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Change in Profit Sharing Ratio among Existing Partners

Reconstitution of the Firm:

It refers to change in Existing agreement of Partnership Deed. Reconstitution of the Firm takes Place when

- There is Change in profit Sharing Ratio
- On admission, retirement or Death of a Partner
- On Amalgamation of two or more Partnership Firms

Determination of Sacrificing Ratio & Gaining Ratio

Sacrificing ratio

The ratio in which partners sacrifice their share of Profit in favour of other partners of the firm.

Sacrificing Ratio /Share of Partner = Old Ratio of Partner – New Ratio of Partner

Gaining Ratio

The ratio in which partners gain their share of Profit ratio due to sacrifice made by other Partners.

Gaining Ratio /Share of Partner = New Ratio of Partner – Old Ratio of Partner

Accounting Treatment of Goodwill/ Premium for Goodwill

Whenever, there is change in Profit Sharing Ratio we pass Journal entry to adjust goodwill A/C by debiting Gaining partners' capital A/C and Crediting Sacrificing Partners' Capital A/C by an amount which can compensate Sacrificing Partner/s loss due to sacrifice in their Profit sharing ratio by Gaining Partner/s for acquisition of their shares.

Journal Entry passed is

Gaining Partners' Capital A/C/ Current A/C ………………Dr

To Sacrificing Partners' Capital A/C/ Current A/C

Amount of Compensation payable by Gaining Partner to Sacrificing Partner = Firm's Goodwill Value × Share of Profit Gained.

Note: In case, Multiple Partners sacrifice, then above amount will be credited to sacrificing Partners' Capital A/C in sacrificing ratio.

For Example,

Partner C Gained 2/10 share equally from Partner A & B that is 1/10 from Partner A and 1/10 from Partner B. value of Goodwill is Rs. 100000. In this case

Amount of Compensation payable by Gaining Partner to Sacrificing Partner = Firm's Goodwill Value × Share of Profit Gained = 2/10 × Rs. 100000 = Rs. 20000

Amount credited to Partner A & B Capital A/C will be in sacrificing ratio that is 1:1.

1/2 × Rs. 20000 = Rs. 10000 Payable to Partner A.

1/2 × Rs. 20000 = Rs. 10000 Payable to Partner B.

Journal Entry:

C's Capital A/C ………………..Dr 20000

To A's capital A/C 10000

To B's capital A/C 10000

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Accounting Treatment of Existing Goodwill

Existing Goodwill means Goodwill appearing in Balance Sheet. It is a loss to the Firm and is written off by debiting Partners' Capital / Current A/C in their Old Profit Sharing Ratio.

Journal Entry passed for the same is

Partners' Capital / Current A/C………………..Dr

To Existing Goodwill A/C

Accounting Treatment of Reserves & Accumulated Profits or Losses

These items are transferred to Partners' Capital A/C/ Current A/C in their Old Profit Sharing Ratio, if appearing in Balance Sheet, before Reconstitution of the Firm takes Place.

Journal Entries are as follows:

For Transfer of reserve & Accumulated Profits:

Reserve A/C……………………………………………….Dr

Investment Fluctuation Reserve A/C…………Dr

Workmen Compensation Reserve A/C……….Dr

Accumulated Profit / P&L A/C…………………….Dr

To Partners' Capital A/C/ Current A/C

For Transfer of Accumulated Losses:

Partners' Capital A/C/ Current A/C ………………….Dr

To Accumulated Losses / P&L A/C

To Advertisement Expenditure A/C

To Deferred Revenue Expenditure A/C

Note:

Employees' Provident Fund is a Liability. So it is not distributed among partners.

Reserves, Accumulated Profit & Losses are accounted even if question is silent with regard to it.

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Investment Fluctuation Reserve (IFR)

Reserve set aside out of Profit to meet fall in Market Value of Investment. Accounting treatment of IFR can be understood with the help of following cases.

Case 1. When Book Value & Market Value of Investment is same

In this case, Total Balance of IFR is transferred to Partners' capital/ Current A/C in their Old Profit Sharing ratio (OPSR).

Journal Entry in this case is:

IFR A/C………………………Dr

To Partners' capital / Current A/C

Case 2. When Market Value of Investment is less than Book Value

Three situations can exist under this case.

