1. Details of Module and its structure

Module Detail	
Subject Name	Accountancy
Course Name	Accountancy 03 (Class XII, Semester - 1)
Module Name/Title	Reconstitution of Partnership Firm-Admission of a Partner – Part 6
Module Id	leac_10306
Pre-requisites	Basic knowledge of Partnership – Fundamentals, Revaluation Account, Calculation of Ratios, Capital Adjustments, etc.
Objectives	After going through this lesson, the learners will be able to understand recording of business transactions in the journal. • Accounting Treatment of Hidden Goodwill • Treatment of Accumulated Profits / Losses • Revaluation of Assets & Liabilities
Keywords	Adjustment of Capital, Excess / Shortage adjustment – Cash / Current Account

2. Development Team

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Table of Contents:

1. Change in Profit Sharing Ratio among the existing Partners

Sometimes, the partners of a firm decide to change their existing profit sharing ratio without any admission or retirement of a partner.

A change in the profit sharing ratio may take place when one partner purchases a share of profit from another partner or There may be Health issues, One Partner would like to devote Less Time and thereby it is decided to give him less share as compared to those who are working more.

In such a case, the old partnership agreement stands terminated and a new agreement comes into force, incorporating the change in profit sharing ratio.

Now, this will result in a gain of additional share in future profits of the firm for some partners while a loss for the other partners. This will give rise to New Profit Sharing Ratio

It should always be kept in mind that the gaining partner should always compensate to the sacrificing partner to the extent of his gain. The gaining partner (i.e. the partner who purchases a share of profit) must compensate the sacrificing partner (i.e. the partner from whom the share of profit is purchased) to the extent of his gain by paying the proportionate amount of goodwill.

For example, If A, B and C are partners in a firm sharing profits in the ratios of 8:5:3 And they decide that as A, not being well, is not able to actively participate in the affairs of the firm. Hence, in future they will share profits in the ratio of 5: 6: 5.

This will result in A losing 3/16 while Band C gaining 1/16 and 2/16 respectively

In such a situation, we will / may have to adjust (As per the information in Que.):

1. Loss and gain in the value of goodwill,
2. Revaluation of assets and liabilities,
3. Transfer of accumulated profit and losses to partners' capital accounts in the old profit sharing ratio and
4. Adjustment of partners' capitals, if specified, so as to make them proportionate to the new profit sharing ratio.

As regards Point no.1,

This is done by **raising Goodwill** at its full value in the old profit sharing ratio **and then writing it off** in the new ratio.

Alternatively, Partners Sacrificing can be credited and Gaining partners debited with appropriate amounts without goodwill account appearing in the books, as explained before in the admission of a new partners.

The following journal entry shall be passed:

Gaining Partners' Capital, A/c Dr. (with the gaining share × goodwill)

To Sacrificing Partners' Capital **A/c** (with the sacrificing share × goodwill)

Example

A, B and C are partners sharing profits equally. They decided that in future C will get l/5th share in profits and remaining profit will be shared by A and B equally. On the day of change, firm's Goodwill is valued at Rs. 30,000. Give journal entries arising on account of change in profit-sharing ratio.

Solution:

Books of A, B and C

JOURNAL

Date	**Particulars**		**L.F.**	**Debit**	**Credit**
	A's Capital A/c	Dr.		2,000	
	B's Capital A/c	Dr.		2,000	
	To C's Capital A/c				4,000
	(Being C compensated by A and B for Sacrifice made by him 2 x Rs. 30,000/15 = Rs. 4,000)				

<u>**Note**</u> In the normal course, raising goodwill as an asset should be avoided. However, when it is brought into the books it should be written off immediately or in the shortest possible period.

Working Notes: Original Ratio: A: B: C =1:1:1

New Ratio: A: B:C =2:2:1

Sacrifice or gain made:

A =1/3 – 2/5 = (-) 1/15 (Gain)

B= 1/3 – 2/5 = (–) 1/15 (Gain)

C= 1/3 – 1/5 = 2/ 15 (Sacrifice)

As regards Point no. 2,3,4 Adjustments in respect of revaluation of assets and liabilities, transfer of accumulated profit and losses to partners' capital accounts in the old profit sharing ratio and adjustment of partners' capitals, if specified, is done in the same way as in case of admission of a partner.

2. Distribution of reserves and accumulated profits/losses

At the time of change in profit sharing ratio among existing partners, all the Existing Reserves, Accumulated Losses should be distributed among all the Existing Partners in their old ratio as they belong to the Previous period. Let us now see the Journal Entries regarding this:

Accounting Treatment

--- For distribution of Accumulated profits

General Reserve A/c Dr.

