Chapter 3 Part–A

Reconstitution of a Partnership Firm – Admission of a Partner

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Reconstitution of Partnership

Meaning of Reconstruction

Any change in agreement of partnership or profit sharing ratio is called reconstitution of partnership firm. In following circumstances a partnership firm may be reconstituted:

1. Change in Profit Sharing Ratio

2. Admission of a partner

3. Retirement/Death of a partner.

CHANCE IN PROFIT SHARING RATIO AMONG THE EXISTING PARTNERS

Meaning : A Change in profit sharing ratio means one or more partners acquires interest form another partner or partners. Here it share of profit of one or more partners increases then share of one or more partner decreases to same extent.

When all the partners of a firm agree to change their profit sharing ratio. the ratio may be changed

New profit sharing ratio : The ratio in which the partners are to share the profits in future on reconstitution is known as New profit sharing ratio.

Gaining Ratio : It is the ratio in which the profit sharing ratio of gaining partners increases. It is calculated by taking difference between New profit sharing ratio and old profit sharing ratio.

Sacrificing Ratio : It is the ratio in which the profit sharing ratio of sacrificing partners decreases. It is calculated by taking difference between old profit sharing ratio and new profit sharing ratio.

Note : If <u>old ratio-new ratio</u> is positive it means sacrifice and if it is negative it means gain.

Accounting Treatment of Goodwill

In case of change in profit sharing ratio, the gaining partner must components the sacrificing partner by paying the proportionate amount of goodwill.

Note :

(i) Increase in the value of an Asset and decrease in the value of a liability result in profit.

Assets A/cDr.

To Revaluation

(ii) Decrease in the value of any asset and increase in the value of a liability gives loss.

Revaluation A/cDr.

To Assets A/c

(iii) For increase in the value of liabilities.

Revaluation A/cDr.

To Liabilities A/c

(Increase in value of Liability)

(iv) For decrease in the value of Liabilities

Liabilities A/cDr.

To Revaluation A/c

(Decrease in the value of Liabilities)

(v) When Revaluation account shows profit

Revaluation A/cDr.

To Partner's Capital A/c

(Profit credited to Partner's Capital A/c in old ratio)

(vi) In case of Revaluation Loss

Partner’s Capital A/c’sDr.

To Revaluation A/c

(Loss debited to Partner’s Capital A/cs in old ratio)

SPECCIMEN/PROFORMA OF REVALUATION ACCOUNT

Revaluation Account

Particulars	(Rs.)	Particulars	(Rs.)
To Assets (individually) Decrease in value To Liabilities increase On revaluation To Unrecorded Liability To profits transferred to Partner’s capital A/c (in old ratio)		By Assets (individually) Increase in value of Asset By Liabilities (individually) Decrease on revaluation By Unrecorded asset By Loss transferred to partners Capital A/c (in old ratios)	

Admission of a Partner

Meaning

When a new partner is admitted in a running business due to the requirement of more capital or may be to take advantage of the experience and competence the newly admitted partner or any other reason, it is called admission of a part in partnership firm.

According to section 31(1) of Indian partnership Act, 1932, “A new partner be admitted only with the consent of all the existing partners”

At the time of admission of new partner, following adjustments are requires

1. Calculation of new profit sharing ratio and sacrificing ratio.
2. Accounting treatment of Goodwill.
3. Accounting treatment of accumulated profit, reserves and accumulated loss.
4. Accounting treatment of revaluation of assets and reassessment of liabilities.
5. Adjustment of capital in new profit sharing ratio.

1. Calculation of new profit sharing ratio
Following types of problems may arise for the calculation of new profit share ratio.
Case (i) When old ratio is given and share of new partner is given.

Note : Unless agreed otherwise, it is presumed that the new partner acquires his share in profits from the old partners in their old profit sharing ratio.

Alternative Method :
Old Ratio = A : B

1 : 2

Left the profit of the firm = 1
C’s share (New Partner) = 1/3

Remaining Profit = 1-1/3 = 2/3
Now this profit 2/3 will be divided between the old partners in their future profit sharing ratio (old ratio) i.c., 1:2

A's new Profit = 1/3 of 2/3 = $\frac{1}{3} \times \frac{2}{3}$ = 2/9
B's new Profit = 2/3 of 2/3 = $\frac{2}{3} \times \frac{2}{3}$ = 4/9
C's profit = 1/3 or $\frac{1}{3} \times \frac{3}{3}$ = 3/9
Hence the new ratio = 2:4:3
Note : In this case only New Partners share is given then Sacrificing ratio = Old Ratio = 1 : 2 there is not need to calculate it

Case (ii) When new partner acquires his/her share from old partners in agreed share.

2. Accounting Treatment of Goodwill

At the time of admission of a partner, treatment of Goodwill is necessary to compensate the old partners for their sacrifice. The incoming partner must compensate the existing partners because he is going to acquire the right to share future profits and his share is sacrificed by old partners. If goodwill (Premium) is paid to old partners privately or outside the business by the new partner then on entry is required in the books of the firm.

There may be different situations about the treatment of goodwill at the time of the admission of the new partner.

(i) Goodwill (premium) brought in by the new partner in cash and retained in the business

Note : Sacrificing = Old ratio – New ratio

A = 3/5 – 3/8 = $\frac{24-15}{40} = \frac{9}{40}$
B = 2/5 – 3/8 = $\frac{16-15}{40} = \frac{1}{40}$
This sacrificing ratio between A and B i.e., 9 : 1.

3. Accounting treatment of Accumulated Profits

Accumulated profits and reserves are distributed to partners in their old profit sharing ratio. If old partners are not interested to distribute, these accumulated profits are adjusted in the same manner as goodwill and the following adjusting entry will be passed.

New Partner's capital A/c Dr. (New share)
To old partner's capital A/c (Sacrificing ratio)

4. Accounting treatment for revaluation of assets and re-assessment of liabilities

The assets and liabilities are generally revalued at the time of admission of a new partner. Revaluation Account is prepared for this purpose in the same way was in case of change in profit sharing ratio. This account is debited with all losses and credited with all gains. Balance of Revaluation Account is transferred to old partner in their old ratio.

5. Adjustment of Capital in New Profit Sharing Ratio

Working Notes :

Gauri's share of goodwill = Rs. $45,000 \times \frac{1}{3} = Rs.15,000$

Total adjusted capital of old partner for 2/3 share = Rs. 1,42,433 + Rs. 91,217 = Rs. 2,33,650

Proportionate capital of Gauri 1/3 share = Rs. $2,33,650 \times \frac{3}{2} \times \frac{1}{3} = \frac{Rs.233650}{2}$ = Rs. 1,16,855

Bank A/c

Particulars	(Rs.)	Particulars	(Rs.)
To Gauri's Capital To Premium for goodwill	1,16,825 15,000	By balance c/d	1,31,825
	1,31,825		1,31,825