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CHANGE IN PROFIT SHARING RATIO AMONG THE EXISTING PARTNERS

★ Reconstitution of a Partnership Firm

→ Partnership is the result of an agreement between persons for sharing the profits of a business. Any change in the partnership agreement brings to an end the existing agreement and a new agreement comes into force. It known as reconstitution of a firm.

→ Reconstitution of the firm may happen in the following circumstances:

(i) Change in profit sharing ratio among the existing partners.

(ii) Admission of a new partner.

(iii) Retirement of an existing partner.

(iv) Death of a partner.

(v) Amalgamation of two partnership firms (combination of two or more companies)

★ SACRIFICING RATIO

→ When the existing partners have to surrender some of their old share in favour of other partners. The ratio of surrender of profit sharing ratio is called sacrificing ratio.

Sacrificing ratio = Old ratio - new ratio.

$$\boxed{SR = OR - NR}$$

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★ GAINING RATIO

→ When the exciting partners gain some portion of other partners share of profit. The ratio of gain in profit sharing ratio is called gaining ratio.

Gaining ratio = new ratio − old ratio

$$\boxed{GR = NR - OR}$$

★ GOODWILL

→ Goodwill means the 'good-name' or the reputation earned by a firm through hardwork and honesty of its owner.

→ It's a monetary reputation of the firm.

•) Characterstics

(i) It is an intangible asset.
(ii) It is a valuable asset.
(iii) It is helpful in earning excess profits.
(iv) Its value is liable to constant fluctuations.
(v) It is valuable only when entire business is sold.
(vi) It is difficult to place an exact value on goodwill.

•) Factors affecting the value of goodwill.

(i) Favourable location of the business.
(ii) Efficiency of management.
(iii) Longevity of the business.
(iv) Quality of products.
(v) Possession (hold / ownership) of licence.
(vi) Effective advertising to establish brand popularity
(vii) Good industrial relations.

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CLASSIFICATION OF GOODWILL

- PURCHASED GOODWILL
- SELF-GENERATED GOODWILL

(a) Purchased goodwill : It is the goodwill which is acquired by making a payment.

(b) Self-generated goodwill : It is internally generated goodwill which arises from number of characteristics or attributes which an on-going business possesses.

• Need for the Valution of Goodwill

(i) Change in profit sharing ratio
(ii) When new partner is admitted.
(iii) When a partner retires or dies.
(iv) When firm is sold.
(v) When firm is amalgamated with another firm.

* METHODS OF VALUATION OF GOODWILL

(A) AVERAGE PROFIT METHOD

This is very simple and widely followed method of valuation of goodwill. In this method goodwill is calculated on the basis of number of past years profits.

$$\boxed{\text{Goodwill} = \text{Average profit} \times \text{purchase year}}$$

Abnormal income → deducted (−)
Abnormal loss → added (+)

- **Weighted Average Profit Method**
This is modified version of average profit method, each year's profit is assigned a weight.

$$\text{Weighted Av. profit} = \frac{\text{Total product [Profit} \times \text{weight]}}{\text{Total weight}}$$

$$\text{Goodwill} = \text{W. Av. profit} \times \text{No. of purchase years}$$

(B) SUPER PROFIT METHOD
This method, goodwill is calculated on the basis of surplus (excess) profits earned by a firm in comparison to AP earned by other firms. If a business has no anticipate ~~a~~ excess earnings, it will have no goodwill.

$$\text{Normal profit (NP)} = \frac{\text{capital invested} \times \text{Normal Rate of return (NRR)}}{100}$$

$$\text{Super profit SP} = AP - NP$$

$$\text{Goodwill} = SP \times \text{No. of years purchase.}$$

$$\text{Capital employed} = \underset{\text{employed}}{\text{asset}} \begin{bmatrix}\text{exclude} \\ \text{goodwill}\end{bmatrix} - \text{liability}$$

$$\text{Capital employed} = \text{capital} + \text{profit \& loss} + \text{reserve} - \text{miscellaneous expenditure}$$

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(C) CAPITALISATION METOD

(i) Capitalisation of Average Profit.

