation showed building up 30k, machinery down 10k, debtors up 5k. C brings Rs. 60k capital + 20k goodwill. Pass journal entries through to capital adjustment.

Solution outline:

- Revaluation A/c profit = $30{,}000 + 5{,}000 - 10{,}000 = 25{,}000$. To A: $25{,}000 \times 2/3 = 16{,}667$; B: $8{,}333$.
- Goodwill 20k split 2:1 (sacrificing = old) $\Rightarrow$ A 13,333; B 6,667.
- Pass cash entries, revaluation entries, goodwill entries.

11.3 CBSE 2022 (4-mark)

Q. State any four factors affecting goodwill.

Answer.

1. Quality of product / service.
2. Efficient management.
3. Favourable location.
4. Strong customer base / future prospects.

12 Additional Practice Problems with Hints

12.1 Practice 1 – New PSR with specific source

Q. X and Y share 5:3. Admit Z for 1/10, who acquires from X and Y equally. Find new PSR.

Hint. Z's share = 1/10; takes 1/20 from X and 1/20 from Y. X's new = $5/8 - 1/20 = 25/40 - 2/40 = 23/40$. Y's new = $3/8 - 1/20 = 15/40 - 2/40 = 13/40$. Z = $4/40$. **New PSR = 23:13:4**.

12.2 Practice 2 – Hidden Goodwill

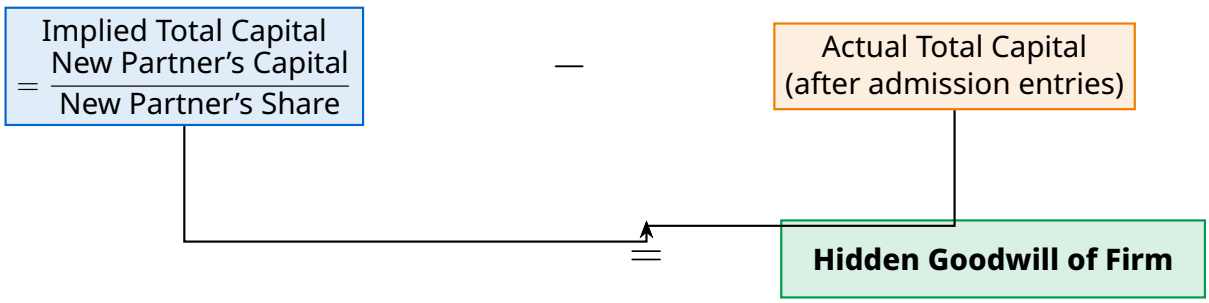

Figure 7: Hidden goodwill back-calculated when the question does not give a goodwill figure but does give the new partner's capital and share. Multiply new partner's capital up to imply the total; the gap against the actual aggregate capital is the firm's goodwill.

Q. Total capital of A + B + C (new) = 1,20,000. C's share = 1/4, capital 25,000. Find hidden goodwill of firm.

Hint.

- Total capital implied by C's capital = $25{,}000 \times 4 = 1{,}00{,}000$.
- Actual capital = $1{,}20{,}000$.
- Hidden goodwill = $20{,}000$.

12.3 Practice 3 – Capitalisation with External Liabilities

Q. Assets Rs. 10,00,000; external liabilities Rs. 1,80,000; avg profit Rs. 1,00,000; normal rate 10%. Find goodwill.

Hint.

- Net assets (capital employed) = $10{,}00{,}000 - 1{,}80{,}000 = 8{,}20{,}000$.
- Capitalised value = $1{,}00{,}000 \times 100/10 = 10{,}00{,}000$.
- Goodwill = $10{,}00{,}000 - 8{,}20{,}000 =$ **Rs. 1,80,000**.

13 Common Mistakes Summary

1. Forgetting to write off existing goodwill in old PSR before passing the premium entry.
2. Distributing reserves or revaluation gain in the new PSR (should be *old* PSR).
3. Passing a goodwill journal entry when the new partner has paid privately (no entry needed).
4. Using gross assets instead of net assets for "capital employed" in capitalisation method.
5. Confusing sacrificing ratio with gaining ratio.
6. Treating the new partner's goodwill credit as a cash entry when he brings it as an in-kind contribution.

14 Detailed Full-Cycle Admission Example

Question. A and B share 3:2 with capitals Rs. 1,80,000 and Rs. 1,50,000. They admit C for 1/4 share. C brings Rs. 1,00,000 capital and Rs. 60,000 as goodwill premium. Adjustments: Plant increased by 20k (to 1,20,000), Building up 10% (now 1,65,000), Stock overvalued by 4k, Provision for doubtful debts at 5% on debtors of 60k = 3k, Creditors unrecorded 1k.

