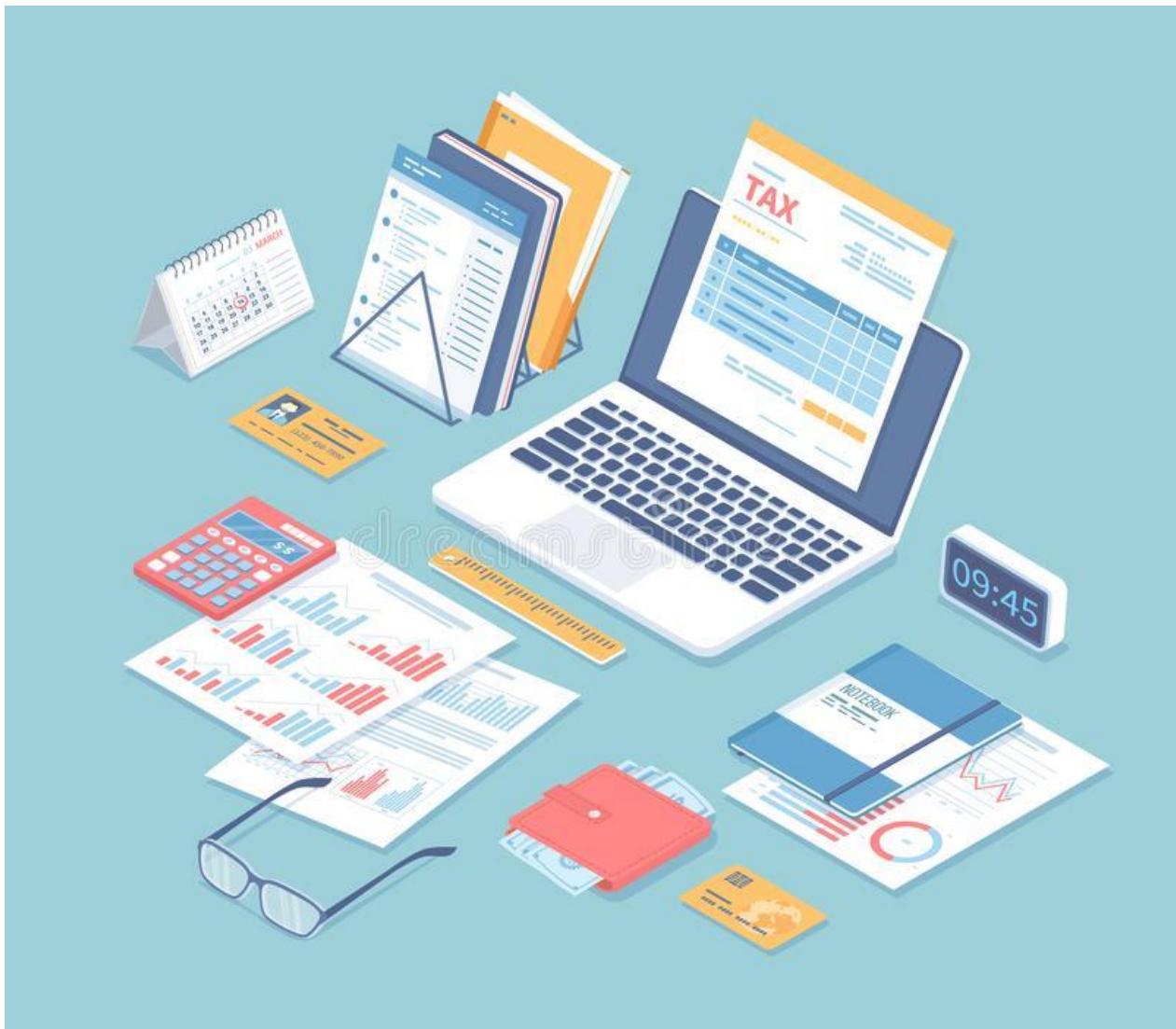


ACCOUNTANCY

Chapter 3: Reconstitution: Admission of a Partner



Reconstitution: Admission of a Partner

Introduction to Admission of a Partner

Section 31, Rights, Liabilities, Effects and Adjustments in the event of Admission of a Partner:

- **Section 31 of the Indian Partnership Act, 1932:** According to section 31 of the Indian Partnership Act, 1932, a person can be admitted as a new partner:
 - i. if it is so agreed in the Partnership Deed, or
 - ii. in the absence of the above, if all partners agree for the admission.
- **Rights and liabilities of the newly admitted partner:**
 - When a partner is newly admitted into the partnership, the new partner gets the following rights:
 - i. Right to share the future profits of the firm, and
 - ii. Right to share in the assets of the firm.
 - At the same time, the newly admitted partner becomes liable for any liability of the business incurred after his admission and any loss incurred by the firm
- **Effects of admission of a Partner:** Following are the effects of admission of a new partner:
 - i. New partnership comes into existence.
 - ii. Old partnership comes to an end but the firm continues.
 - iii. New partner is entitled to share of future profits.
 - iv. The combined share of old partners get reduced.
 - v. New partner contributes an agreed amount towards the capital of the firm.
 - vi. Goodwill is to be valued and paid to the sacrificing partners for their sacrifice by the gaining partners through their Capital Accounts.
 - vii. Incoming partner is entitled to the rights in the assets of the firm and also liable for the liabilities.
 - viii. Adjustment is to be made for reserves, accumulated profits or losses.
 - ix. Revaluation of assets and reassessment of liabilities is to be done. The net increase or decrease is then adjusted in the existing partner's capital account in their old profit sharing ratio.
- **Adjustments required on the admission of a partner:** Following are the adjustments required on the admission of a partner:

- i. Determining the new profit sharing ratio and gaining/ sacrificing ratio.
- ii. Goodwill valuation and its adjustment.
- iii. Revaluation of Assets and reassessment of liabilities and adjustment of the net gain or loss on such revaluation.
- iv. Adjustment of reserves, accumulated profits and losses.
- v. Adjustment of capital on the basis of new profit sharing ratio.

