CHAPTER 3

Reconstitution of Partnership

Meaning of Reconstitution:

Any change in agreement of partnershipis 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

Change in profit sharing ratio among the existing partners

Meaning:

When all 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.

Accounting treatment of goodwill:

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

Illustration 1

Amit and Kajal were partners in a firm sharing profits in the ratio of 3:2. With effect from January 1,2012 they agreed to share profits equally. For this purpose the goodwill of the firm was valued at '60,000. Pass the necessary journal entry.

Solution:

Old ratio of A and B = 3:2

New ratio of A and B = 1:1

Sacrifice or Gain:

Amit = 3/5 – 1/2 = 6-5/10 = 1/10 Sacrifice

Kajal = 2/5 – 1/2 = 4-5/10 = 1/10 Gain

Journal

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
2012 Jan 1	Kajal capital A/c To Amit' Capital A/c (Adjustment for goodwill on change in profit sharing ratio)	Dr.		6,000	6,000

Accounting treatment of Reserves and Accumulated Profits:

Case (i) When reserves and accumulated profits/losses are to be distributed

At the time of change in profit sharing ratio, if there are some reserves or accumulated profits/losses existing in the books of the firm, these should be distributed to partners in their old profit sharing ratio.

Illustration 2 : Vaishali, Vinod and Anjali are partners sharing profits in the ratio of 4:3:2. From April 1,2011, they decided to share the profits equally. On that date their books showed a credit balance of '3,60,000 in the profit and loss account and a balance of ' 90,000 in the General reserve. Record the journal entry for distribution of these profits and reserves.

Solution :

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
2011	Profit & Loss Dr.		3,60,000	
Apr. 1	General Reserve A/c Dr.		90,000	
	To Vaishali's Capital A/c			2,00,000
	To Vinod's Capital A/c			1,50,000
	To Anjali's Capital A/c			1,00,000
	(Profit and general reserve distributed in old ratio)			

Illustration 3 : Anjum and Kanchan are partners sharing profits and losses in the ration of 3:2, From April 1, 2011 they decided to share the profits in the ratio of 2:1. On that date, profit and loss account showed a debit balance of ₹ 1,20,000. Record the Journal for transferring this to partner's capital accounts.

Solution :

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
2011	Anjum's capital A/c Dr.		72,000	
Apr. 1	Kanchan's capital A/c Dr.		48,000	
	To Profit and Loss A/c			1,20,000
	(Undistributed losses transferred to partners' capital accounts in old ratio)			

Case (ii) When accumulated profits/losses are not be distributed at the time of change in ratio

Partners may decide that reserves and accumulated profits/losses will not be affected and remains in the books with same figure. In this case, the gaining partner must compensate the sacrificing partner by the share gained by him i.e.

Gaining Partner's Capital A/c Dr.

To Sacrificing Partner's Capital A/c.

Illustration 4: Keshav, Meenakshi and Mohit sharing profit and losses in the ratio of 1:2:2,decide to share future profit equally with effect from April 1, 2011. On that date general reserve showed a balance of ₹ 2,40,000. Partners do not want to distribute the reserves. You are required to give the adjusting entry.

Solution: Keshav : Meenakshi : Mohit

Old ratio 1/5 : 2/5 : 2/5

New ratio 1/3 : 1/3 : 1/3

Sacrifice or Gain:

Keshav = 1/5 – 1/3 = 3-5/15 = 2/15 (Gain)

Meenakshi = 2/5 – 1/3 = 6-5/15 = 1/15 (Sacrifice)

Mohit = 2/5 – 1/3 = 6-5/15 = 1/15 (Sacrifice)

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
2011 Apr. 1	Keshav's capital A/c Dr.		32,000	
	To Meenakshi's capital A/c			16,000
	To Mohit's capital A/c			16,000
	(Adjustment for General reserve on change in profit sharing ratio			

Illustration 5: Neha, Niharika, and Nitin are partners sharing profits and losses in the ratio of 2:3:4. They decided to change their ratio and their new ratio is 4:3:2. They also decided to pass a single journal entry to adjust the following without affecting their book values:

	₹
Profit & Loss account	80,000
General Reserve	40,000
Advertisement Suspense A/c	30,000

You are required to give the single journal entry to adjust the above.

Solution:

Profit & Loss account	80,000
Add: General Reserve	40,000
	1,20,000
Less: Advertisement Suspense	30,000
Total amount to be adjusted	90,000

	Neha	Niharika	Nitn
Old ratio	2/9	3/9	4/9
New ration	4/9	3/9	2/9

Sacrifice or Gain :

Neha = 2/9-4/9=-2/9 (Gain)
Niharika = 3/9-3/9=0 (No change)
Nitin = 4/9-2/9=2/9 (Sacrifice)

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Date	Particulars	L.F.	Debit ₹	Credit ₹
	Neha's capital A/c Dr.		20,000	
	To Nitin's capital A/c			20,000
	(adjustment for profit & loss A/c, General reserves and advertisment Suspense A/c			

Accounting treatment for Revaluation of Assets and reassessment of Liabilities on change in Profit sharing ratio:

At the time of change in profit sharing ratio of existing partners, Assets and liabilities of a firm must be revalued because actual realizable value of assets and liabilities may be different from their book values. Change in the assets and liabilities belongs to the period prior to change in profit sharing ratio and therefore it must be shared in old profit sharing ratio.

Revaluation of assets and liabilities may be treated in two ways:

(i) When revised values are to be shown in the books.

