Reconstitution- Change in Existing Profit Sharing Ratio

Introduction to Reconsitution of Partnership Firm

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Meaning of Reconstitution of a Partnership Firm
- Modes of Reconstitution of a Partnership Firm

Reconstitution of a Partnership Firm

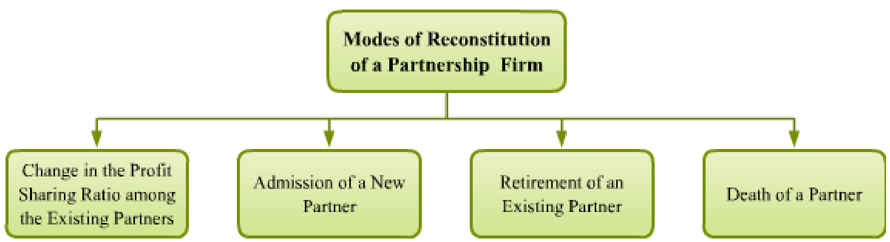
As we know that a partnership deed is an agreement between two or more persons carrying out the business activities of a partnership firm. Therefore, any change in the partnership deed leads to the ***Reconstitution of a Partnership Firm***. In other words, reconstitution of a partnership firm can be described as a situation when there occurs any change in the existing partnership agreement. In the case of reconstitution of a partnership firm, the old or existing partnership deed terminates and a new partnership agreement comes into form. This new deed defines a new relationship among the partners of the reconstituted partnership firm. However; reconstitution of the partnership firm should not be misunderstood as discontinuation of the old partnership firm, in fact, it is only the change in the partnership deed.

Modes of Reconstitution of a Partnership Firm

Modes of reconstitution of a partnership firm refer to the various ways in which the reconstitution of a partnership firm can take place. The following are the different ways which leads to reconstitution of a partnership firm.

i. Change in profit-sharing ratio
ii. Admission of a new partner
iii. Retirement of an existing partner
iv. Death of a partner

The following is the diagrammatic presentation of the various modes of reconstitution of a partnership firm.



(i) Change in the Profit-Sharing Ratio

Change in the profit-sharing ratio means an alteration in the existing profit-sharing ratio among the existing partners. Whenever the existing partners of a partnership firm decide to change their existing profit-sharing ratio, then it results in reconstitution of the partnership firm.

Example

Charu, Soniya and Amita are three partners sharing profits and losses in the ratio of 5:3:2. On April 01, 2012, they decided to share profits and losses in the ratio of 2:2:1. Hence, as there is a change in the old profit-sharing ratio from 5:3:2 to 2:2:1, so it results in the reconstitution of the partnership firm.

(ii) Admission of a New Partner

Often with the passage of time business expands and it becomes necessary for a partnership firm to admit a new partner or partners. It may be due to requirement of more capital and/or need of more partners to manage business efficiently. With the admission of a new partner, a new partnership agreement is formed, which replaces the existing partnership agreement.

Example

Rina and Hina are two partners sharing profits and losses in the ratio of 4:3. They decided to admit Meena as a new partner for $\frac{1}{4}^{\text{th}}$ share in profits. Meena is to bring Rs 50,000 as her capital contribution. Hence, we can conclude that with the admission of a new partner, there exists reconstitution of a partnership firm.

(iii) Retirement of an Existing Partner

A partner may take retirement from (or leave) a partnership firm due to many reasons such as, illness, old age, change in the business interests, etc. Similar to the admission of a new partner, retirement of a partner also results in the reconstitution of the firm. This is because on the eve of retirement of a partner a new partnership agreement is formed, which replaces the old agreement.

Example

Jiya, Riya and Priya are three partners sharing profits and losses in the ratio of 3:2:1. On April 1, 2012, Riya decided to retire from the firm. Consequently, this results in reconstitution of the partnership firm.

(iv) Death of a Partner

In case of death of any partner of a firm, the remaining partners may wish to continue the business of the firm. In such a situation, reconstitution of a partnership firm will automatically take place. This is because a new partnership agreement is to be formed in order to continue with the partnership business.

However, if there is only two partners in a firm and in the meanwhile one partner dies, the firm will have to dissolve even if the remaining one partner wants to carry on a business. This is because the basic condition of having minimum of two partners to carry a partnership business get violated. A single partner can not carry a partnership business and rather he/she is treated as a sole proprietor.

Example

Dinesh, Deepak and Pinaki are partners of a partnership firm with profit-sharing ratio of 2:1:2. On October 1, 2012, Deepak dies. After his death, Dinesh and Pinaki decided to continue with the partnership business sharing future profits and losses in the ratio of 2:1. This is regarded as reconstitution of a partnership firm due to death of a partner.

Calculation of New Profit Sharing Ratio, Sacrificing and Gaining Ratio

Objective

After going through this lesson, you shall be able to understand the following concepts in the context of 'Change in Profit Sharing Ratio'.

- Introduction to Change in Profit-Sharing Ratio among Existing Partners
- New Profit Sharing Ratio and its Calculation
- Sacrificing/Gaining Ratio and its Calculation

Introduction to Change in Profit-Sharing Ratio among Existing Partners

By now, we all know that on the eve of the change in profit sharing ratio, there occurs a change in the existing relationship among the partners. It may happen that a partner sacrifices some part of his/her share in favour of the other partner(s) or vice versa. Thus, it becomes necessary to calculate the new ratio of the partners and the part sacrificed/gained thereof.

Example

Anushka and Aditya are partners sharing profits and losses in the ratio of 5:3. They decided to share future profits and losses in the equal ratio. Due to change in profit-sharing ratio among the partners, one or more partner (partners) sacrifice in the equal proportion of gain by the other partner (s). In other words, we can say that the amount of gain by one or more partner (s) is equal to the amount of sacrifice by the other partner(s).

Example

Riya, Raju and Rishi are partners sharing profits and losses in the ratio of 2:3:1. One day, they mutually decided to share future profits and losses in the ratio of 1:3:2. Thus, there exists a change in the profit sharing ratio among the existing partners.

Now, when profit-sharing ratio changes, there are various adjustments that must be dealt with. These adjustments are given below.

- Calculation of New Ratio, Sacrificing Ratio and Gaining Ratio
- Treatment of Goodwill
- Adjustment of Accumulated Profits and Losses
- Revaluation of Assets and Revaluation of Liabilities

In this particular lesson, our prime focus is to understand the calculation of new profit sharing ratio and sacrificing/gaining ratio at the time of change in profit sharing ratio among the existing partners.

New Profit Sharing Ratio

The ratio in which all the partners have agreed to share the future profits and losses is regarded as new profit sharing ratio.

Calculation of New Ratio

The computation of new profit sharing ratio mainly depends upon how the partner is acquiring his/her share of profit from the other partners. There are various permutations and combinations to it. For example, A, B and C are partners of a partnership firm sharing profits and losses equally. It was decided that B will get 1/5th share in the profits of the firm in addition to his existing shares. Now there may arise two possibilities.

- Either, B will acquire his share from A or C individually
- Or, B will acquire the share from both A and C

Now, let us consider the following examples to have a better conceptual understanding.

***Example* 1**: Anurag, Ashish and Aniket are partners sharing profits and losses equally. Aniket acquires 1/3rd additional share in the profits of the firm. It was acquired 16th from Anurag and 1/6th from Ashish. Calculate the new profit sharing ratio.

Solution

Old Ratio = 1:1:1
Aniket takes $\frac{1}{6}\mathrm{th}$ share from Anurag and $\frac{1}{6}\mathrm{th}$ share from Ashish
Therefore,

New Ratio = Old Ratio — Share Surrendered (+ Share Acquired)

Anurag's New Share = $\frac{1}{3} - \frac{1}{6} = \frac{2-1}{6} = \frac{1}{6}$

Ashish's New Share = $\frac{1}{3} - \frac{1}{6} = \frac{2-1}{6} = \frac{1}{6}$

Aniket's New Share = $\frac{1}{3} + \frac{1}{6} + \frac{1}{6} = \frac{2+1+1}{6} = \frac{4}{6}$

∴ New Profit Sharing Ratio = 1:1:4

Consider the same question but with a twist. Now, the question says, Aniket acquires his $\frac{1}{3}rd$ share equally from both the partners.
Here, we have to compute the share surrendered by the other partners i.e. Anurag and Ashish.

Aniket acquires $\frac{1}{3}\mathrm{rd}$ share from Anurag and Ashish in the ratio of 1:1
This means,
Anurag surrendered $\frac{1}{2}\mathrm{nd}$ of the share given to Aniket i.e. $\frac{1}{3} \times \frac{1}{2} = \frac{1}{6}$

Ashish surrendered $\frac{1}{2}$nd of the share given to Aniket i.e. $\frac{1}{3} \times \frac{1}{2} = \frac{1}{6}$

New Ratio = Old Ratio — Share Surrendered (+ Share Acquired)

Anurag's New Share = $\frac{1}{3} - \frac{1}{6} = \frac{2-1}{6} = \frac{1}{6}$

Ashish's New Share = $\frac{1}{3} - \frac{1}{6} = \frac{2-1}{6} = \frac{1}{6}$

Aniket's New Share = $\frac{1}{3} + \frac{1}{6} + \frac{1}{6} = \frac{2+1+1}{6} = \frac{4}{6}$

∴ New Profit Sharing Ratio = 1:1:4

The ratio in both the cases is same. It is because the surrendered share in both the cases is same.

***Example* 2**: Priya, Kriya and Riya are partners in a firm. The profits and the losses were shared in the ratio of 5:3:2. They decided to change their profit sharing ratio. Kriya acquires 12nd share from Priya and Riya in the ratio of 2:1. Calculate the new profit sharing ratio of Priya, Kriya and Riya.

Solution

Old Ratio = 5:3:2

Kriya acquires $\frac{1}{2}$nd share from Priya and Kriya in the ratio of 2:1
This means,
Share acquired from Priya = $\frac{1}{2} \times \frac{2}{3} = \frac{1}{3}$

Share acquired from Kriya = $\frac{1}{2} \times \frac{1}{3} = \frac{1}{6}$

New Ratio = Old Ratio — Share Surrendered (+ Share Acquired)

Priya's New Share = $\frac{5}{10} - \frac{1}{3} = \frac{15-10}{30} = \frac{5}{30}$

Riya's New Share = $\frac{2}{10} - \frac{1}{6} = \frac{6-5}{30} = \frac{1}{30}$

Kriya's New Share = $\frac{3}{10} + \frac{1}{3} + \frac{1}{6} = \frac{9+10+5}{30} = \frac{24}{30}$

∴ New Profit Sharing Ratio of Priya, Kriya and Riya = 5:1:24

***Example* 3**: Neha, Sam and Saurabh are partners in a firm. They share profits and losses in the ratio of 4:4:2. Saurabh acquires 13rd additional share in the firm's profit. Ascertain the new profit sharing of Neha, Sam and Saurabh in each of the following cases.
Case (a): When Saurabh acquires his share from Neha.
Case (b): When Saurabh acquires his share from Neha and Sam equally.

