

## **DISSOLUTION OF A PARTNERSHIP FIRM – 1**

Any change in the relations of the partners is called the dissolution of partnership.

### **CONDITIONS OF DISSOLUTION OF PARTNERSHIP:**

- Retirement of a partner
- Death of a partner
- Insolvency of partner (s)
- Incapability of a partner
- Fulfillment of the objects

### **DIFFERENCE BETWEEN DISSOLUTION OF PARTNERSHIP AND DISSOLUTION OF FIRM:**

1. **Change in relation:** the dissolution of the firm implies a complete breakdown of the partnership relation between all the partners whereas; dissolution of the partnership merely involves a change in the relation of the partners.
2. **Continuance of business:** in case of dissolution of firm, the business comes to an end whereas; in case of dissolution of partnership, the business of the (reconstituted) firm is continued.
3. **Effect:** dissolution of partnership does not necessarily mean dissolution of firm, whereas; dissolution of firm necessarily implies dissolution of partnership.
4. **Closure of books of accounts:** on dissolution of firm all account books are closed whereas; in the case of dissolution of partnership, closure of books is not required.
5. **Nature:** dissolution of partnership is voluntary whereas; dissolution of firm may be voluntary or compulsory.
6. **Court order:** The firm may be dissolved by the order of the Court whereas; dissolution of partnership is a process of reconstitution.
7. **Disposal of assets and liabilities:** in case of dissolution of partnership, assets and liabilities are revalued and a new balance sheet is drawn whereas; in case of dissolution of firm, assets are realized and liabilities are paid off.

### **MODES OF DISSOLUTION OF PARTNERSHIP FIRM:**

- 1) **Dissolution by Agreement:** anytime by way of :-
  - Will of all the partners; or
  - Any agreement between all the partners [sec.42]
- 2) **Compulsory dissolution:** through:-
  - By the adjudication of all the partners, or of all the partners but one, as insolvent. [sec.41]
  - By the business of the firm becoming unlawful.
- 3) **Dissolution by notice:** [sec.43]
- 4) **On happening of contingencies:** [sec 42]
- 5) **Dissolution by the Court:** [sec. 44]
  - A partner becoming of unsound mind

- Permanent incapability of a partner to perform his duties
- On misconduct of a partner affecting business
- Willful or persistent breaches of agreement by a partner
- Transfer or sale of interest by a partner
- Business running in losses continuously
- The Court being satisfied on other equitable and just grounds that the firm should be dissolved.

#### **SETTLEMENT OF ACCOUNTS ON DISSOLUTION:**

- 1) All the assets of the firm (including unrecorded assets) are sold. If any of partner wishes to take any asset or liability, he can take it at the determined price.
- 2) The amount on sale of assets is realized. Due amount is also recovered from debtors.
- 3) Realization expenses are paid out of the amount realized from the sale of assets.
- 4) Outside liabilities like creditors, loans, bank o/d, B/P, loans from partner's wife, o/s expenses, etc.; are paid off from this amount.
- 5) After this partners' loan is paid off.
- 6) If some amount is left, i.e., there is any surplus the capitals of partners are repaid.
- 7) If there is any surplus after repayment of capitals of partners, it will be distributed among partners in their profit sharing ratio.

#### **ACCOUNTING TREATMENT TO BE MADE:**

- 1) Passing necessary journal entries
- 2) Preparing Realisation Account and distributing the profit or loss arising from the account among partners in their profit sharing ratio.
- 3) Closing of Partner's Loan Account, if any
- 4) Preparing ledger for Partners' Capital Accounts, so that i

### Realisation Account

A 'Realisation Account' is a *Nominal Account*. It is opened for disposing of all the assets of the firm and making payment to all the liabilities. Its object is to find out the profit or loss on realisation of assets and payment of liabilities. The profit or loss on realisation is distributed among all partners in their profit sharing ratio.

#### (1) Specimen of Realisation Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Sundry Assets (Write names of all assets separately)	Book Value	By Sundry Creditors :	Book Value
To Bank A/c (Payment of Liabilities)	.....	Bills Payable	
To Partner's Capital or Current A/c (Liability taken over by Partner)	.....	Loan/Wife's Loan	
To Bank A/c (Realisation Expenses)	.....	Bank Overdraft	
To Partner's Capital or Current A/c (Remuneration)	.....	Reserve for Doubtful Debts	
To Profit transferred to Capital A/cs (Balancing figure) :	.....	By Bank A/c (Assets realised)	.....
A	.....	By Partner's Capital or Current A/c (Asset taken over by Partner)	.....
B	.....	By Loss transferred to Capital A/cs (Balancing figure) :	.....
C	.....	A	.....
	In profit sharing ratio	B	.....
	.....	C	.....
	.....		In profit sharing ratio
	.....		.....

