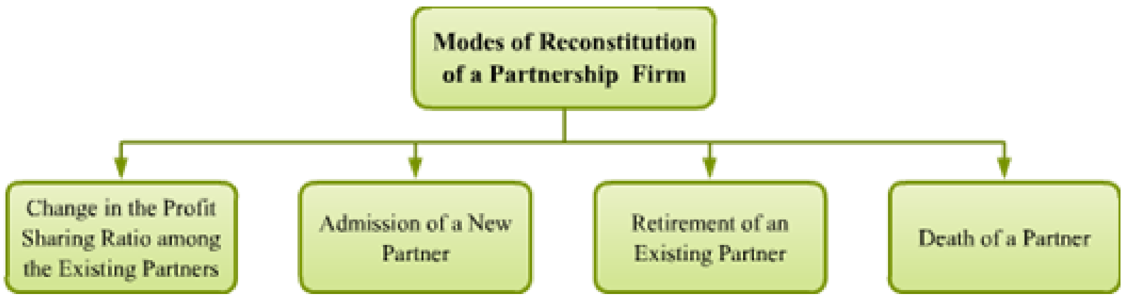
Reconstitution- Change in Existing Profit Sharing Ratio

❖ Reconstitution of a Partnership Firm

It implies change in the existing partnership deed or agreement among the partners in a partnership firm.

❖ Modes of Reconstitution of a Partnership Firm



❖ Meaning of Change in Profit Sharing Ratio among Existing Partners

It refers to the mutual agreement among the partners to change their existing relationship of sharing profits and losses in future.

❖ Adjustment at the time of Change in Profit Sharing Ratio

- Calculation of New Profit Sharing Ratio
- Adjustment of Goodwill
- Treatment of Reserves
- Adjustment of Accumulated Profits and Losses
- Revaluation of Assets and Reassessment of Liabilities

❖ New Profit Sharing Ratio

The ratio in which all the partners have agreed to share the future profits and losses is regarded as new profit sharing ratio.
Algebraically,
New Ratio = Old Ratio – Share Surrendered/+Share Acquired

❖ Cases for calculation of New Profit Sharing Ratio

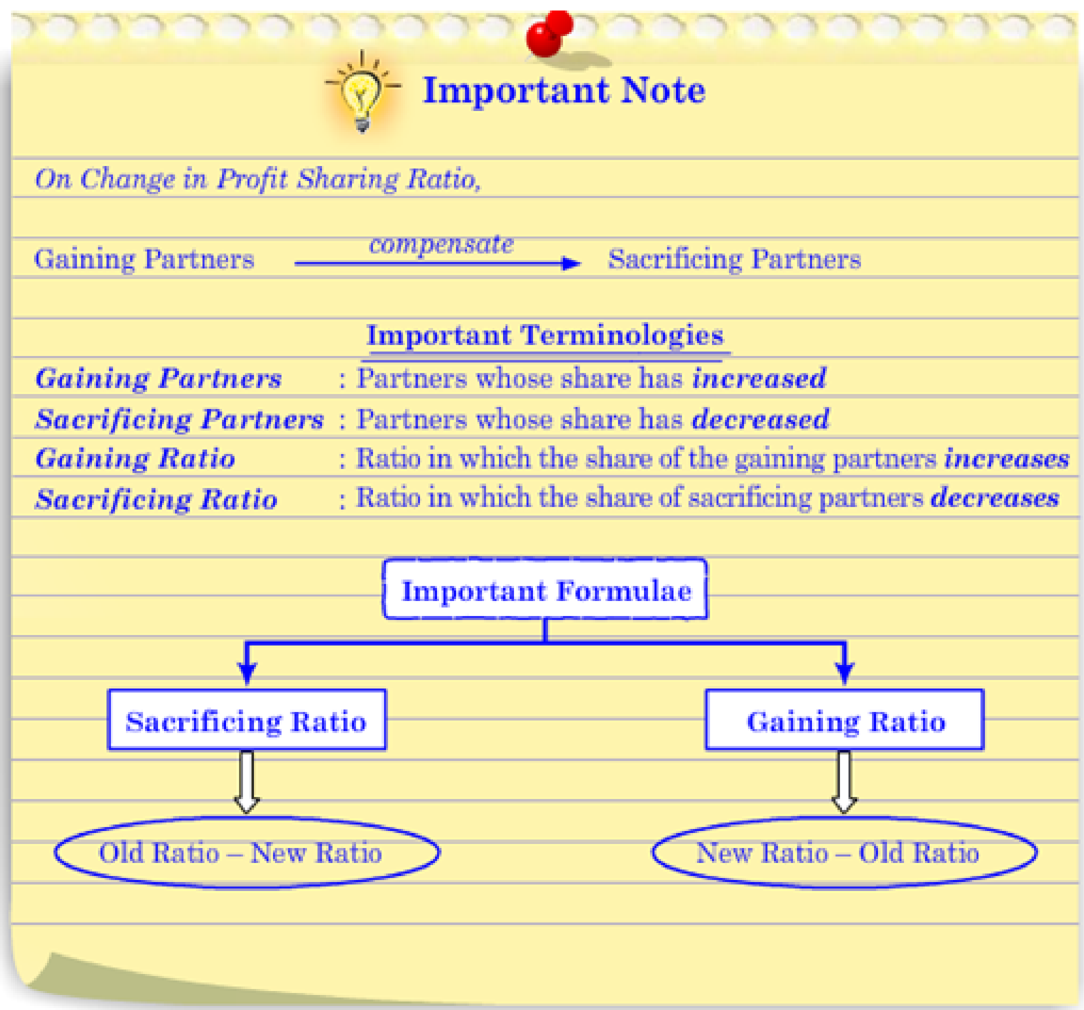
1. When only one partner surrenders his/her share in favour of another partner
2. When all the partners surrender their share in favour of another partner in an agreed ratio

