Chapter-3

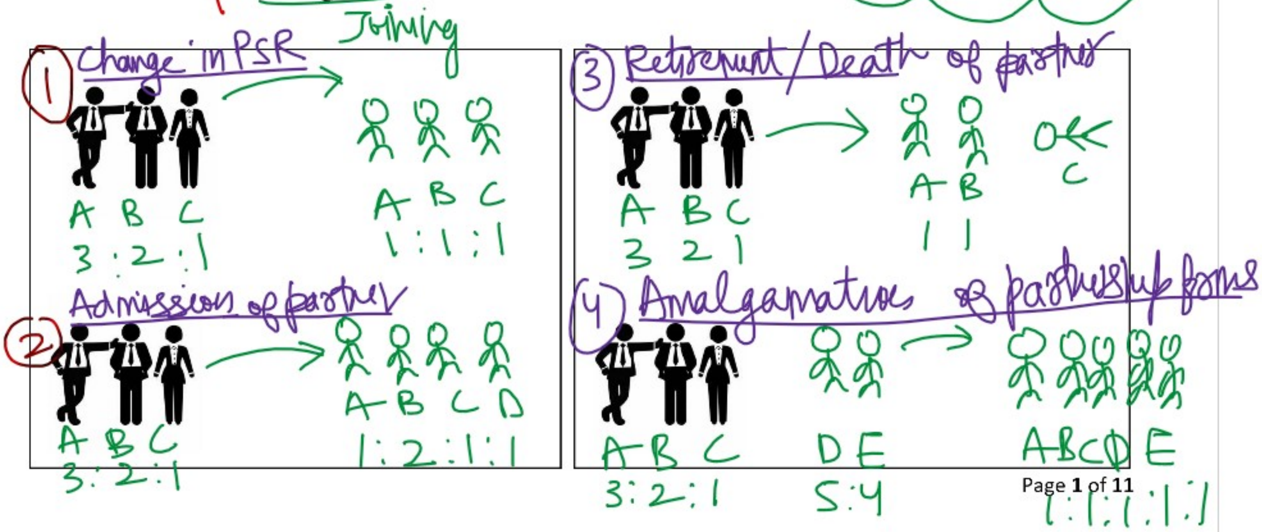
# CHANGE IN PROFIT SHARING RATIO (PSR)


## Topic 1 - Reconstitution of Partnership

- Reconstitution of partnership refers to the change in the agreement of partnership.
- Reconstruction of partnership always results in a change in profit sharing ratio among the partners.
- Reconstitution of Partnership is also known as the Dissolution of partnership.
- A partnership is reconstituted when there is
  1. Change in profit sharing ratio (PSR)
  2. Admission of a partner
  3. Retirement of a partner
     Death of a partner
  4. Amalgamation of two or more firms

Joining

Dissolution of Partnership firm = closure of firm



## Topic 2 - Adjustments in Reconstitution of partnership

1. Old ratio, New Ratio, Sacrificing ratio and Gaining ratio
2. Reserves and accumulated losses
3. Revaluation of assets and liabilities
4. Adjustment for Premium for goodwill
5. Capital adjustment

Change in PSR
Admission
Retirement/
Death

## Topic 3 - Old ratio, New Ratio, Sacrificing ratio and Gaining ratio

Old ratio - The ratio before reconstitution of partnership is called an old ratio.

New ratio - The ratio after reconstitution of partnership is called as new ratio.

Sacrificing ratio = Old ratio – New ratio

~~Gaining ratio = New Ratio – Old ratio~~

*Note:* In case, sacrificing ratio comes out to be negative, it is the Gaining ratio.

*Note:* The total sacrifice is always equal to the total gain.

Change in PSR

| | | |
|---|---|---|
| A | B | C |
| $\frac{3}{6}$ | $\frac{2}{6}$ | $\frac{1}{6}$ |

| | | |
|---|---|---|
| A | B | C |
| $\frac{1}{3}$ | $\frac{1}{3}$ | $\frac{1}{3}$ |
| $\frac{2}{6}$ | $\frac{2}{6}$ | $\frac{2}{6}$ |

A = Sacrifice $= \frac{3}{6} - \frac{2}{6} = \frac{1}{6}$

(1) Always work ratios in fraction.

