

CHAPTER 6

DISSOLUTION OF A PARTNERSHIP FIRM

Dissolution of a firm: As per the Indian Partnership Act, 1932: *“Dissolution of a firm means termination of partnership among all the partners of the firm”*. When a firm is dissolved, the business of the firm terminates. All the assets of the firm are disposed of and all outsiders’ liabilities and partners’ loan and partner capitals are paid.

Dissolution of Partnership: *Dissolution of Partnership refers to the termination of the old partnership agreement (i.e., Partnership Deed) and a reconstruction of the firm.* It may take place on

Change in profit sharing ratio among the existing partner;

- Admission of a partner; and
- Retirement or Death of a partner.

It may or may not result in the closing down of the business as the remaining partners may decide to carry on the business under a new agreement.

Types of dissolution of firms: A partnership firm can be dissolved in any of the following ways:

Without the intervention of the court :

When all partners agree to dissolve the firm (Sec. 40);

Compulsory Dissolution (Sec. 41)

When all or all but one partner of the firm become insolvent.

when the business of the firm becomes unlawful.

On the happening of any of the following events : (Sec. 42)

On the insolvency of a partner.

On the fulfillment of the objective of the firm for which the firm was formed.

On the expiry of the term (period) for which the firm was formed.

By Notice (Sec. 43): When the duration of the partnership firm is not fixed and it is at the will of the partners. Any partner by giving notice to other partners can dissolve the firm.

Dissolution by order of the court (Sec 44): A court on application by a partner may order the dissolution of the firm under the following circumstances :

- When a partner has become of unsound mind.
- When a partner has become permanently incapable of performing his duties as a partner.
- When a partner is found guilty of misconduct that may harm the partnership
- When a partner consistently and deliberately commits a breach of a partnership agreement.
- When a partner transfer whole of his interest in the business firm to a third party, without the consent of existing partners.
- When the court is satisfied that the partnership firm cannot be carried on except at a loss.
- When the court found is that the dissolution of the firm is justified and equitable.

ACCOUNTING TREATMENT ON DISSOLUTION

On dissolution of a firm, the following accounts are opened to close the books of the firm:

Realisation Account;

- Partner's Loan Account;
- Partners' Capital Accounts; and
- Cash or Bank Account.

Realization Account: It is a **nominal account** opened on the dissolution of a firm **to ascertain the profit or loss on the realisation of assets and payments of outsiders' liabilities**. This account is closed by transferring the balance (i.e., profit or loss on realization) to the partner's capital accounts.

Preparation of Realisation Account

The following Journal Entries are passed:

For Closing Assets Accounts :

- Realization A/CDr.
- To Sundry Assets A/C (Being assets transferred to Realisation A/c) Note :
- Cash and Bank balance are not transferred to the Realisation Account.
- Assets (tangible and intangible) are transferred to Realisation Account at their

Gross Value

Fictitious Assets such as the Debit balance of Profit and Loss Account or Advertisement Suspense Account etc. are not transferred to Realisation Account. These are directly debited to partners' capital accounts in their profit sharing ratio by passing the following entry:

Partner's capital A/c Dr.
To Profit and Loss A/c
To Advertisement Suspense A/c

(Being Balance of losses transferred to capital accounts)

Provisions against assets such as Provision for Depreciation or Provision for Bad & Doubtful debts etc. are transferred to Realisation Account by passing a

separate entry:

Provision's for Bad Debts A/c Dr.
Provision's for Depreciation A/c Dr.
Investment Fluctuation Fund A/c Dr.
Machinery Replacement Reserve A/c Dr.

To Realisation A/c

(Being Provisions & Reserves Against Assets transferred to Realisation Account)

For Closing Liabilities Accounts :

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Sundry Liabilities A/cs Dr.

To Realisation A/c

(Being sundry liabilities transferred to Realisation A/c)

Note:

Only third parties' liabilities/outside's liabilities are transferred to Realisation A/c.