Step 1 – Compute New PSR.

Source unspecified $\Rightarrow$ default old PSR (3:2). Remaining = $1 - 1/4 = 3/4$.

- A's new = $3/5 \times 3/4 = 9/20$.
- B's new = $2/5 \times 3/4 = 6/20$.
- C's = $5/20$. New PSR = 9:6:5.

Step 2 – Sacrificing Ratio.

A: $3/5 - 9/20 = 12/20 - 9/20 = 3/20$. B: $2/5 - 6/20 = 8/20 - 6/20 = 2/20$. Sacrificing Ratio = 3:2 = old PSR.

Step 3 – Goodwill Distribution.

Rs. 60,000 split 3:2: A = 36,000; B = 24,000.

Step 4 – Revaluation A/c.

Dr.	Rs.	Cr.	Rs.
Stock (overvalued)	4,000	Plant (increase)	20,000
Provision for D.D.	3,000	Building (increase, 10% of 1,50,000)	15,000
Creditors (unrecorded)	1,000		
Profit to A (3/5)	16,200		
Profit to B (2/5)	10,800		
Total	**35,000**	**Total**	**35,000**

Revaluation profit = Rs. 27,000.

Step 5 – Partners' Closing Capitals.

Each partner's closing capital is built from his opening balance plus credits (goodwill share, revaluation profit) minus any debits.

- A: $1{,}80{,}000 + 36{,}000 + 16{,}200 =$ Rs. $2{,}32{,}200$.
- B: $1{,}50{,}000 + 24{,}000 + 10{,}800 =$ Rs. $1{,}84{,}800$.
- C (new partner): Rs. $1{,}00{,}000$ (capital brought).

Total of capitals in new firm $= 2{,}32{,}200 + 1{,}84{,}800 + 1{,}00{,}000 =$ Rs. $5{,}17{,}000$.

Step 6 – Final Balance Sheet of New Firm.

Total cash = 1,00,000 (capital) + 60,000 (goodwill) = 1,60,000. Other assets adjusted per revaluation.

15 Topic-wise Mind Map

High-yield topics ranked by CBSE marks-per-chapter

1. Full admission Balance Sheet — 8 marks
2. Revaluation A/c + Capital adjustment — 6 marks
3. Goodwill valuation (any method) — 4 marks
4. Treatment of goodwill (four sub-cases) — 4 marks
5. New PSR / Sacrificing ratio calculation — 3 marks
6. AS-26 conceptual SA / Why revalue LA — 3 marks

Quick Tip

For an 8-mark full-cycle admission problem, allocate roughly 1.5 minutes per step: ratios, revaluation, goodwill, reserves, capitals, balance sheet. The balance sheet tally is the final audit gate, if liabilities $\neq$ assets, scan revaluation and reserve entries first.

16 Frequently Asked Conceptual Questions

16.1 Q1. What is reconstitution and what events trigger it?

Reconstitution = change in the existing relations among partners. Four triggers: (a) Admission of a new partner; (b) Retirement / death; (c) Change in PSR; (d) Dissolution.

16.2 Q2. Why is goodwill brought in by the new partner credited to old partners?

Because old partners surrender share of future profit. Goodwill premium is compensation for this surrender. It is credited in the sacrificing ratio.

16.3 Q3. What if a new partner cannot bring goodwill in cash?

Use the *hidden goodwill method*: debit new partner's Capital A/c by his share of goodwill and credit sacrificing partners' Capital A/cs in sacrificing ratio.

16.4 Q4. Why are reserves and accumulated P&L distributed in the OLD ratio?

Because they were earned (or lost) by the old partners during their tenure, before the new partner joined. The new partner has no claim.

16.5 Q5. What happens if revaluation results in a loss?

The net debit balance of the Revaluation A/c is transferred to old partners' Capital A/cs in old PSR. They bear the loss.

16.6 Q6. Can the new partner be admitted without revaluation?

Strictly, only if all partners agree in writing. Otherwise revaluation is necessary to ensure fairness. If skipped, hidden gains accrue to the new partner.

17 Important Formulas Reference Sheet

Key Formulas for Admission of a Partner

1. **New PSR (default source):** New share of old partner = Old share $\times(1-$ new partner's share$)$.
2. **Sacrificing Ratio:** Sacrifice = Old Share $-$ New Share.
3. **Goodwill – Average Profit:** $G = \overline{P} \times n$ (years' purchase).
4. **Super Profit:** $SP =$ Actual Profit $-$ (Capital Employed $\times r/100$).
5. **Goodwill – Super Profit:** $G = SP\times$ Years' Purchase.
6. **Goodwill – Capitalisation of Avg Profit:** $G = (\overline{P} \times 100/r)-$ Capital Employed.
7. **Hidden Goodwill:** Hidden $G =$ (Implied total capital from new partner) $-$ (Actual total capital).
8. **New Partner's Capital from Total:** $C_{\text{new}} =$ Total Capital $\times$ New Share.

