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FINANCIAL ACCOUNTING

Unit 5

DISSOLUTION OF PARTNERSHIP FIRM

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Q: What do you understand by Dissolution of Partnership and Dissolution of Firms? Differentiate between Dissolution of Partnership and Dissolution of Firms. *(www.prepnext.com)*

Ans.:
The Indian Partnership Act, 1932 recognises the difference between the 'dissolution of partnership' and 'dissolution of firm'. The definitions of the two terms are given as follows:

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." Thus, the dissolution of a firm is the complete breakdown of a partnership and partners do not continue the firm. On the other hand, dissolution of the partnership means a reconstitution of the firm due to the retirement of a partner or the insolvency of a partner or the death of a partner and the remaining partners provide for the continuance of the firm in pursuance of an express or implied agreement to that effect. On dissolution of a firm the firm's assets are realised and the liabilities are discharged because the firm is to be closed, whereas on dissolution of a partnership, the share of the outgoing partner is ascertained and the firm is not closed.

DISTINCTION BETWEEN DISSOLUTION OF PARTNERSHIP AND DISSOLUTION OF A FIRM

Following are the main distinctions between dissolution of partnership and dissolution of a firm:

Point of Distinction	***Dissolution of Partnership***	***Dissolution of a Firm***
Meaning	It means discontinuance of relationship between partners but the business is not terminated.	It means dissolution of partnership of all partners of the firm along with winding up of the business of the entire firm. The business of the firm is closed.
Books of Accounts	In this case, books of accounts may not be closed.	In this case, books of accounts are closed.
Dissolution	It does not mean dissolution of firm.	It means dissolution of partnership also.
Nature	It is voluntary and is dissolved by mutual agreement and through the process of reconstitution.	It may be both voluntary and compulsory. A firm can be dissolved by Court's orders.

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Winding Up	It involves reconstitution of the firm and requires revaluation of the assets and reassessment of liabilities of the firm.	It involves winding up of the firm and requires realisation of assets and settlement of liabilities.
Dissolution by Court	Dissolution of partnership is not ordered by the Court	A firm **MAY** be dissolved by the order of the Court
Settlement of assets and liabilities	In this case, assets and liabilities are revalued and new balance sheet is drawn.	In this case, assets are sold and realised and liabilities are paid off.
Economic relationship	Such relationship between the partners remains and changes.	Such relationship between the partners comes to an end.

Q: Explain the different modes of dissolution of firm.

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Ans.:

Modes of Dissolution of Firm:

Sections 40 to 44 of the Indian Partnership Act, 1932 deal with the various ways in which a firm may be dissolved. A firm may be dissolved in any of the following ways:

Dissolution by agreement: A firm is dissolved when all the partners agree that it should be dissolved. A partnership firm is the creation of an agreement; similarly a firm can be dissolved by an agreement.

Dissolution on the happening of contingencies: A firm is dissolved in any of the following ways unless there is a contract between the partners to the contrary:

(i) By the expiry of the term of duration of the firm.
(ii) By the completion of the adventure for which the firm was constituted.
(iii) By the death of a partner.
(iv) By the adjudication of a prtner as insolvent.

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Dissolution by notice of partnership at will: When the partnership is at will, the firm may be dissolved at any time by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

Compulsory dissolution or dissolution by the operation of law : A firm is compulsorily dissolved in any of the following ways:

(i) When all the partners except one become insolvent.
(ii) When all the partners become insolvent.
(iii) When the business becomes illegal.
(iv) Where the number of partners exceed twenty in case of ordinary business or ten in case of banking business.

Dissolution by the Court: At the suit of a partner, a court may order the dissolution of the firm in any of the following ways:

(i) When a partner becomes of unsound mind.
(ii) When a partner suffers from permanent incapacity and becomes incapable of performing his duties as a partner.
(iii) When a partner is guilty of misconduct affecting the business of the firm.
(iv) When a partner commits wilful or persistent breaches of agreement.
(v) When a partner has transferred the whole of his interest in the firm to a third party or when his share has been attached under a decree or sold under process of law.
(vi) When the business of the firm cannot be carried on except at a loss.
(vii) When the court is satisfied as to grounds which render it just and equitable to dissolve the firm.