(ii) When revised values are not to be shown in the books

When revised values are to be shown in the books:

In this case revaluation of assets and liabilities is completed with the help of "Revaluation Account". This account is also known as "Profit and Loss Adjustment Account". All losses due to revaluation are shown in debit side of this account and all gains due to revaluation are shown in credit side of this account.

Note : (1) Increase in the value of an Asset and decrease in the value of a liability result in profit.

(2) Decrease in the value of any asset and Increase in the value of liability gives loss.

Illustration 6:

Piyush, Puja and Praveen are partners sharing profits and losses in the ratio of 3:3:2. There balance sheet as on March 31st 2011 was as follows.

Liabilities		₹	Assets	₹
Sundry creditors		48,000	Cash at bank	74,000
Bank Loan		72,000	Sundry debtors	88,000
Capital :			Stock	2,40,000
Piyush	4,00,000		Machinery	3,18,000
Puja	3,00,000		Building	4,00,000
Praveen	3,00,000	10,00,000		
		11,20,000		11,20,000

Partners decided that with effect from April 1, 2011, they would share profits and losses in the ratio of 4:3:2. It was agreed that:
(i) Stock be valued at ₹ 2,20,000.
(ii) Machinery is to be depreciated at 10%.
(iii) A provision for doubtful debts is to be made on debtors at 5%.
(iv) Building is to be appreciatd by 20%.
(v) A liability for ₹ 5,000 included in sundry creditors is not likely to arise.
Partners agreed that the revised value are to be recorded in the books. You are required to prepare journal, revaluation account, partners capital account and revised balance sheet.

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
2011	Revaluation A/c Dr.		56,200	
	To Stock			20,000
	To Machinery			31,800
	To Provision for doubtful debts A/c			
	(Revaluation of assets)			
	Building A/c		80,000	
	Sundry creditors		5,000	
	To Revaluation A/c			85,000
	(Revaluation of assets and liabilities)			
	Revaluation A/c		28,800	
	To Piyush's capital A/c			10,800
	To Pooja's capital A/c			10,800
	To Praveen's capital A/c			7,200
	(Profit on revaluation)			

Revaluation Account

Particulars		₹	Particulars	₹
To stock		20,000	By building	80,000
To machinery		31,800	By sundry creditors	5,000
To Provision for doubtful debts		4,400		
To profit distributed :				
Piyush	10,800			
Pooja	10,800			
Praveen	7,200			
		28,800		
		85,000		85,000

Partners' Capital Account

Particulars	Piyush	Pooja	Praveen	Particulars	Piyush	Pooja	Praveen
To balance c/d	4,10,800	3,10,800	3,07,200	By balance b/d By reval -uation	4,00,000	3,00,000	3,00,000
					10,800	10,800	7,200
	4,10,800	3,10,800	3,07,200		4,10,800	3,10,800	3,07,200

Balance Sheet
as on April 1, 2011

Liabilities		₹	Assets		₹
Sundry creditors		43,000	Cash at bank		74,000
Bank Loan		72,000	Sundry debtors	88,000	
Capital account :			Less : provision 5%	4,400	83,600
Piyush	4,10,000				
Puja	3,10,800		Stock		2,20,000
Praveen	3,07,200		Machinery		2,86,200
		10,28,800	Building		4,80,000
		11,43,800			11,43,800

When revised values are not to be shown in the books.

Illustration 7.

In illustration 6, Partners agreed that the revised value of assets and liabilities are not to be shown in the books. You are required to record the effect by passing a single journal entry. Also prepare the revised value balance sheet.

Gain due to revaluation		₹
Building		80,000
Sundry creditors		5,000
	Total A	**85,000**
Less: loss due to revaluation		
Stock		20,000
Machinery		31,800
Provision for doubtful debts		4,400
	Total B	**56,200**
Net gain from revaluation	**Total (A-B)**	28,800

Old Ratio = 3:3:2

New Ratio = 4:3:2

Sacrifice or Gain :

Piyush = 3/8-4/9 = -5/72 (Gain)

Pooja = 3/8-3/9 = 3/72 (Sacrifice)

Praveen = 2/8-29 = 2/72 (Sacrifice)

Amount to be adjusted :

Piyush = ₹ 28,800 x 5/72 = ₹ 2,000 Debit

Pooja = ₹ 28,800 x 3/72 = ₹ 1,200 Credit

Praveen = ₹ 28,800 x 2/72 = ₹ 800 Credit

Journal

Date	Particulars	L.F. Rs.	Debit Rs.	Credit
2011 Apr. 1	Piyush's capital A/c Dr. To Pooja's capital A/c To Praveen's capital A/c (Adjustment for profit on revaluation)		2,000	 1,200 800

Capital Accounts

Particulars	Piyush	Pooja	Praveen	Particulars	Piyush	Pooja	Praveen
To Pooja's Capital A/c	1,200	-	-	By Balance b/d	4,00,000	3,00,000	3,00,000
To Praveen Capital A/c	800	-	-	By Piyush's Capital A/c	-	1,200	800
To Balance C/d	3,98,000	3,01,200	3,00,800				
	4,00,000	3,01,200	3,00,800		4,00,000	3,01,200	3,00,800

Balance Sheet
as on April 1, 2011

Liabilities		₹	Assets	₹
Sundry Creditors		48,000	Cash at bank	74,000
Bank Loan		72,000	Sundry debtors	88,000
Capital account :			Stock	2,40,000
Piyush	3,98,000		Machinery	3,18,000
Puja	3,01,200		Building	4,00,000
Praveen	3,00,800			
		10,00,000		
		11,20,000		11,20,000