18 Journal Entries – Quick Reference for Admission

18.1 Sequence of admission journal entries (visual)

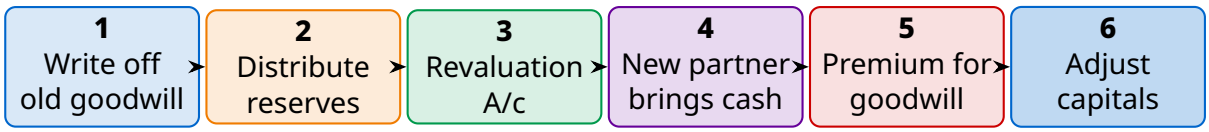

Figure 8: Recommended order of journal entries on admission. Doing entries 1 and 2 first keeps existing assets and reserves with the old partners; entries 3 to 5 settle the new partner's stake; entry 6 (optional) aligns capitals.

18.2 For New Partner's Capital

When the incoming partner brings his agreed capital contribution into the firm, the firm's cash balance rises and his Capital A/c is opened with a credit balance. This is the very first entry passed on the date of admission.

- Cash / Bank A/c Dr.
- To New Partner's Capital A/c

18.3 For Goodwill Premium (Cash)

Cash / Bank A/c Dr.
To Premium for Goodwill A/c

Premium for Goodwill A/c Dr.

To Sacrificing Partners' Capital A/cs (in sacrificing ratio)

18.4 For Existing Goodwill Write-off

Old Partners' Capital A/cs Dr. (in old PSR)
To Goodwill A/c

18.5 For Hidden Goodwill

New Partner's Capital A/c Dr.
To Sacrificing Partners' Capital A/cs (sacrificing ratio)

18.6 For Revaluation Profit/Loss

Profit: Revaluation A/c Dr. To Old Partners' Capital A/cs (old PSR)
Loss: Old Partners' Capital A/cs Dr. (old PSR) To Revaluation A/c

18.7 For Reserves and Accumulated Profit

General Reserve A/c Dr.
P&L A/c Dr. (Cr. balance)
To Old Partners' Capital A/cs (old PSR)

19 Differences Table – Tested Conceptual Questions

19.1 Sacrificing Ratio vs Gaining Ratio

- **Sacrificing Ratio.** Old share $>$ new share. Used at admission and when a partner's PSR is reduced.
- **Gaining Ratio.** New share $>$ old share. Used at retirement and when a partner's PSR is increased.

19.2 Revaluation A/c vs Realisation A/c

- **Revaluation A/c.** Opened at reconstitution (admission / retirement / change in PSR); assets and liabilities continue in books.
- **Realisation A/c.** Opened only at dissolution; assets sold and liabilities paid; firm ends.

19.3 Premium Method vs Revaluation Method

- **Premium Method.** New partner brings goodwill in cash; sacrificing partners credited.

- **Revaluation Method (rare).** Goodwill A/c is raised, then written off in new PSR.

20 Additional Worked Problems

20.1 Additional Problem 1 – New PSR with surrender fractions

Q. Radha and Rukmani share 3:2. Admit Gopi. Radha surrenders 1/3 of her share; Rukmani surrenders 1/4 of her share. Find new PSR.

Solution.

- Radha surrenders: $3/5 \times 1/3 = 1/5$. New share: $3/5 - 1/5 = 2/5$.
- Rukmani surrenders: $2/5 \times 1/4 = 1/10$. New share: $2/5 - 1/10 = 3/10$.
- Gopi's share: $1/5 + 1/10 = 3/10$.
- Common denominator 10: Radha 4/10, Rukmani 3/10, Gopi 3/10.
- **New PSR = 4 : 3 : 3**.

20.2 Additional Problem 2 – Hidden Goodwill Calculation

Q. P, Q's total capital after admission of R is Rs. 4,50,000. R's share is 1/3 and his capital is Rs. 1,25,000. Find hidden goodwill of the firm.

Solution.

- Implied total capital based on R = $1{,}25{,}000 \div (1/3) = 3{,}75{,}000$.
- Actual total capital = Rs. 4,50,000.
- Hidden Goodwill = $4{,}50{,}000 - 3{,}75{,}000 =$ Rs. 75,000.
- R's share of goodwill = $75{,}000 \times 1/3 =$ Rs. 25,000.