Q: How the accounts are settled on dissolution of a firm?

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Ans.:

Settlement of Accounts on Dissolution

The mode of settlement of accounts between partners after the dissolution of a firm is determined by the partnership agreement. In the absence of any specific agreement between them in this regard, provisions of the Indian Partnership Act will apply.

1) **Sale of goodwill**: In settling the accounts of a firm after dissolution, the goodwill shall be included in the assets and it may be sold either separately or along with other property of the firm.

2) **Sharing of Deficiency**: Losses, including deficiencies, of capital, shall be paid first out of profits, next out of capital, and lastly, if necessary, by the partners individually in the proportions in which they are entitled to share profits.

3) **Application of Assets**: 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:

   (i) in paying the debts of the firm to third parties;
   (ii) in paying to each partner rateably what is due to him from the firm for advances as distinguished from capital;
   (iii) in paying to each partner rateably what is due to him on account of capital; and
   (iv) the residue, if any, shall be divided among the partners in the proportions in which they are entitled to share profits".

In other words, on dissolution of the firm, the normal business of the firm comes to an end and the assets of the firm are sold. The cash realised on sale of assets will be first used for paying outside liabilities of the firm and the surplus cash (if any) left after paying outside liabilities will be distributed among the

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partners. In short, the amount available will be used in the following order:

(i) Payment of expenses incurred on sale of the assets and collecting the debts due to the firm, i.e. realisation expenses.

(ii) Payment of outside liabilities of the firm, e.g., creditors, bank overdraft, borrowings, bills payables, loans from partners' wives etc. Secured creditors will get preference over unsecured creditors upto the value of amount secured or realisable value of asset/ assets given as security whichever is less. Unsecured portion of such creditors will rank pari passu with other unsecured creditors.

(iii) Repayment of the partners' loans given to the firm.

(iv) Payment of the capital accounts of the partners i.e., settlement of capital accounts of the partners which are left after transferring losses, profits, reserves and the effect of entries relating to dissolution.

If the assets, on dissolution, after satisfying all the liabilities to the third parties and advances of the partners, are insufficient to repay to each partner his full capital, the deficiency in the capital shall be borne by the partners in the proportion in which they are entitled to share profits.

Inability of a partner to contribute towards Deficiency: *If a partner is unable to contribute towards the deficiency of his capital account, he/ she is said to be insolvent, and the sum not recoverable is treated as capital loss for the firm.* **In the absence of any agreement** *to the contrary, such a capital loss is to be borne by the remaining solvent partners in accordance with the principle laid down in Garner vs. Murray case, which states that the solvent partners have to bear such loss in the ratio of their capitals as on the date of dissolution.*

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4) **Firm Debts and Private Debts:** Where there are partnership debts and private debts of the partners in their individual capacity, the rules for settlement of the debts are as follows:

(a) The assets of the firm shall be first applied in payment of the debts of the firm and surplus of assets, if any, would be paid to the partners in the proportion in which they were entitled to share profits.

(b) The private property of each partner shall be applied first in the payment of his private debts, and the surplus of private assets, if any, would be handed over to the firm if the firm needs it for the payment of its debts

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Q: Distinguish between firm's debts and private debts.

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Ans.:

Distinction Between Firm's Debts and Private Debts:

Basis	Firm's Debts	Private Debts
Meaning	Firm's debt means the debt owed by the firm to outsiders.	Private debt means debt owed by a partner in his personal capacity to any other person.
Liability	All the partners are liable jointly and severally for firm's debt.	The concerned partner is liable personally for his private debt.
Application of Firm's Property	Firm's property shall be applied first for settling firm's debts.	The share of the concerned partner in excess of firm's property over firm's debts can be applied for private debts.

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Application of Private Property	The excess of partner's private property over his private debts can be applied for firm's debts.	Private property shall be applied first for private debts.