(2) Always make denominators of ratios same

B = No sacrifice, No gain = 0

C = Gain $= \frac{1}{6} - \frac{2}{6} = -\frac{1}{6}$ (gain)

Sacrificing Ratio = Old Ratio − New Ratio

Savings

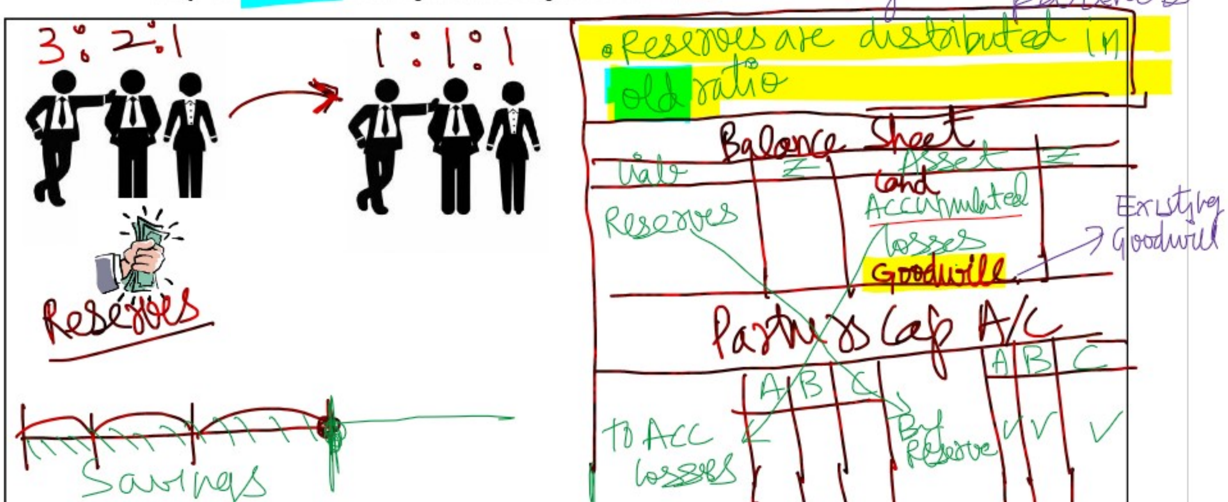
## Topic 4 - Reserves and accumulated losses

- Reserves or accumulated Profits refer to the amount set aside by old partners in the past. These are shown on the liability side of the Balance sheet. Examples: ↳ because they are part of Capital.
    - General Reserve
    - Workmen compensation reserve
    - Investment Fluctuation reserve
    - Credit Balance of Profit and loss account → Profit
    - Pappu Reserve, etc.

- Accumulated losses are the losses that are accumulated by the partners over the years. These are shown on the assets side of the Balance sheet. Examples:
    1. Existing goodwill → It needs to be written off → Khatm खत्म
    2. Fictitious assets → Fake
    3. Debit Balance of Profit and loss account → loss
    4. Deferred revenue expenditure
    5. Advertisement suspense account

- Reserves are distributed [redacted] in the old ratio. In simple words, they are credited in partners' capital account. because they are given to partners

- Accumulated losses are taken [redacted] in the old ratio. In simple words, they are debited in the partner's capital account. because they are taken from partners




Res 10K 5K 5K

*Note:* Workmen compensation reserve refers to the amount set aside out of profits to meet possible liability for workmen compensation. Example – for an accident.

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*Note:* Investment Fluctuation reserve means the amount set aside out of profits to meet the fall in the value of investments. → Shares/debentures, etc.

*Note:* In case Accumulated Profits and losses are to be retained in books of accounts, then they should not be distributed. Instead, the following entry should be passed.

