Reconstitution of Partnership-Change in Profit Sharing Ratio

Change in Profit Sharing Ratio Among the Existing Partners

The study of this chapter would enable you to understand:

- The concept of Reconstitution of Partnership
- Meaning of change in Profit sharing ratio among the existing partners
- Sacrificing Ratio and Gaining Ratio
- Accounting Treatment of Goodwill
- Account Treatment of Reserve and Accumulated Profits or Losses
- Revaluation of Assets and Reassessment of Liabilities
- Preparation of the Balance Sheet of the Reconstituted Firm

“Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all”

-Section 4 of the Indian Partnership Act, 1932

Partnership firm comes in existence with an agreement and establishes relationship among the partners and whenever there is any change in that agreement results in reconstitution of the firm.

A firm is reconstituted, whenever there is a

- Change in the profit sharing ratio among the existing partners.
- Admission of a new partner
- Retirement of an existing partner
- Death of partner
- Amalgamation of two or more partnership firms.

Change in Profit Sharing Ratio Among Existing Partners

Change in profit sharing ratio among the existing partners means **reconstitution** of the firm where the profit sharing ratio among all partners changes. The change will come in the form of **sacrifice or gain** by the partners. One or more partners will sacrifice and others will gain.

Adjustments for change in profit sharing ratio

1. Determination of Sacrificing Ratio and Gaining Ratio
2. Accounting Treatment of Goodwill
3. Accounting Treatment of Reserves and Accumulated Profit or Losses
4. Revaluation of Assets and Reassessment of Liabilities

Determination of Sacrificing Ratio and Gaining Ratio

Change in profit sharing means there is decrease in the share of one or more partner while increase in the share of other partners.

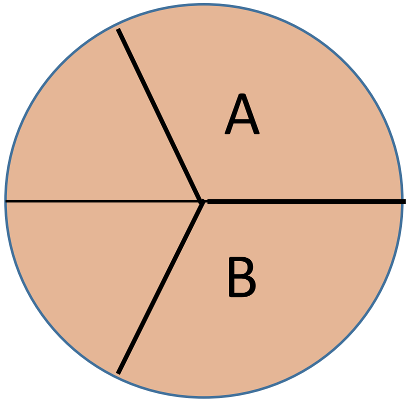
Sacrificing Ratio:- Sacrificing Ratio is the ratio in which one or more partners of the surrender their share of profit in favour of one or more partners of the firm.

$$Sacrificing\ Ratio = Old\ Ratio - New\ Ratio$$

Gaining Ratio:- It is the ratio in which one or more partners get the shares from the other partners due to change in profit sharing ratio.

$$Gaining\ Raio = New\ Raio - Old\ Raio$$

Que. **Raman and Gautam are partners in a firm sharing profits in the ratio of 2:1. It was decided by them to share future profits equally w.e.f. 1st April, 2019. Calculate Sacrificing and Gaining Ratio.**



Solution:-

$$New\ Ratio = 1:1$$

$$Old\ Ratio = 2:1$$

$$Sacrificing\ Ratio = Old\ Share - New\ Share$$

$$Raman = \frac{2}{3} - \frac{1}{2} = \frac{4-3}{6} = \frac{1}{6}\ (Sacrify)$$

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

Que. George, Meera and Rahul are partners in a firm sharing profits in the ratio of 5:3:2. It was decided by them to share future profits 2:2:1 w.e.f. 1st April, 2020. Calculate Sacrificing and Gaining Ratio.

Solution:-

$$\text{Old } Ratio = 5:3:2$$

$$\text{New } Ratio = 2:2:1$$

$$Sacrificing\ Ratio = Old\ Share - New\ Share$$

$$George = \frac{5}{10} - \frac{2}{5} = \frac{5-4}{10} = \frac{1}{10}\ (Sacrify)$$

$$Meera = \frac{3}{10} - \frac{2}{5} = \frac{3-4}{10} = -\frac{1}{10} = \frac{1}{10}(Gain)$$

$$Rahul = \frac{2}{10} - \frac{1}{5} = \frac{2-2}{10} = \frac{0}{10} = 0$$

A, B and C are partners sharing profits in the ratio of 3:3:2. Calculate new profit sharing ratio, sacrificing ratio and gaining ratio in each of the following cases:-