### Partner's Loan Account and Realisation Account

**Partner's Loan Account :** Partner's Loan Account is a liability payable to partner. Hence, it is not transferred to Realisation Account. It is paid of through Cash or Bank Account.

#### Partner's Loan Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Bank A/c	.....	By Balance b/d	.....
	.....		.....

**Partner's Capital Account :** Partner's Capital Account is prepared to ascertain the amount to be finally paid to him or to be collected from him. Following is the specimen of Partner's Capital Account when capital is fluctuating :

#### Partner's Capital Account (When Capital is Fluctuating)

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Balance b/d (Capital/Drawings shown on Assets side)	.....	By Balance b/d (Capital of Liabilities side)	.....
To Realisation A/c (Assets taken over)	.....	By Reserve/Reserve Fund	.....
To Profit & Loss A/c (Old Loss)	.....	By Profit & Loss A/c (Old undistributed profit)	.....
To Realisation A/c (Loss on Realisation)	.....	By Realisation A/c (Liability taken over)	.....
To Bank A/c (Final Payment to Partner)	.....	By Realisation A/c (Profit on Realisation)	.....
	.....	By Bank A/c (Amount brought in)	.....
	.....		.....

### Partner's Current Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Balance b/d (If Debit Balance)	.....	By Balance b/d (If Credit Balance)	.....
To Profit & Loss A/c (Old Loss)	.....	By Profit & Loss A/c (Cr.)	.....

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To Realisation A/c (Loss on Realisation)	.....	By Reserve A/c	.....
To Partner's Capital A/c (transfer) (Balancing figure)	.....	By Reserve Fund	.....
		By Realisation A/c (Liability taken over)	.....
		By Realisation A/c (Profit on Realisation)	.....
		By Partner's Capital A/c (transfer) (Balancing figure)	.....
	.....		.....

### Partner's Capital Account (When Capital is Fixed)

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Balance b/d (Capital/Drawings shown on Assets side)	.....	By Balance b/d (Capital-Liabilities side)	.....
To ..... Current A/c (Debit Balance of Current A/c transfer)	.....	By ..... Current A/c (Credit Balance of Current A/c transfer)	.....
To Bank A/c (Final Payment to Partner) (Balancing figure)	.....	By Bank A/c (Amount brought in)	.....
	.....		.....

**Cash/Bank Account :** After making all realisations and payments the balance of cash account should be closed automatically because receipts have to be equal to the payments.

### Cash/Bank Account

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Balance b/d	.....	By Realisation A/c (Liabilities paid off)	.....
To Realisation A/c (Assets realised)	.....	By Realisation A/c (Realisation Expenses)	.....
To Partner's Capital A/c (Amount brought in by Partner)	.....	By Partner's Capital A/c (Final payment made)	.....
	.....		.....

(2) For Closing Accounts of Various Liabilities : For closing the accounts related to third parties and outside liabilities, they will be transferred to Realisation Account at their book values.

Dr.  
Dr.  
Dr.  
Dr.  
Dr.  
Dr.  
Dr.  
Dr.  
Dr.  
Dr.  
Dr.

Sundry Liabilities A/c  
Sundry Creditors A/c  
Bills Payable A/c  
Bank Overdraft A/c  
Loan A/c  
Partner's Wife Loan A/c  
Partner's Loan A/c  
To Realisation A/c  
(Various liabilities transferred to Realisation A/c)

(3) For Transfer of Provisions and Reserves against Asset to Realisation Account : If such items exist in the Balance Sheet.

Dr.  
Dr.  
Dr.  
Dr.

Reserve or Provision for Doubtful Debts A/c  
Provision for Depreciation A/c  
Investment Fluctuation Fund A/c  
Joint Life Policy Fund/Reserve A/c  
To Realisation A/c  
(Various specific reserves and funds transferred)

Note : Investment Fluctuation Fund and Joint Life Policy Fund can be directly written off by crediting them to Partners' Capital Accounts in their profit sharing ratio (without transferring them to the Realisation Account if there are no investments and Joint Life Policy on assets side of the Balance Sheet.

(4) For Realising Assets :

(i) When Sold for Cash :

Dr.  
To Realisation A/c  
Cash or Bank A/c  
(Sundry assets realised)

(ii) When Assets are taken over by Partner(s) :

Dr.  
Partner's Capital (or Current) A/c  
To Realisation A/c  
(Taking over of assets by partner(s))

Notes : (a) Entry will be made with the amount realised or sale price or by the amount on which partner(s) agree to take over the asset.