20.3 Additional Problem 3 – Weighted Average Goodwill

Q. Profits for last 4 years: 2022: 80k, 2023: 100k, 2024: 120k, 2025: 140k. Weights: 1, 2, 3, 4 respectively. Find goodwill at 2 years' purchase.

Solution.

- Products: $80 \times 1 + 100 \times 2 + 120 \times 3 + 140 \times 4 = 80 + 200 + 360 + 560 = 1{,}200$ (in thousands).
- Sum of weights = $1 + 2 + 3 + 4 = 10$.
- Weighted Avg = $1{,}200/10 = 120$ (thousands) = Rs. 1,20,000.
- Goodwill = $1{,}20{,}000 \times 2 =$ Rs. 2,40,000.

20.4 Additional Problem 4 – Capital Adjustment after Admission

Q. After admission, total capital of new firm is to be Rs. 4,00,000. New PSR is 2:2:1. Compute each partner's required capital.

Solution.

- Partner 1 (2/5): $4{,}00{,}000 \times 2/5 = 1{,}60{,}000$.
- Partner 2 (2/5): $4{,}00{,}000 \times 2/5 = 1{,}60{,}000$.
- Partner 3 (1/5): $4{,}00{,}000 \times 1/5 = 80{,}000$.

Any difference between actual capital (after revaluation, goodwill credits and reserve distributions) and required capital is adjusted through cash or current accounts.

21 Real-World Context

Real-World Application

The procedure you learn here is used in every law firm, CA firm, and family business reconstitution in India. Sec. 187 of the Companies Act, 2013 governs LLP reconstitutions in a similar spirit. The Revaluation A/c discipline also flows into IFRS 3 "Business Combinations", the international accounting standard for company-level acquisitions.

22 Frequently Tested Theory Questions – Quick Bank

22.1 Why is a Revaluation A/c (not the P&L A/c) opened?

The Revaluation A/c keeps reconstitution adjustments isolated from regular trading results. P&L A/c records day-to-day earnings; revaluation adjustments are one-off, capital-nature changes. Mixing the two would distort the firm's reported profitability.

22.2 Distinguish: Sacrificing Ratio and Profit-Sharing Ratio

Sacrificing ratio is computed only at reconstitution and applies only to the partners who lose share. PSR is the on-going basis for distributing future profits among ALL partners.

22.3 When is goodwill written off in new PSR (rare "revaluation method")?

When the firm chooses to raise a Goodwill A/c in the books at admission (debit goodwill, credit old partners in old PSR) and then immediately write it off (debit all partners in new PSR, credit goodwill). The net effect: gaining partner pays sacrificing partner in cash through the capital A/cs.

22.4 Why does the new partner pay goodwill premium?

Because the new partner is buying a share of future profits from the old partners. Goodwill is the price of that share of super-earning capacity.

22.5 What is "capital employed" in goodwill calculation?

Capital Employed = Total Assets $-$ External Liabilities (i.e. net assets). It represents the amount on which the firm earns its return. "Gross assets" is wrong because external liabilities are not the partners' funds.

22.6 What is the difference between Accumulated Profits and Reserves?

Accumulated Profits = profit retained over the years (e.g. P&L A/c Cr. balance). Reserves = appropriations earmarked for specific purposes (general reserve, workmen compensation reserve, investment fluctuation reserve). Both are distributed in old PSR at admission.

Memory aid – "S minus N" for sacrificing ratio

Sacrifice $=$ Old (the **S**tarting share) **minus** **N**ew (the **N**ext share). At admission the bigger pie shrinks, so Old $>$ New $\Rightarrow$ positive sacrifice. At retirement the bigger pie grows for continuing partners, so Old $<$ New $\Rightarrow$ gaining ratio.

Quick Tip

"Goodwill paid privately to old partners outside the firm" triggers no entry in the books. If the question says "paid privately" or "outside the firm", the only firm-side entry is for the cash capital the new partner brings in.

23 Chapter Summary – One-Page Revision

Quick Revision Map

1. Six adjustments at admission: New PSR, Sacrificing Ratio, Goodwill, Revaluation, Reserves, Capitals.
2. Default source = old PSR; sacrificing ratio = old PSR when source unspecified.
3. AS-26: write off existing goodwill in old PSR before admission entry.
4. Three goodwill methods: Average Profit, Super Profit, Capitalisation.
5. Revaluation: Asset up = credit, Liability up = debit. Net to old partners in old PSR.
6. Reserves and accumulated P&L distributed in old PSR.
7. Capital adjustment: Total Capital = New Partner Capital / New Share.
8. Goodwill paid privately = no entry in firm's books.

End of Notes – Class 12 Accountancy Chapter 2