Chapter-5

Dissolution of Partnership Firm

Dissolution of Firm is entirely different from Dissolution of Partnership. Dissolution of Firm leads to complete closure of a partnership business. In case of dissolution of partnership, the business may continue with a new agreement, but in dissolution of firm, business will not continue.

Dissolution of Partnership

Any change in the relation between partners leads to dissolution of partnership. At the time of change in profit sharing ratio between partners, admission, retirement, death etc. of partners cause change in the relationship between partners. In all these cases dissolution of partnership takes place. At the time of dissolution of partnership, the business can continue with a new agreement.

Situations (reasons) of Dissolution of Partnership

1) Admission of a new partner
2) Retirement/death of an existing partner 3) Change in profit sharing ratio among partners
4) Amalgamation of firms

In all the above cases the firm can continue its business with a new agreement, there is no need to close (Dissolution of Firm) the firm.

Dissolution of a Firm

Dissolution of Firm means complete closure of the business. Dissolution of a firm also known as winding up of a firm, results in termination of relationship between all partners and stoppage of business. At the time of dissolution of firms, all assets of the firm are sold, cash realized and with that cash liabilities are to be paid off. If there is any cash, balance left, it will be distributed among the partners as per their ratio.

Distinguish between Dissolution of Partnership and Dissolution of Firm

Basis	Dissolution of Partnership	Dissolution of Firm
Meaning	Relation of partnership among different partners changes	Partnership between all the partners of a firm comes to an end
Termination of business	Business is not terminated, it can continue with new agreement	On dissolution of firm, business will not continue.

Settlement of Assets Liabilities	Assets and Liabilities are revalued	Assets are realized and liabilities are paid off
Economic relationship among partners	Economic relationship often changes	Economic relationship comes to an end
Preparation of Balance Sheet	Assets and liabilities are revalued and new balance sheet prepared	There is no scope for balance sheet as the accounts of assets and liabilities are closed

Modes of Dissolution of a Firm

Dissolution of a firm takes place in the following ways:

I. Dissolution by Agreement II. Compulsory Dissolution

III. On the happening of certain contingencies IV. Dissolution by notice

V. Dissolution by court

I. Dissolution by agreement A firm is dissolved

a) With the consent of all the partners

b) As per the terms of the partnership agreement II. Compulsory Dissolution

A firm is dissolved compulsorily in the following cases:

a) When the business of the firm becomes illegal
b) When all the partners or all except one become insolvent
c) When all the partners or all except one decide to retire from the firm
d) When all the partners or all except one die

III. On the happening of certain contingencies

In the absence of an agreement to the contrary, a firm will be dissolved in the following cases:

a) If the constituted for a fixed period, by the expiry of that term
b) If constituted to carry out one or more ventures, by the completion thereof;
c) By the death of a partner
d) By the declaration of a partner as an insolvent

IV. Dissolution by notice

In case of a partnership at will, the firm may be dissolved if any one of the partners gives a notice in writing to the other partners, signifying his intention to dissolve the firm.

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V. Dissolution by court

At the suit of a partner, the court may order a partnership firm to be dissolved on any of the following ground:

a) When a partner becomes of unsound mind
b) When a partner becomes permanently incapable of performing his duties as a partner
c) When the partner transfers whole of his interest in the firm to a third party
d) When the business of the firm is can't be carried on at a loss.
e) When the partner commits breach of agreement relating to the management of the firm
f) When, on any ground, the court regards dissolution to be just and equitable.

Settlement of Accounts

Dissolution of Firm means complete closure of the business. So on dissolution, the firm disposes off all its assets for set off all its liabilities. The mode settling accounts will be mentioned in the partnership deed. But in the absence of an agreement between the partners, the rules given in section 48,49 and 55 of the Indian Partnership Act,1932 will apply. These rules are:

A. Treatment of losses

Losses including deficiencies of capital shall be paid first out of profit, next out of capital and lastly, if needed, by the partners individually in their profit sharing ratio

BEApplication of Assets

The assets of the firm including any amounts contributed by the partners to compensate deficiencies of capital ,must be applied in the following manner:

a) Paying the realization expenses
b) Paying the debts from third parties-creditors, loans, bills payable, bank overdraft, loan from partners' relatives etc.
c) Repayment of loans from partners.
d) Repayment of capital contributed by partners.
e) Surplus, if any, is distributed by among the partners in their profit sharing ratio.

