Reconstitution of Partnership Firm

Partnership is a voluntary association of two or more persons who on the basis of an agreement pool together their financial and managerial resources and jointly start a lawful business. **Any change in the relationship among partners may lead to reconstitution of the partnership firm.** A change in the partnership agreement brings to an end to the existing agreement. Thus in reconstitution the existing agreement comes to an end and the firm may continue its business with a new agreement.

Other word when there is change in the relations among partners of the firm without affecting the existence of partnership firm, it is called reconstitution of partnership firm. As a result of reconstitution the firm continues as a new or reconstituted firm

Modes of Reconstitution/ Occasions when reconstitution of a firm take place

Reconstitution of a partnership firm is usually takes place in any of the following ways:

1. Change in the profit sharing ratio among the existing partners
2. Admission of a partner
3. Retirement of an existing partner
4. Death of a partner
5. Amalgamation of two partnership firms

1. Change in the profit sharing ratio among the existing partners: - A Change in profit sharing ratio means one or more partners acquires interest from another partner or partners. Here it share of profit of one or more partners increases then share of one or more partner decreases to same extent.

2. Admission of a partner: - Inclusion of a person as a partner to an existing partnership firm is called admission of a partner. When a firm requires additional capital or managerial help or both for the expansion of its business, a firm can admit a person as a partner to an existing firm. The new person admitted is called as incoming partner. On admission, old partnership agreement comes to an end and with a new agreement the business will continue. A person can be admitted as a partner only with the consent of all partners.

3. Retirement of an existing partner: - Retirement means withdrawal of a partner from an existing business. Retirement may be due to his bad health, old age or change in business interests.

Example: A, B and C are partners sharing in the ratio of 3:2:1.After C's retirement A and B decided to continue the business with a profit sharing ratio of 3:2.This results in reconstitution of the firm.

4. Death of a partner: - Death of a partner will also result in the change of relationship between surviving partners. Their profit sharing ratio will change and it leads to reconstitution.

5. Amalgamation of two partnership firms: - Sometimes two firms amalgamate in order to avoid competition and reduce administrative cost. This arrangement brings new relationship among partners of two firms. A new agreement is signed .New profit sharing arrangements takes place. Here also reconstitution occurred.

As such, any change in the partnership agreement due to change in the ratio of existing partners or admission or retirement or death of a partner or amalgamation of partnership firm is known as Reconstitution of Partnership.

Change in Profit Sharing Ratio among the Existing Partners

- **Meaning:**
  i. It means reconstitution of the firm whereby the profit-sharing ratio among all the partners' changes.
  ii. It can be due to change in capital contribution or increased participation in management by one or more partners.
  iii. It can also be on account of one or more partner(s) acquiring share of profit in the business from another partner(s). Therefore, the aggregate amount of gain of one (or more) partner(s) is equal to the aggregate amount loss/sacrifice borne by other partner(s).
  iv. Therefore, if the share of one (or more) partner(s) increases then share of profit of one (or more) partner(s) decreases.
  v. It leads to dissolution of partnership but not the dissolution of the firm. This is because the existing partnership agreement ends and the new agreement come into effect.

When one or more partners acquire an interest in the business from another partner(s), it is said to be a change in the profit sharing ratio in a partnership firm. A change in the profit sharing ratio among the existing partners means it is a reconstitution of the firm without admission, retirement or death of a new partner(s). Other word a change in profit sharing ratio basically refers to the purchase of profit by one partner from another partner. As result of change in profit sharing ratio, some partners may gain in future profit whereas others may lose.

the sacrifice made or gain received by a partner is calculated by deducting the new share from the old share of a partner.

Sacrificing/(Gaining) Share = Old Share – New Share

Accounting Treatment

At the time of reconstitution of firm due to change in profit sharing ratio, the right, duties and obligation of partners are necessary to be change then following accounting adjustment to be required in the books of firm

(1) Determination of sacrificing ratio and gaining ratio.
(2) Valuation of goodwill and Accounting for goodwill.
(3) Accounting treatment of reserves and accumulated profits.
(4) Accounting for revaluation of assets and liabilities.
(5) Adjustment of capitals.