1. **If C acquires $\frac{1}{4}$ *share* from A and B equally.**
2. **If C acquires $\frac{1}{4}$ share from A.**
3. **If C acquires $\frac{1}{16}$ *from A and* $\frac{1}{32}$ from B**
4. **If A, B and C share the future profits and losses in 1:1:1**

Solution:-

Accounting Treatment of Goodwill

According to AS-26, 'Intangible Assets' goodwill should be recorded in the books only when consideration of money or money's worth has been paid for it. Thus in case of change in profit sharing ratio, admission of a partner or retirement/death of a partner goodwill will not be shown in the books of account because no money or money's worth is paid for it. It should be adjusted through partner's capital accounts. And, if goodwill is raised, it should be written off immediately.

$$Increase\ in\ share\ of\ one\ partner$$

$$-(means)\ purchase/acquire\ of\ share\ of\ profit\ from\ others$$

$$Decrease\ in\ share\ of\ one\ partner$$

$$-(means)\ Sale\ of\ share\ of\ profit\ to\ others$$

In this gaining partner compensate the sacrificing partner

This amount of compensation is paid in the form of Goodwill

For this capital accounts of partner's should be adjusted

$$Gaining\ Partner\ will\ pay$$

$$-\ Capital/Current\ \ A/c\ \ of\ Gaining\ Partner\ will\ be\ Debited$$

$$Sacrificing\ Partner\ will\ receive$$

$$-\ Capital/Current\ \ A/c\ \ of\ Sacrificing\ Partner\ will\ be\ Credited$$

When there is a change in Profit Sharing Ratio, entry passed to adjust goodwill is:

(A) When goodwill is adjusted through Partners' Capital A/c

Gaining Partners' Capital/Current A/c Dr.

To Sacrificing Partners' Capital/Current A/c

(For adjustment entry made for goodwill on change in profit sharing ratio)

A and B are partners sharing profits in the ratio of 3:2. They have agreed to change in profit sharing ratio equally w.e.f. 1st April, 2019. Goodwill of the firm was valued at Rs.30,000. Pass necessary journal entry for the adjustment of goodwill.

Solution:-

$$Old\ Ratio = 3:2$$
$$New\ Ratio = 1:1$$
$$Sacrificing\ Ratio = Old\ Ratio - New\ Ratio$$
$$A = \frac{3}{5} - \frac{1}{2} = \frac{6-5}{10} = \frac{1}{10}\ (Sacrify)$$
$$B = \frac{2}{5} - \frac{1}{2} = \frac{4-5}{10} = \frac{1}{10}\ (Gain)$$

Amount of Goodwill paid by B = $30,000 \times \frac{1}{10} = Rs.3,000$

Journal entry:-

B's Capital A/c	**Dr.**	**3,000**	
To A's Capital A/c			**3,000**

(For goodwill adjusted on change of profit sharing ratio)

(B) When Goodwill Account is opened:-

Goodwill A/c Dr.

To Partner's Capital/Current A/c

(For goodwill raised and credited to Partners' Capital/Current A/c in old profit sharing ratio)

Partners' Capital/Current A/c Dr.

To Goodwill A/c

(For goodwill written off by debiting the Partners' Capital/Current A/c in new profit sharing ratio)

A and B are partners sharing profits in the ratio of 3:2. They have agreed to change in profit sharing ratio equally w.e.f. 1st April, 2019. Goodwill of the firm was valued at Rs.30,000. Pass necessary journal entry for the goodwill when goodwill account is raised.

Solution:-

Journal entry:-

Goodwill A/c	Dr.	30,000	
To A's Capital A/c			18,000
To B's Capital A/c			12,000

(For goodwill A/c raised on change of profit sharing ratio)

A's Capital A/c	Dr.	15,000	
B's Capital A/c	Dr.	15,000	
To Goodwill A/c			30,000

(For goodwill is written off in new profit sharing ratio)

Accounting Treatment of Existing Goodwill

Goodwill appearing in the books of accounts means, the goodwill is given in Balance Sheet on Assets side. And, it also means, it is purchased goodwill.

For this, the goodwill appearing in the books or existing goodwill is written off because fresh goodwill valuation is made and it includes goodwill appearing in the books of accounts. If existing goodwill is not written off, it will lead to accounting of goodwill twice up to the extent of existing goodwill.