❖ Sacrificing Ratio

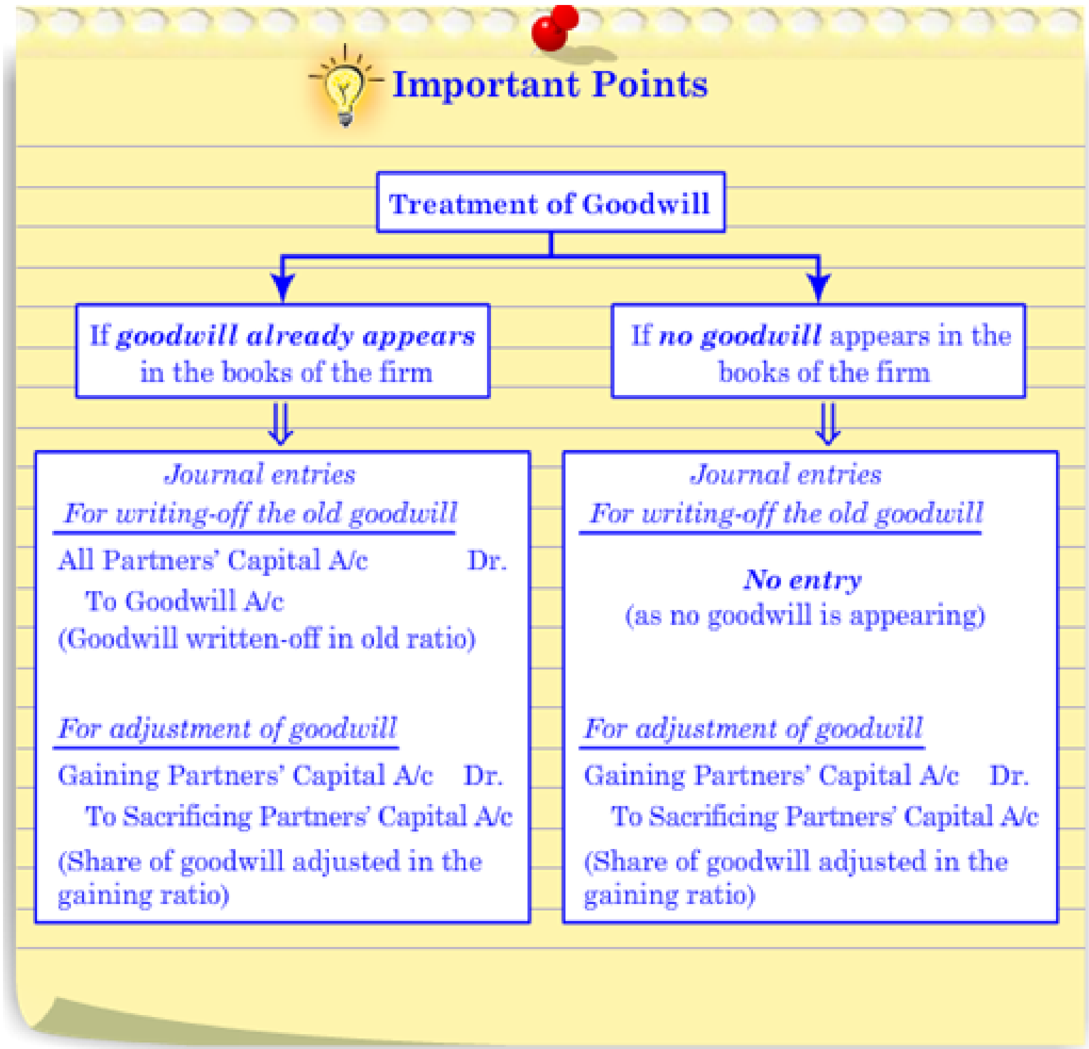
It refers to the ratio in which the partners surrender their share in favour of the other partner.
Algebraically,
Sacrificing Ratio = Old Ratio – New Ratio