Settlement of Private Debts and Firm's Debt

Where private debts of the partner and firm's debt co-exist, the following rules, as stated in Section 49 of the Act, shall apply.

Settlement of private debts

The personal debts and liabilities of individual partners should be paid first out of his private property and surplus if any can be utilized for the payment of firm's debts.

On the other hand firm's debts are first paid out of firm's assets and the surplus if any would be distributed to partners. The partners can use this amount to pay off their private debts.

Accounting Treatment

On dissolution of a firm, the firm ceases (stop) to conduct business and has to settle its accounts. So at the time of dissolution of a firm, books of accounts are to be closed, assets realized, liabilities are to be paid off and balance if any, distributed among partners according to their ratio. In this process the following accounts are prepared:

i. Realisation Account
ii. Partners Capital Account
iii. Bank/Cash Account

Realisation Account

Realisation account is a nominal account. It is prepared at the time of dissolution of a firm.Realisation account is prepared to close the accounts of assets and liabilities and to find out profit or loss on realization of assets and repayment of liabilities.

All assets except cash, bank and fictitious assets are closed by transfer it to the debit side of the realization account at its book values and all external liabilities are closed by transfer it to the credit side of the realization account at its book value. Any provision relating to asset/liability must also be transferred to the realization account. Amounts realized are credited and liabilities settled are debited to this account.Realisation expense is debited to this account. At last this account is closed by transferring the realization profit or loss to partner's capital accounts.

Journal Entries in connection with Realisation Account

1.To close assets: All assets except cash, bank and fictitious assets (P&l account debit balance) are closed by transferring it to the debit side of the realization account at their book value. Note-	Realisation A/C Dr To Assets (Individually) (Being assets closed)

I:Cash/bank account balance opened in Cash/Bank account.	

Note-2:Sundry debtors should transferred to realization account at its full value(without deducting provision, if any)	
2.To close external liabilities: All external liabilities are closed by transferring it to the credit side of the realization account at its book value Example for external liabilities: Creditors, bills payable, bank over draft, outstanding liabilities, partners wife's loan etc.	External Liabilities A/C Dr To Realisation A/C (Being liabilities closed)
3.To close provision against various assets like provision for doubtful debts, provision for depreciation etc.(Provision against asset is a liability)	Provision for doubtful debts A/C Dr Provision for depreciation A/C Dr Joint life policy reserve A/C Dr Contingency Reserve A/C Dr Investment fluctuation fund A/C Dr To Realisation A/C (Being provision against to assets closed)
4. To close provision against various liabilities like provision for discount on creditors.(Provision against liability is an asset)	Realisation A/C Dr To Provision for discount on creditors (Being provision for discount on creditors closed)

5.When closed assets realized(Sold)	Cash/Bank A/C Dr To Realisation A/C (Being assets sold)
6.When closed assets taken over by a partner	Particular Partner's Capital A/C Dr To Realisation A/C (Being assets taken over by a partner)
7.When closed liabilities paid off	Realisation A/C Dr To Cash (Being liabilities paid off)
8.When closed liabilities taken over by a partner	Realisation A/C Dr To Particular partner's Capital A/C (Being liabilities taken over by a partner)

9.When realization expense paid	Realisation A/C Dr To Cash/Bank (Being realization expense paid)
10.When realization expense taken over by a partner	Realisation A/C dr To Particular Partner's Capital A/C (Being realization expense taken over by......)
11.For the amount realized from unrecorded assets	Cash/Bank A/C Dr To Realisation A/C (Being cash realized on unrecorded assets)
12.When unrecorded assets taken over by a partner	Particular partner's capital A/C Dr To realization A/c (Being unrecorded assets taken over by a partner)
13.When payment of an unrecorded liability	Realisation A/C Dr To cash/ Bank (Unrecorded liability paid off)