If Reserve and Acc. Losses are not to be distributed, then they should be adjusted

Adjust

| | | |
|---|---|---|
| Gaining partners Capital a/c …Dr | XXX | |
| To Sacrificing partners capital a/c | | XXX |
| (Being Reserves and accumulted losses adjusted) | | |

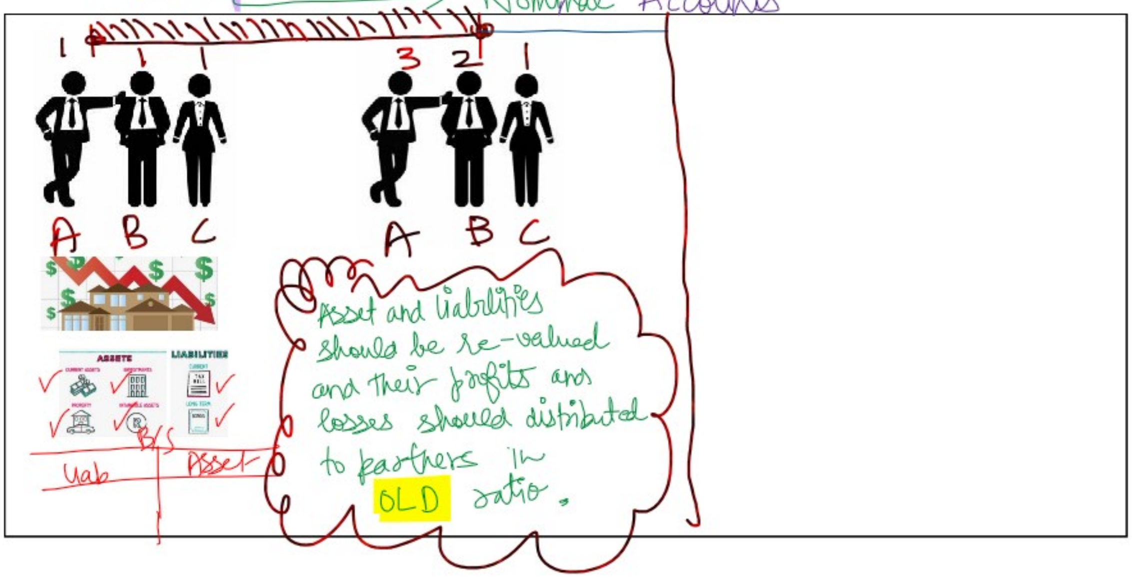
In such a case, the Accumulated Profits and losses will appear in the new balance sheet.

*Note:* Employee Provident Fund (EPF) is a liability and not a reserve. EPF is not to be distributed among the partners.

## Topic 5 - Revaluation of assets and liabilities

↳ Dubara value Nikalna (Market value)

- When a firm a reconstituted, all the assets and liabilities are revalued and their profits/losses are transferred to [redacted] partners in the old ratio. For this purpose, the revaluation account is prepared. → Nominal Accounts



- Revaluation account is a nominal account. It records all the expenses and incomes.
- It is also known as P/L adjustment account.

Dr **Revaluation a/c** Cr

| Particulars | | Amount | Particulars | Amount |
|---|---|---|---|---|
| To नुकसान | | XXX | By फायदे | XXX |
| To | | XXX | By | XXX |
| | | | | |
| To Profit | | | | |
| A cap a/c (in old ratio) | XXX | | | |
| B cap a/c | XXX | XXX | | |
| | | | | |
| | | XXX | | XXX |

Decrease in value in asset → नुकसान    increase in asset → फायदा
increase in value of liability → नुकसान    Decrease in liab. → फायदा

*Note:* After the Revaluation account, the assets and liabilities in the balance sheet are shown at revised amounts.

*Note:* In case assets and liabilities are to be shown in books of accounts at old amounts, then they should not be revalued. Instead, the following entry should be passed.