(b) When nothing is mentioned about the realised values of assets, it will be presumed that all tangible assets are realised at their book values but all intangible assets realise nothing.

(5) For Payment of Liabilities :

Dr. (With the actual amount)  
Realisation A/c  
To Bank or Cash A/c  
(Payment of liabilities)

'With actual amount' means that amount which is paid to meet the liabilities. Therefore :

(i) If creditors are paid at 5% (reduced amount), this amount will be reduced from the amount of creditors.

(ii) In the same way outstanding expenses will be paid off.

(iii) All external liabilities have to be paid unless otherwise given in the questions.

(iv) When nothing is mentioned about the payment of liabilities, payment will be made equal to the book value of liabilities.

(6) Payment of Liabilities by the Partner(s) or Liability taken over or Discharged by Partner :

Dr.  
Realisation A/c  
To Partner's Capital A/c  
(Taking over of liability by partner)

## Journal Entries

(1) For Closing the Accounts of Various Assets : All the assets excepting Cash and Bank Balance will be transferred to the Realisation Account at their book values.

Dr.  
Realisation A/c

To Building A/c  
To Plant and Machinery A/c  
To Furniture and Fixture A/c  
To Investments A/c  
To Debtors A/c  
To Bills Receivable A/c  
To Stock A/c  
To Goodwill A/c

(Transfer of sundry assets to Realisation A/c)

It should be noted that the assets in respect of whom provision or reserve has been made, such assets should be transferred at Gross Value and not at Net Value. Provision or Reserve for doubtful debts is transferred with other liabilities.

For example, If Debtors of Rs. 16,000 are given in the Balance Sheet and Rs. 1,000 has been reduced from it as provision and Rs. 15,000 has been shown in the amount column then Debtors will be transferred at Rs. 16,000 and Rs. 1,000 will be transferred on the credit side of the Realisation Account alongwith the other liabilities.

**(7) Unrecorded Assets and Unrecorded Liabilities :**

**(A) Unrecorded Assets :** Sometimes some assets are not recorded in the Balance Sheet at the time of dissolution, but they physically exist. On dissolution these assets are :

- (i) Sold off; or
- (ii) Taken over by any partner; or
- (iii) Taken over by any creditor on a fixed value.

Following accounting method is adopted in relation to unrecorded assets :

- (i) *Never Transfer Unrecorded Assets to Realisation Account.*
- (ii) *If unrecorded asset is sold :*

Bank A/c  
 To Realisation A/c  
 (Unrecorded asset sold) Dr.

- (iii) *If unrecorded asset is taken over by any partner :*

Partners' Capital A/c  
 To Realisation A/c  
 (Unrecorded asset taken over by partner) Dr.

- (iv) *When unrecorded asset is taken over by any creditor :*

(a) *In full settlement of his claim :*  
 No payment will be made by the firm.

(b) *In part payment of his claim :*

The amount of payment will be reduced by the agreed value of the asset taken over.

**(B) Unrecorded Liability :** If there is some liability which did not exist in the Balance Sheet at the time of dissolution but at the time of dissolution it arised due to decision of some pending court cases (like contingent liability or claim for some disputed case etc.), then the method of accounting will be as follows :

- (i) *Never Transfer Unrecorded Liability to Realisation Account.*
- (ii) *When unwritten or unrecorded liability is paid off :*

Realisation A/c  
 To Bank  
 (Unrecorded liability paid off) Dr.

- (iii) *When unrecorded liability is taken over or paid by a partner :*

Realisation A/c  
 To Partner's Capital A/c  
 (Unrecorded liability taken over by partner) Dr.

**(8) For Expenses on Dissolution or Realisation or Cost of Dissolution :**

- (a) *If expenses of dissolution are paid in cash :*

Realisation A/c  
 To Bank or Cash A/c  
 (Payment of dissolution expenses) Dr.

(b) Sometimes a partner, for the realisation of amount on sale of the assets, receives commission at fixed rate or in lump-sum, then it will be assumed that all expenses of realisation or dissolution will be paid by the partner who receives this commission. In this case entry will be made as under :

Realisation A/c (With the amount of Commission)  
 To Partners' Capital/Current A/c  
 (Partners' Capital/Current A/c credited with commission) Dr.

*Note :* Generally, in such a situation no entry is made for payment of realisation expenses by the partner because these expenses are paid by the partner from his personal sources. Therefore, no entry will be made in the books. Even then if entry is to be passed, such expenses will be treated as drawings and the entry will be made as under :

Partner's Capital A/c Dr.  
 To Bank or Cash A/c

(Realisation expenses incurred by partner treated as drawings)

**(9) For Closing Realisation Account :**

(i) If the credit side of the Realisation Account exceeds the debit side, such excess shall be treated as profit.