Solution

Case (a):When Saurabh acquires his share from Neha	**Case (b): When Saurabh acquires his share from Neha and Sam equally**
Old Ratio = 4:4:2	Old Ratio (Neha and Sam) = 4:4:2
Saurabh acquires 13rd share of the profit.	Saurabh acquires 13rd share of the profit.
Saurabh acquires his share from Neha	Saurabh acquires his share from Sam and Neha equally.

Share acquired from Neha $= \frac{1}{3}$ Neha's New Share $= \frac{4}{10} - \frac{1}{3} = \frac{12-10}{30} = \frac{2}{30}$ Sam's New Share $= \frac{4}{10}\, or\, \frac{12}{30}$ Saurabh's New Share $= \frac{2}{10} + \frac{1}{3} = \frac{6+10}{30} = \frac{16}{30}$	Share acquired from Neha $= \frac{1}{3} \times \frac{1}{2} = \frac{1}{6}$ Share acquired from Sam $= \frac{1}{3} \times \frac{1}{2} = \frac{1}{6}$ Neha's New Share $= \frac{4}{10} - \frac{1}{6} = \frac{12-5}{30} = \frac{7}{30}$ Sam's New Share $= \frac{4}{10} - \frac{1}{6} = \frac{12-5}{30} = \frac{7}{30}$ Saurabh's New Share $= \frac{2}{10} + \frac{1}{6} + \frac{1}{6} = \frac{6+5+5}{30} = \frac{16}{30}$
∴ New Profit Sharing Ratio of Neha, Sam and Saurabh = 2:12:16 or 1:6:8	∴ New Profit Sharing Ratio of Neha, Sam and Saurabh = 7:7:16

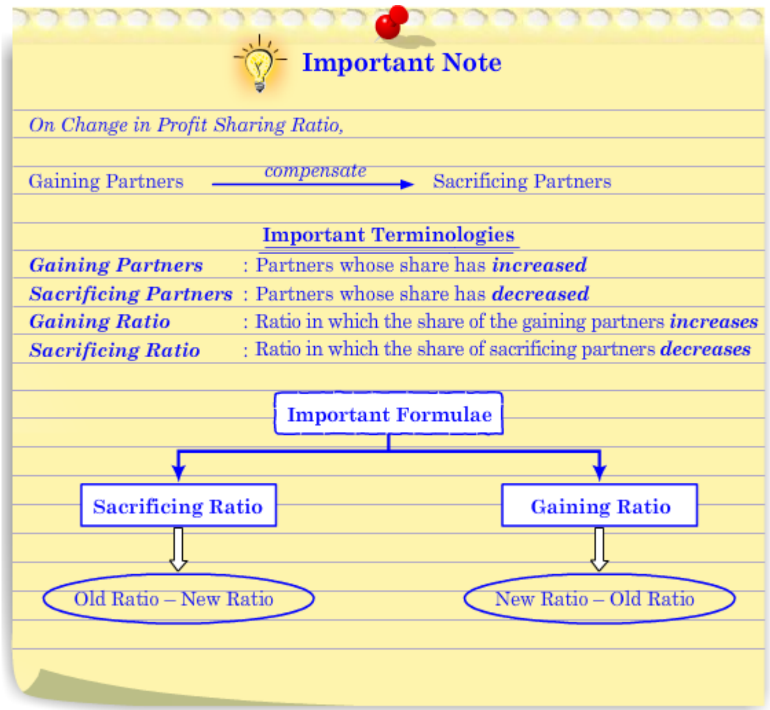
Sacrificing Ratio and its Calculation

So far, we have learnt that whenever there is a change in the profit sharing ratio among the existing partners, the partners sacrifice a portion of their profit share in favour of the other partner in an agreed ratio. The ratio in which the partners surrender their share of profit in favour of the other partner is termed as Sacrificing Ratio. In this manner, the sacrificing ratio is defined as a difference between the old profit share and the new profit share of the partners.

Algebraically,

Sacrificing Ratio = Old Ratio – New Ratio

Now let us have a look on the following diagram.



Now, let us enhance our understanding with the help of the following examples.

Example **4**: Ritika and Sohita are two partners in a firm. They share the profits and the losses in the ratio of 9:6. On any given date, they decided to share profits and losses equally. Ascertain the gain or sacrifice made by the partners.

Solution

Old Ratio = 9:6
New Ratio = 1:1

Sacrificing/Gaining Ratio = Old Ratio – New Ratio

$$\text{Ritika} = \frac{9}{15} - \frac{1}{2} = \frac{18-15}{30} = \frac{3}{30}\left(\text{Sacrifice}\right)$$
$$\text{Sohita} = \frac{6}{15} - \frac{1}{2} = \frac{12-15}{30} = -\frac{3}{30}\left(\text{Gain}\right)$$

The negative sign implies that Sohita is gaining.
Thus, in this case, Ritika is sacrificing and Sohita is gaining.

Example **5**: Meet, Geet and Reet are two partners in a firm. They share the profits and the losses in an equal ratio. The partners decided to share their future profits and losses in the ratio of 8:4:3. Ascertain the Sacrificing Ratio.

Solution

Sacrificing/Gaining Ratio = Old Ratio – New Ratio

$$\text{Meet} = \frac{1}{3} - \frac{8}{15} = \frac{5-8}{15} = -\frac{3}{15}\left(\text{Gain}\right)$$

$$\text{Geet} = \frac{1}{3} - \frac{4}{15} = \frac{5-4}{15} = \frac{1}{15}\left(\text{Sacrifice}\right)$$

$$\text{Reet} = \frac{1}{3} - \frac{3}{15} = \frac{5-3}{15} = \frac{2}{15}\left(\text{Sacrifice}\right)$$

Thus, the Sacrificing Ratio of Geet and Reet is 1:2.

***Example* 6**: Ramesh, Mahesh and Rakesh are partners in a firm. They share the profits and the losses in the ratio of 5:3:2. They all decided to share their future profits and losses in the ratio of 2:5:5. Calculate the sacrificing ratio.

Solution

Sacrificing/Gaining Ratio = Old Ratio – New Ratio

Ramesh =510-212=30-1060=2060 (Sacrifice)Mahesh =310-512=18-2560=-760 (Gain)Rakesh =210-512=12-2560=-1360 (Gain)

The Sacrificing Ratio cannot be computed as only one partner (Ramesh) is sacrificing while the others are gaining. However, their sacrifice/gain shares have been calculated.

***Example* 7**: J, K and L are partners sharing their profits and losses in the ratio of 2:2:1. Calculate the new profit sharing ratio and gain/sacrifice of each partner if L acquires 13rd share from J and K equally.

Solution

Particulars	J	K	L
Old Ratio	$\frac{2}{5}$	$\frac{2}{5}$	$\frac{1}{5}$
L acquires 1/3 from J and K	$\frac{1}{3} \times \frac{1}{2} = \frac{1}{6}$	$\frac{1}{3} \times \frac{1}{2} = \frac{1}{6}$	$\frac{1}{6} + \frac{1}{6} = \frac{2}{6}$
New Share	$\frac{2}{5} - \frac{1}{6} = \frac{7}{30}$	$\frac{2}{5} - \frac{1}{6} = \frac{7}{30}$	$\frac{1}{5} + \frac{2}{6} = \frac{16}{30}$
New Ratio of J, K and L = 7:7:16			

Sacrifice/Gaining Ratio = Old Ratio – New Ratio

$$\text{J} = \frac{2}{5} - \frac{7}{30} = \frac{5}{30}\,(Sacrifice)$$

$$\text{K} = \frac{2}{5} - \frac{7}{30} = \frac{5}{30}\,(Sacrifice)$$

$$\text{L} = \frac{1}{5} - \frac{16}{30} = -\frac{10}{30}\,(Gain)$$

The negative sign implies that L is gaining. Thus, L needs to compensate J and K, who are sacrificing.

Objective

After going through this lesson, you shall be able to understand the following concepts.

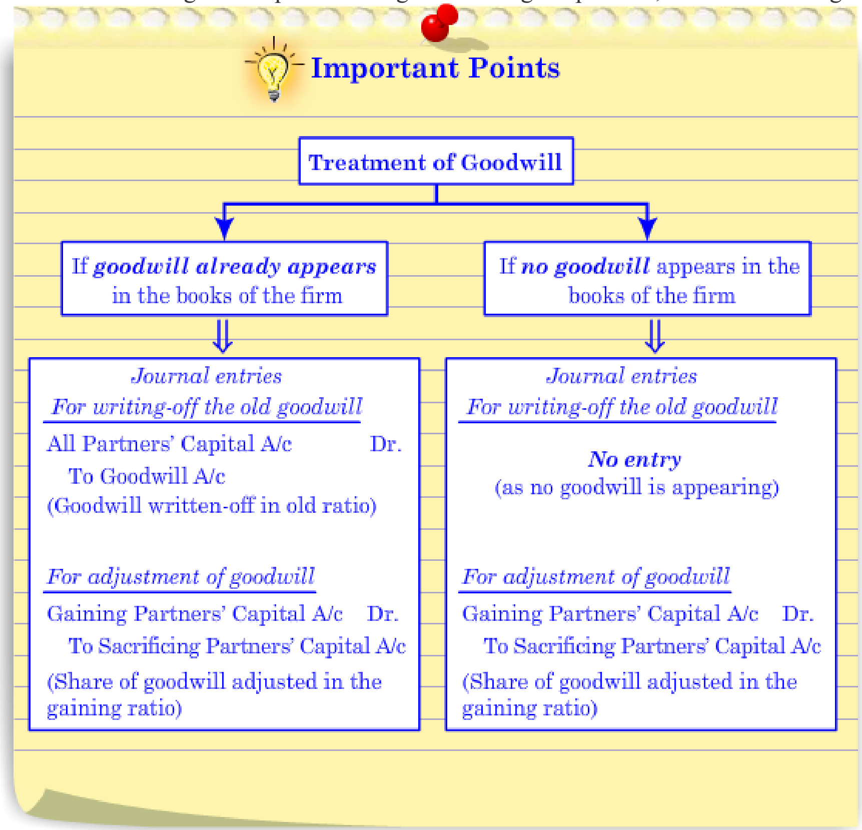
- Treatment of Goodwill
- Treatment of Reserves and Accumulated Profits and Losses
- Treatment of Workmen Compensation Reserve and Contingency Reserve
- Treatment of Investment Fluctuation Fund

Introduction

We already know that a partnership is the result of *an agreement between two or more persons who have agreed to share profits and losses of the business carried on by all or any one of them acting for all*. But sometimes, the partners may decide among themselves to change the profit sharing ratio. In such a situation, the partnership firm is said to be reconstituted. In this particular lesson, we will tackle all the adjustments that are required to be made at the time of change in profit sharing ratio.