Change in Profit Sharing Ratio

Change in Profit Sharing Ratio and Calculation of Ratios:

- **Change in Profit Sharing Ratio in the event of admission of a Partner:** In the event of admission of a partner in the existing firm, the incoming partner becomes entitled to share future profits of the firm. Such share is acquired by the incoming partner from old partners, therefore, it is necessary to determine new profit sharing ratio and also the gaining or sacrificing ratio. The new partner may acquire his share from old partner or partners in old ratio, in a particular ratio (sacrificing ratio) or in a particular fraction from old partners.
- **Calculation of new profit sharing ratio when profit share of new or incoming partner is given but sacrifice made by old partners is not given:**
 - i. In such a case, it is assumed that the new partner has acquired his share from old partners in their old profit-sharing ratio.
 - ii. Therefore, old partners will continue to share balance profits or losses in their old profit sharing ratio. It means that, in the absence of any information, profit sharing ratio among the existing partners remains unchanged.
 - iii. Calculation of new profit sharing ratio for each partner will be as follows:
 - Deduct new or incoming partners' share of profit from 1; and
 - Divide the remaining share of profit among old partners in their old profit sharing ratio.
- **Calculation of new profit sharing ratio when share of new or incoming partner is given and also new profit sharing of old partners is given:**
 - i. In such a case, new partner's share of profit is deducted from 1 and balance share of profit is divided among old partners in their new profit sharing ratio.
 - ii. Such arrangement gives the new profit share of each of the partners in the new firm.
- **Calculation of new profit sharing ratio when new or incoming partner acquires his share from the old or existing partners equally:**
 - i. In such case, new share of each old partner is to be determined by calculating the new

profit sharing ratio among all the partners.

ii. The sacrifice made in favour of the new or incoming partner is deducted from the existing share of profit of each old partner.

- **Calculation of new profit sharing ratio when new or incoming partner acquires his share from the old or existing partners in a particular ratio:**
 - i. In such situation, share of existing or old partners will change to the extent of share sacrificed on admission of the new or incoming partner.
 - ii. New share of profits of the existing partners in the reconstituted firm is determined by deducting the sacrifice made by them from their existing share of profits.
- **Calculation of new profit sharing ratio when new or incoming partner acquires his share in a particular fraction from old or existing partners:**
 - i. In such situation, share of new or incoming partner is to be determined by adding the shares surrendered by the old partners in favour of new or incoming partner.
 - ii. Such share surrendered by the old or existing partners are deducted from their respective shares to determine old partners' shares in the reconstituted firm.
- **Calculation of new profit sharing ratio when one of the existing partner retains his original share of profit on admission of a new partner:**
 - i. In such a case, the share of profit of new partner and share of profit of existing partner who retains his old share is deducted from 1.
 - ii. After such deduction, remaining share of profit is divided among remaining old partners in their profit sharing ratio.
- **Calculation of sacrificing ratio when share of new or incoming partner is given without giving details of sacrifice made by old or existing partners:**
 - i. In such a case, it is assumed that old partners make sacrifice in their old profit sharing ratio.
 - ii. In such situations, sacrificing ratio and old profit sharing ratio will always be same and therefore, there will be no change in profit sharing ratio of old partners.
- **Calculation of sacrificing ratio when old ratio of existing partners and new ratio of all partners is given:**
 - i. When old ratio and new ratio of the old and existing partners is available, sacrificing ratio is to be calculated by deducting the new share from the old share.
 - ii. Formula used is as follows:

Sacrificing Share = Old Share - New Share

- **Calculation of sacrificing ratio when new or incoming partner acquires the share by surrender of a particular fraction of shares by old partners:**
 - i. In such a case, the share surrendered by the partner is deducted from his old share of profit to determine his share in the reconstituted firm.
 - ii. Total of shares surrendered by all the partners in favour of new or incoming partner is considered as the share of new or incoming partner.
- **Gain in Profit Share of Existing or Old Partner or Partners:**
 - i. In the event of admission of a partner in a partnership firm, some partners sacrifice while some partners gain.
 - ii. Sacrifice made by one or more old partner(s) is the total of share acquired by new or incoming partner and share gained by existing or old partner or partners.
 - iii. Therefore, gain in profit share can be calculated from such shares sacrificed by the partners or where old and new share is given, by using the below mentioned formula:
 - iv. Gaining Share = New Share - Old Share

Difference between Sacrificing or New-Profit Sharing Ratio:

Sr. no.	Basis	Sacrificing Ratio	New Profit-Sharing Ratio
1.	Meaning	Ratio in which the old partners agree to sacrifice their share in profits in favour of a new partner.	Ratio in which all the partners of the firm including the incoming partner share the future profits and losses.
2.	Related Partners	Old partners of the firm	All the partners including incoming partner
3.	Calculation	<p>It is calculated using following formula:</p> $\text{Sacrificing Ratio} = \text{Old Ratio} - \text{New Ratio}$	<p>It is calculated using following formula:</p> $\text{New Profit-Sharing Ratio} = \text{Old Ratio} - \text{Sacrificing Ratio}$

Valuation and Adjustment of Goodwill

Valuation, Adjustment and Accounting Treatment of Goodwill:

- **AS-26 on Valuation and Adjustment of Goodwill:**

- i. As per AS-26 on Intangible Assets self-generated goodwill is not recognised as an asset in the books of account. It means that the goodwill which is internally generated by the company over past few years, cannot be recognised as it is self-generated by the business.

- ii. Goodwill should be recorded in the books only when consideration in money or money's worth is paid for it, i.e., when goodwill is purchased.
- iii. In case of change in profit sharing ratio among the partners or admission or retirement/death of a partner, goodwill is not to be raised in the books of the firm as no consideration in money or money's worth is paid for it. If goodwill is raised, it should be immediately written off.

● **Accounting Treatment of Goodwill at the time of Admission of a Partner:** In the event of admission of a partner, new partner who acquires the share in future profits from the existing partners should compensate sacrificing partners by paying them an amount. This amount paid by the incoming partner is termed as Goodwill or Premium for Goodwill. Accounting treatment of such Goodwill has been explained with respect to 5 situations which may arise in the event of partner's admission which are as follows:

- i. Goodwill (Premium on Goodwill) is paid privately;
- ii. Goodwill (Premium on Goodwill) is brought in cash or by cheque by the new or Incoming Partner and is retained in business;
- iii. Goodwill (Premium on Goodwill) is brought in cash or by cheque by the new or Incoming Partner and is withdrawn by Sacrificing Partners fully or partly;
- iv. Goodwill (Premium on Goodwill) is brought in kind;
- v. Goodwill (Premium on Goodwill) is not brought in full or a part by the new or Incoming Partner.

• Accounting Treatment of Goodwill Existing in Books of Account:

Goodwill existing in the books of the firm is written off by debiting Old Partners' Capital Account/Current Account in their Old Profit Sharing Ratio and crediting Goodwill Account.