Meaning and the Computation of Sacrificing and Gaining Ratio:

The prime purpose of computing the sacrificing and gaining ratio is to determine the amount of compensation (goodwill) that the gaining partner shall pay to the sacrificing partner. Following points help us in understanding their meaning:

i. **Sacrificing Ratio:**

- **Meaning:** It is that ratio in which one or more partners forego their share of profits in favor of one or more partners of the firm. In simple terms, it the ratio of sacrifice made by one or more partners.
- **Computation:**
  Sacrificed Share = Old Share – New Share

ii. **Gaining Ratio:**

- **Meaning:** It is that ratio in which one or more partners gain share of profit as a result of sacrifice made by other partners of the firm. Other word it is the ratio in which the profit sharing ratio of gaining partners increases. It is calculated by taking difference between New profit sharing ratio and old profit sharing ratio
- **Computation:**
  Gaining Share = New Share – Old Share

Note: If old ratio-new ratio is positive it means sacrifice and if it is negative it means gain.

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Valuation of Goodwill and Accounting Treatment of Goodwill

Meaning of Goodwill: It is good name or the reputation of the business, which is earned by a firm through the hard work and honesty of its owners. If a firm renders good service to the customers, the customers who feel satisfied will come again and again and the firm will be able to earn more profits in future.

Thus, goodwill is the value of the reputation of a firm which enables it to earn higher profits in comparison to the normal profits earned by other firms in the same trade.

Other **word Goodwill is the value of the reputation of a firm built over time with respect to the expected future profits over and above the normal profits. A well-established firm earns a good name in the market, builds trust with the customers and also has more business connections as compared to a newly set up business. Thus, the monetary value of this advantage that a buyer is ready to pay is termed as Goodwill.**

Importance of goodwill may be understood from the following lines

- **If Capital is Lost, Nothing is Lost**
- **If Customers are Lost, Something is Lost**
- **If Goodwill is Lost, Everything is Lost**

Features of Goodwill

1. It is an intangible asset: Goodwill cannot be seen or touched, it does not have any physical existence, thus it belongs to the category of intangible assets such as patents, trademarks, copy rights, etc.

2 It is a valuable asset
3 It is helpful in earning excess profits.
4 Its value is liable to constant fluctuations: While goodwill does not depreciate, its value is liable to constant fluctuation; its value is liable to constant fluctuations. It is always present as a silent asset in a business where there are super profits (i.e. more than the normal) but declines in value with the decline in earnings.

5 It is valuable only when entire business is sold: Goodwill cannot be sold in part. It can be sold with the entire business only. The only exception is at the time of admission or retirement of the partner.

6 It is difficult to place an exact value on goodwill : This is because its value may fluctuate from time to time due to changing circumstances which are internal and external to business.

Types of Goodwill

Goodwill is divided into two categories.

I. Purchased Goodwill: Purchased goodwill means goodwill for which a consideration has been paid e.g. when business is purchased the excess of purchase consideration of its net assets i.e. (Assets – Liabilities) is the Purchased Goodwill. It is separately recorded in the books because as it is purchased by paying in form of cash or kind.

Characteristics
(i) It arises on purchase of a business or brand.
(ii) Consideration is paid for it so it is recorded in books.
(iii) Shown in balance sheet as on asset.
(iv) It is amortized (depreciated).
(v) Value is a subjective judgment & ascertained by agreement of seller & purchaser. It is approximate value and cannot be sold separately in the market or in parts.

II. Self-generated Goodwill also called as inherent goodwill. It is an internally generated goodwill which arises from a number of factors that a running business possesses due to which it is able to earn more profits in the future.

Features
(i) It is generated internally over the years.
(ii) A true cost cannot be placed on this type of goodwill.
(iii) Value depends on subjective judgment of the value.
(**iv) As per Accounting Standard 26(Intangible Asset)**, it is not recorded in the books of accounts because consideration in money or money's worth has not be paid for it.