P, Q and R are partners sharing profits in the ratio of 5:3:2. They have agreed to change in profit sharing ratio equally w.e.f. 1st April, 2020. Goodwill of the firm was valued at Rs.90,000. Pass necessary journal entry when goodwill appears in the books at Rs.60,000.

Solution:-

Journal Entries:-

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
	P's Capital A/c Dr. Q's Capital A/c Dr. R's Capital A/c Dr. To Goodwill A/c (For goodwill written off)		30,000 18,000 12,000	 60,000
	Q's Capital A/c Dr. R's Capital A/c Dr. To P's Capital A/c (For adjustment of goodwill is made)		3,000 12,000	 15,000

When existing goodwill retained

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
	Q's Capital A/c Dr. $(30000 \times \frac{1}{30})$ R's Capital A/c Dr. $(30000 \times \frac{4}{30})$ To P's Capital A/c $(30000 \times \frac{5}{30})$ (For adjustment of goodwill is made)		1,000 4,000	 5,000

Working Note:-

$$\boldsymbol{Old\ Ratio = 5:3:2}$$

$$\boldsymbol{New\ Ratio = 1:1:1}$$

$$\boldsymbol{Sacrificing\ Ratio = Old\ share - New\ share}$$

$$\boldsymbol{P = \frac{5}{10} - \frac{1}{3} = \frac{15-10}{30} = \frac{5}{30}\ (Sacrify)}$$

$$\boldsymbol{Q = \frac{3}{10} - \frac{1}{3} = \frac{9-10}{30} = \frac{1}{30}\ (gain)}$$

$$\boldsymbol{R = \frac{2}{10} - \frac{1}{3} = \frac{6-10}{30} = \frac{4}{30}\ (gain)}$$

Accounting Treatment of Reserves and Accumulated Profits or Losses

If at the time of change in profit sharing ratio, reserves and accumulated profits or losses are given in the books of the firm, they will be transferred to the partners' capital or current account in their old profit sharing ratio.

Journal Entries:-

1. For transfer of Reserve and Accumulated Profits:-

Reserve A/c Dr.

Profit and Loss A/c (Cr. Balance) Dr.

Workmen Compensation Reserve A/c Dr.

Investment Fluctuation Reserve A/c Dr.

To All Partners' Capital/Current A/c

2. For transfer of Accumulated losses:-

All Partner's Capital A/c Dr

To Profit and Loss A/c (Dr. Balance)

To Deferred Revenue Expenditure A/c

Workmen Compensation Reserve

This is a reserve set aside out of firm's profits to meet possible liability to pay compensation to employees, if it arises. The claim may or may not arise.

(B) When Goodwill Account is opened:-

Goodwill A/c Dr.

To Partner's Capital/Current A/c

(For goodwill raised and credited to Partners' Capital/Current A/c in old profit sharing ratio)

Partners' Capital/Current A/c Dr.

To Goodwill A/c

(For goodwill written off by debiting the Partners' Capital/Current A/c in new profit sharing ratio)

A and B are partners sharing profits in the ratio of 3:2. They have agreed to change in profit sharing ratio equally w.e.f. 1st April, 2019. Goodwill of the firm was valued at Rs.30,000. Pass necessary journal entry for the goodwill when goodwill account is raised.

Solution:-

Journal entry:-

Goodwill A/c Dr.		30,000	
To A's Capital A/c			18,000
To B's Capital A/c			12,000

(For goodwill A/c raised on change of profit sharing ratio)

A's Capital A/c	Dr.	15,000	
B's Capital A/c	Dr.	15,000	
To Goodwill A/c			30,000

(For goodwill is written off in new profit sharing ratio)

Accounting Treatment of Existing Goodwill

Goodwill appearing in the books of accounts means, the goodwill is given in Balance Sheet on Assets side. And, it also means, it is purchased goodwill.

For this, the goodwill appearing in the books or existing goodwill is written off because fresh goodwill valuation is made and it includes goodwill appearing in the books of accounts. If existing goodwill is not written off, it will lead to accounting of goodwill twice up to the extent of existing goodwill.