Profit and Loss A/c Dr.

Investment Fluctuation Fund A/c Dr.

Workmen Compensation Fund A/c Dr.

To All Existing Partners' Capital, A/c (in the old ratio)

(Being distribution of accumulated profits, reserves amongst the existing partners in old ratio)

---For distribution of Accumulated Losses

All Existing Partners' Capital A/c Dr. (in old ratio)

To Profit & Loss A/c

To Deferred Revenue Expenditure A/c

(Being accumulated losses transferred to existing partners in their old ratio)

Some important points to remember

A. Workmen Compensation Reserve/ Fund is a reserve created out of profits of the firm. If there is no claim on account of workmen's compensation, the entire amount is distributed among the partners in their old ratio. But if some liability is existing, it should remain in the Balance sheet and the remaining should be distributed.

B. Investment Fluctuation Reserve is also a very Good Observation. It is related to Fluctuation in the Market value of Investments. There can be following situations:

1. If nothing else is mentioned, Full amount is distributed.
2. If the market value falls, fluctuation reserve will be reduced by that amount, bal. distributed.
3. If the market value increases, we will credit Revaluation account and then both fluctuation reserve and Revaluation will be distributed.
4. If the market value decreases, beyond the existing reserve, then we will debit Revaluation account and then Revaluation Loss will be distributed.

Example on the above cases

A, B and C sharing profits/losses in the ratio of 3: 2: 1 decided to share in the ratio of 2: 2 : 1 with effect from 1-4- 2020. An extract of their Balance Sheet as at 31-3- 2020 is under:

Liabilities	Rs.	**Assets**	Rs.
Investment Fluctuation Reserve	15,000	Investments (At cost)	1,50,000

Show the accounting treatment under the following alternative cases:

Case 1. If there is no other information.

Case 2. If the market value of investments is Rs. 1,50,000.

Case 3. If the market value of investments is Rs. 1,36,200.

Case 4. If the market value of investments is Rs. 1,68,000.

Case 5. If the market value of investments is Rs. 1,32,000.

Solution: **JOURNAL**

Date	**Particulars**		**L.F.**	**Debit**	**Credit**
Case 1	Investments Fluctuation Reserve A/c	Dr.		15,000	
	To A's Capital A/c				7,500
	To B's Capital A/c				5,000
	To C's Capital A/c				2,500

	(Being the distribution of investments fluctuation reserve to Partner' Capital Accounts in their old profit-sharing ratio)				
Case 2	Investments Fluctuation Reserve A/c	**Dr.**		15,000	
	To A's Capital A/c				7,500
	To B's Capital A/c				5,000
	To C's Capital A/c				2,500
	(Being the distribution of investments fluctuation reserve to Partner' Capital Accounts in their old profit-sharing ratio)				
Case 3	Investments Fluctuation Reserve A/c	**Dr.**		15,000	
	To Investments A/c				13,800
	To A's Capital A/c				600
	To C's Capital A/c				300
	To R's Capital A/c				200
	(Being the distribution of excess investments fluctuation reserve to Partner' Capital Accounts in their old profit-sharing ratio)				

Case 4	Investments Fluctuation Reserve A/c Dr.		15,000	
	To A's Capital A/c			7,500
	To B's Capital A/c			5,000
	To C's Capital A/c			2,500
	(Being the distribution of investments fluctuation reserve to Partner' Capital Accounts in their old profit ratio)			
	Investments A/c		18,000	
	To Revaluation A/c			18,000

	(Being value of investments brought up to market Value)			
	Revaluation A/c Dr.		18,000	
	To A's Capital A/c			9,000
	To B's Capital A/c			6,000
	To C's Capital A/c			3,000
	(Being the distribution of revaluation profit among old Partners in their old ratio)			
Case 5	Investments Fluctuation Reserve A/c Dr.		15,000	
	Revaluation A/c Dr.		3,000	
	To Investments A/c			18,000
	(Being the decrease in the value of investment and deficit is debited to Revaluation A/c)			
	A's Capital A/c Dr.		1,500	
	B's Capital A/c Dr.		1,000	
	C's Capital A/c		500	
	To Revaluation A/c			3,000
	Being loss on revaluation distributed among partners in their old ratio)			

But Remember

Employees Provident Fund is not a form of accumulated profit. It is a certain liability towards employees and thus is not to be distributed among old partners. This should be treated as other liabilities are treated during the course of reconstitution of partnership firms

3. Reserves and accumulated profits/losses to be shown at their original values (memorandum revaluation system)

Sometimes, partners agree that accumulated profits/losses may be shown at their original values. In that case these profits or losses are not distributed to partners. Instead, necessary journal entries shall be made in such a manner that, **"The gaining partner(s) should compensate to the sacrificing partner(s) with the amount of gain"**

Following journal entry shall be made:

Gaining Partner's Capital, A/c Dr.