❖ Gaining Ratio

It is defined as a difference between the new profit share and the old profit share of the partner.
Algebraically,
Gaining Ratio = New Ratio – Old Ratio



❖ Treatment of Goodwill



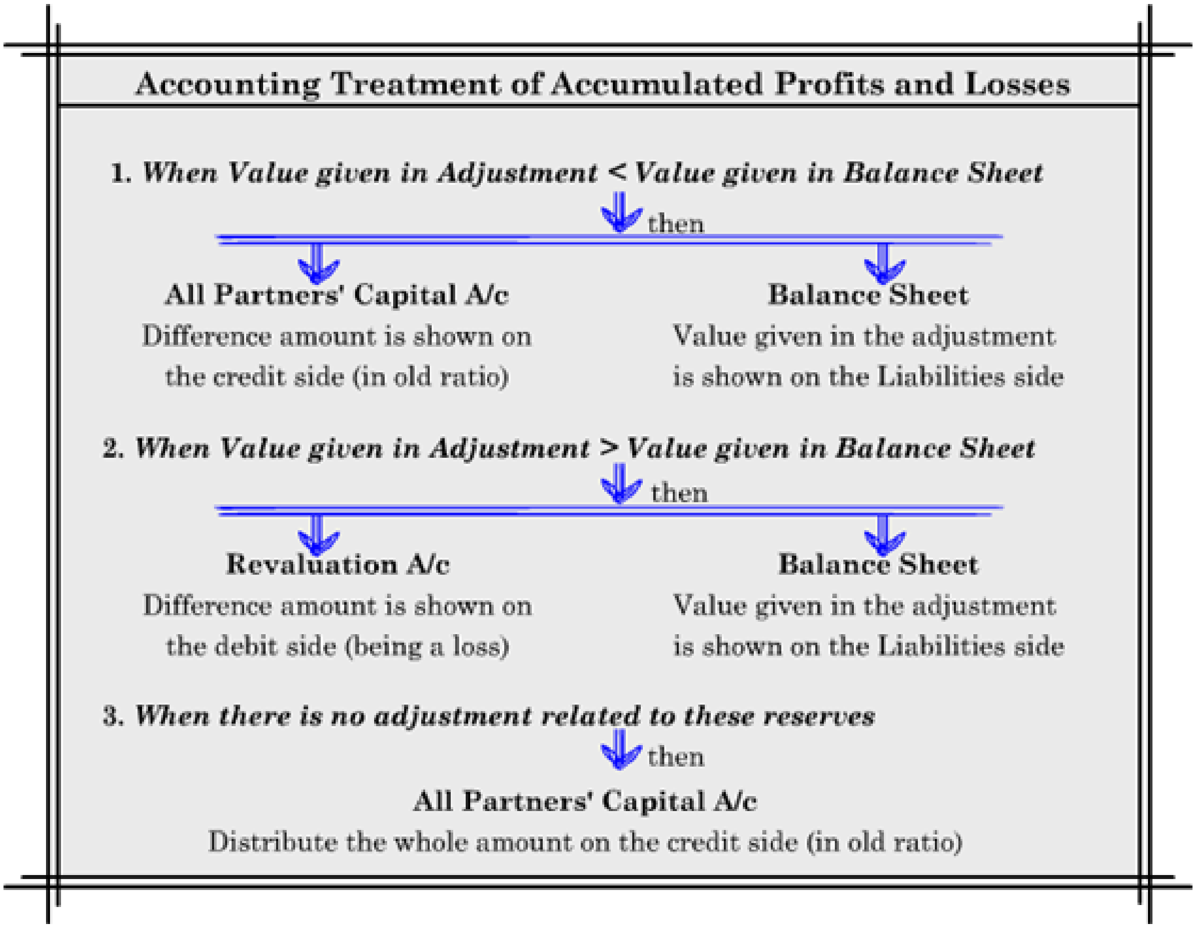
Note: *In case of fixed capital, goodwill is to be adjusted through Partners' Current Account.*