Factors Affecting the Value of Goodwill

1. Efficient management: If the business is run by experienced and efficient management, its profits will go on increasing, which results in increase in the value of goodwill

2. Quality of products: If the firm is supplying good quality of products, then the customer will come again and again for the same and thus will create the goodwill and brand name for the same.

3. Location of business: If the business is located at a convenient or prominent place, it will attract more customers and therefore will have more goodwill.

4. The Longevity of the business: An older business is better known to its customers; therefore it is likely to have more goodwill. When a business enterprise has built up good reputation over a period of time, the number of customers will be more in comparison to the customers of new entrants. Number of customers is an indicator of profit earning capacity of a business.

5. Monopolistic and other Rights: If a business enjoys monopoly market, it will have assured profits. Similarly, if it holds some special rights such as patents, trademarks, copyrights or concessions, etc, it will have more goodwill.

6. Other factors:

(i) Good industrial relations.

(ii) Favorable Government regulations

(iii) Stable political conditions

(iv) Research and development efforts

(v) Effective advertising to establish brand popularity

(vi) Popularity of product in terms of quality.

Need for Valuing Goodwill: Whenever the mutual rights of the partner's changes the party which makes a sacrifice must be compensated. This basis of compensation is goodwill so we need to calculate goodwill.

Mutual rights change under following circumstances

1. When profit sharing ratio changes
2. On admission of a partner
3. On Retirement or death of a partner
4. When amalgamation of two firms taken place
5. When partnership firm is sold.

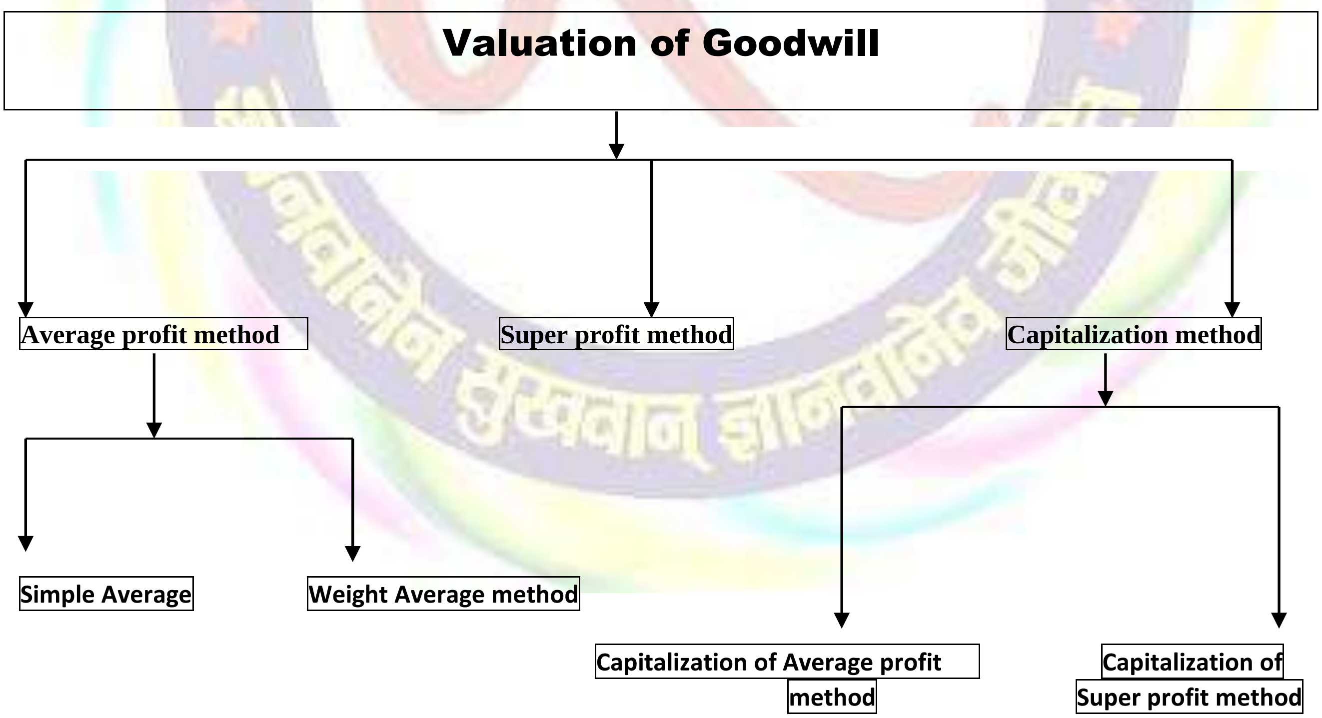
Methods of valuation of goodwill :