The Balance of Partner's Loan Accounts is not transferred to the Realisation Account.

Separate accounts are opened to settle such liabilities.

Undistributed profits and reserves are also not transferred to Realisation A/c. These are directly credited to partners' capital accounts in their profit – sharing ratio by passing the following entry:

Profit and Loss A/c Dr.

General Reserves A/c Dr.

Reserve Fund A/c Dr.

Contingency Reserve A/c Dr.

To Partners' Capital A/cs

(Being balance of undistributed profits transferred to capital accounts)

Provident Fund is a liability on the firm towards employees and hence it is transferred to Realisation A/c

If any liability is expected to rise against any fund or reserve e.g., Workmen's Compensation Fund, then an amount equal to such liability is transferred to Realisation A/c and balance, if any, is distributed among the partners in their profit-sharing ratio by passing the following entry:

Workmen's Compensation Fund A/c Dr.

To Realisation A/c (Liability)

To Partners' Capital A/cs (Balance, if any)

(Being liability against workmen's compensation

fund transferred to Realisation A/c and balance

distributed among partners)

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Example. Workmen's Compensation Fund shown on the liability side of the Balance Sheet is Rs. 50,000. At the time of dissolution liability against this fund is estimated at Rs. 30,000. Pass necessary Journal Entry.

Workmen's Compensation Fund A/c Dr. 50,000

To Realisation A/c 30,000

To A's Capital A/cs 10,000

To B's Capital A/cs 10,000

(Being liability against workmen's compensation fund transferred to Realisation A/c and the balance distributed among partners)

For Realisation of Assets (whether recorded or unrecorded)

When assets are sold for cash

Cash/Bank A/c Dr.

To Realisation A/c

(Being assets sold for cash)

When assets are taken over by any partner

Partner's Capital A/c Dr.

To Realisation A/c

(Being assets were taken over by any partner)

When assets are taken over by any creditor in part or full payment of his dues :

In case of Full Settlement :

- NO ENTRY is passed for the transfer of assets to the creditor
- NO ENTRY is passed for the payment to creditor

In the case of Part Settlement :

- NO ENTRY is passed for the transfer of assets to the creditor.
- The agreed amount of assets is deducted from the claims of the creditor and the balance is paid to him.

Note:

If nothing is stated regarding the realization of any tangible assets then such assets should be assumed to be realized at book value

If nothing is stated regarding the realization of any intangible assets like goodwill, patents, trademarks, etc. then it is assumed that such assets have not realized any amount.

For Payments of Liabilities

When liabilities are paid in cash

Realization A/c Dr.

To Cash/Bank A/c

(Being liabilities paid in cash)

When liabilities are taken over by any partner

Realization A/c Dr.

To Partner's Capital A/c

(Being liabilities were taken over by a partner)

When assets are taken over by any creditor in part or full payment of his dues :

In case of Full Settlement:

- NO ENTRY is passed for the transfer of assets to the creditor
- NO ENTRY is passed for the payment to creditor

In the case of Part Payment:

NO ENTRY is passed for the transfer of assets to the creditor

The agreed amount of assets is deducted from the claims of the creditor and the balance is paid to him.

Note:

If nothing is stated regarding the settlement of any outside liability, then it should be assumed that the amount equal to book value is paid.

For Realisation Expenses

a. When expenses are paid by the firm and borne by the firm:

Realization A/c Dr.

To Cash/Bank A/c

(Being realization expenses paid in cash) b. When expenses are paid by any partner and borne by the firm:

Realization A/c Dr.

To Partner's Capital A/c

(Being realization expenses paid by a partner)

c. When expenses are paid by a firm (on behalf of any partner) and borne by any partner:

Partner's Capital A/c Dr.