Situation 1. Fall in Market Value of Investment is less than IFR

In this Case, Balance of IFR to the extent of fall in Value (Book Value – Market Value) will be transferred to Investment A/C and Remaining Balance of IFR will be transferred to Partners' capital/ Current A/C in their Old Profit Sharing ratio (OPSR).

Journal Entry in this case is:

IFR A/C……………………..Dr

To Investment A/C

To Partners' capital / Current A/C

Situation 2. Fall in Market Value of Investment is equal to IFR

In this Case, Total Balance of IFR will be transferred to Investment A/C and nothing will be transferred to Partners' capital/ Current A/C.

Journal Entry in this case is:

IFR A/C……………………..Dr

To Investment A/C

Situation 3. Fall in Market Value of Investment is more than IFR

In this Case, Total Balance of IFR will be transferred to Investment A/C and Fall in value amount in excess of IFR will be transferred/ debited to Revaluation A/C.

Journal Entry in this case is:

IFR A/C…………………………….Dr

Revaluation A/C…………………Dr

To Investment A/C

Case 3. When there is an increase in Market Value of Investment

In this case, Total Balance of IFR is transferred to Partners' capital/ Current A/C in their Old Profit Sharing ratio (OPSR) and amount of increase in value (Market Value – Book value) will be credited to Revaluation A/C.

Journal Entry in this case is:

IFR A/C……………………..Dr

To Partners' capital / Current A/C

To Revaluation A/C

Adjustment of Accumulated Profits, Losses & Reserve through Capital A/C only, that is, when they are to be retained in the Books after Reconstitution and not to be Distributed

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In this case, we calculate the net effect of Accumulated Profits, Losses & Reserve which means

Accumulated Profits + Reserve– Accumulated Losses.

Then we calculate Gain / Sacrifice ratio of Share of Partner/s.

Gaining Partner will compensate to Sacrificing Partner in Sacrificing Ratio in case of Positive Net effect.

Journal entry passed will be:

Gaining Partner/s Capital / Current A/C…………..Dr

To Sacrificing Partner/s Capital/ Current A/C

In Case of Negative effect, Journal Entry will reverse.

Sacrificing Partner/s Capital/ Current A/C………..Dr

To Gaining Partner/s Capital / Current A/C

Note:

Positive effect means Resulting value of Accumulated Profits + Reserve– Accumulated Losses wiil be positive value and vice versa for negative value.

Revaluation of Assets & Reassessment of Liabilities

In case of Reconstitution of Firm, Assets and Liabilities are revalued and Loss or gain on revaluation is debited or credited to Partners' Capital A/C in their Old Profit Sharing Ratio. Two situations can exist:

I. When revised value of Assets and Liabilities are to be recorded in Balance Sheet.

II. When revised value of Assets and Liabilities are not to be recorded in Balance Sheet.

I. When revised value of Assets and Liabilities are to be recorded in Balance Sheet.

In this case, Journal entries passed for Revaluation of Assets and Liabilities are as follows:

1. for increase in Value of Asset:

Asset A/C…………………………….Dr

To Revaluation A/C

2. For Decrease in Value of Asset:

Revaluation A/C………………………..Dr

To Asset A/C

3. For Increase in Liability:

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Revaluation A/C…………………….Dr

To Liability A/C

4. For Decrease in Liability:

To Liability A/C…………………………Dr

To Revaluation A/C

5. For Recording an Unrecorded Asset:

Unrecorded Asset A/C……………………………….Dr

To Revaluation A/C

6. For Recording an Unrecorded Liability:

Revaluation A/C…………………….Dr

To Unrecorded Liability A/C

7. For Transfer of Balance of Revaluation A/C

In Case of Gain on Revaluation:

Revaluation A/C…………………Dr

To Partners' Capital / Current A/C (in OPSR)

In Case of Loss on Revaluation:

Partners' Capital / Current A/C (in OPSR)…………………Dr

To Revaluation A/C

Format of Revaluation A/C

Revaluation A/C			
Particulars	Amount	Particulars	Amount
To Asset A/C (Decrease in Value of Asset) To Liabilities A/C(Increase in Liabilities Value) To Unrecorded Liability To Partner's Capital A/C (Remuneration Payable) To Cash/Bank A/C (Reconstitution expenses) *To Gain On Revaluation transferred to Partners' Capital/Current A/C in OPSR		By Asset A/C (Increase in Value of Asset) BY Liabilities A/C (Decrease in Value of Liabilities) By Unrecorded Asset A/C *By Loss On Revaluation transferred to Partners' Capital/Current A/C in OPSR	

Note

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* Either of the two will come. Loss and Gain can not come together.