❖ Treatment of Reserves and Accumulated Profits and Losses

(i) *For Distribution of Accumulated Profits and Reserves*

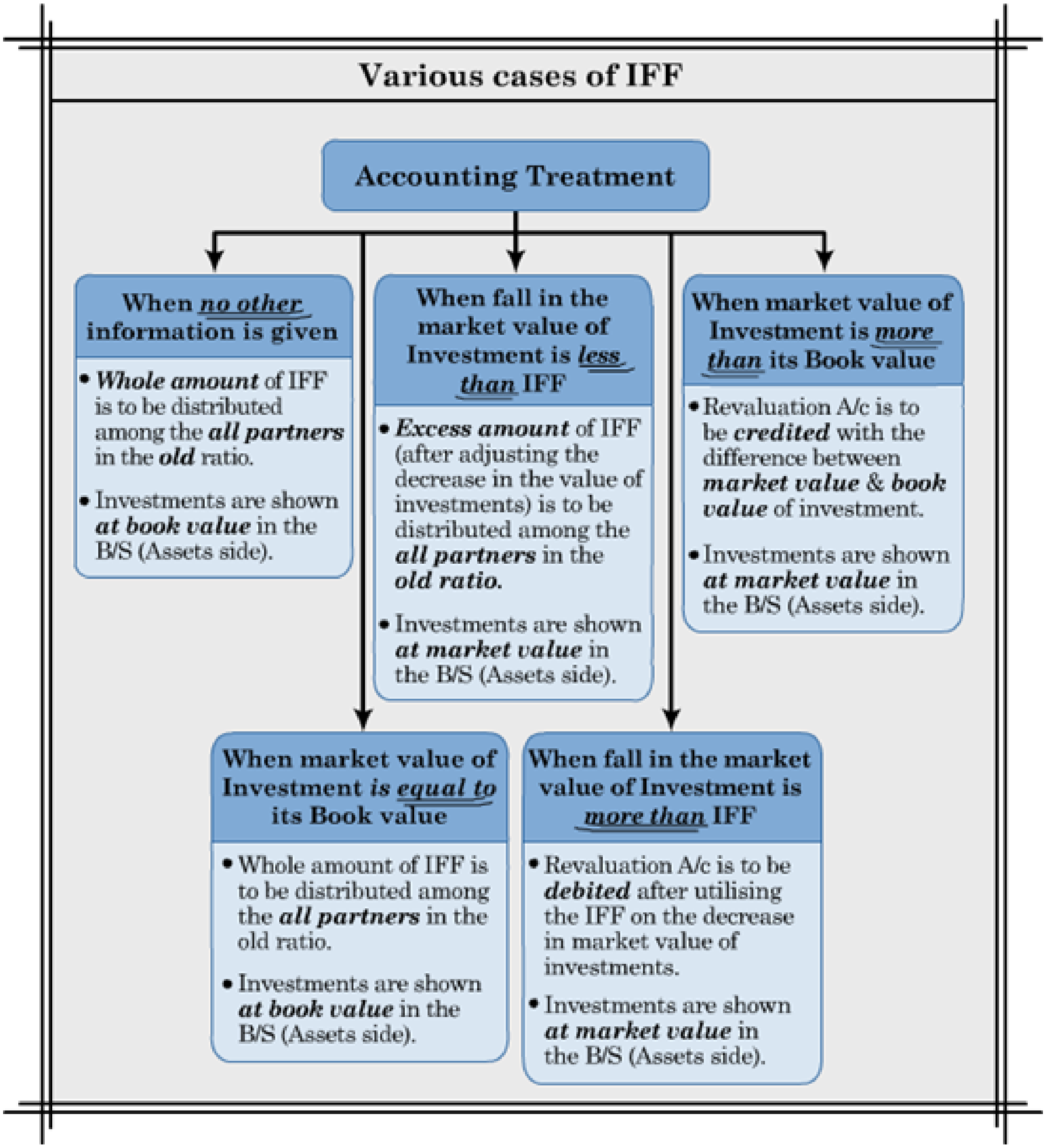
Profit & Loss A/c	Dr.	In Old Ratio
General Reserve A/c	Dr.	
Reserve Fund A/c	Dr.	
Workmen's Compensation Fund A/c* (*See Note*)	Dr.	With excess amount only
Contingency Reserve A/c* (*See Note*)	Dr.	
Investment Fluctuation Fund A/c* (*See Note*)	Dr.	
To All Partners' Capital A/c		
(Undistributed profits and reserves are distributed among old partners in their old profit sharing ratio)		