Treatment of Goodwill

At the time of change in the profit sharing ratio among the partners, the treatment of goodwill is explained through the following diagram.



Note: *In case of fixed capital, goodwill is to be adjusted through Partners' Current Account.*

After discussing the treatment of goodwill, now let us go through the following examples.
***Example* 1**: Amit and Sumit are partners in a firm sharing profits and losses in the ratio of 3:2. They decided to share the profits and losses in the ratio of 5:3. Goodwill of the firm was valued at Rs 63,000. Show the effect of the change in profit sharing ratio.

Solution

In this case, old goodwill does not appear in the books, therefore, goodwill is to be adjusted by calculating the gaining and the sacrificing share of partners.

Journal				
Date	**Particulars**	**L.F.**	**Debit Amount**	**Credit Amount**

Date	Particulars		L.F.	(Rs)	(Rs)
	Amit's Capital A/c	Dr.		1,575	
	To Sumit's Capital A/c				1,575
	(Adjustment made for Goodwill)				

Sacrificing/Gaining Ratio = Old Ratio – New Ratio

Amit = 35 - 58=24 - 2540=-140 (Gain)Sumit = 25 - 38 = 16 - 1540 = 140 (Sacrifice)Amount of goodwill to be adjusted= 63,000×140=Rs 1,575

***Example* 2**: Sneha and Neha are partners in a firm. They share their profits and losses in the ratio of 4:3. They decide to share their profits and losses in the ratio of 3:5. Goodwill of the firm was valued at Rs 63,000. Show the effect of the above in the following cases.
Case 1: When no goodwill appears in the books
Case 2: When goodwill appears in the books at Rs 35,000

Solution

Case 1: **When no goodwill appears in the books**

Journal

Date	Particulars		L.F.	Debit Amount (Rs)	Credit Amount (Rs)
	Neha 's Capital A/c	Dr.		12,375	
	To Sneha's Capital A/c				12,375
	(Adjustment made for Goodwill)				

Sacrificing/Gaining Ratio = Old Ratio – New Ratio

Sneha = 47-38= 1156(Sacrifice)Neha = 37-58= -1156(Gain)

Calculation of amount of Goodwill = 63,000 ×1156= Rs 12,375

Case 2: **When goodwill appears in the books at Rs 35,000**

Journal

Date	Particulars		L.F.	Debit Amount (Rs)	Credit Amount (Rs)
	Sneha's Capital A/c	Dr.		20,000	
	Neha's Capital A/c	Dr.		15,000	
	To Goodwill A/c				35,000
	(Old goodwill written off)				
	Neha's Capital A/c	Dr.		12,375	
	To Sneha's Capital A/c				12,375
	(Adjustment made for Goodwill)				

Treatment of Reserves and Accumulated Profits and Losses

Generally, accumulated profits (or losses) and reserves in the form of Reserve Fund, General Reserve, Profit and Loss Account, Investment Fluctuation Fund, Workmen's

Compensation Reserve, etc. appear in the books of the firm at the time of change in profit sharing ratio. Such accumulated profits (or losses) are to be adjusted before such change in the ratio is put into effect.

Accounting Treatment

(i) *For Distribution of Accumulated Profits and Reserves*

Profit & Loss A/c	Dr.	In Old Ratio
General Reserve A/c	Dr.	
Reserve Fund A/c	Dr.	
Workmen's Compensation Fund A/c* (*See Note*)	Dr.	With excess amount only
Contingency Reserve A/c* (*See Note*)	Dr.	
Investment Fluctuation Fund A/c* (*See Note*)	Dr.	
To All Partners' Capital A/c (Undistributed profits and reserves are distributed among old partners in their old profit sharing ratio)		

* The accounting treatment of accumulated profits and losses is presented in the note given below.

Accounting Treatment of Accumulated Profits and Losses

1. ***When Value given in Adjustment < Value given in Balance Sheet***

then

All Partners' Capital A/c
Difference amount is shown on the credit side (in old ratio)

Balance Sheet
Value given in the adjustment is shown on the Liabilities side

2. ***When Value given in Adjustment > Value given in Balance Sheet***

then

Revaluation A/c
Difference amount is shown on the debit side (being a loss)

Balance Sheet
Value given in the adjustment is shown on the Liabilities side

3. ***When there is no adjustment related to these reserves***

then

All Partners' Capital A/c
Distribute the whole amount on the credit side (in old ratio)

(ii) *For Distribution of Accumulated Losses*

All Partners' Capital A/c	Dr.	
To Profit & Loss A/c (Debit balance)		} [In Old Ratio]
To Deferred Advertisement Expenses A/c		
(Undistributed losses are distributed among old partners in their old profit sharing ratio)		

***Example* 3**: Gaurav and Saurav are the two partners sharing profits and losses in the ratio of 7:3. With mutual agreement, they decided to change their profit sharing ratio to 3:2. On the same date, the firm had a reserve fund of Rs 50,000 and also had a debit balance of Rs 15,000 in the Profit and Loss Account. Pass the necessary Journal entries in the books of accounts.

Solution

(i)	Reserve Fund A/c	Dr.	50,000		
	To Gaurav's Capital A/c			35,000	[In Old Ratio]
	To Saurav's Capital A/c			15,000	
	(Reserve Fund transferred to the capitals accounts of Gaurav and Saurav in their old profit sharing ratio)				
(ii)	Gaurav's Capital A/c	Dr.	10,500		
	Saurav's Capital A/c	Dr.	4,500		
	To Profit and Loss A/c			15,000	
	(Debit balance of Profit and Loss Account is transferred to Partners' Capital Account in their old ratio)				

The following is the list of items that should not be distributed among the old partners while distributing accumulated profits and reserves.

Important Point

DON'T ever distribute the following items among the partners!!

1. Employees Provident Fund
2. Provision for Tax
3. Taxation Reserve
4. Joint Life Policy (JLP) Reserve
5. Depreciation Reserve (such as Machinery Replacement Reserve)

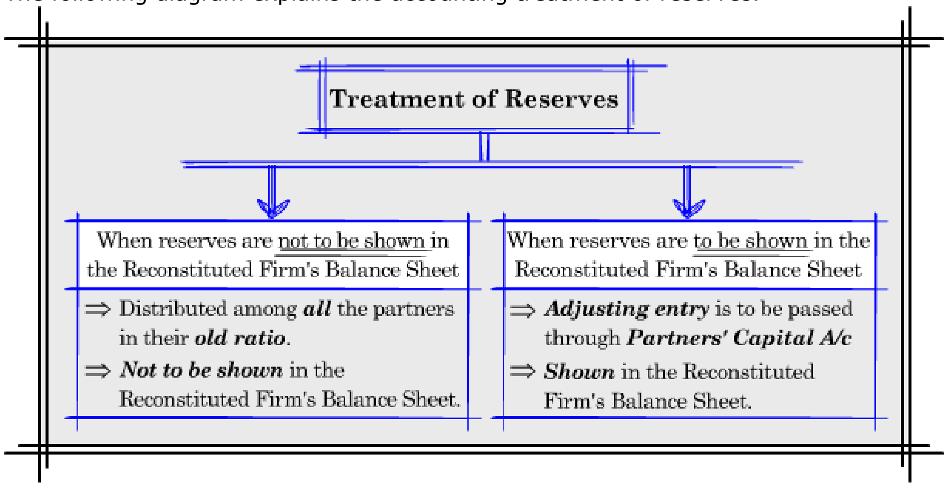
Note: *Do not distribute such items among the partners as these are shown on the 'Liabilities' side of the New Balance Sheet of the reconstituted firm.*

When Reserves are to be shown in the New Books

The treatment of reserves will remain the same as mentioned above if the question does not specify any specific condition for it. Besides this, at times, it might be stated in the question that the partners wish to show reserves in the books of the newly reconstituted firm. In such instances, the question specifies this statement in the following manner "*the partners decided to show the reserves (say, General Reserve) in the books of the reconstituted firm*". In such cases, the concerned reserve is adjusted among the gaining and sacrificing partners (as indicated after the calculation). The Journal entry so passed is termed as the 'adjusting Journal entry'. As per this entry, the gaining partners compensate the sacrificing partners. Therefore, the former's capital accounts are debited, while the latter's capital accounts are credited. This is presented below.

Adjusting Journal Entry: **When Reserves are to be shown in New Balance Sheet**		
Gaining Partners' Capital A/c To Sacrificing Partners' Capital A/c (Adjustment is made through Partners' Capital Accounts)	Dr.	*In Gaining or Sacrificing Ratio*

The following diagram explains the accounting treatment of reserves.



Example **4**: Ruhi, Shikha and Roshan are partners sharing their profits and losses in the ratio of 5:3:2. They decide to share their future profits in the ratio of 3:1:1 with effect from April 01, 2014. The following items appear in the firm's Balance Sheet.
General Reserve Rs 75,000, Advertisement Suspense A/c Rs 50,000 and Contingency Reserve Rs 25,000.
Show the treatment of the above items in each of the following cases.
Case 1: When reserves are ***not to be shown*** in the Balance Sheet
Case 2: When reserves are ***to be shown*** in the Balance Sheet

Solution

Case 1: **When reserves are not to be shown in the Balance Sheet**

Journal Entry					
Date	**Particulars**		**L.F.**	**Debit Amount Rs**	**Credit Amount Rs**
	General Reserve A/c	Dr.		75,000	
	Contingency Reserve A/c			25,000	
	To Ruhi's Capital A/c				50,000
	To Shikha's Capital A/c				30,000

	To Roshan's Capital A/c				20,000
	(Reserves distributed among partners in their old profit sharing ratio)				
	Ruhi's Capital A/c	Dr.		25,000	
	Shikha's Capital A/c	Dr.		15,000	
	Roshan's Capital A/c	Dr.		10,000	
	To Advertisement Suspense A/c				50,000
	(Accumulated loss transferred to all Partners' Capital Accounts in their old ratio)				

Case 2: **When reserves are to be shown in the Balance Sheet**

Journal Entry				
Particulars		**L.F.**	**Debit Amount Rs**	**Credit Amount Rs**
Ruhi's Capital A/c	Dr.		5,000	
To Shikha's Capital A/c				5,000
(Adjustment of reserves due to change in profit sharing ratio)				

Working Note

Reserves to be distributed	=	General Reserve + Contingency Reserve – Advertisement Suspense Account
	=	75,000 + 25,000 – 50,000 = Rs 50,000

$$\text{Ruhi} = \frac{5}{10} - \frac{3}{5} = -\frac{1}{10}$$
$$\text{Shikha} = \frac{3}{10} - \frac{1}{5} = \frac{1}{10}$$
$$\text{Roshan} = \frac{2}{10} - \frac{1}{5} = 0$$

The negative sign implies that Ruhi is gaining. Thus, Ruhi needs to compensate Shikha, who is sacrificing.