Adjust

| | | | |
|---|---|---|---|
| Gaining partners Capital a/c | …Dr | XXX | |
| To Sacrificing partners capital a/c | | | XXX |
| (Being Revaluation of assets and liabilities adjusted) | | | |

In such a case, the assets and liabilities will appear in the new balance sheet at old amounts.

Premium for G/w is shown in Adjustments

## Topic 6 - Adjustment for Premium for goodwill

- Existing Goodwill (appearing in the Balance Sheet) is an accumulated loss. It is written off by debiting the partner's capital account.
- Premium for Goodwill is paid by gaining partners to the sacrificing partners in the sacrificing ratio.

Reserves — old Ratio
Revaluation Profit / Loss — old Ratio
Prem for G/w — sacrificing Ratio



step 1 — Find sacrificing Ratio
step 2 —

- The journal entry is as follows:

| | | | |
|---|---|---|---|
| Gaining partners Capital a/c | …Dr | XXX | |

Step The journal entry is as follows:

| | | | |
|---|---|---|---|
| Gaining partners Capital a/c | …Dr | XXX | |
| To Sacrificing partners capital a/c | | | XXX |
| (Being premium for goodwill adjusted) | | | |

$A = \frac{3}{6} - \frac{1}{3} = \frac{3-2}{6} = \frac{1}{6}$ (Sacrifice)

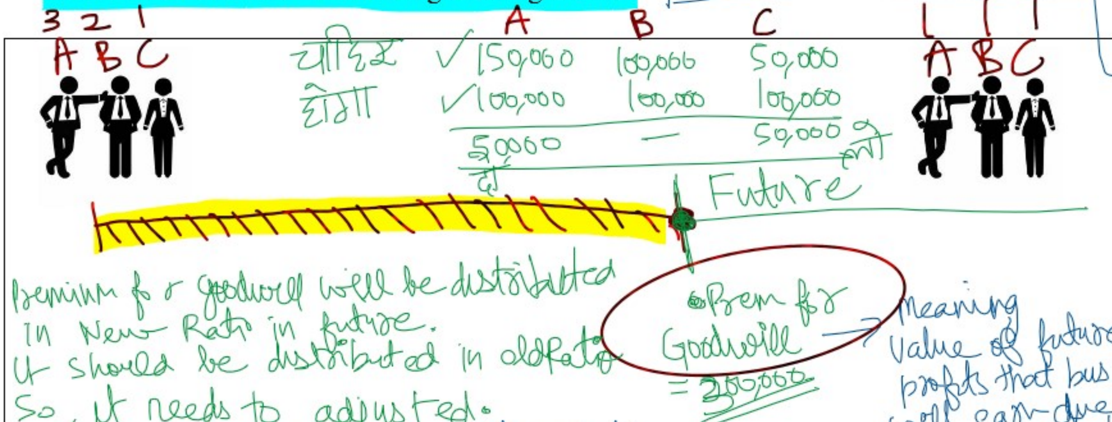
$B = \frac{2}{6} - \frac{1}{3} = \frac{2-2}{6} = 0$

$C = \frac{1}{6} - \frac{1}{3} = \frac{1-2}{6} = -\frac{1}{6}$ (Gain)

C Cap ...Dr 50,000
To A Cap 50,000

*Note:* Amount to be calculated as follows:

Goodwill of the firm * Sacrificing/Gaining fraction




By calculating sacrificing Ratio

## Topic 7 – Capital Adjustment

Capital adjustment refers to making the capital in proportion to the Profit-sharing Ratio.

Steps for Capital adjustment

1. Find capital of the new firm
2. Distribute capital in the new ratio and write it as "To balance c/d".
3. Find balancing figures of capital accounts.

