CHAPTER – 5

DISSOLUTION OF A PARTNERSHIP FIRM

According to Section 39 of the Indian Partnership Act, 1932, Dissolution of a firm means the dissolution of partnership between all the partners and no business is being carried out afterwards.

Differences between Dissolution of partnership and Dissolution of a firm

BASIS	DISSOLUTION OF PARTNERSHIP	DISSOLUTION OF FIRM
Meaning	Economic relation between the partners change	Partnership between all the partners of a firm comes to an end.
Termination	The business is not terminated	The business of the firm is completely closed.
Court's intervention	No court intervention	Court may intervene and order for dissolution of firm.
Settlement	Assets and liabilities are revalued and new balance sheet is prepared	Assets are sold, liabilities are paid off and balance utilized towards settlement of partners.
Closure of Books	Books of accounts are not closed	All books of accounts are closed.
Settlement of Assets and Liabilities	Assets and liabilities are revalued	Assets are sold and liabilities are paid off.

Dissolution of Partnership

Dissolution of partnership changes the existing relationship between partners but the firm may continue its business as before. It may take place in any of the following ways:

1. Change in profit sharing ratio among partners.
2. Admission of a new partner.
3. Retirement of a partner.
4. Death of a partner
5. Insolvency of a partner.
6. Completion of the venture, if partnership is formed for that.
7. Expiry of the period of partnership, if partnership is for a specific period of time.

Modes of Dissolution of a firm

1. Dissolution by agreement (Sec. 40) – A partnership firm may be dissolved when:
   a. All the partners give consent for dissolution.
   b. As per the contract between partners.
2. Compulsory dissolution (Sec.41) – A firm is dissolved compulsorily in the following cases:
   a. Where all the partners or all except one become insolvent or insane.
   b. Where the business becomes illegal.
   c. Where all the partners except one decide to retire from the firm.
   d. Where all the partners or all except one partner die.
3. Dissolution on the happening of certain contingencies (Sec. 42) – In the absence of an agreement to the contrary, a firm will be dissolved in the following cases:

a. On the expiry of the term of the firm.
b. On the death of a partner.
c. On the adjudication of a partner as insolvent.
d. On the completion of the venture for which the firm was constituted.

4. Dissolution by Notice (Sec. 43)– In case of a partnership at will, the firm may be dissolved by any partner giving a notice in writing to all the other partners of his intention to dissolve the firm.
5. Dissolution by Court (Sec. 44)– A court may order a partnership firm to be dissolved in case of a suit by a partner in the following cases:

   a. Where a partner becomes of unsound mind.
   b. Where a partner becomes permanently incapable of performing his duties as a partner.
   c. Where a partner commits willful or persistent (continuous) breaches of agreement.
   d. Where a partner's conduct is likely to adversely affect the business of the firm.
   e. Where a partner transfers whole of his interest in the firm to a third party without the consent of the other partners.
   f. Where the business of the firm cannot be carried on except at a loss.
   g. Where the court regards dissolution to be just and equitable.

SETTLEMENT OF ACCOUNTS

At the time of dissolution, the firm stops its business and has to settle its accounts. For this, it disposes off all the assets for satisfying all the claims (liabilities) against it. Section 48 of the Partnership Act provides the following rules in the mode of settlement of account between the partners:-

1. Loss to be paid first out of profits, next out of capital and lastly by the partners individually in their profit sharing ratio.
2. All the assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:
   a. Payment of expenses for realizing the assets and collection of debts.
   b. Payment of outside liabilities of the firm, ie; creditors, loans, bank overdraft, bills payable, loans from partner's relatives etc.
   c. Repayment of loans from partners.
   d. Repayment of capital contributed by the partners.
   e. Any surplus left is distributed among all the partners in their profit sharing ratio.

Firms Debts and Private Debts

a. The resources of the firm shall be utilized to pay off the firm's creditors and if any surplus left out can be applied to pay off the creditors of a partner.

b. The individual property of a partner must be applied first for satisfying his private debts and any surplus is made available to settle the firm's debts.

Accounting Treatments

When a firm is dissolved, the books of accounts are to be closed and profit or loss on realizing the assets and discharge of liabilities are to be calculated. For this, a **Realisation Account** is prepared, by which assets are realized and liabilities are paid off.

Assets may be realized at more or less than the book values. Profit or loss on realisation is transferred to partners' capital accounts in their profit sharing ratio. Partners with debit balance in their capital account should bring necessary cash and partners having credit balance in their capital accounts are paid off.

Loan from a partner – It is not transferred to the realization account, but it is paid directly through the loan account itself. This is because partner's loan must be repaid before making payment of capitals.

Loan from the wife of a partner – It is transferred to the realization account as it is an outside liability.

Cash / Bank Accounts – After making all the settlement it will be automatically closed.

The following Journal Entries are required to close the books of the firm:

All assets other than cash, bank and the fictitious assets are closed by transfer to the debit of Realisation Account at their gross book values.

Realisation Account Dr
To Assets Account (individually)

Note – 1. Fictitious Assets are those assets which are having no marketable values but they are treated only for the sake of convenience, they have existence merely in name, eg. Prepaid expenses, Preliminary expenses, deferred revenue expenses etc.