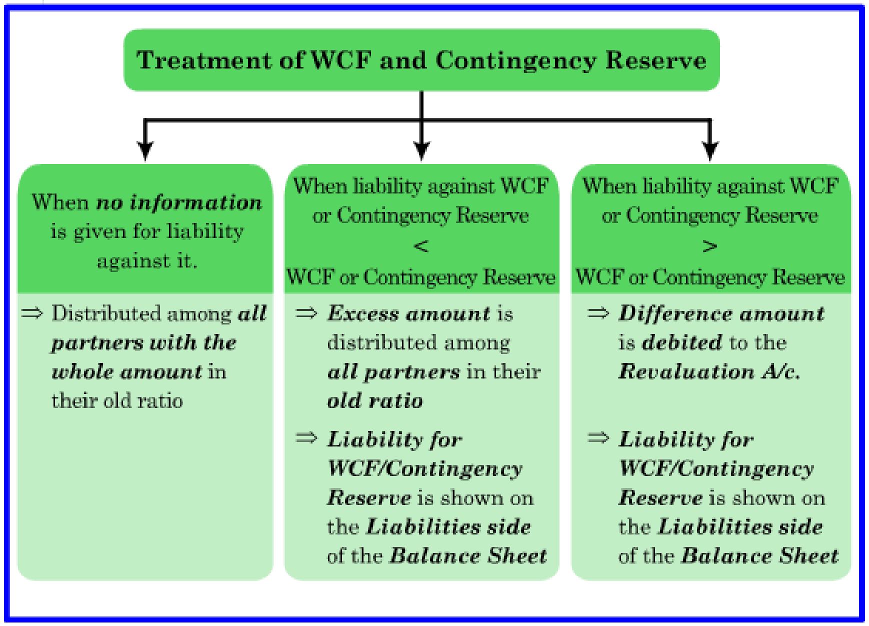
Treatment of Workmen Compensation Reserve and Contingency Reserve

Workmen Compensation Reserve- It is quite likely that the employees might get injured while working in the factories. Generally, in such cases, the employers compensate the employees for the expenses incurred by them on their medication. For such purposes, the firms transfer a certain portion of their profits to a separate reserve known as workmen compensation reserve.

Contingency Reserve- Contingent as the word suggests, refers to '*something the happening of which depends upon some future event*'. Numerous instances can be traced where the likelihood of possible claim against the firm is probable. For example, a suit filed in the court of law. Thus, the firms generally keep aside certain portion of their profits in the form of reserves to provide cover against such probable losses. Such reserves are termed as contingency reserves.

Accounting Treatment

Let us understand the accounting treatment in case of workmen compensation reserve and contingency reserve with the help of the following diagram.



<u>Example</u> **5**: Param, Karam and Varun are partners sharing their profits and losses in the ratio of 3:2:1. With effect from April 01, 2014 they decided to share profits and losses in the ratio of 1:2:5. An extract of their Balance as on March 31, 2014 is as follows.

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Workmen Compensation Fund (WCF)	3,000		

Show the treatment of WCF in each of the following cases.
Case 1: If there is no other information
Case 2: If a claim on account of WCF is estimated at Rs 600
Case 3: If a claim on account of WCF is estimated at Rs 4,800

Solution

Case 1: **If there is no other information**

Journal Entry					
Date	**Particulars**		**L.F.**	**Debit Amount Rs**	**Credit Amount Rs**
	Workmen Compensation Reserve A/c	Dr.		3,000	
	To Param's Capital A/c				1,500
	To Karam's Capital A/c				1,000
	To Varun's Capital A/c				500
	(WCF transferred among partners in their old profit sharing ratio)				

Case 2: **If a claim on account of WCF is estimated at Rs 600.**

Journal Entry					
Date	**Particulars**		**L.F.**	**Debit Amount Rs**	**Credit Amount Rs**
	Workmen Compensation Reserve A/c	Dr.		3,000	
	To Provision for WCF Claim A/c				600
	To Param's Capital A/c				1,200
	To Karam's Capital A/c				800
	To Varun's Capital A/c				400
	(Excess of WCF transferred among partners in their old profit sharing ratio)				

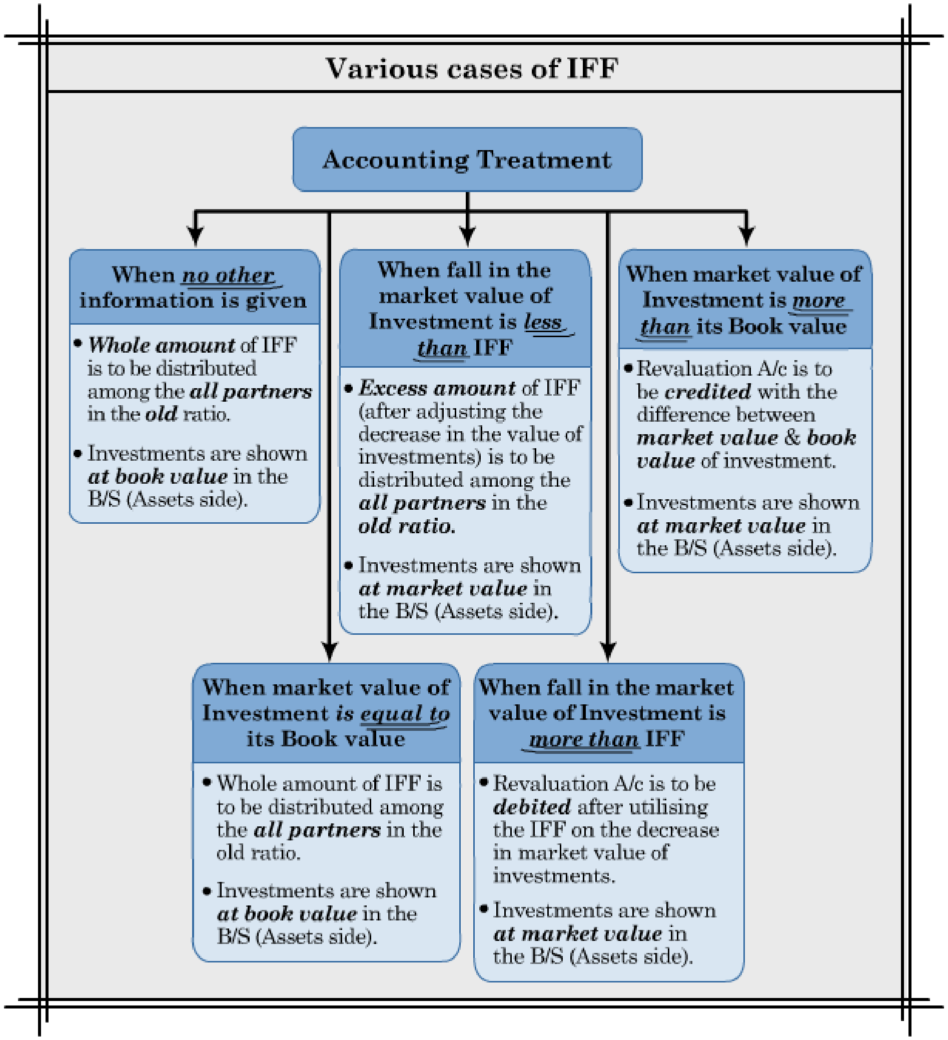
Case 3: **If a claim on account of WCF is estimated at Rs 4,800.**

Journal Entry					
Date	**Particulars**		**L.F.**	**Debit Amount Rs**	**Credit Amount Rs**
	Workmen Compensation Reserve A/c	Dr.		3,000	
	Revaluation A/c	Dr.		1,800	
	To Provision for WCF Claim A/c				4,800
	(Provision created and deficiency charged to Revaluation A/c)				
	Param's Capital A/c	Dr.		900	
	Karam's Capital A/c	Dr.		600	
	Varun's Capital A/c	Dr.		300	
	To Revaluation A/c				1,800
	(Loss on Revaluation transferred to Partners' Capital A/c in old ratio)				

Accounting Treatment of Investment Fluctuation Fund (IFF)

Investment Fluctuation Fund- Sometimes, the book value and market value of investments are not same. It is quite possible that the book value is greater (or less) than the market value. The firms generally create a separate fund known as Investment Fluctuation Fund to be secured from such fluctuations.

The treatment of IFF under various cases is diagrammatically presented below.



***Example* 6**: Richa and Nikhil are equal partners in a firm (i.e.sharing profits and losses in equally). They decided to share future profits and losses in the ratio of 3:2 with effect from April 01, 2014. An extract of the Balance Sheet as on March 31, 2014 is as follows.

Balance Sheet			
Liabilities	**Amount (Rs)**	**Assets**	**Amount (Rs)**
Investment Fluctuation Fund (IFF)	20,000	Investments	5,00,000

You are required to show the treatment of IFF in each of the following cases.

Case 1: If there is no other information
Case 2: If the market value of the investment is Rs 5,00,000
Case 3: If the market value of the investment is Rs 4,95,000

Case 4: If the market value of the investment is Rs 4,70,000
Case 5: If the market value of the investment is Rs 5,45,000

Solution

Both Case (1) and (2) will have the same effect.

<table>
<tr><th colspan="4">Case 1</th><th>Case 2</th></tr>
<tr><td>Investment Fluctuation Fund A/c</td><td>Dr.</td><td>20,000</td><td></td><td rowspan="4">The Journal entry will remain the same as in case (a) along with the respective amounts.</td></tr>
<tr><td colspan="2">To Richa’s Capital A/c</td><td></td><td>10,000</td></tr>
<tr><td colspan="2">To Nikhil’s Capital A/c</td><td></td><td>10,000</td></tr>
<tr><td colspan="2">(For transfer of IFF to Capital Accounts of Partners in old profit sharing ratio)</td><td></td><td></td></tr>
<tr><td colspan="5">Explanation: In case (1), since no information is given, the entire balance in the fund is distributed among the partners in their old ratio. Similarly, in case (2), the book value of the investment is equal to its market value. So, here also, the whole amount is distributed in the old ratio.</td></tr>
</table>

<table>
<tr><th colspan="4">Case 3</th><th>Explanation</th></tr>
<tr><td>Investment Fluctuation Fund A/c</td><td>Dr.</td><td>20,000</td><td></td><td rowspan="5">In this case, the market value of the investment (i.e. 4,95,000) is lesser than that of the book value (i.e. 5,00,000). However, this value is less than the balance available in the related fund (i.e. 20,000). Thus, the amount of 5,000 will be adjusted through the fund and the remaining amount will be distributed among the partners.</td></tr>
<tr><td colspan="2">To Investment A/c</td><td></td><td>5,000</td></tr>
<tr><td colspan="2">To Richa’s Capital A/c</td><td></td><td>7,500</td></tr>
<tr><td colspan="2">To Nikhil’s Capital A/c</td><td></td><td>7,500</td></tr>
<tr><td colspan="2">(For transfer of excess IFF to Capital Accounts of Partners in the old profit sharing ratio)</td><td></td><td></td></tr>
</table>

<table>
<tr><th colspan="4">Case 4</th><th colspan="4">Case 5</th></tr>
<tr><td>Investment Fluctuation Fund A/c</td><td>Dr.</td><td>20,000</td><td></td><td colspan="2">Investment Fluctuation Fund A/c</td><td>Dr. 20,000</td><td></td></tr>
<tr><td>Revaluation A/c</td><td>Dr.</td><td>10,000</td><td></td><td colspan="2">To Richa’s Capital A/c</td><td></td><td>10,000</td></tr>
<tr><td colspan="2">To Investment A/c</td><td></td><td>30,000</td><td colspan="2">To Nikhil’s Capital A/c</td><td></td><td>10,000</td></tr>
<tr><td colspan="2">(for fall in the value of investment adjusted against IFF and debited to Revaluation A/c)</td><td></td><td></td><td colspan="2">(for transfer of IFF to Capital Accounts of Partners in the old profit sharing ratio)</td><td></td><td></td></tr>
<tr><td colspan="4" rowspan="5">Explanation for case 4: In this case, the entire balance in the fund is used to cover the fall in the value of adjustment.