It is very difficult to assess the value of goodwill, as it is an intangible asset. In case of sale of a business, its value depends on the mutual agreement between the seller and the purchaser of the business. Usually, there are three methods of valuing goodwill:

1. average profit method

2. Super profit method

3. Capitalization method



1. Average Profit Method

This is a very simple and widely followed method of valuation of goodwill. In this method, goodwill is calculated on the basis of the number of past years. Average of such profits is multiplied by the agreed number of years (such as two or three) to find out the value of goodwill

Average profit method-important assumptions

a) This method is based on the assumption that a new business will not be able to earn any profit during the first few years of its operations. Hence, a person who purchases The share of a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years.

b) In this method calculation of goodwill is based on the assumption that no change in the overall situation of profit is expected in the future.

Categories of Average profit methods

There are two types of average profit methods

(a) Simple Average Profit Method

(b) Weight Average Profit Method

(a) Simple Average Profit Method:- Under this method, the goodwill is valued at agreed number of year's purchase of the average profit of the past few years.

The following factors should be taken into account while calculating the average profits:

(i) Abnormal income of a year should be deducted out of the net profit of that year.

(ii) Abnormal loss of a year should be added back to the net profit of that year.

(iii) Income from investments should be deducted out of the net profits of that year, because this income is received from outside the business

Calculation of adjusted profit –

Profit for the year		*********
Add-abnormal loss		*********
Less-abnormal gain		(********)
Less-income from investment	-	(**********)
Adjusted profit	-	*************

Steps of Valuation of Goodwill (under simple average profit method)

Step -1 Determine normal past few years' business profits with adjusting each year profit by deducting abnormal gain and adding abnormal losses.

Step -2 Sums up the normal profit calculated above

Step-3 Calculate Average profit = Total Profit / Number of Years
Step-4 Determine number of Years Purchase

Step-5 Calculate Goodwill

Goodwill = Average profit X Agreed number of years purchase

Number of years of purchase means for how many years the firm will earn the same amount of profits in future

Weight Average Profit Method:- This method is a modified version of average profit method. In this Method each year's profit is assigned a weight. The highest weight is attached to profit of most recent year.

Eg: 2011-1, 2012-2, 2013-3, and 2014-4.
Each year profits are multiplied by assigned weights. Products are added & divided by total number of weights. Weighted average is multiplied by agreed Number of years of Purchase. Hence we calculate goodwill based on specific weights like 1,2,3,4 and so on for respective year's profit

Steps of Valuation of Goodwill (under weight average profit method)

Step-1 Determine the profits of the last few years and Determine weights of each year
Step-2 Multiply each year's profit by its weight to find out product

Step-3 Find out sum of products and weights

Step-4 Divide the total of products by total of weights to find out the weighted average profit

$$\text{Weighted Average Profit:} = \frac{\textbf{Total of Products}}{\textbf{SUM OF Weights}}$$

Step-5 Determine Number of Years Purchase
Step-6 Calculate goodwill by multiplying the weighted average profits with agreed number of years purchase.

Goodwill= Weighted Average profit × Number of years' purchase

2. Super Profit Method: - In this method goodwill is calculated on the basis of surplus (excess) profits earned by a firm in comparison to average profits earned by other firms. If a business has no anticipated excess earnings, it will have no goodwill.