Old Partners' Capital/Current A/c ... Dr (in Old Ratio)
To Goodwill A/c

- **Accounting Treatment when Goodwill (Premium on Goodwill) is paid privately:** In this situation, Goodwill (Premium on Goodwill) is paid by the new or Incoming Partner privately to the sacrificing partners. In such situation, journal entry is not passed in the books of account of the firm.
- **Accounting Treatment when Goodwill (Premium on Goodwill) is brought in cash or by cheque by the new or Incoming Partner and is retained in business:** In this situation, either of the 2 options are to be followed to record the accounting treatment of Goodwill:

A. Amount brought in by the new or Incoming Partner is transferred to Capital Accounts of the sacrificing partners in their sacrificing ratio. Following entries are to be passed:

i. Premium for goodwill brought in cash by the new or incoming partner:

Cash/Bank A/c ... Dr. [With share of Goodwill]

To Premium for Goodwill A/c

ii. Capital brought in cash by the new or Incoming Partner:

Cash/Bank A/c ... Dr. [With Capital brought in Cash]

To New Partner's Capital A/c

Alternatively, instead of above 2 entries, a combined single entry can be passed as follows:

Cash/Bank A/c ... Dr. [With Share of Capital and Goodwill]

To New Partner's Capital [With Capital]

To Premium for Goodwill A/c [With Share of Goodwill]

iii. Goodwill brought in by new partner distributed among the sacrificing partners:

Premium for Goodwill A/c ... Dr.[With Share of Goodwill]

To Sacrificing Partners' Capital/Current A/cs [In sacrificing Ratio]

B. Amount of Goodwill is credited to the New Partner's Capital Account and thereafter, adjusted in favour of old or existing partners in their sacrificing ratio for which following entries are passed:

i. Cash/Bank A/c ... Dr. [With share of goodwill and capital]

To New Partner's Capital

(Being the amount brought by new partner for his share of goodwill and capital)

ii. New Partner's Capital A/c ... Dr. [With share of goodwill]

To Sacrificing Partner's Capital/Current A/cs (Individually)

(Being the goodwill brought by new partner distributed among the sacrificing partners in their sacrificing ratio)

- Accounting Treatment when Goodwill (Premium on Goodwill) is brought in cash or by cheque by the new or Incoming Partner and is withdrawn by Sacrificing Partners fully or partly:** Such amount of premium brought in by the new or incoming partner is shared by the sacrificing partners in the sacrificing ratio. These sacrificing partners may withdraw the premium amount fully or partly. Following entries are to be passed:

i. Premium for goodwill brought in cash by the new partner:

Cash/Bank A/c ... Dr. [Amount of premium]

To Premium for Goodwill A/c

ii. Sharing of premium for goodwill:

Premium for Goodwill A/c ... Dr. [Amount of premium]
 To Sacrificing Partners' Capital A/cs [Sacrificing ratio]

iii. Withdrawal of premium money fully/partly:

Sacrificing Partners' Capital A/cs ... Dr. [Amount withdrawn]
 To Cash/Bank A/c

- **Accounting Treatment when Goodwill (Premium on Goodwill) is brought in kind:** In such situation, the assets brought in are debited individually with their values and Premium for Goodwill Account is credited with his share of goodwill and also new Partner's Capital Account with his capital. Such Premium for Goodwill is transferred to the Capital Accounts of the sacrificing partners in their sacrificing ratio. Following are the accounting entries to be passed:

i. Assets brought in by New Partner:

Assets A/c ... Dr. [Individually]
 To New Partners' Capital A/c [With amount of Capital]
 To Premium for Goodwill A/c [With share of Goodwill brought in]

ii. Crediting sacrificing partners' capital accounts for Goodwill:

Premium for Goodwill A/c ... Dr.
 To Sacrificing Partners' Capital A/cs [In Sacrificing Ratio]

- **Accounting Treatment when Goodwill (Premium on Goodwill) is not brought in full or a part by the new or Incoming Partner:** In such case, premium for goodwill account is credited with the amount of premium for goodwill brought by the new or incoming partner. Transfer entry is to be passed by debiting New or Incoming Partner's Capital/Current Account with the amount of premium on goodwill not brought by him besides debiting premium for Goodwill Account with the amount of premium paid by him. Where, Fixed Capital Accounts method is used for maintaining Capital Accounts, it is debited to his Current Account. Accounting entries are passed as follows:

i. Writing off Goodwill already appearing in the Balance Sheet:

Old Partners' Capital/Current A/cs ... Dr. [In old ratio]
 To Goodwill A/c

ii. Amount Brought in by Incoming Partner:

Bank A/c ... Dr.
 To Incoming Partners' Capital A/c [With Capital]
 To Premium for Goodwill A/c [With Share of Goodwill brought in]

iii. Credit to Sacrificing Partners by Incoming Partner's full share of Goodwill:

Premium for Goodwill A/c	... Dr. [With Premium for Goodwill brought in]
Incoming Partner's Capital/Current A/c	... Dr. [With unpaid Share of Goodwill]
To Sacrificing Partners' Capital A/cs[In sacrificing ratio]	

Alternatively, Goodwill Account is raised for the amount not brought by the incoming partner and is also written off by passing the following entries:

i. Premium for Goodwill A/c ... Dr. [With Premium for Goodwill brought in]
 Goodwill A/c ... Dr. [With Unpaid Amount]
 To Sacrificing Partners' Capital/Current A/cs[In sacrificing ratio]

ii. Incoming Partner's Capital/Current A/c ... Dr.[Unpaid Amount]
 To Goodwill A/c

- **Hidden or Inferred Goodwill:** It is possible that the value of Goodwill of the firm is not given and such value of goodwill is to be inferred based on the net worth (capital of the firm). Such inferred value of Goodwill is termed as Hidden or Inferred Goodwill. In order to identify the value of hidden goodwill, following steps are to be followed:

Step 1: Calculate the net worth (including goodwill) of the firm based on the capital brought in by incoming partner using following formula:

Net Worth = Incoming Partner's Capital * Reciprocal of his share

Step 2: Calculate the actual total capital of all the partners (including the incoming partner) excluding amount of goodwill.

Step 3: Any excess of step 1 over step 2 is termed as Hidden Goodwill.

Revaluation of Assets and Liabilities

Revaluation and Memorandum Revaluation Account:

- Accounting Treatment for revaluation of assets and reassessment of liabilities: In the event of change in profit sharing ratio of the partners, assets are revalued and liabilities are to be reassessed. Such revaluation will result in gain or loss which is to be distributed to the partners in their old profit sharing ratio. The partners are not necessarily required to record the revised values in the books of the firm. The partners may decide to:
 - Record revised values of assets and liabilities; or
 - Not to record the revised values of assets and liabilities.