****Note***:



❖ **Treatment of Investment Fluctuation Fund**

Investment Fluctuation Fund- The losses that may arise on account of differences in the book value and the market value of investments, an investment fluctuation fund is created.
The treatment of IFF under various cases is diagrammatically presented below.



(ii) *For Distribution of Accumulated Losses*

All Partners' Capital A/c To Profit & Loss A/c (Debit balance) To Deferred Advertisement Expenses A/c (Undistributed losses are distributed among old partners in their old profit sharing ratio)	Dr.	} [In Old Ratio]

❖ **When Reserves are to be shown in the New Books**

Adjusting Journal Entry: When Reserves are to be shown in New Balance Sheet		
Gaining Partners' Capital A/c To Sacrificing Partners' Capital A/c (Adjustment is made through partners' capital accounts)	Dr.	*In Gaining or Sacrificing Ratio*

Note: *However, in case of fixed capital, adjustment is to be made through Partners' Current Account.*

Treatment of Reserves

When reserves are <u>not to be shown</u> in the Reconstituted Firm's Balance Sheet	When reserves are <u>to be shown</u> in the Reconstituted Firm's Balance Sheet
⇒ Distributed among ***all*** the partners in their ***old ratio***. ⇒ ***Not to be shown*** in the Reconstituted Firm's Balance Sheet.	⇒ ***Adjusting entry*** is to be passed through ***Partners' Capital A/c*** ⇒ ***Shown*** in the Reconstituted Firm's Balance Sheet.

The following is the list of items that should not be distributed among the old partners while distributing accumulated profits and reserves.

Important Point

DON'T ever distribute the following items among the old partners!!

1. Employees Provident Fund
2. Provision for Tax
3. Taxation Reserve
4. Joint Life Policy (JLP) Reserve
5. Depreciation Reserve (such as Machinery Replacement Reserve)

Note: *Do not distribute such items among the partners as these are shown on the 'Liabilities' side of the New Balance Sheet of the reconstituted firm.*