P, Q and R are partners sharing profits in the ratio of 5:3:2. They have agreed to change in profit sharing ratio equally w.e.f. 1st April, 2020. Goodwill of the firm was valued at Rs.90,000. Pass necessary journal entry when goodwill appears in the books at Rs.60,000.

Solution:-

Journal Entries:-

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
	P's Capital A/c Dr. Q's Capital A/c Dr. R's Capital A/c Dr. To Goodwill A/c (For goodwill written off)		30,000 18,000 12,000	 60,000
	Q's Capital A/c Dr. R's Capital A/c Dr. To P's Capital A/c (For adjustment of goodwill is made)		3,000 12,000	 15,000

When existing goodwill retained

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
	Q's Capital A/c Dr. $(30000 \times \frac{1}{30})$ R's Capital A/c Dr. $(30000 \times \frac{4}{30})$ To P's Capital A/c $(30000 \times \frac{5}{30})$ (For adjustment of goodwill is made)		1,000 4,000	5,000

Working Note:-

$$\boldsymbol{Old\ Ratio = 5:3:2}$$

$$\boldsymbol{New\ Ratio = 1:1:1}$$

$$\boldsymbol{Sacrificing\ Ratio = Old\ share - New\ share}$$

$$\boldsymbol{P = \frac{5}{10} - \frac{1}{3} = \frac{15-10}{30} = \frac{5}{30}\ (Sacrify)}$$

$$\boldsymbol{Q = \frac{3}{10} - \frac{1}{3} = \frac{9-10}{30} = \frac{1}{30}\ (gain)}$$

$$\boldsymbol{R = \frac{2}{10} - \frac{1}{3} = \frac{6-10}{30} = \frac{4}{30}\ (gain)}$$

Revaluation of Assets and Reassessment of Liabilities

Assets are revalued and liabilities are reassessed at the time of change in profit sharing ratio to calculate gain or loss on revaluation of assets and reassessment of liabilities.

If there is increase in the value of asset and decrease in the amount of liability then there is a gain.

If there is decrease in the value of asset and increase in the amount of liability then there is a loss.

The gain or loss should be share by the partners in their old profit sharing ratio.

The partner may decide:-

(i) Record revised (changed) values of assets and liabilities in books of accounts of the firm.

(ii) Not to record the revised (changed) values of assets and liabilities in the books of accounts of the firm.

When revised (changed) values of assets and liabilities are to be recorded

Revaluation of assets and reassessment of liabilities are recorded in an account called Revaluation Account or Profit and Loss Adjustment Account. Increase in the value of assets and decrease in the amount of liabilities are credited and decrease in the value of assets and increase in the amount of liabilities are debited in this account.

Journal Entries

1.	For increase in the value of Assets	Assets A/c Dr. To Revaluation A/c (For assets increased)
2.	For decrease in the value of Assets	Revaluation A/c Dr. To Assets A/c (For assets decreased)
3.	For increase in the amount of liability	Revaluation A/c Dr. To Liability A/c (For liability increased)
4.	For decrease in the amount of liability	Liability A/c Dr. To Revaluation A/c (For liability decreased)
5.	For recording an unrecorded asset	Assets A/c Dr. To Revaluation A/c (For unrecorded assets recorded)
6.	For recording an unrecorded liability	Revaluation A/c Dr. To Liability A/c (For unrecorded liability recorded)

For transfer of Balance in Revaluation Account

(a) If credit side of Revaluation Account is more than debit side

Revaluation A/c Dr.

To Partners' Capital A/c

(For profit on revaluation transferred to partners' capital account in their old ratio)

(b) If debit side of Revaluation Account is more than credit side

Partners' Capital A/c Dr.

To Revaluation A/c

(For loss on revaluation transferred to partners' capital account in their old ratio)

Format of Revaluation Account

Particualrs	Rs.	Particulars	Rs.
To Assets (decrease in assets)	------	By Assets (increase in assets)	------
To Liability (increase in liability)	------	By Liability (decrease in liability)	------
To Unrecorded Liability	------	By Unrecorded Assets	-------
To Profit (transfer to partners' Capital/Current A/c)	------	By Loss (transferred to partners' Capital/current A/c)	-------
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For transfer of Balance in Revaluation Account

(a) If credit side of Revaluation Account is more than debit side

Revaluation A/c Dr.