Realisation A/c Dr.  
 To Partners' Capital/Current A/c

(Profit on realisation transferred to Partners' Capital/Current A/c in profit sharing ratio)

(ii) If the debit side of the Realisation Account exceeds the credit side, such excess shall be treated as loss.

Partners' Capital/Current A/cs Dr.  
 To Realisation A/c

(Loss on realisation transferred to Partners' Capital/Current A/c)

**(10) For Payment of Partner's Loan :** If firm has taken loan from any of the partner, it will have to be repaid :

Partner's Loan A/c Dr.  
 To Bank A/c

(Partner's loan paid off)

**(11) For Transfer of Free Reserves/Reserve Funds/Accumulated Profits, etc. :** Reserves/Reserve Fund/Undistributed Profit or Profit & Loss Account (credit balances) etc. are transferred to Partners' Capital Account or Current Account, in their profit sharing ratio :

Reserve A/c Dr.

Reserve Fund A/c Dr.

Profit & Loss A/c Dr.

Workmen's Compensation Fund A/c Dr.

To Partners' Capital/Current A/c

(Transfer of reserve and accumulated profits to Partners' Capital/Current A/c)

**(12) For Closing Accumulated Losses :** If Profit & Loss Account or undistributed losses exist in the assets side of the Balance Sheet, they will be transferred to Partners' Capital or Current Account.

Partners' Capital/Current A/c Dr.  
 To Profit & Loss A/c

(Transfer of undistributed loss)

**(13) For Closing Capital Account :** Lastly, Partners' Capital Accounts will be closed. If there is credit balance in the Capital Account, i.e., total of credit side is more than that of debit side, such excess shall be paid to partners in cash.

(i) *In Case of Credit Balance on Payment of Cash :*

Partners' Capital A/c Dr.  
 To Bank or Cash A/c

(Payment of the amount finally due to the partners)

On the other hand, if there is debit balance, i.e., total of debit side is more than total of credit side, such partners will bring in cash upto the extent of their debit balances. Such situation is called *simple dissolution of the firm*.

(ii) *In Case of Debit Balance for bringing in Cash :*

Bank A/c Dr.  
 To Partner's Capital A/c

(Amount brought in by partner to meet capital deficiency)

## Guidelines for Treatment of Different Reserves

S.N.	Name of Reserve	Transfer to Realisation A/c	Transfer direct to Partner's A/c
1.	<b>Workmen's Compensation Fund</b>	If there is any claim by the workers for compensation.	If there is no claim for compensation for whatsoever.
2.	<b>Investment Fluctuation Fund</b>	If there are corresponding investments on the assets side of the Balance Sheet.	If there is no investments on the assets side of the Balance Sheet
3.	<b>Joint Life Policy Reserve</b>	If there is corresponding Joint Life Policy on the assets side of the Balance Sheet. <i>Note : J.L.P. is also transferred to Realisation Account.</i>	If there is no Joint Life Policy on the assets side.
4.	<b>Mechinery/Plant Replacement Fund</b>	When there is machinery on the assets side of the Balance Sheet.	When there is no machinery/plant on the assets side of the Balance Sheet.
5.	<b>General Reserve—Reserve Fund</b>	—	Always transferred to Partner's Capital Accounts or Current Accounts.
6.	<b>Contingency Fund</b>	—	—Do—

What Journal entries would you pass for the following transactions on the dissolution of the firm of partners X and Y :

- (i) Dissolution expenses Rs. 800 were paid by Y.
- (ii) An unrecorded asset realised Rs. 3,000.
- (iii) Stock Rs. 5,000 already transferred to 'Realisation Account' was taken over by X.
- (iv) Creditors already transferred to 'Realisation Account' were paid Rs. 4,000.
- (v) Loss on realisation Rs. 3,000 was distributed between the partners X and Y in their profit sharing ratio of 3 : 2.



**Solution**

<b>Journal Entries</b>				
<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i>	<i>Cr.</i>
			<i>Amount</i>	<i>Amount</i>
(i)	Realisation A/c To Cash A/c (Payment of dissolution expenses)	Dr.	Rs. 800	Rs. 800
(ii)	Cash A/c To Realisation A/c (Unrecorded asset realised)	Dr.	3,000	3,000
(iii)	X's Capital A/c To Realisation A/c (Stock taken over by X)	Dr.	5,000	5,000
(iv)	Realisation A/c To Cash A/c (Creditors paid off)	Dr.	4,000	4,000
(v)	X's Capital A/c Y's Capital A/c To Realisation A/c (Loss on Realisation A/c transferred to X's and Y's Capital A/cs)	Dr. Dr.	1,800 1,200	3,000