Liability

A : B : C

1 : 1 : 1

**Question on Workmen Compensation Reserve** (WCR)

3+2+1

to

There are 3 partners A, B, and C with PSR 1:1:1. They change their PSR 3:2:1. Their Balance sheet shows the Workmen compensation reserve as Rs.6,00,000. Show Journal entries and Revaluation a/c and Partners Capital account in the flowing cases.

| | Cases | Journal entry | Revaluation account and capital account |
|---|---|---|---|
| 1 | No information is given/There is no claim<br>workmen compensation claim<br>WCR should be distributed in old ratio | Workmen Comp. Reserve —— Dr. 600,000<br>To A Cap 200000<br>To B Cap 200000<br>To C Cap 200000<br>(Being WCR distributed) | R A/C<br>Dr PC A/C Cr<br>A \| B \| C \| By WCR \| 2L \| 2L \| 2L |
| 2 | The claim on workmen compensation is Rs. 3,00,000.<br>WCR 6L: claim 3L, Distribute 3L | WCR —— Dr 600,000<br>To WC Claim 300,000<br>To A Cap 100,000<br>To B Cap 100,000<br>To C Cap 100,000<br>(Being WCR distributed) | R a/c<br>PC A/C<br>A \| B \| C \| By WCR \| 1L \| 1L \| 1L |
| 3 | The claim on workmen compensation is Rs. 9,00,000.<br>WCR 6L: claim 9L, Distribute 0, loss 3L | WCR —— Dr 6L<br>Revaluation —— Dr 3L<br>To WC Claim 9L<br>(Being WCR given as claim) | Dr R A/C Cr<br>Particulars \| ₹ \| Particulars \| ₹<br>To WC Claim \| 300000<br>Dr PC A/C Cr<br>A \| B \| C \| A \| B \| C |

| | |
|---|---|
| 4 The claim on workmen compensation is Rs. 600,000.<br>WCR 6L — WC Claim 6L<br>— Distribute 0 | WCR —— Dr 600,000<br>To WC Claim 600,000<br>(Being WCR given for claim)<br>R A/C<br>Particulars \| ₹ \| Particulars \| ₹<br>PC A/C<br>A \| B \| C \|\| A \| B \| C |
| Workmen Compensation reserve is to be retained | |

Asset

Liability

Book Value = Value in Books of Accounts

Market Value = Value in market

## Question on Investment Fluctuation Reserve

There are 3 partners A, B, and C with PSR 1:1:1. They change their PSR 3:2:1. Their Balance sheet shows Investment Fluctuation Reserve as Rs. 30,000 and Investment at Rs. 2,00,000. Show Journal entries and Revaluation a/c and Partners Capital account in the flowing cases.

Book Value

| | Cases | Journal entry | Revaluation account and capital account |
|---|---|---|---|
| 1 | No information is given/Market Value of Investments is Rs. 2,00,000<br>IFR → distribute 30,000<br>30,000 | IFR A/C ...Dr 30,000<br>To A Cap 10,000<br>To B Cap 10,000<br>To C Cap 10,000<br>(Being IFR distribute) | R A/C<br>PC A/C<br>Dr A B C — Cr A B C<br>By IFR 10K 10K 10K |
| 2 | Market Value of Investments is Rs. 190,000<br>IFR 30,000 → Investments (–) 10,000; distribute 20,000 | IFR A/C ...Dr 30000<br>To Investments 10000<br>To A Cap 6666<br>To B Cap 6666<br>To C Cap 6667<br>(Being IFR distributed) | R A/C<br>PC A/C<br>A B C — A B C<br>By IFR 6666 6666 6666 |
| 3 | Market Value of Investments is Rs. 2,40,000 → Profit = 40,000<br>IFR 30,000 → distributed 30,000 | IFR ...Dr 30000<br>To A Cap 10000<br>To B Cap 10000<br>To C Cap 10000<br>(Being IFR distributed)<br>Investments ...Dr 40,000<br>To Revaluation a/c 40000<br>(Being investment appreciated) | R A/C<br>Par ₹ Par ₹<br>By Inv 40,000<br>PC A/C<br>By IFR 10K 10K 10K |

| | | |
|---|---|---|
| Market Value of Investments is Rs. 1,50,000 | | |
| Investment Fluctuation Reserve is to be retained | | |