CHAPTER 3

RECONSTITUTION OF A PARTNERSHIP FIRM- ADMISSION OF A PARTNER

RECONSTITUTION OF A PARTNERSHIP FIRM

Partnership is an agreement between two or more persons for sharing profits of a business carried on by all or any of them acting for all. Any change in the relationship among partners are called Reconstitution of a Partnership Firm.

Modes of Reconstitution of a Partnership Firm

Reconstitution of a Partnership Firm usually takes place in any of the following ways:

1. Changes in profit sharing ratio
2. Admission of a partner
3. Retirement of a partner
4. Death of a partner
5. Amalgamation of two partnership firms

ADMISSION OF A PARTNER

Inclusion of a new person as partner to an existing firm is called admission of a partner. The new partner who joins the business is called incoming partner, he receives the following rights:

a. A right to share the assets of the firm
b. A right to share profits/loss of the business

For acquisition of the right to share the asset, he has brought in an agreed amount of capital. For the right to share profits he is required to bring his share of goodwill.

Accounting Treatment at the time of Admission of a partner

1. Capital of incoming partner
2. Ascertainment of new ratio and sacrificing ratio
3. Revaluation of assets and liabilities
4. Distribution of reserves and accumulated profits or losses
5. Treatment of goodwill
6. Adjustment of capital accounts

I. Capital of Incoming Partner

The new partner has brought in an agreed amount of capital; the journal entry is:

Cash/Assets a/c Dr
    Incoming Partner's Capital A/c

II. Ascertainment of New Ratio and Sacrificing Ratio

a. New Profit Sharing Ratio

On admission of a partner, the profit sharing ratio among old partners will change keeping in view their respective contribution to the profit sharing ratio of the new partner. Hence, there is a need to ascertain the New Profit Sharing Ratio.

b. *Sacrificing Ratio*

The ratio in which the old partners agreed to sacrifice their share of profit in favour of the incoming partners is called sacrificing ratio.

Sacrificing Ratio= Old Ratio- New ratio

Distinction between New Profit - Sharing ratio and sacrificing ratio:

New Profit Sharing Ratio	Sacrificing Ratio
It is related to all the Partners (including new)	It is related to old partners only
It is the ratio in which the all partner (including new) will share profit in future.	It is the ratio in which old partners have sacrificed their share in favour of new Partner or when profit sharing Ratio is changed.
New Profit sharing Ratio = Old Ratio - Sacrificing Ratio	Sacrificing Ratio = Old Ratio - New Ratio

III. Revaluation of assets and liabilities

For ascertaining the profit or loss on revaluation of assets and liabilities, the firm has to prepare the ***Revaluation account*** or ***Profits and Loss Adjustment account***.

Revaluation account is a ***nominal account*** which is prepared to bring the assets and liabilities of the firm to their true values and to find out the profits or loss on revaluation of assets and revaluation of liabilities.

The revaluation account is credited with increase in the value of assets and decrease in the value liabilities and debited with decrease in the value of assets and increase in the value of liabilities. The balance in the Revaluation Account represents ***the profits or loss on revaluation*** and is transferred to the old partners' capital account in their ***Old Ratio***.

Journal Entries;

(a) For Profit Items:		
For any increase in the value of assets	Assets Account To Revaluation Account	Dr.
For any decrease in the value of liabilities	Liabilities Account To Revaluation Account	Dr.
(b) For Loss Items:		
For any decrease in the value of assets	Revaluation Account To Assets Account	Dr.
For any increase in the value of liabilities	Revaluation Account To Liabilities Account	Dr.
(c) For Transferring the Profit or Loss on Revaluation Account:		
For Profit on Revaluation Account	Revaluation Account To Old Partners' Capital Account	Dr.
For any Loss on Revaluation Account	Old Partners' Capital Account To Revaluation Account	Dr.

IV. Distribution of reserves and accumulated profits or losses

(i) ***For distribution of undistributed profit and reserve.***

Reserves A/c Dr
Profit & Loss A/c(Profit) Dr.
    To Partner's Capital A/c [individually]
[Reserves and Profit & Loss (Profit) transferred to all partner's capitals A/c in existing profit sharing ratio]

(ii) ***For distribution of loss***

Partner's Capital A/c Dr. [individually]
    To Profit and Loss A/c [Loss]

[Profit & Loss (loss) transferred to all partner's capitals A/c in existing profit sharing ratio]

V. Accounting Treatment of Goodwill

1. When Goodwill (Premium) is paid by the New Partner Privately- **No Entry**

2. When Goodwill brought in Cash by the New Partner

   Cash/Bank A/c ...Dr.
       To Old Partners' Capital A/c (Sacrificing Ratio)

3. Goodwill Withdrawn by the Sacrificing (Old) Partners

   Old Partners' Capital A/c s ...Dr.
       To Cash/Bank A/c (Sacrificing Ratio)

4. Goodwill not brought in Cash

   New Partner's Capital or Current A/c ... Dr.
       To Old Partners' Capital or current A/c [Sacrificing Ratio]

5. Goodwill brought in Kind

   Assets A/c ...Dr.
       To Old Partners' capital A/c (Sacrificing Ratio)

6. Hidden goodwill

It is excess of estimated total capital of the firm over the adjusted combined capital of all the partners (including new partner)

Sometime goodwill is not given in question, but required to determine on basis of given information

Calculation of goodwill	Amount
Total Estimated capital (New partner capital × reciprocal of his share)	XXX
Less : Adjusted capital of all partners (including new partner)	XXX
Goodwill of the firm	XXX

VI. <u>Adjustment of capital</u>

Adjustment of capital may be classified into two types:

a) ***Adjustment of old partner capital on basis of new partner capital***

On admission of a new partner, capital of old partner will be adjusted in proportionate to their new profit sharing ratio.

<u>Following steps are followed:</u>

Particular
Amt.

STEP1: Calculate total estimated capital of the firm XX

(New partner's capital × Reciprocal of his share)

STEP2: Determine new capital of old partner XXX

Total capital (STEP-1) is divided in their new profit sharing ratio.

STEP3: Ascertain adjusted capital of old partner by preparing partner capital A/c XXX

STEP4: Find out surplus/deficit of old partner by comparing Step-2 & STEP-3 XXX

ACCOUNTING ENTRY

(i) *Surplus partner will withdraw surplus capital from*

Surplus partner Capital A/c	Dr.	XXX	
To cash A/c or partner Current A/c			XXX
(Being Surplus partner will withdraw surplus capital from firm)			

(ii) Deficit partner will bring deficit capital in the firm.

Cash A/c or partner Current A/c	Dr.	XXX	
To Deficit partner Capital A/c			XXX
(Being Deficit partner will bring deficit capital in the firm)			

Note : Surplus / Deficit of old partner can be adjusted through Cash A/c or Partner Current A/c as per instruction of the question.

b) Adjustment of new partner capital on basis of old partner capital

On admission of a new partner, new partner will contribute capital in proportionate to his share of profit.

Following steps are followed:

Particular	Amt.
STEP1: Calculate total estimated capital of the firm (Sum of adjusted capital of the old partners × Reciprocal of their share)	XXX
STEP2: Determine capital of new partner { Total capital (STEP-1) × Reciprocal of new partner share}	XXX