❖ **Revaluation Account**

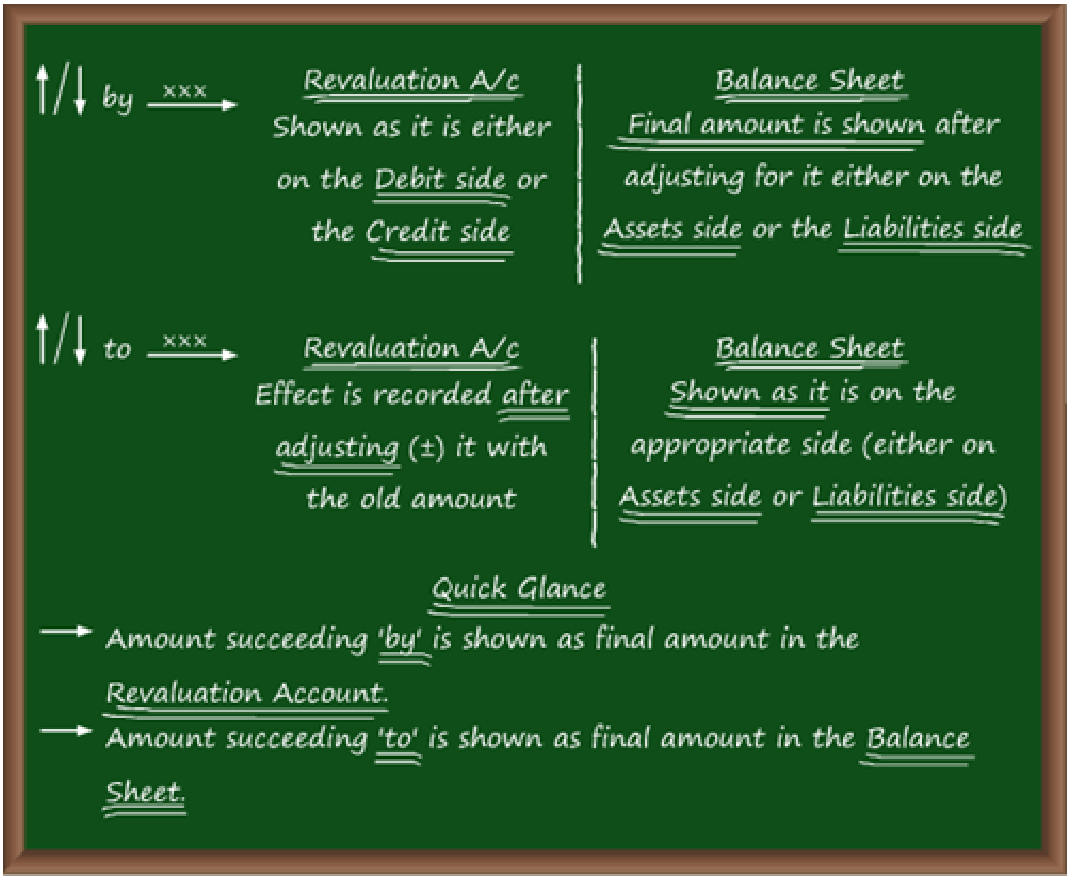
Revaluation A/c

Dr. **Cr.**

Particulars	**Amount (Rs)**	**Particulars**	**Amount (Rs)**
Decrease in Value of Assets	×××	Increase in Value of Assets	×××
Increase in Value of Liabilities	×××	Decrease in Value of Liabilities	×××
Unrecorded Liabilities	×××	Unrecorded Assets	×××
Outstanding Expenses (e.g. Salaries)	×××	Prepaid Expenses (Salaries in advance)	×××
Income received in advance	×××	Income Earned but not yet received	×××
Revaluation Profit* A's Capital A/c B's Capital A/c (Transferred to Credit side of Partners' Capital Account in Old Ratio)	×××	Revaluation Loss# A's Capital A/c B's Capital A/c (Transferred to Debit side of Partners' Capital Account in Old Ratio)	×××