Explanation for case 5: In this case, the value of investment has increased by Rs 45,000. So, the entire balance of the fund is distributed among the partners in their old ratio.</td><td colspan="2"></td><td></td><td></td></tr>
<tr><td>Investment A/c</td><td>Dr.</td><td>45,000</td><td></td></tr>
<tr><td colspan="2">To Revaluation A/c</td><td></td><td>45,000</td></tr>
<tr><td colspan="2">(for increase in the value of the investment recorded)</td><td></td><td></td></tr>
</table>

Revaluation Account and Partners' Capital Account

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Revaluation of Assets and Reassessment of Liabilities
- Partners' Capital Account

Revaluation of Assets and Reassessment of Liabilities

Sometimes the value of the assets and liabilities of a firm does not appear at its current value in the books of accounts. With the passage of time, their values in the books may differ from its current values. It means there could be an increase or decrease in the values. Therefore, at the time of change in profit sharing ratio among the existing partners, it is desirable to ascertain the true current value of all the assets and liabilities. There may also be a situation when some assets or liabilities of a firm are not recorded in the books of accounts. So, in order to reveal the assets and liabilities of a firm at their current values, an account named as 'Revaluation Account' is prepared. This account may sometimes be called Profit and Loss Adjustment Account.

Any increase in the value of assets and decrease in the value of liabilities is credited to the Revaluation Account. This is because, it is a profit (or gain) for a firm. On the other hand, any decrease in the value of assets and increase the value of liabilities are debited to this account. This is because, it is a loss to the firm. Also, any unrecorded assets of the firm will be credited and unrecorded liability of the firm will be debited to this account. If credit side of Revaluation Account is more than its debit side then it reveals the profit. On the other hand, if debit side is more than its credit side it will be considered as net loss. Any profit or loss arising from this account will be transferred to the All Partners' Capital Account in their old profit sharing ratio.

Journal Entries to be recorded for Revaluation of Assets and Liabilities

*For **Increase** in the Value of **Assets***		*For **Decrease** in the Value of **Assets***	
Assets A/c	Dr.	Revaluation A/c	Dr.
To Revaluation A/c		To Assets A/c	
{By increased value}		{By decreased value}	

*For **Increase** in the Value of **Liability***		*For **Decrease** in the Value of **Liability***	
Revaluation A/c	Dr.	Liability A/c	Dr.
To Liability A/c		To Revaluation A/c	
{By increased value}		{By decreased value}	

*For recording **Unrecorded Assets***		*For recording **Unrecorded Liability***	
Assets A/c	Dr.	Revaluation A/c	Dr.
To Revaluation A/c		To Liabilities A/c	

For Transfer of Profit on Revaluation (*i.e. credit side > debit side*)		For Transfer of Loss on Revaluation (*i.e. debit side > credit side*)	
Revaluation A/c	Dr.	All Partners' Capital A/c	Dr.
To All Partners' Capital A/c		To Revaluation A/c	
{Old Ratio}		{Old Ratio}	

Procedure to Prepare Revaluation Account

The following are the various steps involved in preparation of Revaluation Account.

1. First of all, any ***decrease*** in the value of ***assets*** and ***increase*** in the value of ***liabilities*** are recorded on the ***debit side*** of Revaluation Account.
2. Secondly, any ***increase*** in the value of ***assets*** and ***decrease*** in the value of ***liabilities*** is recorded on the ***credit side*** of Revaluation Account.
3. If there is any ***unrecorded asse***t of the firm then it is shown on the ***credit side*** of the Revaluation Account.
4. Similarly, any ***unrecorded liabilities*** are shown on the ***debit side*** of the Revaluation Account.

5. Then, outstanding expenses of the firm are recorded on the ***debit side*** and prepaid expenses are recorded on the ***credit side*** of the Revaluation Account.
6. Similarly, any income that is received in advance is shown on the ***debit side*** and accrued income (i.e. income earned but not yet received) is recorded on the ***credit side*** of the Revaluation Account.
7. Lastly, if the total of the debit side ***exceeds*** the total of the credit side, then it is regarded as ***Revaluation Loss*** and is transferred to the ***debit side*** of the Partners' Capital Account in their old profit sharing ratio. On the other hand, if the total of the debit side is ***short*** of the total of the credit side, then it is regarded as ***Revaluation Profit*** and is transferred to the ***credit side*** of Partners' Capital Account in their old profit sharing ratio.

Format of Revaluation Account

Revaluation A/c

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Decrease in Value of Assets	×××	Increase in Value of Assets	×××
Increase in Value of Liabilities	×××	Decrease in Value of Liabilities	×××
Unrecorded Liabilities	×××	Unrecorded Assets	×××
Outstanding Expenses (e.g. Salaries)	×××	Prepaid Expenses (Salaries in advance)	×××
Income received in advance	×××	Income Earned but not yet received	×××
Revaluation Profit* A's Capital A/c B's Capital A/c (Transferred to Credit side of Partners' Capital Account in Old Ratio)	×××	Revaluation Loss# A's Capital A/c B's Capital A/c (Transferred to Debit side of Partners' Capital Account in Old Ratio)	×××

* If Credit Side > Debit Side

If Credit side < Debit Side

***Example* 1**: The value of Furniture in the Old Balance Sheet of a firm is given as Rs 35,000. Explain the treatment of the following adjustments.
a) Furniture depreciated ***by*** Rs 6,000
b) Furniture depreciated ***to*** Rs 10,000
c) Furniture appreciated ***by*** Rs 5,000
d) Furniture appreciated ***to*** Rs 45,000

Solution

Case (a)- In this case, furniture is depreciated by Rs 6,000, therefore, in the Revaluation Account, the decrease in the value of furniture is to be shown on the ***debit side with*** **Rs 6,000** and on the Assets side of the New Balance Sheet, furniture is to be shown at **Rs 29,000** (i.e. 35,000 – 6,000).

Case (b)- In this case, furniture is depreciated to Rs 10,000. It means there is a fall in the value of furniture by Rs 25,000 (i.e. 35,000 – 10,000). So, in the Revaluation Account, the fall in the value of furniture is to be shown on the ***debit side*** with **Rs 25,000** and the furniture is to be shown on the Assets side of the New Balance Sheet at its final value of **Rs 10,000**.

Case (c)- In this case, furniture is appreciated by Rs 5,000, therefore, in the Revaluation Account, the increase in the value of furniture is to be shown on the ***credit side*** with **Rs 5,000** and on the Assets side of the New Balance Sheet, furniture is to be shown at **Rs 40,000** (i.e. 35,000 + 5,000).

Case (d)- In this case, furniture is appreciated to Rs 45,000. It means there is an increase in the value of furniture by **Rs 10,000** (i.e. 45,000 – 35,000). So, in the Revaluation Account, the increase in the value of furniture is to be shown on the ***credit side*** with Rs 10,000 and on the Assets side of the New Balance Sheet, furniture is to be shown at its final value of **Rs 45,000**.

Posting in Revaluation Account and Balance Sheet

Revaluation Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
(Case-a) Furniture	6,000	**(Case-c)** Furniture	5,000
(Case-b) Furniture	25,000	**(Case-d)** Furniture	10,000

Example **2**: Ronak, Vishal and Ashish are partners sharing profits and losses in the ratio of 3:2:1. They decided to change their future profit-sharing ratio i.e. 3:1:1. For this purpose, certain assets and liabilities were revalued as follows.

(a) Furniture appearing the books Rs 5,000 was revalued at Rs 3,000
(b) Machinery with the book value of Rs 1,00,000, was depreciated to Rs 75,000
(c) Building having book value of Rs 1,20,000 was appreciated by Rs 10,000.
(d) Rs 50,000 have been earned but yet not received
(e) Salary of Rs 12,000 is yet not paid
(f) Debtors of the firm are Rs 1,25,000 and provision on debtors is to be prepared @ 5% p.a.
Prepare the Revaluation Account

Solution

Revaluation Account

Dr. **Cr.**

Particulars		**Amount Rs**	**Particulars**	**Amount Rs**
Furniture		2,000	Accrued Income	50,000
Machinery		25,000	Building	10,000
Outstanding Salary		12,000		
Provision for Doubtful Debts		6,250		
Profit transferred to				
Ronak	7,375			
Vishal	4,917			
Ashish	2,458	14,750		
		60,000		**60,000**

Adjustments related to Provision for Doubtful Debts- It is one of the most common adjustment, where the students often make mistakes. However; it should always be remember that any adjustment related to provision for doubtful debts such as Provision on debtors should be brought up to 10%, Provision on debtors to be increased by Rs 2,200, etc. is to be provided on the amount of debtors and not on the provision. Also, it should be remember that any increase (or decrease) in amount of provisions implies a fall (or rise) in the amount of debtors and accordingly, is shown on the debit (or credit) side of the Revaluation Account.

***Example* 3**: : Mihika, Raman and Ishita are partners in a firm sharing profits and losses in the ratio of 4:1:3. From April 01, 2014, they decided to share profit and losses in the ratio of 5:3:3. The Balance Sheet as on 31st March, 2014 is as follows.

Balance Sheet

as on 31st March, 2014

Liabilities		Amount (Rs)	Assets		Amount (Rs)
Unearned Income		10,000	Cash		45,500
Creditors		50,000	Building		55,000
Capital:			Investments		25,000
Mihika	40,000		Stock		40,000
Raman	80,000		Prepaid Insurance		9,000
Ishita	21,000	1,41,000	Debtors	24,000	
			Less: Provision for Doubtful Debts	(1,000)	23,000
			Preliminary Expenses		3,500
		2,01,000			**2,01,000**

You are required to prepare Revaluation Account after considering following transactions.
1. Building appreciated to Rs 70,000
2. Stock was undervalued by Rs 5,000
3. Creditors of Rs 4,000 were written back
4. Provision to be made on @ 10% debtors.