To Cash/Bank A/c

(Being realization expenses paid on behalf of a partner)

When expenses are paid by any partner and borne by the same partner :

NO ENTRY

When a partner is paid a fixed amount for bearing realization expenses then :

Actual expenses are not to be considered; and

Realization A/c Dr. [With Fixed Amount]

To Partner's Capital A/c

(Being realization expenses paid by a partner)

When expenses are paid by one partner and borne by another partner:

Partner's Capital A/c Dr. (Who borne the expenses)

To Partner's Capital A/c (Who pays the expenses)

(Being realization expenses paid by one partner and borne by another partner)

For Closing Realisation Account

When Realisation A/c discloses profit (in case the total of credit side is more than the total of debit side)

Realization A/c Dr.

To Partners' Capital A/cs

(Being profit on realization transferred to partners' capital/cs)

When realization/c discloses loss (in case the total of a debit side is more than the total of credit side)

Partners' Capital A/cs Dr.

To Realisation A/c

(Being loss on realization transferred to partners' capital A/cs)

FORMAT OF REALISATION ACCOUNT

Realisation Account

Dr.			Cr.
Particulars	Rs.	Particulars	Rs.
To Sundry Assets A/c		By Sundry Liabilities A/c	
(Excluding cash or bank		(Excluding Cr. Balance of	
balance, fictitious assets, Dr.		P & L A/c, Reserves, Partners'	
balance of P & L A/c, Dr.		capital/current A/cs, Loan	
balance of partners' capital/		from Partner and Bank	
current A/cs, Loans to		Overdraft)	
partners		By Provision on any Assets	
To Cash/Bank A/c		A/c	
(Amount paid for discharging		(Such as Provision for	
liabilities-recorded and		Depreciation, Provision for	
unrecorded)		Doubtful Debts, Joint Life Policy Reserve, etc.	
To Cash Bank A/c		By Cash/Bank A/c	
Expenses on Realisation)		(Amount received on	
To Partner's Capital A/cs		realization of assets-recorded	
(Liabilities are taken over by a and unrecorded)			
commission payable to him or		By Partners' Capital A/cs	
any expenses payable to him or		(Assets took over by a partner	
		- recorded or unrecorded)	
To partners' Capital A/cs		By Partners' Capital A/cs	
(For transferring profit on		(For transferring loss on	
Realization)		Realization)	

Preparation of Partners' Loan Account

If a partner has given any loan to firm, his loan will be paid

After payment of all the outside liabilities: but

Before making any payment to partners on account of capital

Partner's Loan A/c Dr.

To Cash/Bank A/c (Being loan of a partner paid)

Dr.		Partner's Loan A/c	Cr.
Particulars	Rs.	Particulars	Rs.
To Cash/Bank A/c		By Balance b/d	

Note :

If the firm has given a loan to any partner then such a loan account will show a debit balance and will appear on the asset side of the Balance Sheet of the firm. Such loan accounts are settled through a partner's capital account bypassing the following entry

Partner's Capital A/c Dr.

To Partner's Loan A/c

(Being loan to partner transferred to his Capital A/c)

Preparation of Partner's Capital Accounts After the transfer of Undistributed profits and reserves Profit on Realisation

Any liability is taken over by any partner And Undistributed losses and fictitious assets

Loss of realization Any assets were taken over by any partner

The balance of partners' capital A/cs are closed in the following manner

For making final payment to a partner (if a total of credit side is more than the total of debit side)

Partner's Capital A/c Dr.

To Cash/Bank A/c

(Being excess paid to partner in cash)

For any amount received from a partner against the debit balance in his capital account

Cash/Bank A/c Dr.

To Partners' Capital

(Being cash brought in by any partner)

Preparation of Cash or Bank Account

This account is prepared at the end and closed last of all. This account helps in the verification of the arithmetical accuracy of accounts as both sides of this account must be equal. **There should be no balance left in Cash or Bank A/c.**

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Balance b/d (Dr. Balance)			By balance b/d (Cr. Balance)		
To Profit and Loss A/c To Advertisement			By General Reserve A/c		
To Realisation A/c (Assets took)			By Profit and Loss A/c		
To Realisation A/c (Loss on Realisation To Cash/Bank A/c (Excess cash paid)			Compensation Fund By Realisation A/c (Liabilities have taken)		
			By Realisation A/c (Profit on Realisation)		
			By Cash/Bank A/c (Cash brought in)		
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Note :

If cash and bank balance (or Bank Overdraft) both are given in the Balance Sheet, only one A/c is prepared, either a Cash A/c or a Bank A/c. If Cash A/c is opened, an entry for withdrawing the bank balance is made :

Cash A/c Dr.