Accounting treatment under each of the option is different and hence, partners need to be careful of the treatment for the option chosen.

- **Accounting Treatment when revised values of assets and liabilities are to be recorded:** In such situation, revaluation of assets and reassessment of liabilities are to be recorded in an account known as 'Revaluation Account' or 'Profit and Loss Adjustment Account'.
- **Understanding Revaluation Account:** It is an account which is used to record change in value of assets and liabilities. Following are the items which are to be recorded in the Revaluation Account:
 - i. Credited to Revaluation Account:
 - Increase in assets,
 - Unrecorded assets,
 - Decrease in liabilities,
 - Writing back excess provision.
 - ii. Debited to Revaluation Account:
 - Decrease in assets,
 - Increase in liabilities,
 - Unrecorded liabilities,
 - Liabilities provided.
 - iii. Any gain or loss from the revaluation of assets and liabilities is to be distributed among the partners in their old profit sharing ratio and is adjusted in their Capital or Current Accounts.
 - iv. Assets and liabilities revalued are to be shown in the books of firm at the revalued figures only.

- **Accounting entries to record the Revaluation of Assets and Reassessment of Liabilities:**

- i. **Increase in the value of an asset:**

Asset A/c (Individually)	... Dr.
To Revaluation A/c	

- ii. **Decrease in the value of an asset:**

Revaluation A/c.	... Dr.
To Asset A/c (Individually)	

- iii. **Increase in the amount of a liability:**

Revaluation A/cDr.
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To Liability A/c (Individually)

iv. Decrease in the amount of a liability:

Liability A/c (Individually) ... Dr.
To Revaluation A/c

v. Recording an unrecorded asset:

Unrecorded Asset A/c ... Dr.
To Revaluation A/c

vi. Recording an unrecorded liability:

Revaluation A/c ... Dr.
To Unrecorded Liability A/c

vii. Revaluation Gain(profit):

Revaluation A/c ... Dr.
To Old Partners' Capital A/cs [In old profit sharing ratio]

viii. Revaluation Loss:

Old Partners' Capital A/cs ... Dr.[In old profit sharing ratio]
To Revaluation A/cs

● **Specimen of a Revaluation Account:**

Particulars	Amount	Particulars	Amount
To Assets (individually)	...	By Assets (individually)	...
-Decrease in value on revaluation		-Increase in value on revaluation	
To Liabilities (individually)	...	By Liabilities (individually)	...
-Increase in amount on reassessment		-Decrease in amount on reassessment	
To Unrecorded Liabilities A/c	...	By Unrecorded Assets A/c	...
To Partners' Capital A/c (Remuneration)	...	By Loss on Revaluation transferred to Partners' Capital (or Current) A/cs*	...
To Cash/Bank A/c (Expenses)	...		
To Gain (Profit) on Revaluation transferred to Partners' Capital (or Current) A/cs*	...		

Only one will appear at a time

Note: If Revaluation Account is prepared by an entity, assets and liabilities will appear in the Balance Sheet of the reconstituted firm at their revised (changed) values.

- **Treatment for profit or loss arising from the revaluation of assets and reassessment of liabilities:**

- i. In the event of change in the profit sharing ratio, assets are revalued and liabilities are reassessed. This is basically done to increase or decrease the value of assets and liabilities up to the date of change in profit sharing ratio.
- ii. The net gain or loss arising on account of such revaluation and reassessment is for the period before the change in profit sharing ratio. Such gain or loss is therefore, credited or debited to the Partner's Capital Accounts in their old profit sharing ratio.

- **Points to remember for adjustments:**

- i. Care has to be taken to adjust and revalue the assets. Difference between asset reduced by 10% and asset reduced to 10% should be done with care. The term 'by' means value of asset is to be brought down by 10%. The term 'to' means value of asset is to be brought down by 90%.
- ii. If it is mentioned that 'All debtors are good', then it is to be understood that Provision for Doubtful Debts is not required and hence should be credited (written back) to Revaluation Account.

iii. When bad debts and provision for doubtful debts both are specified in the question, first bad debts are to be deducted from Debtors and then Provision for Doubtful Debts is to be calculated on balance bad debts. Any excess of Bad Debts over old Provision for Doubtful Debts should be debited to Revaluation Account. Also, any deficit in Provision for Doubtful Debts should be debited to Revaluation Account.

- **Accounting Treatment when revised values of assets and liabilities are not to be recorded:** In such case, the partners may decide that the value of assets and liabilities will continue to appear in the books at their existing values and therefore, any increase or decrease in the value of assets and liabilities is recorded in the Memorandum Revaluation Account.

- **Memorandum Revaluation Account:**

- A Memorandum Revaluation Account is prepared by the partners of the firm when they mutually decide to give effect to the revaluation of assets and reassessment of liabilities without affecting the existing book values.
- It is prepared in 2 parts where the balance of the first part is transferred to the Capital Accounts of old partners in their old profit sharing ratio and the balance of the second part is transferred to the Capital Accounts of all the partners including incoming partner in their new profit sharing ratio.

- **Journal Entries when revised values of assets and liabilities are not to be recorded:**

- i. **Increase in the value of assets and decrease in the amount of liabilities:**

Assets A/c (Individually) ... Dr.

Liabilities A/c (Individually) ... Dr.

To Memorandum Revaluation A/c

- ii. **Decrease in the value of assets and decrease in the amount of liabilities:**

Memorandum Revaluation A/c ... Dr.

To Assets A/c (Individually)

To Liabilities A/c (Individually)

- iii. **Transferring the balance of the first part of the Memorandum Revaluation Account:**

- a. **If credit side exceeds debit side and it is a gain:**

Memorandum Revaluation A/c ... Dr.

To Old Partners' Capital A/cs [In old ratio]

- b. **If debit side exceeds credit side and it is a loss:**

Old Partners' Capital A/c ... Dr.

To Memorandum Revaluation A/c [In old ratio]

iv. Reversing the first entry: (entry no.i)

Memorandum Revaluation A/c ... Dr.

To Assets A/c (Individually) To Liabilities A/c (Individually)

v. Reversing the second entry: (entry no.ii.)

Assets A/c (Individually) ... Dr.

Liabilities A/c (Individually) ... Dr.

