CHAPTER – 3

RECONSTITUTION OF A PARTNERSHIP FIRM - ADMISSION OF A PARTNER

Reconstitution of a partnership means a change in the nature of relationship among the members, effected through a fresh agreement under which the existing business continues.

MODES OF RECONSTITUTION

- Admission of a partner.
- Change in profit sharing ratio.
- Retirement of a partner.
- Death of a partner.

ADMISSION OF A NEW PARTNER

According to Partnership Act, 1932, a person can be admitted as a new partner with the consent of all the existing partners. Usually a new partner is admitted when the firm needs additional capital or managerial help or both.

While admitting a new partner he acquires the <u>right to share the assets</u> of the firm and <u>to share the future profits</u> of the firm. In order to get the first right the new partner has to bring an agreed amount of <u>capital</u> and for acquiring the second right he has to bring his share of <u>goodwill</u> (also called premium) which will be shared among the old partners, as they sacrifice a part of their profit in favour of the incoming partner.

Following are the accounting treatments at the time of admission:-

1. Capital of the new partner
2. Calculation of new profit sharing ratio.
3. Calculation of sacrificing ratio.
4. Treatment of Goodwill.
5. Revaluation of Assets and Liabilities.
6. Adjustment of reserves and other accumulated profits and losses.
7. Adjustment of capital accounts of the partners.

Capital of the new partner – When a person is admitted as a partner he will bring the capital. Usually it may be in cash. Sometimes, he brings certain assets along with cash towards capital.

Journal Entries:

1. When a new partner brings cash as capital

    Cash A/c Dr

    To New Partner's Capital A/c

2. When the new partner brings cash and other assets

    Cash A/c Dr

    Assets A/c (individually) Dr

    To New partner's capital A/c

Calculation of New Profit Sharing Ratio (Change in Profit Sharing Ratio)

While admitting a new partner it is necessary to find out the new profit sharing ratio as the incoming partner acquires his share of profit from the old partners. The new ratio is determined by considering how the new partner acquires his share of profit from the old partners. The various possibilities are:-

a) He may acquire it from the old partners in the old ratio.
b) Equally from the old partners.
c) At some agreed ratio.
d) He may acquire it wholly from one or more partners.
e) He may acquire it in the form of certain fraction of old partners' share in profits. (Eg. A surrendered 1/32 of his share and B 3/32 of his share in favour of C).

If the partnership deed is silent regarding this matter, the new partner acquires his share in profits from the old partners in the old ratio, and the old partners continue to share the remaining profits in the old ratio.

Calculation of Sacrificing Ratio

Sacrificing ratio is the ratio in which the old partners have agreed to sacrifice their share of profits in favour of the new partner. While admitting a new partner, he is required to compensate the old partners for his right to share in the future profits of the firm, if it is made in cash, it can be shared by the old partners in their sacrificing ratio.

SACRIFICING RATIO = OLD RATIO – NEW RATIO
:. Sacrificing Share = Old Share – New Share

GOODWILL

Goodwill is the value of reputation of a firm in respect of the profits expected in future over and above the normal profits. Over a period of time a well established business develops an advantage of good name, reputation and wide business connections which help the business to earn more profits. In accounting, the monetary value of such advantage is known as goodwill.

Factors Affecting Goodwill:

1. **Location of Business** – If it is centrally located in a place having more customer traffic, the goodwill tends to be high.
2. **Nature of Business** – The firm which produces the products having a stable demand is able to earn more profits and therefore has more goodwill.
3. **Efficiency of Management** – Based on the efficiency of management the productivity as well as the profitability of an organization be higher and it determines the value of goodwill.
4. **Time Factor** – A business concern running profitably for a longer period will have more goodwill since it is better known to the customers.
5. **Market Situation** – The monopoly or limited competition enables the business to earn more profit, which leads to higher goodwill.
6. **Special Advantages** – Import licenses, well known foreign collaboration, patents, trademarks etc. will help to earn more profit which leads to higher goodwill for the firm.

Need for valuation of goodwill

The need for valuation of goodwill arises at the following circumstances:

1. Change in profit sharing ratio among the existing partners.
2. Admission of a partner.
3. Retirement of a partner.
4. Death of a partner.
5. Dissolution of a firm or sale of partnership business.
6. Amalgamation of firms.

Methods of valuation of goodwill

1. <u>AVERAGE PROFIT METHOD</u>

Under this method, the goodwill is valued at an agreed number of 'years' purchase of the average profits of the past a few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Eg: Net profit of a business for the last 3 years was Rs. 10000, 20000 and 30000, the partners decided to calculate the goodwill based on 2 years purchase. Therefore, Average Profit = (10000 + 20000 + 30000) / 3 = 20000. Here goodwill = 20000 x 2 = 40000.

Treatment of Goodwill

At the time of admission of a new partner, he gets his share of profit from the existing partners, for which he has to compensate them. For this he has to bring in his share of goodwill (premium) in cash. The goodwill thus brought in by the new partner is shared by the old partners in their sacrificing ratio.

