Reconstitution of a Partnership

4 CHAPTER

Reconstitution of a partnership firm

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.

Model of reconstitution of a partnership firm

(a) Change in the profit sharing ratio of existing partners.
(b) Admission of a new partner.
(c) Retirement of an existing partner.
(d) Death of a partner.
(e) Amalgamation of two partnership firm.

Change in profit sharing Ratio

When one or more partners acquire an interest in the business from another existing partners (s), it is said to be a change in the profit sharing ratio in a partnership firm. A change in the profit sharing ratio among the existing partners means, it is reconstitution of the firm without admission, retirement or death of a partner.

Adjustments required at the time of change in profit sharing ratio

Due to change in profit sharing ratio, following adjustments need to be incorporated in the books of accounts.

(a) Calculation of each partners sacrifice or gain.
(b) Treatment of goodwill
(c) Treatment of revaluation of assets and liabilities.
(d) Treatment of accumulated profits, reserves and losses.

New profit Sharing ratio : It is the ratio in which the partners are to share profits/losses in future.

Sacrificing Ratio: It is the ratio in which the partner(s) has/have agreed to sacrifice their share of profit in favor of other partner or partners. This ratio is calculated by taking out the difference between old profit share and new profit share.

Sacrificing ratio = old share – new share

- Ram, Shyam and Mohan were partners sharing profits in the equal ratio. They have decided to share the profits in the ratio of 5 : 3 : 2 with retrospective effect. Calculate the sacrificing or Gain of the partners. (Answer :

Gaining ratio: it is the ratio in which the partners(s) has/have agreed to gain their share of profit from other partner(s). This ratio is calculated by taking out the difference between new profit share and old profit share.

Gaining ratio = new share – old share

Calculation of sacrifice or gain of partners: The sacrifice made or gain received by a partner is calculated by deducting the new share from the old share of partner.

Sacrifice/(gain) share = old profit share – new profit share
If difference is positive then it is sacrifice share and in case of negative difference, it will be gain share.

1. **Treatment of goodwill** At the time of change in profit sharing ratio, the treatment of goodwill would be in the following manner

For goodwill appearing in the balance sheet	All partners' capital/current A/c Dr. To goodwill A/c (in old ratio)	(Book Value)
For recording of goodwill share without opening goodwill account.	Gaining partners' capital/current A/c Dr. To sacrificing partners' capital/current A/c	[in gaining ratio] [in sacrificing ratio]

2. Treatment of revaluation of assets and liabilities

Two alternative available for this purpose are:

1. When revised values are to recorded in the books of accounts an account titled 'revaluation account' or 'profit and loss adjustment account' is opened for this purpose.

Dr. revaluation Account Cr.

Particulars	Amt	Particulars	Amt

	(Rs.)		(Rs.)
To decrease in value of assets (loss) To increase in value of liabilities (loss) To unrecorded liabilities (at an agreed value) *to profit transferred to old partners' Capital/current A/c (in old ratio)	…. …. …. …. ….	By increase in value of assets (profit) By decrease in value of liabilities (profit) By unrecorded assets (at an agreed value) *by loss transferred to old partners' Capital/current A/c (in old ratio)	

2. When revised values are not to be recorded in the books of accounts (Adjustments of profits/losses on revaluation of assets and reassessment of liabilities through the capital account only).

If partners decide to record the net effect of revaluation of assets and liabilities without affecting the old amount of assets and liabilities, a single adjusting entry involving the capital accounts of gaining partners and sacrificing partners is passed.

i. For profit on revaluation	Gaining partners' capital A/c Dr. To sacrificing partners' capital A/c
ii. For loss on revaluation	Sacrificing partners' capital A/c Dr. To gaining partners' capital A/c

3. **Treatment of Accumulated profits, reserves and losses**: At the time of change in profit sharing ratio, the past profits, reserves and losses appearing in the balance sheet, shall be treated in following two ways.

When these are not required to be shown in the books of the new firm	In this case, if any reserves accumulated profits/losses exits in the books of the firm, they are transferred to partners' capital/current accounts in their old profit sharing ratio. (a) For transfer of reserves and accumulated profits Reserves/Profit and loss A/c Workmen compension Reserve A/c Investment fluctuation RESERVES A/c TO All Partners capital/Current A/c (b) For transfer of accumulated losses All Partners' capital/current A/c To profit and Loss A/c To deferred Revenue Expenditure A/c
When these are	In this case, a single adjusting entry involving the capital

required to be shown in the books of new firm	accounts of sacrificing and gaining partners is passes, when the partners decide to record net effect of reserves and accumulated profits/losses without affecting the old figures. Gaining partners' capital/current A/c To Sacrificing Partners' Capital/Current A/c

4. **Preparation of the Balance Sheet of the Reconstituted firm** Reconstitution of the firm results in a change in the capital accounts of partners and in the value of assets and amount of liabilities. This shall also require preparation of the balance sheet of the new firm. Before we prepare the balance sheet of the new firm, accounts that have been affected because of the reconstitution are Prepared.