To Memorandum Revaluation A/c

vi. Transferring the balance of the second part of the Memorandum Revaluation Account:**a. If debit side exceeds credit side**

All Partners' Capital A/c ... Dr. [In new ratio]

To Memorandum Revaluation A/c

b. If credit side exceeds debit side

Memorandum Revaluation A/c ... Dr. [In new ratio]

To All Partners' Capital A/c

Remember, if the first part of Memorandum Revaluation Account shows profit, then the second will result into a loss and vice versa.

- **Difference between Revaluation Account and Memorandum Revaluation Account:**

Sr. no.	Basis	Revaluation Account	Memorandum Revaluation Account
1.	Purpose	It is prepared to record the effect of revaluation of assets and liabilities when they are to appear at their revised (new) figure.	It is prepared to record the effect of revaluation of assets and liabilities when the assets and liabilities are to appear their old figures.
2.	Parts	It is not divided into two parts.	It is divided into two parts where first part records the changes in the value of assets and liabilities and the second part is to nullify the changes recorded in the first part.
3.	Transfer of Balance	Transferred to the Old Partners' Capital Accounts in their old profit sharing ratio.	Balance of the first part is transferred to the Capital Accounts of old partners in old profit sharing ratio, and
			The balance of the second part of this account is transferred to the Capital Accounts of all the partners including new partner in the new profit sharing ratio.

Treatment of Reserves and Accumulated Profits or Losses

If any reserves and accumulated profits or losses exist in the books of firm at the time of change in profit sharing ratio, they are to be transferred to the Partners' Capital Accounts or their Current Accounts in their old profit sharing ratio as such existing reserves and profits are earned before the reconstitution of the firm.

Workmen Compensation Reserve:

- **Meaning:**
 - i. It is a reserve that is set aside or appropriated out of firm's profits to meet any of the possible liabilities with respect to employees' compensation, if it arises.
 - ii. Claim with respect to such liabilities may or may not arise.
 - iii. The amount of claim may or may not be equal to the amount of reserves.
- **Accounting Treatment of Workmen Compensation Reserve under different situations:**

Following are the journal entries for explaining accounting treatment of Workmen Compensation Reserve under different situation:

a. **When claim against workmen compensation reserve does not exist:** In this situation, amount of this reserve is transferred to Partners' Capital Accounts in their old profit sharing ratio. Entry to be passed is:

Workmen Compensation Reserves A/c ... Dr.

To Partners' Capital (or Current) A/c

(Being workmen compensation reserves credited to partners' capital or current accounts in their old profit sharing ratio)

b. **When claim for workmen compensation reserve exists: In such situation, treatment shall depend on the amount of liabilities:**

i. **Claim is equal to reserves:** Amount of reserves is transferred to Provision for Workmen Compensation Claim Account. Entry to be passed:

Workmen Compensation Reserves A/c ... Dr.

To Provision for Workmen Compensation Claim A/c

(Being the provision made for estimated compensation claim)

ii. **Claim amount is lower than the reserve: Excess of Workmen Compensation Reserve over the Workmen Compensation Claim is credited to all partners in their old profit sharing ratio. Entry is:**

Workmen Compensation Reserve A/c ... Dr.

To Provision for Workmen Compensation Claim A/c

To Old Partners' Capital or Current A/c

(Being the surplus of Workmen Compensation Reserve transferred to Old Partners' Capital or Current Account in their old profit sharing ratio)

iii. **Claim amount is higher than the reserve:** Amount in excess of reserve is debited to Revaluation Account as the loss is to be borne by the partners in old profit sharing ratio. Entry is:

a. Workmen Compensation Reserve A/c ... Dr.

Revaluation A/c ... Dr.

To Provision for Workmen Compensation Claim A/c

(Being amount of estimated claim debited to Workmen Compensation Reserve and Revaluation Account)

b. Old Partners' Capital or Current A/cs ... Dr. (In Old Ratio)

To Revaluation A/c

(Being the loss on revaluation transferred to Capital or Current Account of partners in their old profit sharing ratio)

Investments Fluctuation Reserve:

- **Meaning:**

- i. It is a reserve which is set aside out of the profits to meet fall in the market value of investments.
- ii. In order to decide the treatment of this reserve, it is necessary to first determine whether the book value and the market value are same or different and if different, which value is higher and which is lower.

- **Accounting Treatment of Investment Fluctuation Reserve:**

- i. **When Book Value and Market Value are same:** Entry has to be passed to transfer the amount of Investment Fluctuation Reserve to Partners' Capital or Current Accounts in their old profit sharing ratio as below:

Investment Fluctuation Reserve A/cDr.

To Partners' Capital (or Current) A/cs [In Old Ratio]

- ii. **When Market Value is less than the Book Value:** In this case, treatment of Investments Fluctuation Reserve shall depend on the quantum of decrease, which has 3 possibilities as follows:

- a. **Fall in Value is less than Investments Fluctuation Reserve:** The amount of Investment Fluctuation Reserve to the extent of fall in value, is transferred to Investment Account and balance is distributed among the partners in their old profit sharing ratio for which following entry is to be passed:

Investment Fluctuation Reserve A/c Dr.

To Investment A/c [Book Value - Market Value]

To Old Partners' Capital (or Current) A/cs [In Old Ratio]

- b. **Fall in Value is Equal to Investments Fluctuation Reserve:** In this case, amount of Investment Fluctuation Reserve is transferred to Investment Account and no amount is distributed among the partners. Entry for the same is as follows:

Investment Fluctuation Reserve A/c Dr.

To Investment A/c

- c. **Fall in Value is More than Investments Fluctuation Reserve:** In this case, amount of Investments Fluctuation Reserve along with balance amount of fall in value is

transferred to Investment Account and the amount in excess of reserve is debited to the Revaluation Account for which following entries are passed:

- Investment Fluctuation Reserve A/c ... Dr. Revaluation A/c
To Investment A/c
- Partners' Capital (or Current) A/cs ... Dr.[In Old Ratio]
To Revaluation A/c

iii. **When there is an Increase in Market Value of Investment:** In this case, total amount of Investment Fluctuation Reserve is distributed among partners and increase in value of investment is credited to Revaluation Account for which following entry is to be passed:

Investment Fluctuation Reserve A/c	... Dr.
To Partners' Capital (or Current) A/cs	[In Old Ratio]
Investment A/c	... Dr.
To Revaluation A/c	[Investment Brought up to Market Value]
Revaluation A/c... Dr.	
To Partners' Capital (or Current) A/cs	[In Old Ratio]

Adjustment of Accumulated Profits, Losses and Reserves Adjustment Entry

- i. If the partners of the firm decide that the existing balances of accumulated profits, losses and reserves should continue to appear at the same amount in the Balance Sheet of the reconstituted firm, then an adjustment entry for the net effect of accumulated profits, losses and reserves is passed since they were earned in past.
- ii. Such entry is passed through the Partners' Capital Accounts using the following steps:

Step 1: Net effect of Reserves, Accumulated Profits and Losses is to be calculated.