To Bank A/c

(Being cash withdrawn from Bank)

If Bank A/c is opened, an entry for depositing the cash into the bank is passed.

Bank A/c Dr.

To Cash A/c

(Being cash deposited into Bank)

Dr. Cash/Bank A/c Cr.

Particulars	Rs.	Particulars	Rs.
To Balance b/d (Cash in Hand or Cash at Bank)		By Balance b/d (Bank Overdraft)	
To Realisation A/c (Assets Realised)		By Realisation A/c (Liabilities Paid)	
To Partners' Capital A/cs (Cash brought in by partner)		By Realisation A/c (Realisation Expenses Paid)	
		By Partner's Loan A/c (Partner's Loan Paid)	
		By Partners' Capital A/cs (Excess cash paid to partner)	

distinction between the Revaluation Account and Realisation Account

Basis of Difference	Revaluation Account	Realization Account
Purpose	It is prepared to show assets and liabilities in the books at their revised values	It is prepared to ascertain the profit or loss on the sale of assets and repayment of liabilities.
When to be prepared	It is prepared at the time of change in profit sharing ratio among the existing partner, admission, retirement, and death of a partner.	It is prepared at the time of dissolution of a firm
Preparation of Account	This account maybe prepared at some times during the life of a firm	This account is prepared only once during the life of a firm

The firm was dissolved on the above date and the following arrangements were decided upon :

X agreed to pay off his wife's loan.

Debtors of Rs.5,000 proved bad.

Others assets realized - Investments 20% less; and Goodwill at 60%

One of the creditors for Rs.5,000 was paid only Rs.3,000

Buildings were auctioned for Rs.30,000 and the auctioneer's commission amounted to Rs.1,000.

Y took over the part for Stock at Rs.4,000 (being 20% less than the book value). The balance stock realized 50%.

Realization expenses amounted to Rs.2,000.

Prepare Realisation A/c, Partners' Capital A/cs and Bank A/c

Solution :

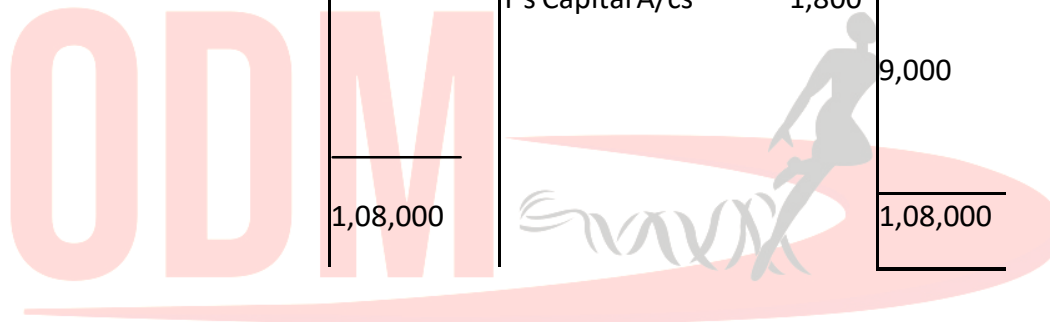
Dr.

Realisation Account

Cr.

