

1. Meaning of Dissolution

In legal and accounting terms, a distinction must be made between the **dissolution of partnership** and the **dissolution of a partnership firm**.

Dissolution of Partnership

Dissolution of partnership refers to a change in the existing relationship between partners, but the **firm continues its business**. This occurs during reconstitution, such as:

- Change in the profit-sharing ratio among existing partners.
- Admission of a new partner.
- Retirement or death of a partner.
- Insolvency of a partner.
- Expiry of the term or completion of a specific venture.

Dissolution of a Partnership Firm

According to **Section 39 of the Indian Partnership Act, 1932**, the dissolution of partnership between **all the partners** of a firm is called the "dissolution of the firm".

This brings an end to the existence of the firm, and no business is transacted thereafter except for activities related to winding up its affairs.

Key Differences for CUET Revision: | Basis | Dissolution of Partnership | Dissolution of Firm | | :--- | :--- | :--- | | **Termination of Business** | The business is not terminated. | The business of the firm is closed. | | **Settlement of Assets/Liabilities** | Assets/liabilities are revalued; a new Balance Sheet is drawn. | Assets are sold, and liabilities are paid off. | | **Court Intervention** | Court does not intervene; it's by mutual agreement. | A firm can be dissolved by a court order. | | **Economic Relationship** | Relationship continues

in a changed form. | Relationship comes to an end. | | **Closure of Books** | Does not require closure of books. | Books of account are terminated. |

2. Modes of Dissolution of a Firm

A firm may be dissolved in several ways, with or without the intervention of the court:

1. **Dissolution by Agreement:** A firm is dissolved with the consent of all partners or in accordance with a contract between them.
2. **Compulsory Dissolution:** Occurs when all (or all but one) partners become insolvent, or when the business becomes illegal due to unlawful events (e.g., war making a partner an 'alien enemy').
3. **On the Happening of Contingencies:** Subject to a contract, dissolution may occur upon the expiry of a fixed term, completion of a venture, death of a partner, or adjudication of a partner as insolvent.
4. **Dissolution by Notice:** In a partnership at will, a firm may be dissolved if any partner gives written notice of their intention to dissolve the firm.
5. **Dissolution by Court:** At the suit of a partner, a court may order dissolution on grounds of a partner's insanity, permanent incapacity, misconduct, persistent breach of agreement, transfer of interest to a third party, or if the business can only be carried on at a loss.

3. Settlement of Accounts (Section 48)

Upon dissolution, the firm must satisfy all claims against it by disposing of assets. The rules provided in **Section 48** of the Act are as follows:

A. Treatment of Losses

Losses, including deficiencies of capital, are paid in the following order:

1. First out of profits.
2. Next out of the capital of partners.
3. Lastly, if necessary, by the partners individually in their profit-sharing ratio (PSR).

- **Firm's property** is applied first to firm's debts; any surplus is used for partners' private debts.
- **Partner's private property** is applied first to their private debts; any surplus is used for firm's debts if assets are inadequate.
- *Note:* Private property does not include the personal properties of a partner's spouse or children.



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B. Application of Assets

The assets of the firm (including contributions by partners to cover capital deficiencies) are applied in this specific order:

1. **Paying debts of the firm to third parties (External Liabilities).**
2. Paying each partner proportionately for advances/loans made to the firm (distinguished from capital).
3. Paying to each partner proportionately what is due to them on account of capital.
4. The residue, if any, is divided among the partners in their PSR.

4. Accounting Treatment and Preparation of Accounts

The primary objective of accounting during dissolution is to close the books and determine the final profit or loss on realization.

I. Realisation Account

The **Realisation Account** is prepared to ascertain the net effect of realizing assets and paying liabilities. The balance (profit or loss) is transferred to partners' capital accounts in their PSR.

Steps and Journal Entries:

1. **Transfer of Assets:** All asset accounts (except cash, bank, and fictitious assets like P&L debit balance) are transferred to the **debit side** of the Realisation Account at their **book values**.
 - *Entry:* Realisation A/c Dr. To Sundry Assets A/c.
 - *Note:* Debtors are transferred at gross value; provisions (like Provision for Doubtful Debts) are transferred to the **credit side**.
2. **Transfer of Liabilities:** All external liabilities (creditors, loans, bank overdrafts, etc.) are transferred to the **credit side** of the Realisation Account.
 - *Entry:* Sundry Liabilities A/c Dr. To Realisation A/c.
3. **Sale of Assets:**
 - *Entry:* Bank/Cash A/c Dr. To Realisation A/c (amount realized).

Firm's Debts vs. Private Debts (Section 49)

- This includes the realization of **unrecorded assets**.

4. Asset Taken Over by a Partner:

- *Entry:* Partner's Capital A/c Dr. To Realisation A/c.

5. Payment of Liabilities:

- *Entry:* Realisation A/c Dr. To Bank/Cash A/c.
- This includes the payment of **unrecorded liabilities**.

6. Liability Assumed by a Partner:

- *Entry:* Realisation A/c Dr. To Partner's Capital A/c.

7. Realisation Expenses:

- If paid by the firm: Realisation A/c Dr. To Bank A/c.
- If paid by a partner on behalf of the firm: Realisation A/c Dr. To Partner's Capital A/c.
- If the firm pays a partner a fixed remuneration for dissolution work: Realisation A/c Dr. To Partner's Capital A/c.

8. Settlement with Creditors via Assets:

- If a creditor accepts an asset in **full and final settlement**, no entry is required.
- If there is a difference in value, cash paid or received is recorded.

9. Closing the Realisation Account:

- If credit side > debit side (Profit): Realisation A/c Dr. To Partners' Capital A/cs.

- If debit side > credit side (Loss): Partners' Capital A/cs Dr. To Realisation A/c.

II. Partner's Loan Account

A partner's loan is **not transferred** to the Realisation Account. It is settled after external liabilities are paid but before capital is returned.

- *Entry:* Partner's Loan A/c Dr. To Bank/Cash A/c.
- *Exception:* If a firm has given a loan to a partner, it is settled by: Bank A/c Dr. To Loan to Partner A/c.



III. Partner's Capital Account

These accounts record the final adjustments for:

- **Accumulated profits/reserves** (General Reserve, etc.), which are transferred to the credit side in PSR.
- **Accumulated losses** and fictitious assets, which are transferred to the debit side in PSR.

- **Partner's Current Account** balances are transferred to their respective Capital Accounts.

- **Realisation profit or loss.**

Final Settlement:

- If the capital account shows a **credit balance**:
Partner's Capital A/c Dr. To
Bank/Cash A/c (Payment made to partner).

- If the capital account shows a **debit balance**:
Bank/Cash A/c Dr. To Partner's
Capital A/c (Partner brings in cash).

IV. Bank or Cash Account

This account records all cash receipts (from asset realization and partner contributions) and all cash payments (to creditors, for expenses, loans, and final capital settlement).

This account must close with no balance; the total receipts must equal total payments.