Capitalised value of Average profit = $AP \times \frac{100}{NRR}$

Capital employed / Net assets = Assets − Liability.

G/W = Capitalised value of ~~go~~ AP − Net assets

(ii) Capitalisation of Super profit

Goodwill = $SP \times \frac{100}{NRR}$

★ Accounting treatment of Goodwill when there is change in the profit sharing ratio of existing partners.

→ Journal entry:

Gaining partner's capital A/C Dr. To sacrificing partner's capital A/C

★ Dr. the receiver } Personal A/C
Cr. the giver. }

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★ WORKMEN COMPENSATION RESERVE (WCR)

This reserve is created out of firm's profits to pay compensation to employees. At the time of change in profit sharing ratio, it's treated as follows:

(i) If there is no claims against WCR

Workmen compensation reserve A/c Dr.
    To partner's capital A/c

(ii) If claim for WC is lower than WCR amount.

Workmen compensation reserve A/c Dr.
    To provision for WC claim A/c
    To partner's capital A/c.

(iii) If the claim is equal to WCR.

Workmen's compensation A/c Dr.
    To provision for WC claim A/c

(iv) If claim is more than the amount of WCR.

ⓐ Workmen compensation reserve A/c Dr.
Revaluation A/c Dr.
    To provision for WC claim

ⓑ Partner's capital A/c Dr.
    To revaluation A/c

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* INVESTMENT FLUCTUATION RESERVE

This reserve is created out of firm's profits to meet fall in the market value of investment. At the time of change in profit sharing ratio, reserve is treated as follow.

(i) When book value & market value is same.

Investment Fluctuation Reserve A/c Dr.
To Partner's capital A/c

(ii) When market value of investment is less than the book value.

(a) Fall in the value is less than investment

Investment fluctuation reserve A/c Dr.
To Investment A/c [Book - market value]
To partner's capital A/c

(b) Fall in value is equal to investment.

Investment fluctuation reserve A/c Dr.
To investment A/c

(c) Fall in the value is more than investment Fluctuation reserve.

(I) Investment Fluctuation reserve A/c Dr.
Revaluation A/c Dr.
To investments A/c

(II) Partner's capital A/c Dr.
To Revaluation A/c

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(iii) When market value of investment is more than book value.

ⓐ Investment Fluctuation A/C Dr.
To partner's capital A/C

ⓑ Investment A/C Dr.
To revaluation A/C

ⓒ Revalution A/C Dr.
To partner's capital A/C

★ REVALUATION ACCOUNT

→ It is a nominal account, which is prepared for the distribution and transfer of profits and losses arising due to the increase and decrease of the value of assets and liabilities during change in profit sharing ratio, admission of partner, retire / death of partner.

→ Proforma of revaluation A/C

Dr. REVALUATION ACCOUNT Cr.

Particulars	₹	Particulars	₹
To decrease in assets	——	By increase in assets	——
To increase in liability	——	By decrease in liability	——
To unrecorded liabilities	——	By unrecorded assets	——
To profit on revaluation transferred to partner's capital A/C (old ratio)	——	By loss on revaluation transferred to partner's capital A/C (old ratio)	——

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→ **Journal Entries**

(i) For decrease in assets
Revaluation A/C Dr.
To assets A/C

(ii) For increase in assets
Assets A/C Dr.
To revaluation

(iii) For increase in liability
Revaluation A/C Dr.
To liability A/C

(iv) For decrease in liability
Liability A/C Dr.
To revaluation A/C

(v) When revaluation shows profit
Revaluation A/C Dr.
To partner's capital A/C

(vi) When revaluation shows losses.
Partner's capital A/C Dr.
To revaluation A/C.