<u>Accounting Treatment</u>

A. If this amount is paid to the old partners privately, ie; outside the business, No entry

is to be passed in the books of the firm.

B. If the amount is paid through the firm and the same is retained in the business, the following journal entries are to be passed:-

1. Cash Account Dr
   To Goodwill Account.
   (Amount brought in by the new partner as goodwill)

2. Goodwill Account Dr
   To Old Partners' Capital Account (individually)
   (Goodwill transferred to the old partners' capital account in their sacrificing ratio)

C. If the new partner brings in his share of goodwill in cash and the same in full or part is withdrawn by the old partners, the following entries are to be passed.

Old Partner's Capital Account Dr To
   Cash Account
(The amount of goodwill withdrawn by the old partners)

Alternatively, the cash premium brought in by the new partner may be directly credited to old partners' capital accounts. In such a case only one journal entry is enough instead of the above two entries 1 and 2.

Cash Account Dr
To Old Partners' Capital Account

(Cash brought in for goodwill by the new partner credited to old partners in their sacrificing ratio)

Premium (Share of Goodwill) Brought in Kind

If the new partner brings his share of premium in the form of assets, instead of cash the amount of assets brought in by the new partner will be debited and credit is given for the premium account. Afterwards the premium amount should be transferred to the old partners' capital account in their sacrificing ratio.

Journal Entry:-

1. Capital and goodwill brought in by the new partner in the form of asset –
   Assets (individually) Account Dr To
   New Partner's Capital Account
   To Goodwill Account.

2. The premium brought in by the new partner shared among the old partners capital account –
   Goodwill Account Dr
   To Old Partners' Capital Account

New Partner brings in only a portion of the goodwill in cash

In case the new partner may not be in a position to bring the full amount of his share of goodwill in cash, the balance amount may be adjusted from his capital account or current account if it is maintained.

Journal Entry:-

1. The new partner brings a portion of his share of goodwill in cash –

   Cash Account Dr
   To Goodwill Account

2. To share the premium among the old partners and the deficit of goodwill adjusted from the new partner's capital account –

   Goodwill account Dr
   New Partner's Capital Account Dr To
   Old Partners' Capital Account

REVALUATION OF ASSETS AND LIABILITIES

It is better to ascertain that whether the assets and liabilities of the firm are shown at their correct value at the time of admission. If they are overstated or understated, they must be revalued and any profit or loss should be adjusted to the old partners in their old ratio. The new partner is not affected by the revaluation of assets and liabilities as he is not concerned with the pre-admission profit or loss.

All the adjustments regarding revaluation of assets and liabilities are affected through revaluation account or the Profit and Loss Adjustment Account.

Revaluation account is a Nominal Account, which is credited with the increase in the value of asset, decrease in the value of liability and any unrecorded asset, whereas it is debited with the decrease in the value of assets, increase in the value of liability and unrecorded liabilities. The balance in the revaluation account ie; gains or loss should be transferred to the old partners' capital account in their old ratio.

Need for preparing Revaluation Account

a. To bring the assets and liabilities of the firm to their true values.
b. To find out the profit or loss arising out of revaluation.

Journal Entries:-

a. Increase in the value of asset-
Asset Account Dr
To Revaluation Account

b. Decrease in the value of asset –
Revaluation Account Dr
To Asset Account

c. Increase in the value of liability
Revaluation account Dr
To Liability Account

d. Decrease in the value of liability-
Liability Account Dr
Revaluation Account

e. Unrecorded Asset –
Asset Account Dr
To Revaluation Account

f. Unrecorded Liability –
Revaluation Account Dr
To Unrecorded Liability Account

(In case unrecorded assets are realized and unrecorded liabilities are paid off, the entry will be "CASH" or "BANK" instead of ASSETS and LIABILITIES)

g. Transfer of balance in Revaluation account (profit and loss adjustment account) –

1. If the revaluation account shows a credit balance ie; profit
   Revaluation account Dr
   To Old Partners' Capital (individually) account

2. If the revaluation account shows a debit balance, ie; Loss.
   Old Partners' capital account Dr
   To Revaluation account.

Proforma of Revaluation Account – Refer theText Book

ADJUSTMENT FOR RESERVES AND ACCUMULATED PROFIT OR LOSS

At the time of change in profit sharing ratio, some undistributed profits and reserves may stand in the books. It should be shared among the partners in their old profit sharing ratio before reconstitution takes place. This is to be done even if the question is silent in this regard.

Journal Entry:

1. Undistributed profits or Reserves.

   Profit and Loss Account Dr
   Reserves Account Dr
   To Old Partners' Capital Account

2. Undistributed Losses.

   Old Partners' Capital Account Dr
   To Profit and Loss Account

Note:
Workmen's Compensation Fund and **Investment Fluctuation Fund** etc. are transferred to old partners' capital accounts in their old ratio.

Employees Provident Fund is a liability hence it is to be kept in the liability side of the Balance Sheet after admission.

<u>ADJUSTMENT OF CAPITAL ACCOUNTS OF</u>

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