Step 2: Gain/Loss of Share is to be calculated.

Step 3: Share of Gaining and Sacrificing Partner in the Net Accumulated Profits, Losses and Reserves is to be calculated as below:

- For Gaining Partner = Net Effect Share Gained
- For Sacrificing Partner = Net Effect Share Sacrificed

Step 4: Adjustment entries are to be passed as follows:

- **In case if Positive Effect (Net Profit):**

Gaining Partners' Capital/Current A/cs... Dr.
To Sacrificing Partners' Capital/Current A/cs

- **In case of Negative Effect (Net Loss):**

Sacrificing Partners' Capital/Current A/cs ... Dr.
To Gaining Partners' Capital/Current A/cs

Treatment of reserves, accumulated profits and losses when nothing is mentioned in the question: Journal Entries to be passed for the mentioned transactions are as follows:

a. **For distributing reserves and accumulated profits:**

General Reserves A/c	...Dr.
Profit and Loss A/c	...Dr.
Workmen Compensation Reserves A/c*	Dr.
Investment Fluctuation Reserve A/c**	Dr.
To All Partners' Capital A/c (In old profit sharing ratio)	

*Amount of workmen compensation reserve distributed shall be excess of reserves over liability.

**Amount of investment fluctuation reserve distributed shall be excess of reserve over difference between Book Value and Market Value.

b. **For writing off accumulated losses:**

All Partners' Capital A/c	... Dr. (In old profit sharing ratio)
To Profit and Loss A/c	

Adjustment of Partners' Capital

Adjustment of Partners' Capital on different basis:

Steps to be followed for adjustment of old partners' capitals on the basis of incoming partners' capital:

- Determine total capital of the firm on the basis of capital of new or incoming partner

$$\text{Total Capital of the firm} = \frac{\text{Capital of the New or Incoming Partner}}{\text{Share of profit of the New or incpmg Partner}}$$
- Compute new capital of each partner by dividing total capital in their new profit sharing ratio (i.e. proportionate capital)
- Compute the total capital (present) of the old partners after giving effect to all

adjustments.

- iv. Determine surplus or deficit capital by comparing step (i i.) and step (ii i.) as follows: If, Present Capital > Proportionate Capital = Surplus and
If, Present Capital < Proportionate Capital = Deficit
- v. In order to adjust the surplus or deficit in step (iv.), necessary journal entry has to be passed as follows:
 - In case of surplus:

Concerned Partners' Capital A/c	... Dr.
To Cash/Bank A/c or Concerned Partner's Current A/c	
 - In case of deficit:

Cash/Bank A/c or Concerned Partner's Current A/c	... Dr.
To Concerned Partners' Capital A/c	

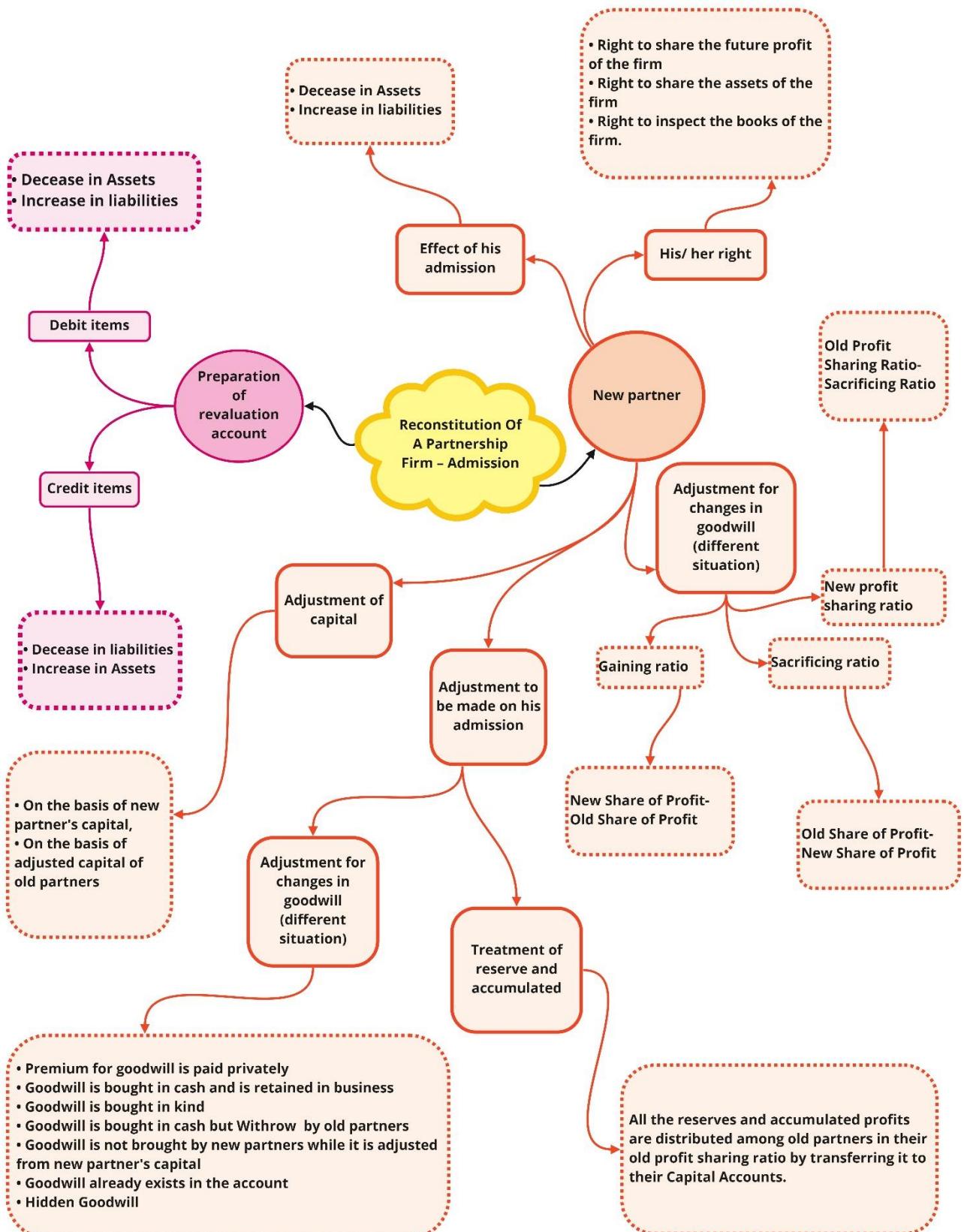
- **Steps to be followed for the purpose of calculating Capital of the Incoming partner on the basis of Capitals of the Old Partners:**