Super Profit are the excess of actual profit over normal profits. Where Normal profits are profits earned by similar business. If a firm earns higher profit in comparison to normal profit (generally earned by other firms of same industry) then the difference is called Super Profit. Goodwill is calculated on the basis of Super profit due to future expectations of earning capacity of the firm. Under this method goodwill is valued multiplying the super profit with the decided number of years.

Normal Profit: - It is reasonable return on capital employed ie, Profit earned by similar type of firms to the same industry having the same degree of business risk

Normal Profit= $\frac{\text{capital Employed} \times \text{Normal rate of return}}{100}$

Normal rate of Return: - it is the rate of earning which partners or investors expect on their investment in a particular time of the business

Capital Employed: - Total amount to be invested by the partners/owner/investors in the business during the particular time

CAPITAL EMPLOYED = Total amount of the partners capital
Or capital employed= All Assets (other than fictitious assets)—current liabilities

Super Profit:-It is the excess of average profit of the business over the normal profit to be called super profit

Super profit= Actual average profit --- Normal profit

Steps of Valuation of Goodwill (under Super profit method)

Step-1 Determine Actual past few years' business profits
Step -2 Sums up the Actual profit calculated above
Step-3 Calculate Average profit = Total Profit / Number of Years
Step-4 Determine Actual capital employed and Normal rate of return
Step-5 Ascertain the Normal Profit

Normal profit = Capital employed X Normal Rate of Return /100

Step -6 Ascertain super profits

Super Profit = Actual Average Profit – Normal Profit

Step -7 Calculate Goodwill

Goodwill = Super profit X Agreed number of years purchase

3. Capitalization method:- Under this method the goodwill can be calculated in two ways: (a) Capitalization of average profit method (b) Capitalization of super profits

(a) <u>Capitalization of average profit method</u>:- Under this method the value of goodwill is ascertained by deducting net tangible assets (capital employed) from the capitalized value of average profits

<u>Steps of Valuation of Goodwill (under Capitalization of average profit method)</u>

Step-1 Ascertain average profits based on the past few years profit
Step -2 Determine Normal Rate of Return
Step-2 Ascertain the capitalized value of Business

$$\text{Capitalized value} = \frac{\text{Average profit} \times 100}{\text{Normal Rate of Return}}$$

Step-3 Ascertain Net Assets by deducting outside liabilities from the total value of assets (excluding goodwill) ie. Capital Employed of the business

Step-4 Compute the value of goodwill

Goodwill = Capitalized value of business – Net Assets (capital Employed)

<u>Capitalization of Super profit method:-</u> In this method goodwill is ascertained by capitalizing the super profit directly. Under this method there is no need to work out the capitalized value of average profits. This method involves the following steps.

<u>Steps of Valuation of Goodwill (under Capitalization of Super profit method)</u>

Step-1 Determine Actual past few years' business profits
Step -2 Sums up the Actual profit calculated above
Step-3 Calculate Average profit = Total Profit / Number of Years
Step-4 Determine Actual capital employed and Normal rate of return
Step-5 Ascertain the Normal Profit

Normal profit = Capital employed X Normal Rate of Return /100

Step -6 Ascertain super profits

Super Profit = Actual Average Profit – Normal Profit

Step-7 Compute the value of goodwill

$$\textbf{Goodwill} = \frac{\textbf{Super Profit} \times 100}{\textbf{Normal rate of return}}$$

Accounting treatment of goodwill:

A change in profit sharing ratio basically implies the gaining partner should pay the sacrificing partner that share of goodwill which is equal to the share gained by him.