Always Remember, if Revaluation A/C is prepared, Value of Assets and Liabilities will be recorded at revised values.

II. When revised value of Assets and Liabilities are not to be recorded in Balance Sheet

In this case, gain or Loss on revaluation of Assets and Liabilities is adjusted through Capital A/C by passing an Adjustment Entry by Debiting Capital /Current A/C of Gaining Partner & Crediting Sacrificing Partners' Capital A/C in Sacrificing Ratio.

Following steps will help to understand the concept better:

Step I. calculate Net effect of Revaluation

Calculation of Net Effect of revaluation

	Amount
Increase in Value of Assets	
Add: Decrease in Amount of Liabilities	
Less: Decrease in Value of Assets	
Less: Increase in Amount of Liabilities	
*Add: Goodwill	
Net Effect of Revaluation	

*We can even add Goodwill to adjust it among Sacrificing Partners' in Sacrificing Ratio. Otherwise, we can do separate calculation For Goodwill.

Step 2. After that we Calculate Gaining/Sacrificing Ratio of all Partners.

Step 3. Calculate Proportional Amount of Net effect of Revaluation

Amount of Compensation payable by Gaining Partner to Sacrificing Partner = Share gained × Net effect of revaluation

Step 4. Pass Necessary Journal entry

Whenever, there is change in Profit Sharing Ratio, we pass Journal entry to adjust Net effect of Revaluation, by debiting Gaining partners' capital A/C and Crediting Sacrificing Partners' Capital A/C by the amount equal to gain on Revaluation amount to compensate Sacrificing Partner/s loss due to not recording of revised value of Asset & Liabilities.

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In Case there is Loss on Net effect of Revaluation, Sacrificing Partner/s will compensate to Gaining Partner/sin Gaining Ratio /Sacrificing ratio.

Journal Entry passed is

For gain on Revaluation

Gaining Partners' Capital A/C/ Current A/C ……………..Dr

To Sacrificing Partners' Capital A/C/ Current A/C

For Loss on Revaluation

Sacrificing Partners' Capital A/C/ Current A/C………..Dr

To Gaining Partners' Capital A/C/ Current A/C

Above Calculation Gets Reversed in case of Loss on revaluation.

Expenses on reconstitution of the Firm

There are different cases for Expenses on Reconstitution of the Firm as explained below:

Case 1. When expenses are borne and paid by Firm

Journal Entry Passed in this case:

Revaluation A/C……………………….Dr

To Cash/Bank A/C

Case 2. When Reconstitution expenses are borne by the Firm but paid by a Partner

Journal Entry Passed in this case:

Revaluation A/C……………………….Dr

To Concerned Partner's Capital A/C

Case 3. When the Firm pays fixed amount to a Partner as his remuneration for Reconstitution expenses and partner is to bear Reconstitution expenses

As Partner is paid fixed amount for Remuneration (including expenses), No entry is passed regarding payment of expenses. Only remuneration due to Partner journal entry is passed.

Journal Entry passed here for remuneration due to Partner is

Revaluation A/C……………………….Dr

To Concerned Partner's Capital A/C

Case 4. If Expenses are paid by the Firm on Behalf of the Partner

In case, amount paid by Firm on behalf of Concerned Partner is considered as his drawings.

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Journal Entry Passed in this case:

Concerned Partner's Capital A/C…………………Dr

To Cash/Bank A/C

Case 5. When Firm pays amount to a Partner as his remuneration for reconstitution expenses but Reconstitution expenses are borne by the Firm:

In this case, Firm pays remuneration to Concerned Partner for carrying reconstitution work But expenses of Reconstitution are borne by the Firm.

Journal Entry passed in this case:

For remuneration due to Partner

Revaluation A/C……………………….Dr

To Concerned Partner's Capital A/C

For expenses borne and paid by Firm

Revaluation A/C……………………….Dr

To Cash/Bank A/C

Case 6: When Reconstitution expenses are to be borne by one Partner Say A and paid by another Partner say B.

In this case, Journal Entry passed will be

A's Capital A/C…………………Dr

To B's Capital A/C

Case 7. In case question is silent about treatment of Reconstitution expenses, it is assumed that it has met by Firm

In this case, Journal Entry passed will be

Revaluation A/C……………………….Dr

To Cash/Bank A/C

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