- i. Calculate the total adjusted capital of the old partners, i.e. after giving effect of all adjustments such as goodwill, reserves and revaluation account, etc.
- ii. Calculate the total capital of the new firm using:
- iii. Total adjusted capital of old partners x Reciprocal of total share of old partners.
- iv. Calculate the capital of incoming partner using:
- v. Total capital as per step 2 x Share of incoming partner

- **Admission of a Partner during the year:**

- i. In case a new or incoming partner is admitted in the firm during the year, profit for that year is to be divided between pre-admission and post-admission period on an agreed basis which can either be time basis or turnover basis.
- ii. If no information is given, the profit of the firm should be divided on the basis of time assuming that the profit was earned evenly throughout the year.
- iii. Once this division is done, the profit of the pre-admission period should be distributed among the old partners in their old profit sharing ratio and the profit for the post-admission period is to be distributed among all the partners in terms of new partnership agreement

Class : 12th Accounts
 Chapter - 3 : Reconstitution Of A Partnership Firm – Admission



Important Questions

Multiple Choice questions-

Question 1. A and B are partners in a firm having a capital of ₹ 54,000 and ₹ 36,000 respectively. They admitted C for 1/3rd share in the profits C brought proportionate amount of capital. The Capital brought in by C would be:

- (a) ₹ 90,000
- (b) ₹ 45,000
- (c) ₹ 5,400
- (d) ₹ 36,00

Question 2. Any change in the relationship of existing partners which results at an end of the existing agreement and enforces making of a new agreement is called

- (a) Revaluation of partnership
- (b) Reconstitution of partnership
- (c) Realisation of partnership
- (d) None of the above

Question 3. When the new partner brings cash for goodwill, the amount is credited to:

- (a) Realisation Account
- (b) Cash Account
- (c) Premium for Goodwill Account
- (d) Revaluation Account

Question 4. Goodwill is an _____ Assets.

- (a) fixed
- (b) intangible
- (c) current
- (d) fictitious

Question 5. Value of reputation of the firm is:

- (a) Royalty
- (b) Assets
- (c) Goodwill
- (d) Patents

Question 6. _____ profit is excess of actual profits over normal profits.

- (a) Net
- (b) Average
- (c) Super
- (d) Appropriated

Question 7. Sacrifice Ratio = _____

- (a) New Ratio – Old Ratio
- (b) Old Ratio – New Ratio
- (c) New Ratio + Old Ratio

(d) Old Ratio + New Ratio

Question 8. Gaining Ratio = _____

(a) New Ratio – Old Ratio

(b) Old Ratio – New Ratio

(c) New Ratio + Old Ratio

(d) Old Ratio + New Ratio

Question 9. Share of old Partners will _____ if new partner admit in the firm.

(a) increase

(b) decrease

(c) remains same

(d) not changed

Question 10. Unrecorded liabilities will be _____ in Revaluation Account.

(a) debited

(b) credited

(c) not shown

(d) shown

Very Short Questions-

1. What is meant by 'Issued Capital'?
2. By which name the profit sharing ratio in which all partners, including the new partner, will share fixture profits?
3. At the time of admission of a partner, who decides the share of profit of the new partner out of the firm's profit?
4. X and Y are partners. Y wants to admit his son K into the business. Can K become the partner of the firm?
5. Name the accounting standard, issued by the Institute of Chartered Accountants of India, which deals with treatment goodwill.
6. Name any one factor responsible which affect the value of goodwill.
7. In which ratio is the profit or loss due to revaluation of assets and liabilities transferred to capital accounts?
8. What is the formula for calculating inferred goodwill?
9. When the new partner brings amount of premium for goodwill, by which ratio is this amount credited to old partners' Capital Accounts?
10. What is the formula of calculating sacrificing ratio?

Short Questions-

1. Identify various matters that need adjustments at the time of admission of a new partner.
2. Why is it necessary to ascertain new profit sharing ratio even for old partners when a new partner is admitted?
3. What is sacrificing ratio? Why is it calculated?
4. On what occasions sacrificing ratio is used?
5. Why is there need for the revaluation of Liabilities and Assets on the admission of a partner?
6. If some goodwill already exists in the books and the new partner brings in his share of goodwill in cash, how will you deal with existing amount of goodwill?

Long Questions-

1. What is goodwill? What are the factors that affect goodwill?
2. Explain how will you deal with goodwill when new partner is not in a position to bring his share of goodwill in cash?
3. Explain various methods for the treatment of goodwill on the admission of a new partner?
4. How will you deal with the accumulated profit and losses and reserves on the admission of a new partner?

Assertion Reason Questions-

1. For two statements are given—one labelled Assertion and the other labelled Reason. Select the correct answer to these questions from the codes (a), (b), (c) and (d) as given below.
 - a. Assertion and Reason both are correct and Reason is the correct explanation of assertion
 - b. Assertion and Reason both are correct but Reason is not correct explanation of assertion
 - c. Assertion is correct but Reason is not correct.
 - d. Both Assertion and Reason are False.

Assertion: Anahat and Parminder are partners sharing profits in the ratio of 2:1. They admit Rubayat as partner w.e.f. 1st January 2021. On that date, Goodwill existed in the books at ₹1,00,000. Goodwill of ₹50,000 was written off by debiting capital accounts of Anahat and

Parminder in the ratio of 2:1. While balance goodwill was carried forward in the Balance Sheet.

Reason (R): Goodwill existing in the books is purchased goodwill and therefore, is not written off.

2. For two statements are given-one labelled Assertion and the other labelled Reason. Select the correct answer to these questions from the codes (a), (b), (c) and (d) as given below.

- a. Assertion and Reason both are correct and Reason is the correct explanation of assertion
- b. Assertion and Reason both are correct but Reason is not correct explanation of assertion
- c. Assertion is correct but Reason is not correct.
- d. Both Assertion and Reason are False.

Assertion: Undistributed profits or losses appearing in the balance sheet at the time of admission should be transferred to the old partner's capital/current account.

Reason (R): Undistributed profits or losses appearing in the balance sheet at the time of admission belong to the old partners as they are earned by them.