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14.When unrecorded liability taken over by a partner	Realisation A/C Dr To Particular partner's capital A/C (Being unrecorded liability taken over by.....)
15.Settlement with outside liabilities like creditors through assets/unrecorded assets	When creditor(a liability)accepts an asset in full and final settlement,No Entry is required The reason is that, the liability(here creditors) has already been closed by crediting it to realization account. The particular asset account is also closed by transferring it to the debit side of the realization accont.Some times, the creditor may accept the part of his payment in cash and part of his payment by taking over an asset. In this case, the entry will be made for the cash payment only.
16.For Closing Realisation Account: (a)/f Realisation Profit:-	Realisation A/C Dr To Partners' Capital A/C (Being Realisation profit distributed among partners)
16. For Closing Realisation Account: (b)If Realisation Loss:-	Partners' Capital A/C Dr To Realisation A/C (Being Realisation loss distributed among partners)
17.Payment of partner's loan Note: Partner's loan directly paid off. (Never transferred to Realisation A/C)	Partner's Loan A/C Dr To Cash (Being partners loan paid off)

18.Receipt of partner's loan Note: Sometimes, firm advances some amount to partner(It is an asset to the firm).It is directly collected from partner's, not transferred to realization account	Cash/Bank A/C Dr To Partner's Loan A/C (Cash received against patrtner's loan)
19.For closing of current account: If it show credit balance:	Partner's Current A/C Dr To Partner's capital A/C (Being current account is closed by transfer it to his capital account)
20.For closing of current account: If it show debit balance:	Partner's Capital A/C Dr To Partner's Current A/C (Being current account is closed by transfer it to his capital account)
21.For closing capital A/C (If it shows credit balance and cash paid off in final settlement)	Partner's Capital A/C Dr To Cash/Bank (Being capital Account closed)
22.For closing capital A/C (If it shows debit balance and balance brought in by the new partner in final settlement)	Cash/Bank A/C Dr To Partnere's Capital A/C (Being capital Account closed)

Treatment of goodwill:-On dissolution of Firm, goodwill is treated like an ordinary asset. No special treatment is required. If it appears in the Balance Sheet, it is closed by transferring it to the debit side of the realization account at its book value. If any amount is realized for goodwill, the amount is credited to realization Account

Proforma of Realisation Account

Particulars	Amount	Particulars	Amount

To Assets (To close assets)	xxx	By Liability Account (To close external liabilities)	xxx
To Provision against Assets	xxx	By Provision against asset	xxx
To Cash (Payment of liabilities)		By Cash (Assets realized)	
To Partner's Capital (Liability taken over by a partner)	xxx	By Partner's capital (Assets taken over)	xxx xxx
To Cash (Realisation expense paid)	xxx	By Cash (Realised from unrecorded assets)	xxx
To Partner's capital (Realisation expense taken over by a partner)	xxx	By Partner's capital (Unrecorded asset taken over by a partner)	xxx
To Cash(Payment of unrecorded liability)	xxx	By Partners Capital A/C (Loss on realization,if any)	xxx
To partner's capital (when unrecorded liability discharged by a partner)	xxx		
To partners capital A/C(Profit on realization)	xxx		
	xxxx		xxxx

Difference between Revaluation account and Realisation account

Revaluation Account	Realisation Account
Revaluation account is prepared at the time of admission,retirement,death or change in profit sharing ratio of a partner	Realisation account is prepared at the time of Dissolution of Firm
It records only changes in values of assets and liabilities	Assets and liabilities are shown at the book values
Revaluation account is prepared to find out profit or loss on revaluation of assets and reassessment of liabilities	It is prepared to find out profit or loss on realization of assets and payment of liabilities.

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