To Scarifying Partner's Capital A/c

4. If assets and liabilities are to be shown at their original value (memorandum revaluation system)

Sometimes, partners agree that assets and liabilities may not be shown at their revised values. In that case Revaluation Account is not to be prepared. Instead, necessary adjusting entry shall be made by following the same golden rule **"The gaining partner(s) should compensate to sacrificing partner(s) with the amount of gain"**.

For recording increase or decrease in assets / liabilities either separate entries can be passed or a single adjusting entry can be passed.

(I) When separate entries are passed -For gains.

Gaining Partners' Capital A/c Dr.	With the gaining/sacrificing part
To Sacrificing Partners' Capital A/c	in change of assets or/and liabilities.

(Being adjustment entry for increase in value of assets and decrease in value of liabilities)

-For losses

Sacrificing Partners' Capital A/c Dr.	With the gaining/sacrificing part in change
To Gaining Partners' Capital A/c	of assets or/and liabilities

(Being adjustment entry for decrease in value of assets and increase in value of liabilities)

This brings us to the end of the chapter. Let us summarise the whole Chapter as to what we have understood.

Summarising our discussion on this chapter

1. Matters requiring adjustments at the time of admission of a partner*:* Various matters which need adjustments in the books of firm at the time of admission of a new partner are: Goodwill, Revaluation of assets and liabilities, Existing reserves and other accumulated profits and losses and the Adjustment of capitals of the old partners on the basis of New Partner or New Partner on the basis of Old Partners (as agreed in Question).

2. Determining the new profit sharing ratio and calculating sacrificing ratio*:* The new partner will acquire his share in profits from the old partners. This will reduce the old partner's share in profits.

Hence, we have to determine the new profit sharing ratio as well as sacrificing ratio.

3.Treatment of Goodwill*:* Goodwill is an intangible asset and belongs to old partners. On the admission of a new partner some adjustments must be made into the capital accounts of the old partners for goodwill so that the new partner will not acquire a share in that goodwill which is earned before his admission without making any payment for the same. The amount that the new partner pays for goodwill is called "**Premium for goodwill"**.

From accounting point of view there can be different situations for the treatment of goodwill at the time of admission of a partner.

a) If new partner brings CASH, then the amount of premium brought in by the new partner is shared by old partners in the ratio of sacrifice.
b) In case the new partner fails to bring his share of premium for goodwill in cash than the capital account of the new partner is debited for his share of premium of goodwill and the old partners' capital accounts are credited in their sacrificing ratio.

4. Adjustments for Revaluation of Assets and Reassessment of Liabilities:

At the time of admission of a partner, the assets and liabilities are revalued or maybe some asset or liability is found unrecorded. The necessary adjustments are to be made through the Revaluation Account.

Any gain or loss arising from such exercise shall be distributed among the old partner's in their old profit sharing ratio as it Rightly belong to them due to their efforts in the past.

5. Adjustment for reserves and accumulated profits/losses: If, at the time of admission of a partner, any reserve and accumulated profits or losses exist in books of the firm, these should be transferred to old partner's capital/current accounts in their old profit sharing ratio.

6. Determining/Adjusting partners' capital*:* If agreed, the partner's capital may be adjusted so as to be proportionate to their new profit sharing ratio.

Generally, the new partner's capital is normally used as a base for determining the new capitals of the old partners and necessary adjustment made through cash or by transfer to partner's current accounts.

Sometimes other basis also may be available for determining capitals of the partners after admission of the new partner like Total capital to be in the firm is specified and all partners capital to be adjusted accordingly.

OR How much a new partner will bring has to be decided on the basis of Adjusted capitals of Old partners.

7. Change in profit sharing ratio*:* Sometimes the partners of a firm may agree to change their existing profit sharing ratio. With a result, some partners will gain in future profits while others will lose. In that situation,

Necessary adjusting entry shall be made by following the same golden rule **"The gaining partner(s) should compensate to sacrificing partner(s) with the amount of gain"**.

For all of these points:

1) Undistributed Profits/ reserves, 2) Revaluation of assets and reassessment of liabilities,

3) Goodwill, 4) Determination of Sacrificing Ratio and Gaining Ratio.