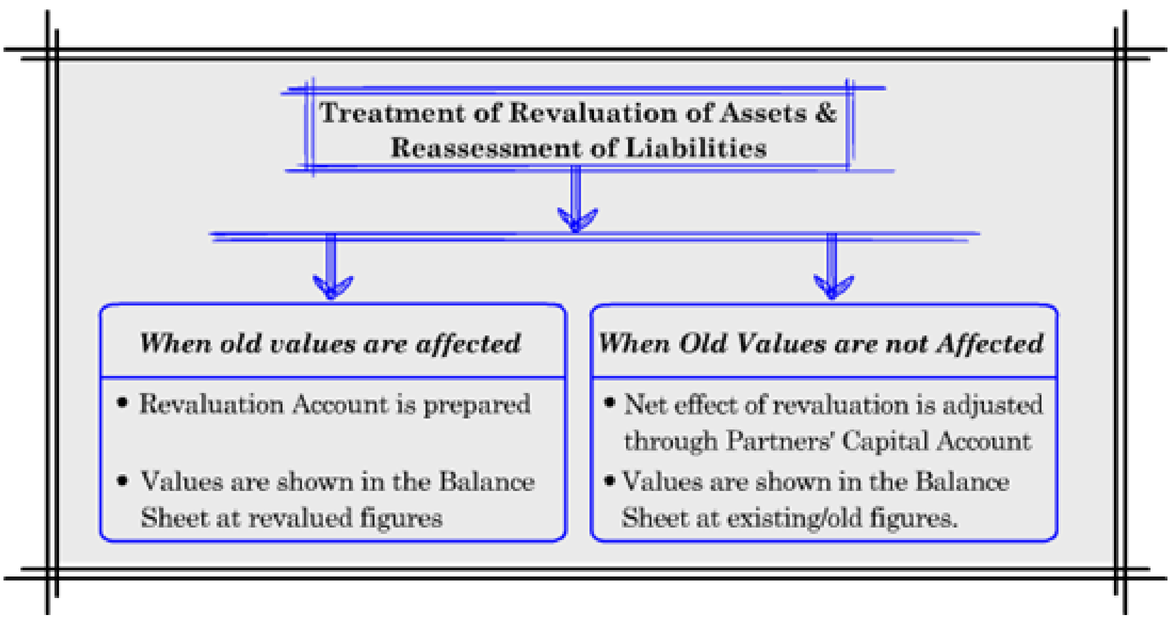
* If Credit Side > Debit Side
# If Credit side < Debit Side

Important Note: Adjustments related to 'To' and 'By' must be handled carefully. Let us have a look on the following diagram.



Important Note:

- Provision amount is calculated on the amount of debtors and not on the provision amount.
- If partners decided to show the assets and liabilities at unaltered figures, then the adjustment is to be made through Partners' Capital or Current Account.



❖ **Partners' Capital Account**

Partners' Capital Account

Dr. **Cr.**

Particulars	**A**	**B**	**C**	**Particulars**	**A**	**B**	**C**
Profit and Loss A/c (Debit Balance)	–	–	–	Balance b/d	–	–	–
Deferred Revenue Expenditure (Advertisement Expenditure)	–	–	–	General Reserve	–	–	–
Goodwill A/c ♣	–	–	–	Reserve Fund	–	–	–
Revaluation Loss	–	–	–	Profit and Loss (Credit Balance)	–	–	–
Assets (Taken over by Partners')	–	–	–	Liabilities (If taken over by Partners')	–	–	–
				Revaluation Profit	–	–	–
				Workmen's Compensation Fund*	–	–	–
				Investment Fluctuation Fund*	–	–	–
				Contingency Reserve*	–	–	–
Balance c/d (If Cr. Side > Dr. side)	–	–	–	Balance c/d (If Dr. side > Cr. Side)	–	–	–

Note:

* Workmen's Compensation Fund, Investment Fluctuation Fund and Contingency Reserve are transferred to the Partners' Capital A/c (credit side) only with the excess amount.

♣ This represents the amount of existing Goodwill that is already appearing on the Assets side of the Old Balance Sheet and written-off among all partners in their old profit sharing ratio.

❖ **Balance Sheet of the Reconstituted Firm**

Balance Sheet of a Reconstituted Firm

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Bank Overdraft		Cash in Hand	
Creditors		Cash at Bank	
General Reserve		Debtors	
Depreciation Reserve		*Less*: Provision for Doubtful Debts	
Contingency Reserve		Bills Receivable	
Workmen's Compensation Fund		Stock	
Investment Fluctuation Fund		Land and Building	
Machinery Replacement Reserve		Plant and Machinery	
		JLP	
Employees Provident Fund		Unrecorded Assets (if given in the adjustments)	
Provision for Tax			
JLP Reserve		Investments	
Bills Payable		Goodwill	
Unrecorded Liabilities (if given in the adjustments)		Patents	
		Capitals**:	
Capitals:		A:	
A:		B:	
B:		C:	
C:			
	*		○

Note:

✓ The equality of * and ○ ensures the arithmetic accuracy of the solution.

✓ ** If the closing balance of the Partners' Capital Account (i.e. Balance c/d) happens to appear on the credit side of the Partners' Capital Account, then it is shown on the Assets side of the New Balance Sheet.

✓ Workmen's Compensation Fund, Investment Fluctuation Fund and Contingency Reserve are shown in the New Balance Sheet at the value given in the adjustment.