MCQ Answers-

1. Answer: (b) ₹ 45,000
2. Answer: (b) Reconstitution of partnership
3. Answer: (c) Premium for Goodwill Account
4. Answer: (b) intangible
5. Answer: (c) Goodwill
6. Answer: (c) Super
7. Answer: (b) Old Ratio – New Ratio
8. Answer: (a) New Ratio – Old Ratio
9. Answer: (b) decrease
10. Answer: (a) debited

Very Short Answers-

1. Answer: Issued capital means such capital as the company issues from time to time for subscription-section 2(50) of the companies Act 2013.
2. Answer: New profit sharing ratio
3. Answer: It is decided mutually between the old partners and the new partner.

4. Answer: Yes, if X agrees to it otherwise not
5. Answer: AS26
6. Answer: Location of a business
7. Answer: Old Ratio of existing partners
8. Answer: Net worth of business on the basis of new partner's capital minus net worth of business in new firm
9. Answer: Sacrificing ratio
10. Answer: Sacrificing Ratio = Old Ratio – New Ratio

Short Answers-

1. Identify various matters that need adjustments at the time of admission of a new partner:
 - i. Capital Adjustment among partners.
 - ii. Revised calculation of profit sharing ratio.
 - iii. Evaluating and adjusting the goodwill of partners who are sacrificing their share.
 - iv. Accumulated profits, reserves and losses should be distributed to old partners as per the old ratio that was agreed upon.
 - v. Revaluation of the Liabilities and Assets to determine the current value and distribution of profit or loss as per the old ratio.
2. At the time of admission of a new partner, the existing partners sacrifice their present profit sharing ratio to make way for a share in profit sharing to new partner which results in reducing their profit. Therefore it is essential to determine the new profit sharing ratio for old partners on the occasion of adding a new partner as it creates a more justified share of profit.
3. The portion of profit sharing ratio that is sacrificed by current partners when a new partner joins the firm is called as sacrificing ratio. It is calculated as the difference between old profit sharing ratio and new profit sharing ratio.

Sacrificing ratio = Old profit sharing ratio – New profit sharing ratio

It is compulsory to determine this ratio as the new partner has to reimburse the existing partner for making the sacrifice of profit. It is paid to them as goodwill.

4. Sacrificing ratio needs to be used in these occasions:
 - i. When it is mutually decided by partners of the firm to change profit sharing ratio among the partners.

- ii. A new partner is introduced in the firm and accordingly the sum contributed by the new partner is distributed as goodwill based on the sacrificing ratio of existing partners.
- 5. When a new partner gets admitted in the firm, there is a need to revalue the Liabilities and Assets of the firm for determining the true value on that day. Revaluation is helpful as the value of Liabilities and Assets may increase or decrease and as such their values in old balance sheet may be not justified, also some assets or liabilities may not be recorded at all. Hence, for recording the changes in market value for the Liabilities and Assets, a revaluation account is needed to be prepared and the associated profits or losses needs to be distributed between the existing partners of firm.
- 6. Goodwill that exists in the firms before arrival of a new partner must be written off between the existing partners in the ratio of their profit sharing as previously decided. The following journal entry needs to be passed.

To Goodwill A/c

(Being goodwill written off in the old ratio between existing partners)

Long Answers-

1. Goodwill refers to the intangible asset that represents the firm's value and reputation and the brand name that it carries in the market. Goodwill is earned by a firm from the work it does which helps earn people trust by meeting all customer demands both in quality and quantity. Having a positive goodwill is very much helpful for a firm to earn extraordinary profits in comparison to its competitors. It also ensures profits that keep coming in the future and helps in retaining old customers.

Factors affecting firms' goodwill are:

- i. Product Quality: A firm which is constantly delivering the best product for its customers will have a greater goodwill.
- ii. Location: A central location makes it easy to reach and attracts more footfalls which leads to higher sales and more goodwill.
- iii. Management: Cost efficiency and higher productivity can be achieved by having an efficient management in place, also it ensures quality products at less price which increases goodwill.
- iv. Market Structure: A firm will enjoy more benefits of goodwill if the market is monopolistic in nature and there are no substitutes, it will add more goodwill to the

firm.

- v. Other Advantages: A firm that is getting benefits such as continuous supply of fuel, power and raw materials and uses it to produce quality goods enjoys a higher goodwill.

2. The situation in which a new partner is unable to bring his share of goodwill in cash, the goodwill account gets adjusted through Old Partners account. New partners' capital account is debited with the share of goodwill and the same gets credited to Old Partner's account.

New Partner's Capital A/c	Dr.
To Old Partners' Capital A/c	
(New Partner account debited)	

Note: According to Para 16 of Accounting Standard 10, Goodwill is recorded only when it is any transaction equivalent to money or money's worth. It is a mandatory practice that is followed.

3. Goodwill is treated in the following ways on introduction of a new partner:

1. Premium Method

2. Revaluation Method

When a new partner pays the share of goodwill in the form of cash, it is called as premium method.

There can be two scenarios:

1. New partners pays directly to old partners.

2. Partner brings goodwill in form of cash and it is retained in the business.

The corresponding entries are:

(i) When goodwill brought in cash by new partner

Cash/Bank A/c Dr.

To Premium for Goodwill A/c

(Amount of goodwill brought in by new partner)

(ii) When goodwill is retained by business:

Premium for Goodwill A/c Dr

To Sacrificing Partners' Capital A/c

(Goodwill brought by new partner distributed among old partners as per the sharing ratio)

Revaluation Method: Situations when new partner is unable to bring goodwill in form of cash

New Partner's Capital A/c Dr. (Goodwill amount not brought by new partner)

To Old Partners' Capital A/c

(Goodwill of new partner distributed to old partners as per their sharing ratio)

Note: According to Para 16 of Accounting Standard 10, Goodwill is recorded only when it is any transaction equivalent to money or money's worth. It is a mandatory practice that is followed.

4. A new partner is not entitled to bear the losses or enjoy the profits of a previous business. Hence, when a new partner is added to the firm, the accumulated profits or losses, reserves needs to be distributed to current partners (partners of old firm) in their profit sharing ratio.

Treatment of accumulated losses, profits and reserve

Profit and Loss A/C Dr.

General Reserve A/C Dr.

Contingency Reserve A/C Dr.

When losses accumulate over a period.

For Profits and losses

Deferred Advertising expense Dr.

(Losses accumulated shared to old partners as per sharing ratio)

Assertion Reason Questions-

1. (d) Both Assertion and Reason are False.

2. (a) Assertion and Reason both are correct and Reason is the correct explanation of assertion.