- **Entry to be passed to adjust Goodwill, when there is a change in the profit sharing ratio and no Goodwill Account is opened:**
  i. In case of Fluctuating Capitals:
  Gaining Partners' Capital A/c …Dr. [In gaining ratio]
  To Sacrificing Partners' Capital A/c [In sacrificing ratio]
  (Being the adjustment made for goodwill on change in profit-sharing ratio)

ii. In case of Fixed Capitals:
Gaining Partners' Current A/c …Dr. [In gaining ratio]

To Sacrificing Partners' Current A/c[In sacrificing ratio]

(Being the adjustment made for goodwill on change in profit sharing ratio)

- **Entry to be passed to adjust Goodwill, when there is a change in the profit sharing ratio and when Goodwill Account is opened:**

  i. In case of Fluctuating Capitals:

  a. Goodwill A/c …Dr. [In Old Profit Sharing Ratio]
  To Partners' Capital A/c
  (Being the goodwill raised and credited to Partners' Capital Accounts in Old Profit Sharing Ratio)

  b. Partners' Capital A/c …Dr. [In New Profit Sharing Ratio]
  To Goodwill A/c
  (Being the goodwill debited Partners' Capital Accounts in New Profit Sharing Ratio)

  ii. In case of Fixed Capitals:

  a. Goodwill A/c …Dr. [In Old Profit Sharing Ratio]
  To Partners' Current A/c
  (Being the goodwill raised and credited to Partners' Current Accounts in Old Profit Sharing Ratio)

  b. Partners' Current A/c …Dr. [In New Profit Sharing Ratio]
  To Goodwill A/c
  (Being the goodwill debited to Partners' Current Accounts in New Profit Sharing Ratio)

- **When Goodwill amount already appear in the books of the firm**

  - Writing off the amount of goodwill by debiting it to the Partners' Capital Accounts or the Current Accounts in their old profit sharing ratio and by crediting Goodwill Account.

  All Partners' Capital/Current A/c's …Dr. [in old ratio]

  To Goodwill A/c [with exiting book value of goodwill]

  (Being Existing goodwill written off)

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Adjustment of Accumulated Profits, Losses and Reserve

I. **When Accumulated Profits, Losses and Reserves are to be retained in the Books**:- If the partners of the firm decide that the existing balances of Profit and Loss Account or Reserve 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.

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 Partners 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/c …Dr.
  To Sacrificing Partners' Capital/Current A/c
  (Being adjustment of accumulated reserve/profit)

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

  Sacrificing Partners' Capital/Current A/c …Dr.
  To Gaining Partners' Capital/Current A/c
  (Being adjustment of accumulated Losses)

<u>When reserves, accumulated profits and losses are closed or when nothing is mentioned in the question:</u>

Such amount of profit /Losses/Reserve Is to be distributed among all the partners in the old profit sharing ratio

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)
(being accumulated profit/reserve written off)

*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

(Being accumulated Losses written off)

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:

i. Record revised values of assets and liabilities; or

ii. 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.

I. **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:** 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. For the purpose recording such increase or decrease on revaluation, revaluation account is maintained.

Revaluation account is a nominal account prepared to bring the assets and liabilities of the firm to their true (market) values and to find out profit or loss on revaluation of assets and reassessment of liabilities. Revaluation account is credited with increase in the value of assets, decrease in the amount of liabilities and unrecorded assets. Revaluation account is debited with decrease in the value of assets, increase in the value of liabilities and unrecorded liabilities. The balance of Revaluation account represents the profit or loss on revaluation and is transferred to the old partners' capital accounts in their old profit sharing ratio.

Note: Revaluation account records only changes in values of assets and liabilities, not book value or real value.

- **Increase in the value of Assets(+)--- Gain**
- **Decrease in the value of Assets (-)--- Loss**
- **Increase in the value of Liabilities (+)--- Loss**
- **Decrease in the value of Liabilities (-)---- Gain**
- **Unrecorded Assets to be recorded (+)----- Gain**
- **Unrecorded Liabilities to be recorded (+)--- Loss**

Features of Revaluation Account are as follows:

i. Increase in assets value and decrease in liabilities are to be credited to the Revaluation Account.

ii. Decrease in assets and increase in liabilities are to be debited to the Revaluation Account.

iii. Unrecorded assets are credited and unrecorded liabilities are to be debited to the revaluation account.

iv. If the credit side is bigger than the debit side of the account, it is referred as gain or profit on revaluation.

v. If the debit side is bigger than the credit side of the account, it is referred as loss on revaluation.

vi. Finally, such profit or loss is credited or debited to the Partners' Capital or Current Accounts in their old profit-sharing ratio.