Solution

Revaluation Account

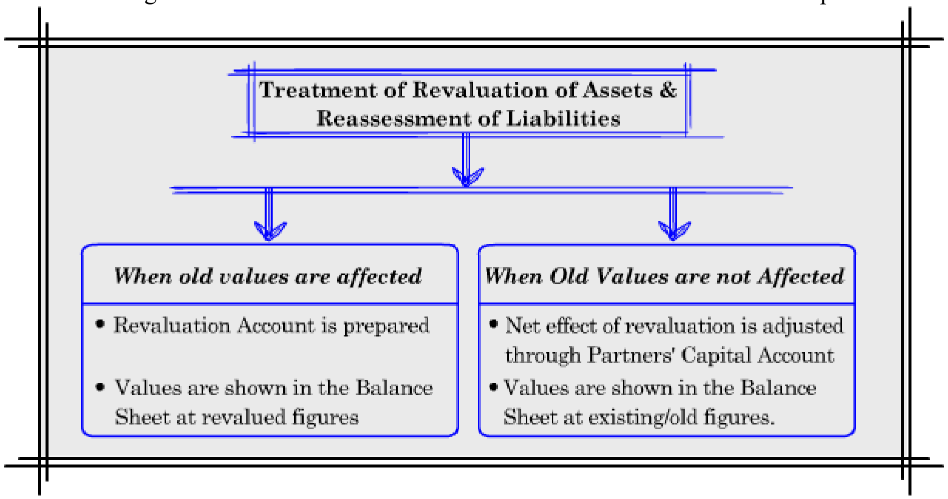
Dr. Particulars		Amount Rs	Particulars	Cr. Amount Rs
Provision for Doubtful Debts (2,400 – 1,000)		1,400	Building	15,000
			Stock	5,000
			Creditors	4,000
Profit transferred to:				
Mihika's Capital A/c	11,300			
Raman Capital A/c	2,825			
Ishita Capital A/c	8,475	22,600		
		24,000		**24,000**

Adjustment of Profit and Losses on Revaluation of Assets and Reassessment of Liabilities through the Capital Account only

Sometimes partners of a firm decided to show the assets and liabilities in the New Balance Sheet at unaltered figures or unchanged values or existing values. In such instances, the question specifies this statement as "*the partners decided to show the assets and liabilities in the New Balance Sheet at existing figures*". In such cases, the net effect of revaluation is adjusted among the gaining and sacrificing partners (as indicated after the calculation). The Journal entry so passed in this case is termed as the 'adjusting Journal entry'. As per this entry, the gaining partners compensate the sacrificing partners. Therefore, the former's capital accounts are debited, while, the latter's capital accounts are credited. This is presented below.

Adjusting Journal Entry: When Assets and Liabilities are to be shown in New Balance Sheet at existing figures		
Gaining Partners' Capital A/c To Sacrificing Partners' Capital A/c (Proportionate amount of profit on revaluation recorded through a single adjusting entry)	Dr.	*In Gaining or Sacrificing Ratio*

The accounting treatment of revaluation of assets and reassessment of liabilities is presented in the below diagram.



Example **4**: Kanika, Shreya and Akshita are partners in a firm, sharing profits and losses in the ratio of 5:3:2. They decided to share future profits and losses in the ratio of 4:3:3 and also agreed upon the decision that assets and liabilities are to be shown at the existing values in the New Balance Sheet. The book value and Revised value of the assets

Assets/Liabilities	Book Value	Revised Value
Building	20,000	15,000
Stock	4,000	6,000
Trade Creditors	15,000	25,000
Unearned Income	1,500	1,000
Plant and Machinery	10,000	21,000

Pass the necessary single adjustment Journal entry.

Solution

Journal Entry					
Date	**Particulars**		**L.F.**	**Debit Amount (Rs)**	**Credit Amount (Rs)**
	Akshita's Capital A/c	Dr.		150	
	To Kanika's Capital A/c				150
	(Adjustment is made through Partners' Capital Accounts)				

Working Notes:

WN1 *Calculation of Net Effect of Revaluation*

Increase/Decrease in the value of assets/liabilities	Amount (Rs)
Increase in the value of Stock	2,000
Increase in the value of Plant and Machinery	11,000
Decrease in the value of Unearned Income	500
Decrease in the value of Building	(5,000)
Increase in the value of Creditors	(10,000)
Loss on Revaluation	**(1,500)**

WN2 Calculation of Sacrifice/Gain by the Partners
Sacrificing Ratio = Old Ratio − New Ratio

WN2 Calculation of Sacrifice/Gain by the Partners
Sacrificing Ratio = Old Ratio − New Ratio

$$\text{Kanika} = \frac{5}{10} - \frac{4}{10} = \frac{1}{10}$$
$$\text{Shreya} = \frac{3}{10} - \frac{3}{10} = \text{Nil}$$
$$\text{Akshita} = \frac{2}{10} - \frac{3}{10} = \left(-\frac{1}{10}\right)$$

WN3 *Calculation of Proportion Amount of Share of Loss on Revaluation*

$$\text{For Kanika} = 1,500 \times \frac{1}{10} = \text{Rs } 150$$
$$\text{For Akshita} = 1,500 \times \frac{1}{10} = \text{Rs } 150$$

Partners' Capital Account

Partners' Capital Account is prepared to ascertain the closing capital balances of the partners of a firm. These capital balances are shown on the Liabilities side of the New Balance Sheet. The below given is the comprehensive format of the Partners' Capital Account.

Procedure to Prepare Partners' Capital Account

The following are the various steps involved in preparation of Partners' Capital Account.

1. First of all, the opening balance of capital is shown on the credit side of the Partners' Capital Account as 'Balance b/d'. In case, if the capital balance of any of the partners appears on the Assets side of the Balance Sheet (in the question), then it is shown on the debit side of the Capital Account as 'Balance b/d'.

2. Then, Revaluation Profit is transferred to the Credit side and in case of Loss, it is transferred to the Debit side of the Partners' Capital Account.

3. Thirdly, we need to transfer reserves such as, *General Reserve, Reserve Fund, Investment Fluctuation Fund*, Workmen Compensation Fund and Contingency Reserve* (see NOTE)*, *Credit Balance of P&L Account, etc.* are transferred to the credit side of the Partners' Capital Account in the old profit sharing ratio of all the partners.

4. Similarly, on the debit side, losses such as *Debit Balance of P&L, Deferred Revenue Expenditure, Advertisement Suspense Account, etc.* are transferred to the debit side of the Partners' Capital Account in the old profit sharing ratio of all the partners.

5. Goodwill already appearing in the old balance sheet is transferred to the debit side of the capital account in the old profit sharing ratio of all the partners

6. If any of the partners has taken-over any of the assets, then it is shown on the Debit side and if any liability is paid-off by any partner, then it is shown on the credit side of the capital account.

7. Finally, if the total of the credit side exceeds the total of the debit side, then the final capital balance of the partners is shown as 'Balance c/d' on the Debit side. On the contrast, if the total of the debit side exceeds the total of the credit side, then the final capital balance of the partners is shown as 'Balance c/d' on the Credit side.

8. If the Partners' Capital Account shows a credit balance (Cr. Side > Dr. Side), then it is also shown on the Liabilities side of the Balance Sheet. On the other hand, if the Partners' Capital Account shows a debit balance (Dr. Side > Cr. Side), then it is shown on the Assets side of the Balance Sheet.

9. Also, often there exists some reserves in the form Employees Provident Fund, Provision for Tax, Taxation Reserve, Joint Life Policy (JLP) Reserve and Depreciation Reserve (such as Machinery Replacement Reserve) in the Old Balance Sheet. It should be noted that such items are ***not distributed among the partners*** and are shown on the Liabilities side of the New Balance Sheet of the new firm.

Partners' Capital Account

Dr. | **Cr.**

Particulars	**A**	**B**	**C**	**Particulars**	**A**	**B**	**C**
Profit and Loss A/c (Debit Balance)	–	–	–	Balance b/d	–	–	–
Deferred Revenue Expenditure (Advertisement Expenditure)	–	–	–	General Reserve	–	–	–
Goodwill A/c ♣	–	–	–	Reserve Fund	–	–	–
Revaluation Loss	–	–	–	Profit and Loss (Credit Balance)	–	–	–
Assets (Taken over by Partners')	–	–	–	Liabilities (If taken over by Partners')	–	–	–
				Revaluation Profit	–	–	–
				Workmen's Compensation Fund*	–	–	–
				Investment Fluctuation Fund*	–	–	–
				Contingency Reserve*	–	–	–
Balance c/d (If Cr. Side > Dr. side)	–	–	–	Balance c/d (If Dr. side > Cr. Side)	–	–	–

Note:

* Workmen's Compensation Fund, Investment Fluctuation Fund and Contingency Reserve are transferred to the Partners' Capital A/c (credit side) only with the excess amount.

♣ This represents the amount of existing Goodwill that is already appearing on the Assets side of the Old Balance Sheet and written-off among all partners in their old profit sharing ratio.

***Example* 5**: Tarun, Varun and Arun are three partners in a partnership firm sharing profits and losses equally. Their Balance Sheet as on March 31, 2014 is as follows.

Balance Sheet

as on 31st March, 2014

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Bills Payable		10,000	Cash	15,500
Creditors		1,80,500	Building	2,00,000
Capital:			Investments	3,25,000
Tarun	1,50,000		Stock	1,15,000
Varun	2,00,000		Advertisement Suspense Account	60,000
Arun	3,50,000	7,00,000	Debtors	2,00,000
Investment Fluctuation Fund		10,000		
General Reserve		15,000		
		9,15,500		**9,15,500**

With the consent of all the partners it was decided that their new profit-sharing ratio would be 2:1:1 from April 01, 2014. The following are the various adjustments.

1. Assets and liabilities were revalued at the following figures.

Building	Rs	1,80,000
Stock	Rs	1,25,000
Creditors	Rs	1,90,000
Bills Payable	Rs	8,000

2. Goodwill is to be valued at Rs 60,000.

You are required to prepare Revaluation Account and Partners' Capital A/c.

Solution

Revaluation Account

Dr. Cr.

Particulars	Amount Rs	Particulars		Amount Rs
Building	20,000	Stock		10,000
Creditors	9,500	Bills Payable		2,000
		Loss transferred to		
		Tarun	5,833.33	
		Varun	5,833.33	
		Arun	5,833.33	17,500
	29,500			**29,500**

Partners' Capital Accounts

Dr. Cr.