To Partners' Capital A/c

(For profit on revaluation transferred to partners' capital account in their old ratio)

(b) If debit side of Revaluation Account is more than credit side

Partners' Capital A/c Dr.

To Revaluation A/c

(For loss on revaluation transferred to partners' capital account in their old ratio)

Format of Revaluation Account

Particualrs	Rs.	Particulars	Rs.
To Assets (decrease in assets)	------	By Assets (increase in assets)	------
To Liability (increase in liability)	------	By Liability (decrease in liability)	------
To Unrecorded Liability	------	By Unrecorded Assets	-------
To Profit (transfer to partners' Capital/Current A/c)	------	By Loss (transferred to partners' Capital/current A/c)	-------
	------- ======		------- ======

Raman, Rahul and Ramesh are partners sharing profits in the ratio of 5:3:2. Their Balance Sheet as at 31st March, 2019 was as follows:

Liabilities		Rs.	Assets		Rs.
Creditors		1,60,000	Bank Balance		1,25,000
Salaries Payable		30,000	Bills Receivable		10,000
Reserves		80,000	Stock		2,00,000
Profit and Loss A/c		30,000	Sundry Debtors	1,00,000	
Capitals:-			Less: Provision	10,000	90,000
Raman	3,00,000		Furniture		50,000
Rahul	1,80,000		Computers		3,00,000
Ramesh	1,20,000	6,00,000	Air Conditioners		1,00,000
			Goodwill		25,000
		9,00,000			9,00,000

Profit sharing ratio among the partners was agreed to be 2:2:1 w.e.f. 1st April, 2019. They agreed to the following:-

(i) Stock to be increased to Rs.2,20,000 and Furniture to be reduced by 20% and Computers to be reduced to Rs.2,70,000.

(ii) Provision for Doubtful Debts to be reduced by Rs.2,000.

(iii) Goodwill of the firm is valued at Rs.1,00,000.

Prepare Revaluation A/c, Partner’s Capital A/c and revised Balance Sheet of the reconstituted firm.

Revaluation A/c

Particulars	Rs.	Particulars	Rs.
To Furniture	10,000	By Stock	20,000
To Computers	30,000	By Provision for D/D	2,000
		By Loss transferred to partners' capitals:-	
		Raman 9,000	
		Rahul 5,400	
		Ramesh 3,600	18,000
	40,000		40,000

Capital A/c

Particulars	Raman	Rahul	Ramesh	Particulars	Raman	Rahul	Ramesh
To Revaluation	9,000	5,400	3,600	By Balance b/d	3,00,000	1,80,000	1,20,000
To Goodwill	12,500	7,500	5,000	By Reserves	40,000	24,000	16,000
To Raman's Cap.		10,000		By P & L A/c	15,000	9,000	6,000
To Balance c/d	3,43,500	1,90,100	1,33,400	By Rahul's Cap.	10,000		
	3,65,000	2,13,000	1,42,000		3,65,000	2,13,000	1,42,000

Balance Sheet
As at 31st March, 2019

Liabilities		Rs.	Assets		Rs.
Creditors		1,60,000	Bank Balance		1,25,000
Salaries Payable		30,000	Bills Receivable		10,000
Capitals:-			Stock		2,20,000
Raman	3,43,500		Sundry Debtors	1,00,000	
Rahul	1,90,100		Less: Provision	8,000	92,000
Ramesh	1,33,400	6,67,000	Furniture		40,000
			Computers		2,70,000
			Air Conditioners		1,00,000
		8,57,000			8,57,000

$$Old\ Ratio = 5:3:2 \qquad New\ Ratio = 2:2:1$$

$$Sacrificing\ Ratio = Old\ share - New\ share$$

$$Raman = \frac{5}{10} - \frac{2}{5} = \frac{5-4}{10} = \frac{1}{10}\ (Sacrify)$$

$$Rahul = \frac{3}{10} - \frac{2}{5} = \frac{3-4}{10} = \frac{1}{10}\ (Gain)$$

$$Ramesh = \frac{2}{10} - \frac{1}{5} = \frac{2-2}{10} = \frac{0}{10}$$

$$Rahul\ will\ pay\ 1{,}00{,}000 \times \frac{1}{10} = \text{Rs.}\,10{,}000\ to\ Raman$$