• 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/c ...Dr.

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. Transfer of Balance in Revaluation Account:

a. In case of gain in Revaluation Account:

Revaluation A/c …Dr. (Individually in old profit sharing ratio)

To Partners' Capital (or Current) A/c

b. In case of loss in Revaluation Account:

Partners' Capital (or Current) A/c …Dr.

To Revaluation A/c (Individually in old profit sharing ratio)

Revaluation Account

Particulars	Amount	Particulars	Amount
To Assets Decrease (-)	XXXX	By Assets Increase (+)	XXXX
To Liability Increase (+)	XXXX	By Liabilities Decrease (-)	XXXX
To Unrecorded Liability (+)	XXXX	By Unrecorded Assets (+)	XXXX
To Old partners 'Capital Accounts (Profit, old ratio)	XXXX	By Old partners 'Capital Accounts (Loss, old ratio)	XXXX
	XXXX		XXXX

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.

- Revaluation a/c is also called profit/Loss Adjustment A/c

II. Accounting Treatment when revised values of assets and liabilities are not to be recorded: When revised values of assets and liabilities are not to be recorded in the books, gain or loss on revaluation is adjusted through Partners' Capital Accounts by passing adjustment entry to the Capital or Current Accounts.

For the treatment mentioned above, following steps should be followed:

i. Calculate net effect of Revaluation (i.e. net effect of increase or decrease in assets and liabilities).

Statement of change in the value of Assets /Liabilities

Increase in the value of Assets	**********
(+) Decrease in the value of Liabilities	**********
	*********
(-) Decrease in the value of Assets	(*******)
(-) Increase in the value of Liabilities	(*******)
Revaluation Profit/Loss	*********

ii. Calculate the share of sacrifice or gain by the partners using formula as follows: Sacrifice/ (Gain) = Old Share – New Share

iii. Calculate proportionate amount of net effect of revaluation.

For Gaining Partner = Share Gained * Net Effect of Revaluation

For Sacrificing Partner = Share Sacrificed * Net Effect of Revaluation

IV Journal entry is to be passed for the amount determined in the previous step follows:

In case of gain or profit on revaluation:
Gaining Partners' Capital A/c …Dr.
To Sacrificing Partners' Capital A/c

In case of loss on revaluation:
Sacrificing Partners' CapitalA/c …Dr.
To Gaining Partners' Capital A/c

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Adjustment of Capital:

- **Need to Adjust Capital:**
  i. In the event of change in profit sharing ratio, adjustments are made for change in values of assets and liabilities, goodwill and distribution of reserves, accumulated profits and losses, change in partners' capitals.
  ii. Also, if the partners decide total capital of the firm and also that the capital shall be in profit sharing ratio of the partners, then also capital of the partners has to be adjusted.
  iii. In case the partners' capital(s) fall(s) short or has shortage of the required capital, then such partner(s) will have to bring more capital.
  iv. In case the partners' capital(s) is (are) surplus (excess) of the required capital, then such partner(s) may withdraw surplus or excess capital.
  v. Any shortage or surplus of Capital can be adjusted through Current Accounts.
  vi. Accounting Treatment:
  - For Adjusting Shortage of Capital:
    Bank A/c or Concerned Partners' Current A/c …Dr.
    To Concerned Partners' Capital A/c
  - For Adjusting Surplus of Capital:
    Concerned Partners' Capital A/c …Dr.
    To Bank A/c or Concerned Partners' Current A/c

- **Adjustment of Partners' Capital, if total Capital of the new firm is already given:**
  i. When total Capital of the new firm (reconstituted firm) is already given, then it is divided among the partners in their new profit-sharing ratio. This respective share of capital will be their new capital.
  ii. Once this is done, the surplus (excess) or deficit (shortage) capital is calculated by comparing the new capital and present adjusted capital.

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