Particulars	Tarun	Varun	Arun	Particulars	Tarun	Varun	Arun
Revaluation A/c (*loss*)	5,833.33	5,833.33	5,833.33	Balance b/d	1,50,000	2,00,000	3,50,000
Advertisement Suspense Account	20,000	20,000	20,000	Investment Fluctuation	3,333.33	3,333.33	3,333.33

Varun Arun Balance c/d	5,000 5,000 1,22,500	 1,87,500	 3,37,500	Fund General Reserve Tarun	5,000	5,000 5,000	5,000 5,000
	1,58,333.33	**2,13,333.33**	**3,63,333.33**		**1,58,333.33**	**2,13,333.33**	**3,63,333.33**

***Working Notes*:**

WN1 Calculation of Gaining Ratio

Old Ratio = 1:1:1
New Ratio = 2:1:1

Gaining Ratio = New Ratio − Old Ratio

$\text{Tarun } = \frac{2}{4} - \frac{1}{3} = \frac{2}{12}$
$\text{Varun} = \frac{1}{4} - \frac{1}{3} = (-\frac{1}{12})$
$\text{Arun} = \frac{1}{4} - \frac{1}{3} = (-\frac{1}{12})$

WN2 Calculation of Share of Goodwill of each partner

$\text{Tarun} = 60,000 \times \frac{2}{12} = \text{Rs } 10,000$
$\text{Varun} = 60,000 \times \frac{1}{12} = \text{Rs } 5,000$
$\text{Arun} = 60,000 \times \frac{1}{12} = \text{Rs } 5,000$

Balance Sheet of a Reconstituted Firm

Objective

After going through this lesson, you shall be able to understand the Procedure and Format of Balance Sheet of a Reconstituted Firm.

New Balance Sheet

At the time of change in profit sharing ratio among the partners, many changes took place such as goodwill appearing in the books has to be written-off, adjustment of accumulated profits and losses, revaluation of assets and reassessment of liabilities, etc. Now because of these adjustments there is change in the balances of Partners' Capital Account as well as in the assets and liabilities of the firm. Therefore, after all such adjustments, the need arises for preparation of New Balance Sheet of the newly reconstituted firm (i.e. after the change in profit sharing ratio among the partners). The below mentioned is the procedure and a comprehensive format of Balance Sheet.

Procedure to Prepare New Balance Sheet

The following are the various steps involved in the preparing New Balance Sheet.

1. Firstly, all the assets are recorded on the Right Hand Side of the Balance Sheet and all the Liabilities are recorded on the Left Hand Side on their net value i.e. after all adjustments in their values.

2. There can be two probable cases of adjustments namely, ***to*** or ***by***. In case the assets are increased or decreased ***to,*** then the final value itself is shown in the New Balance Sheet. For Example, value of machinery increased ***to*** Rs 10,000. In the New Balance Sheet machinery will be shown at Rs 10,000. On the other hand, if the assets are increased or decreased ***by,*** then the value of asset is shown at its net value (i.e. after adding or subtracting the value as the case may be). For example, Machinery of Rs 40,000 is increased ***by*** Rs 6,000. In the New Balance Sheet, machinery will be shown at Rs 46,000 (40,000 + 6,000).

3. Similarly, Liabilities are also shown at their final value after considering all the adjustments.

4. The funds such as Workmen’s Compensation Fund, Investment Fluctuation Fund and Contingency Reserve are shown in the New Balance Sheet at the value given in the adjustment. Example- In case no adjustment regarding these funds is given, then these are not shown in the New Balance Sheet; rather these are distributed among the all the partners in old ratio.

5. Now, the Unrecorded Assets and Liabilities found at the time of revaluation are to be shown in the New Balance Sheet.

6. Capital Balances of the partners revealed through Partners' Capital Account after all adjustments are recorded on the Liabilities side of the Balance Sheet. In case the Partners' Capital Account shows a debit balance (i.e. balance c/d on credit side) then it is shown on the Assets side of the Balance Sheet.

Balance Sheet of a Reconstituted Firm

Liabilities	Amount Rs	Assets	Amount Rs
Bank Overdraft		Cash in Hand	
Creditors		Cash at Bank	
General Reserve		Debtors	
Depreciation Reserve		*Less*: Provision for Doubtful Debts	
Contingency Reserve		Bills Receivable	
Workmen's Compensation Fund		Stock	
Investment Fluctuation Fund		Land and Building	
Machinery Replacement Reserve		Plant and Machinery	
Employees Provident Fund		JLP	
Provision for Tax		Unrecorded Assets (if given in the adjustments)	
JLP Reserve		Investments	
Bills Payable		Goodwill	
Unrecorded Liabilities (if given in the adjustments)		Patents	
Capitals:		Capitals**:	
A:		A:	
B:		B:	
C:		C:	
	*		○

Note: The equality of * and ○ ensures the arithmetic accuracy of the solution.
** If the closing balance of the Partners' Capital Account (i.e. Balance c/d) happens to appear on the credit side of the Partners' Capital Account, then it is shown on the Assets side of the New Balance Sheet.

Example **1**: River, Lake and Sea are partners in a firm sharing profits and losses in the ratio of 3:5:4. Their Balance Sheet as on 31st March, 2014 is as follows.

Balance Sheet

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Capital:			Plant and Machinery	2,00,000
River	2,40,000		Land and Building	1,50,000
Lake	1,50,000	3,90,000	Stock	25,000
Creditors		55,000	Goodwill	12,000
Employees Provident Fund		60,000	Debtors	20,000
Investment Fluctuation Fund		12,000	Profit and Loss A/c (Dr.)	6,000
			Investment	36,000
			Sea's Capital	68,000
		5,17,000		**5,17,000**

It was decided that from 1st April, 2014, they will share the profits and losses in the ratio of 3:2:5. They agreed upon the following adjustments.

1. Goodwill of the firm is valued at Rs 60,000.

2. Land and Building is depreciated to Rs 1,00,000 and Plant and Machinery is appreciated by Rs 15,000.
3. Stock is appreciated by Rs 2,500.
4. Provision for doubtful debts is to be created @ 2.5%.

You are required to prepare Revaluation Account, Partners' Capital Accounts and Balance Sheet of the reconstituted firm after taking considering all the adjustments.

Solution

Revaluation Account

Dr. Particulars	Amount (Rs)	Particulars		Cr. Amount (Rs)
Land and Building	50,000	Machinery		15,000
Provision for Doubtful Debts	500	Stock		2,500
		Loss transferred to:		
		River	8,250	
		Lake	13,750	
		Sea	11,000	33,000
	50,500			**50,500**

Partners' Capital Accounts

Dr. Particulars	River	Lake	Sea	Particulars	River	Lake	Cr. Sea
Balance b/d			68,000	Balance b/d	2,40,000	1,50,000	
Profit and Loss A/c (Dr.)	1,500	2,500	2,000	Investment Fluctuation Fund	3,000	5,000	4,000
Goodwill (*written off*)	3,000	5,000	4,000	River		3,000	
Revaluation A/c (*Loss*)	8,250	13,750	11,000	Sea		10,000	
Lake	3,000		10,000				
Balance c/d	2,27,250	1,46,750		Balance c/d			91,000
	2,43,000	**1,68,000**	**95,000**		**2,43,000**	**1,68,000**	**95,000**

Balance Sheet
as on 31st March, 2014

Liabilities		Amount (Rs)	Assets		Amount (Rs)
Capital:			Plant and Machinery	2,00,000	
River	2,27,250		*Add*: Appreciated value	15,000	2,15,000
Lake	1,46,750	3,74,000	Land and Building	1,50,000	
Creditors		55,000	*Less*: Depreciation	(50,000)	1,00,000
Employee's Provident Fund		60,000	Stock	25,000	
			Add: Appreciated Value	2,500	27,500
			Debtors	20,000	
			Less: Provision for Doubtful Debts	(500)	19,500
			Investments		36,000

		Sea's Capital	91,000
	4,89,000		**4,89,000**

Working Notes:

$$\text{River} = \frac{3}{12} - \frac{3}{10} = \left(-\frac{3}{60}\right)$$
$$\text{Lake} = \frac{5}{12} - \frac{2}{10} = \frac{13}{60}$$
$$\text{Sea} = \frac{4}{12} - \frac{5}{10} = \left(-\frac{10}{60}\right)$$

WN2 Calculation of Share of Goodwill of each partner

$$\text{River will pay} = 60,000 \times \frac{3}{60} = \text{Rs } 3,000$$
$$\text{Lake will get} = 60,000 \times \frac{13}{60} = \text{Rs } 13,000$$
$$\text{Sea will pay} = 60,000 \times \frac{10}{60} = \text{Rs } 10,000$$

Note: *Employee's Provident should not be distributed among the partners because it represents the statutory liability of the firm towards its employees*.

***Example* 2:** Rock, Stone and Pebble are partners sharing profits and losses in the ratio of 3:2:1. Their Balance Sheet as on 31st March, 2014 is as follows.

Balance Sheet
as on 31st March, 2014

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Capital:			Fixed Assets	6,00,000
Rock	3,40,000		Debtors	1,00,000
Stone	1,50,000		Investments	1,50,000
Pebble	4,50,000	9,40,000	Cash	63,000
Workmen Compensation Fund		5,000	Bank	17,000
Provision for Bad-Debts		4,000	Stock	88,000
Sundry Creditors		51,000		
General Reserve		18,000		
		10,18,000		**10,18,000**

From 1st April, 2014 they decided to share future profits and losses in equal ratio. The following are the various adjustments.

1. Goodwill of the firm is valued at Rs 30,000.
2. Fixed assets and investments were appreciated @ 10% and 5% respectively.
3. Stock was depreciated by 2.5%.
4. Creditors of Rs 2,000 were not likely to claim and a worker Rajesh, met with an accident during the production hours. He claimed Rs 6,000.

You are required to prepare Revaluation Account, Partners' Capital Account and Balance Sheet of the reconstituted firm.