Note – 2. Sundry debtors should be transferred at its full value without deducting the provision for doubtful debts, if any.

1. All the provisions against the assets are closed by transfer to the Realisation account.

Provision for doubtful debts Dr Provision
for depreciation Dr Joint Life Policy
Reserve Dr
Contingency Reserve Dr
To Realisation Account

2. All liabilities to outsiders are closed by transfer to realisation account at the book value.

Sundry Creditors Dr Bills Payable Dr
Bank O/d Dr
Outstanding Exp Dr
Partner's Wife's loan Dr
To Realisation Account

3. To transfer the provision on liabilities eg: Provision for Creditors

Realisation Account To Dr
Provision Account

4. For Sale of assets:

Cash / Bank Dr

To Realisation Account

5. For Assets taken over by a partner

Partner's Capital account To Dr
Realisation Account

6. For payment of liabilities:

Realisation Account Dr

To Cash / Bank

7. If a partner agrees to discharge the liabilities to outsiders:

Realisation Account Dr

To Partner's capital account

8. Settlement with the creditor through transfer of assets:

   a. When a creditor accepts partly assets and partly cash, only the cash payment is recorded.

      Realisation Account Dr

      To Cash / Bank

Note: - It is so because, the liability due to the creditor has already been transferred to the credit of Realisation Account and the Assets taken over by the creditor is also transferred to the debit of Realisation account, but the cash account is not transferred. The debit of assets cancels the credit of corresponding liability in the realisation account and the payment of balance will be made in cash. Therefore, the cash payment is only recorded.

Eg: A creditor to whom Rs.10000/- was due, accepts furniture worth Rs. 8000, he will be paid Rs.2000/- in cash and only this Rs.2000 is recorded in the journal entry.

   b. When a creditor accepts assets whose value is more than the amount due to him, he will pay cash to the firm:

      Cash/Bank Dr

      To Realisation Account.

   c. When a creditor accepts assets as full and final settlement, ie; the amount due to him and the value of asset is the same: No Entry…..

9. For payment of realization expense:

Realisation Account Dr

To Cash / Bank

10. If a partner meets the expenses on realisation of assets and liabilities:

Realisation Account Dr

To Partner's capital account

11. When a partner has agreed to undertake the dissolution work for an agreed remuneration and he bears all the realization expenses:

   a. If payment of realization expenses is made by the firm:

Partner's Capital A/c Dr

To Bank A/c

b. If the partner himself pays the realization expenses: No Entry……..

c. For agreed remuneration to that partner:

Realisation A/c Dr

To Partner's Capital A/c

12.For realization of any unrecorded assets including goodwill, if any:

Bank A/c Dr

To Realisation A/c 13.For

settlement of unrecorded liability:

Realisation A/c Dr

To Bank A/c

14.To close the realisation account:

a. If it is profit on realisation account:

Realisation Account Dr

To Partners' capital account

b. If it is loss on realisation account:

Partners' capital account Dr

To Realisation Account

15.Other items on the liability side of the balance sheet like reserve fund and credit balance of P & L Account are transferred to the partners' capital accounts directly.

Reserve fund / General Reserve A/c Dr

P & L Account Dr

To Partners' Capital Account

16.To transfer fictitious assets, if any, to partners' capital accounts in their profit sharing ratio:

Partners' Capital A/c (individually) Dr

To Fictitious Assets A/c

17.For payment of partner's Loan

Partner's loan account Dr
To Cash / Bank account

18.To close the debit balance of profit and loss account (Accumulated Loss)

Partners' Capital Account Dr

To Profit and Loss Account

19.To close the current account (in case of fixed capital method)

a. If the current account shows a credit balance:

Partners' current account Dr

To Partners' capital account

b. If the current account shows a debit balance:

Partners' Capital account Dr

To Partners' current account

20.For settlement of partners' accounts:

a. If the partner's capital account shows a debit balance, he brings in necessary cash

Cash / Bank Dr

To Partners' Capital A/c

b. If it shows a credit balance, he withdraws that amount

Partner's Capital A/c Dr

To Cash / Bank A/c

It must be noted that the aggregate amount finally payable to the partners must equal to the amount available in bank and cash accounts. Thus, all accounts of a firm are closed in case of dissolution.

Differences between Revaluation Account and Realization Account.

	Revaluation Account	Realisation Account
1	Prepared to ascertain the variation in the values of the assets and liabilities of the firm.	Prepared to ascertain the net profit or loss on the sale of assets or discharge of liabilities.
2	It comprises of only those assets and liabilities which are revalued.	All the assets and liabilities.
3	Prepared at the time of reconstitution.	At the time of dissolution.
4	It can be prepared at various events during the life of the firm.	It can be prepared only once, i.e. when the firm is dissolved.
5	Based on the difference in the book value and the revalued amount of assets and liabilities.	Based on the book value of assets and liabilities.
6	Balance is transferred to the capital account of old partners.	Balance is transferred to the capital account of all partners.

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