Class-12 Accountancy
Chapter 3 – Reconstitution of Partnership Firm

Introduction

A partnership is formed by an agreement. Partnership is the result of an agreement and any change in the agreement or relations of the partners will result in the reconstitution of the partnership firm. it means new agreement takes place. Now this new agreement defines the relationship of the partners. In simple words, partnership is an agreement among the partners for sharing the profits of the firm carried on by all partners or any of them acting for all. Any change in the relations of partners will result in the reconstitution of the partnership firm. Existing agreement comes to an end and a new agreement takes place. Whenever there is change in agreement, the business will continue but the relationship among the partners changes. The firm is therefore, said to be reconstituted when :

i) Change in profit sharing ratio
ii) Admission of a new partner
iii) Retirement of a partner
iv) Death of a partner
v) Amalgamation of two partnership firms

Change in the Profit Sharing Ratio of Existing Partners

When there is change in the ratio of existing partners without admission of new partner or without retiring any partner (or Death of a Partner) , it leads to reconstitution of the firm. This change is mostly made when there is change in the capitals of the partners. As a result of this change in profit sharing ratio, one or more partners may get extra share of profits. A partner who is gaining on account of such change should compensate the partner who is losing on account of such change.

Example: A , B and C are partners in a firm sharing profits in the ratio of 4 : 3 : 2. Their capitals on 1st April 2004 were Rs.4,00,000 ; Rs.3,00,000 and Rs.2,00,000. With effect from 1st April 2004 they decided to share the profits equally. This change in profit sharing ratio will result into the reconstitution of the firm.

Admission of a new partner : A new partner can be admitted into the partnership business only with the consent of all the partners. Mostly new partner is admitted into the partnership business when additional capital is required or to strengthen the managerial capacity of the firm.

Example : A and B are partners sharing profits in the ratio of 2 : 1. They decided to admit C into the partnership firm for $1/4^{th}$ share in the profits of the firm. In such a case the new agreement is formed and the firm is reconstituted.

Retirement of a partner : A partner may retire with the consent of all partners or with an express agreement or by giving notice (if partnership at will) .

Example : A, B and C are partners in a firm sharing profits in the ratio of 3 : 2 : 1. C retire from the business. This. retirement will result into the reconstitution or the firm is reconstituted.

Death of a Partner : When a partner dies, partnership will come to an end immediately . all dues of deceased partner are settled to the legal heir or executor of the deceased partner. **Example :** A, B and C are partners in a firm sharing profits in the ratio 4 : 3 : 2. B dies on March 31, 2009. A and C decide to continue the business by sharing future profits equally. In such a case, the business will continue by the A and C sharing future profits equally, it results in the reconstitution of the firm.

Amalgamation of two partnership firms : Raja and Yogesh are partners in a firm sharing profits in the ratio of 2 : 1. They found that they are unable to meet the competition in the market and unable to meet the cost of the business. They decided to amalgamate the firm with the firm of King and Singh who are sharing profits equally. It was decided that the new profit sharing ratio will be 4 : 3 :2 : 1. In such a case, two firms have amalgamated into one which amounts to reconstitution of the firm of Raja and Yogesh on the one hand and the firm of King and Singh on the other hand to form a new reconstituted firm.

Calculation of Sacrificing Ratio and Gaining Ratio

Meaning of Sacrificing Ratio : Ratio in which partners sacrifice their share of profit in favour of a new partner or incoming partner is called sacrificing ratio. It is the difference of old share and new share of the partners.

Formula = Sacrificing Ratio = Old Ratio - New Ratio

Meaning of Gain Ratio : Share of Retiring partner is acquired by the Remaining partners , Ratio in which they acquire the Retiring partners share is known as Gaining Ratio. In simple words, after the retirement of a partner , his share is distributed by the Remaining partners, ratio in which they distribute the share of Retiring partner, is called Gaining ratio.

Formula : Gaining Ratio = New Ratio - Old Ratio

Treatment of Goodwill

When al the partners of a firm agree to change their profit sharing ratio, the ratio may be changed. In this case one profit is purchasing a share of partner from another one. In other words, share of one partner may increase and share of another partner may decrease. Goodwill is also adjusted at the time of change in profit sharing ratio of the partners.

Accounting treatment of goodwil:
In case of change in profit sharing ratio, the gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill.

Gainer Partner Dr.
To Sacrificing Partner

Treatment of Reserve and Accumulated profits

At the time of change in existing ratio, A firm may have Reserves and accumulated profits or losses. All free Reserves and profits given in the liabilities side should be credited to partners capital accounts (when capitals fluctuationg) or Current Accounts (if capitals are fixed) and all fictitious Assets/Accumulated losses should be debited to the partners capital account or current Account (if capitals are fixed). A new partner is not entitled to any share in such accumulated balances of the firm while transferring these reserves and profits/ losses to the partners capital accounts, student must remember that these Reserves and profits/losses are only for old partners and should be transferred to them only, in old ratio. Following journal entries are recorded in the books of accounts:

Journal entries

Date	Particulars	L.F	Debit	Credit
	General Reserve Dr. **Profit and Loss Dr.** **Workmen's Compensation Reserve Dr.** **To Old Partners Capital A/c's** **(Being Reserves and Accumulated profits credited to old partners in their old Ratio)** **Old Partner's Capital A/c's Dr.** **To Preliminary Expense** **To Advertisement Suspense** **To Profit and Loss A/c** **To Goodwill** **(Being Accumulated losses and fictitious assets debited to old partners in their old ratio)**			

Note : <u>Do not distribute</u>
1) E.P.F or employee provident fund
2) Taxation reserve
3) Machinery replacement fund

Revaluation of Assets and Re-assessment of liabilities

When it is decided by the partners to make change in existing ratio, a separate account is opened, which is known as Profit and Loss Adjustment Account or Revaluation Account to make the revaluation of assets and reassessment of liabilities.

Following journal entries are recorded on Revaluation of assets and Re-assessment of liabilities.

1. **For increase in the value of Assets :**

   Asset A/c Dr.
   To Revaluation A/c

2. **For Decrease in the value of Asset :**
   Revaluation A/c Dr.
   To Asset A/c

3. **For increase in the value of liabilities :**
   Revaluation A/c Dr.
   To Liability A/c

4. **For Decrease in the value of liabilities :**
   Liability A/c Dr.
   To Revaluation A/c

5. **When unrecorded assets are recorded :**
   Asset A/c Dr.
   To Revaluation A/c

6. **When unrecorded liabilities are recorded :**
   Revaluation A/c Dr.
   Liability A/c

7. **When profit on revaluation transferred to old partners :**
   Revaluation A/c Dr.
   To Old partners Capital A/c's

8. **When loss on revaluation transferred to old partners :**
   Old partner's Capital A/c's
   To Revaluation A/c

Proforma of Revaluation Account:

Particulars	Amount	Particulars	Amount
To Decrease in value of Asset **To Increase in value of liabilities** **To unrecorded liabilities** **To profit on revaluation transferred to old partners in old ratio.**	**xxxx** **xxxx** **xxxx** **xxxx**	**By Increase in value of asset** **By decrease in value of liabilities** **By unrecorded Assets** **By Loss on revaluation transferred to old partners in old ratio.**	**xxxx** **xxxx** **xxxx** **xxxx**
	xxxx		**xxxx**

Preparation of Balance Sheet

in the case of change in existing ratio, students must make all the necessary adjustments first and than prepare the necessary accounts which are affected by the change in ratio, after this they should prepare New Balance sheet of the firm after reconstitution.