Solution

Revaluation Account

Dr.			Cr.
Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Stock	2,200	Fixed Assets	60,000
Provision for Workmen Compensation Fund	1,000	Investments	7,500
Profit transferred to:		Creditors	2,000
Rock 33,150			
Stone 22,100			
Pebble 11,050	66,300		
	69,500		**69,500**

Partners' Capital Accounts

Dr.							Cr.
Particulars	**Rock**	**Stone**	**Pebble**	**Particulars**	**Rock**	**Stone**	**Pebble**
Rock			5,000	Balance b/d	3,40,000	1,50,000	4,50,000
				Pebble	5,000		
Balance c/d	3,87,150	1,78,100	4,59,050	General Reserve	9,000	6,000	3,000
				Revaluation A/c (*Profit*)	33,150	22,100	11,050
	3,87,150	**1,78,100**	**4,64,050**		**3,87,150**	**1,78,100**	**4,64,050**

Balance Sheet

as on 31st March, 2014

Liabilities		**Amount (Rs)**	**Assets**		**Amount (Rs)**
Capital:			Fixed Assets	6,00,000	
Rock	3,87,150		*Add*: Appreciated value	60,000	6,60,000
Stone	1,78,100		Investments	1,50,000	
Pebble	4,59,050	10,24,300	*Add*: Appreciated value	7,500	1,57,500
Creditors	51,000		Stock	88,000	
Less: Written off	(2,000)	49,000	*Less*: Depreciation	(2,200)	85,800
Liability for Workmen Compensation Fund		6,000	Debtors		1,00,000
Provision for Bad-Debts		4,000	Cash		63,000
			Bank		17,000
		10,83,300			**10,83,300**

***Working Notes*:**

WN1 *Calculation of Sacrificing/Gaining Ratio*

Old Ratio = 3:2:1
New Ratio = 1:1:1

Sacrificing Ratio = Old Ratio − New Ratio

$$\text{Rock} = \frac{3}{6} - \frac{1}{3} = \frac{1}{6}$$
$$\text{Stone} = \frac{2}{6} - \frac{1}{3} = \text{Nil}$$
$$\text{Pebble} = \frac{1}{6} - \frac{1}{3} = \left(-\frac{1}{6}\right)$$

WN2 *Calculation of Share of Goodwill of each partner*

$$\text{Rock will get} = 30{,}000 \times \frac{1}{6} = \text{Rs } 5{,}000$$
$$\text{Pebble will pay} = 30{,}000 \times \frac{1}{6} = \text{Rs } 5{,}000$$

***Example* 3:** Rita, Gita, Meeta and Sita are partners in a firm sharing profits and losses equally. From 1st April, 2014 partners decided to change their profit sharing ratio to 3:2:1:1. The Balance Sheet as on 31st March, 2014 is as follows.

Balance Sheet

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Capital:			Machinery	1,56,000
Rita	1,25,000		Furniture	24,000
Gita	3,50,000		Stock	58,000
Meeta	2,75,000		Building	2,50,000
Sita	50,000	8,00,000	Bills Receivable	90,000
Taxation Reserve		43,000	Prepaid Expenses	68,000
Reserve Fund		48,000	Cash	3,00,000
Sundry Creditors		1,02,000	Loose Tools	22,000
Bills Payable		25,000	Advertisement Suspense A/c	50,000
		10,18,000		**10,18,000**

The following adjustments took place at the time of reconstitution of the firm.

1. Assets and liabilities value on the date is as follows.
   Building: Rs 2,25,000, Machinery: Rs 1,60,000, Stock: Rs 62,000, Furniture: Rs 18,000, Bills Receivable: Rs 80,000, Creditors: Rs 1,10,000 and Bills Payable: Rs 20,000.

2. Goodwill of the firm is valued at Rs 72,000.
   It was decided that partners do not want to show the assets and liabilities at altered value. They neither want to distribute the accumulated profits and losses nor want to show the goodwill in the new books.

You are required to pass the single Journal entry, Prepare Partners' Capital Account and Balance Sheet.

Solution

Journal Entry

Date	Particulars		L.F.	Debit Amount (Rs)	Credit Amount (Rs)
	Rita's Capital A/c	Dr.		6,072	
	Gita's Capital A/c	Dr.		1,214	
	To Meeta's Capital A/c				3,643
	To Sita's Capital A/c				3,643
	(Adjustment is made through Partners' Capital Accounts)				

Partners' Capital Accounts

Dr. **Cr.**

Particulars	Rita	Gita	Meeta	Sita	Particulars	Rita	Gita	Meeta	Sita
Meeta	3,036	607			Balance b/d	1,25,000	3,50,000	2,75,000	50,000
Sita	3,036	607			Rita			3,036	3,036
Balance c/d	1,18,928	3,48,786	2,78,643	53,643	Gita			607	607
	1,25,000	**3,50,000**	**2,78,643**	**53,643**		**1,25,000**	**3,50,000**	**2,78,643**	**53,643**

Balance Sheet
as on 31st March, 2014

Liabilities		Amount (Rs)	Assets	Amount (Rs)
Capital			Machinery	1,56,000
Rita	1,18,928		Furniture	24,000
Gita	3,48,786		Stock	58,000
Meeta	2,78,643		Building	2,50,000
Sita	53,643	8,00,000	Bills Receivable	90,000
Taxation Reserve		43,000	Prepaid Expenses	68,000
Reserve Fund		48,000	Cash	3,00,000
Sundry Creditors		1,02,000	Loose Tools	22,000
Bills Payable		25,000	Advertisement Suspense A/c	50,000
		10,18,000		**10,18,000**

***Working Notes*:**

WN1 *Calculation of Sacrificing/Gaining Ratio*

Old Ratio = 1:1:1:1

New Ratio = 3:2:1:1

Sacrificing Ratio = Old Ratio – New Ratio

$$\text{Rita} = \frac{1}{4} - \frac{3}{7} = \left(-\frac{5}{28}\right)$$
$$\text{Gita} = \frac{1}{4} - \frac{2}{7} = \left(-\frac{1}{28}\right)$$
$$\text{Meeta} = \frac{1}{4} - \frac{1}{7} = \frac{3}{28}$$
$$\text{Sita} = \frac{1}{4} - \frac{1}{7} = \frac{3}{28}$$

WN2 **Calculation of Net Effect**

Increase/Decrease in the values and Adjustments	Amount (Rs)
Increase in the value of Machinery	4,000
Increase in the value of Stock	4,000
Decrease in the value of Bills Payable	5,000
Decrease in the value of Building	(25,000)
Decrease in the value of Furniture	(6,000)
Decrease in the value of Bills Receivable	(10,000)
Increase in the value of Creditors	(8,000)
Loss on Revaluation	**(36,000)**
Adjustment for Reserve Fund	48,000
Adjustment for Goodwill	72,000
Adjustment for Advertisement Suspense Account	(50,000)
Net Effect	**34,000**

So,

$$\text{Rita will pay} = 34,000 \times \frac{5}{28} = \text{Rs } 6,072$$

$$\text{Gita will pay} = 34,000 \times \frac{1}{28} = \text{Rs } 1,214$$

$$\text{Meeta will get} = 34,000 \times \frac{3}{28} = \text{Rs } 3,643$$

$$\text{Sita will get} = 34,000 \times \frac{3}{28} = \text{Rs } 3,643$$

***Notes*:**

1. Taxation Reserve should not be adjusted because it is maintained to meet the liability for tax.

2. Rita and Gita will pay in equal ratio i.e. 1:1 to Meeta and Sita. Thus, Rita will pay Rs 3,036 and Gita will pay Rs 607 to Meeta and Sita.

Adjustment Of Capital

As we all know, partnership is based on certain mutually agreed terms in oral or written form that governs the relationship among the partners. One such term is regarding the division of profits which can be distributed either equally or in any ratio as decided by them. However, sometimes the existing partners may decide to change this ratio for reasons like better and fair division of profits, giving incentive to a partner for his outstanding performance, etc. When such a change occurs, adjustments have to be made for changes in the value of assets, liabilities, goodwill and distribution of reserves, capitals, accumulated profits and losses, etc. Apart from this, the partners may decide to have their capitals in the profit-sharing ratios as a result of this; adjustments in terms of excess or shortfall in the capital of the partners have to be made. This is because there might be a partner whose capital might fall short of the required amount or exceed the required amount of capital as per the newly agreed terms (i.e. Capitals have to be in the profit sharing ratio). The same is then adjusted through the Current Account of the partners.

Accounting Treatment

(i) In case of Shortage of Capital:

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Bank A/c or Concerned Partner's Current A/c Dr. To Concerned Partner's Capital A/c			

(ii) In case of Surplus of Capital:

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
	Concerned Partner's Capital A/c Dr. To Bank A/c			

Example: A, B and C are partners are in a firm sharing profits in the ratio of 2:2:1. On 1st April, 2018 their Balance Sheet was as follows:

Balance Sheet as on 1st April, 2018

Liabilities	Rs.	Assets	Rs.
Capital A/cs:	7,00,000	Fixed Assets	6,00,000
A 4,00,000		Current Assets	3,50,000
B 2,00,000			
C 1,00,000			

Sundry Creditors	2,50,000		
	9,50,000		9,50,000

From the above date, partners decide to share the future profits equally. For this purpose the goodwill of the firm is valued at Rs. 1,80,000. Capitals of the partners were to be adjusted according to the new profit-sharing ratio by bringing or paying cash as the case may be.

Prepare Partner's Capital Accounts and the Balance Sheet of the reconstituted firm.

Answer:

Dr. Partner's Capital A/cs Cr.

Particulars	A(Rs.)	B(Rs.)	C(Rs.)	Particulars	A(Rs.)	B(Rs.)	C(Rs.)
To C's Capital A/c (WN/1)	16,000	16,000	-	By balance b/d	4,00,000	2,00,000	1,00,000
				By A's & B's Capital A/c (WN/1)			32,000
To Cash A/c (Balancing figure)	1,50,667			By Cash A/c (Balancing Figure)		49,333	1,01,334
To balance c/d (W/N2)	2,33,333	2,33,333	2,33,334				
	4,00,000	2,49,333	2,33,334		4,00,000	2,49,333	2,33,334

Balance Sheet of the Reconstituted firm as at 1st April, 2018

Liabilities	Rs.	Assets	Rs.
Capital A/cs:		Fixed Assets	6,00,000
A 2,33,333		Current Assets	3,50,000
B 2,33,333			
C 2,33,334	7,00,000		
Sundry Creditors	2,50,000		
	9,50,000		9,50,000

Working Notes:

1. **Adjustment of Goodwill:**

Value of Goodwill: Rs. 2,40,000

Calculation of Sacrifice/Gain of each partner:

Particulars	A	B	C
Old Share	2/5	2/5	1/5
New Share	1/3	1/3	1/3

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

Journal Entry for adjustment of Goodwill:

Date	Particulars		L.F.	Dr.(Rs.)	Cr.(Rs.)
	A's Capital A/c	Dr.		16,000	
	B's Capital A/c	Dr.		16,000	
	To C's Capital A/c				32,000

2. **Adjustment of Capital:**

	Rs.
A's Adjusted Capital (4,00,000 – 16,000)	3,84,000
B's Adjusted Capital (2,00,000 – 16,000)	1,84,000
C's Adjusted Capital (1,00,000 + 32,000)	1,32,000
Total Capital of the new firm	**7,00,000**

This will be divided equally so the capital of each partner will be Rs. 2,33,333.

3.

Dr. **Cash A/c** **Cr.**

Particulars	Rs.	Particulars	Rs.
To B's Capital A/c	49,333	By A's Capital A/c	1,50,667
To C's Capital A/c	1,01,334		
	1,50,667		1,50,667