Particulars	Rs.	Particulars	Rs.
To Goodwill	10,000	By Investment Fluctuation Fund	5,000
To Buildings	25,000	By Provision for Doubtful Debts	2,000
To Investments	25,000	By Creditors	8,000
To Stock	15,000	By X's Wife Loan	6,000
To Debtors	17,000	By Bank A/c :	8,000
To X's Capital A/c		(Asset realized	
(X's brother loan)	8,000	Debtors	12,000
		Investments	20,000
(Creditors)	6,000		

To Bank A/c		Goodwill	6,000	
(Expenses on Realisation	6,000	Buildings	29,000	
		Stock	5,000	
				72,000
		By Y's Capital A/c		
		(Stock)		4,000
		By Loss transferred to :		
		X's Capital A/cs	7,200	
		Y's Capital A/cs	1,800	
				9,000
	<hr/>			<hr/>
	1,08,000			1,08,000



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Dr. Partner's Capital A/cs *Creating your Tomorrow* Cr.

Particulars	X	Y	Particulars	X	Y
	Rs.	Rs.		Rs.	Rs.
To Profit and Loss A/c	8,000	2,000	By Balance b/d	50,000	40,000
To Realisation A/c (Assets took)			(Cr. Balance) By Realisation A/c		
To Realisation A/c (Loss on Realisation To Bank A/c (Excess cash paid)	7,200 42,800	4,000	(Liabilities are taken)	8,000	
		1,800			
	<hr/>				
	58,000				

	42,800		
		58,000	
	58,000		40,000

Cash/Bank A/c

Dr.		Cr.	
Particulars	Rs.	Particulars	Rs.
To Balance b/d		By Balance b/d	6,000
(Cash at Bank)	20,000	(Bank Overdraft)	
To Realisation A/c (Assets Realised)	72,000	By Realisation A/c (Liabilities Paid)	6,000
To Partners' Capital A/c (Cash brought in by Partner)		By Realisation A/c Realisation Expenses Paid	2,000
		By Y's Loan A/c	3,000
		(Partner's Loan Paid) By X' Capital A/c	42,800
		By Y's Capital A/c	32,200
	92,000		92,000

Q2. A and B were partners in a firm from 1-4-2008 with capitals of Rs.60,000 and Rs.40,000 respectively. They shared profits and losses in the ratio of 3:2. The carried on business for 2 years. In the first year, they made a profit of Rs.50,000 and in the 2nd year ending on 31st March 2010, they incurred a loss of Rs.20,000. As the business was no longer profitable, they decided to wind up. Creditors on that date were Rs.20,000. The partners withdrew Rs.8,000 each per year for their expenses. The assets realised Rs.1,00,000. The expenses on realization were Rs.3,000. Prepare Realisation A/c and Partner's Capital A/c and show your working clearly.

SOLUTION

Realisation A/c

Particulars	Rs.	Particulars	Rs.
To Sundry Assets	1,18,000	By Creditors	20,000
To Bank A/c		By Bank A/c	
(Creditors)	20,000	(Assets realised)	
To Bank A/c		By Loss transferred to :	
(Expenses on Realisation)	3,000	A's Capital A/cs 12,600	
		B's Capital A/cs 8,400	21,000
	1,41,000		1,41,000

Working Notes : (i)

Partners Capital A/c

Date	Particulars	A	B	Date	Particulars	A	B
		Rs.	Rs.			Rs.	Rs.
2008	To Bank A/c	8,000	8,000	1.04.08	By Cash A/c	60,000	60,000
?	(Drawings) To			31.03.09	By Profit and		
31.03.2009	Balance c/d	82,000	52,000		Loss A/c	30,000	30,000
	To Bank A/c	90,000	60,000			90,000	60,000

2009	(Drawings) To Profit and Loss A/c			1.04.09	By Balance b/d		
? 31.03.09						82,000	52,000
31.03.09	To Balance c/d	8,000	8,000				
		12,000	8,000				
	To Realisation A/c (Loss)	62,000	36,000				
01.04.10		82,000	52,000		By Balance b/d	82,000	52,000
	To Bank A/c			1.4.10			
						62,000	36,000
		12,600	8,400				
		49,400	27,600				
		6,2000	36,000			62,000	36,000