Dissolution Before Expiry of a Fixed Term (Section 50)

If a partner on his admission in the firm has paid a premium (i.e. goodwill) to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain period, he will be entitled to a suitable refund of the premium if the firm is dissolved before the term has expired. However, no claim in this respect will arise if:

(i) the firm is dissolved due to the death of a partner.
(ii) the dissolution is mainly due to the partner's (claiming refund) own misconduct.
(iii) the dissolution is as a result of an agreement containing no provision for the return of the premium or any part of it.

The refund of the premium will be such as is reasonable having regard to the terms upon which the admission was made and to the length of the period agreed and the period expired upto the dissolution date. Any refund of premium that becomes due on the dissolution will be debited to other partners' capital accounts in their profit sharing ratio and credited to the refund claiming partners' capital account.

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Q: What is a realisation account? Differentiate between realisation account and revaluation account. *(www.prepnext.com)*

Ans.:

Realisation Account: Realisation Account is prepared in order to realise the assets of the firm and the amount so realised is utilised for the payment of liabilities of firm according to the provisions of the Act. If there are any expenses incurred by the firm in realising the assets of the firm (known as realisation expenses) they are debited to this account. The difference between two sides of this account discloses either the profit or loss on realisation and will be transferred to partners' capital accounts in their profit sharing ratio.

Difference between Realisation Account and Revaluation Account:

Basis of Distinction	Realisation	Revaluation
Time Factor	Is prepared at the time of dissolution of the firm.	Is prepared at the time of admission, retirement, death of the partner, etc.
Purpose	Realisation account is prepared to ascertain profit or loss on the **disposal** of assets and payment of liabilities, and to distribute the profit or loss thus revealed among the partners.	Its main purpose is to ascertain profit or loss on the revaluation of assets and liabilities of the firm at the time of admission, retirement or death of the partner. The profit or loss thus revealed is distributed among the partners entitled for it.
Transfer of Profit/ Loss	In case of dissolution, Profit or Loss on realisation is transferred to all partners' capital accounts.	Profit or Loss on revaluation is transferred to **old** partners' capital accounts in case of admission and to **all** partners' capital accounts in case of retirement and death.
Expenses	It contains an entry for the expenses on dissolution.	It does not contain any entry for the expenses incurred on revaluation of assets and liabilities.

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Effect	It records the effect of realisation of various assets and payments of various liabilities.	It records the effect of revaluation of assets and liabilities.
Repetition of Accounts	This account is prepared only once during the life time of business	This account may be repeated/ prepared many times during the life time of business.
Closing of Accounts	Accounts of assets and liabilities transferred here are closed.	Accounts of assets and liabilities shown in this account are not closed.

Q: Explain Garner vs. Murray rule in case of insolvency of a partner. *(www.prepnext.com)*

Ans.:

Insolvency of a Partner – Garner vs. Murray

If a partner's capital account shows a debit balance on the dissolution of the firm, he is to pay the debit balance to the firm to settle his account. But if such partner is insolvent, i.e., unable to satisfy his debt to the firm, then his deficiency which he is not able to bring will be borne by the other solvent partners in accordance with the decision in *Garner vs. Murray*. In this case it was ruled that, in the absence of any agreement to the contrary, the deficiency of the insolvent partner's Capital Account must be borne by other solvent partners in proportion to their capitals which stood before the dissolution of the firm. The effect of this ruling is to make a distinction between an ordinary loss due to trading or realisation of assets and loss on account of insolvency of a partner. The loss on account of the insolvency of a partner is a capital loss and as such should be borne by other solvent partners in proportion to their capitals. The practice before this decision was to share the deficiency of the insolvent partner by the solvent partners in their profit and loss sharing ratios. No distinction was observed between trading loss and capital loss.

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Another ruling in *Garner vs. Murray* case is that the solvent partners should bring in cash equal to their share of loss on realisation. This ruling has been given to bring the capital accounts of the solvent partners to the figures that stood before transferring the loss on realisation. A large majority of the accountants are of the view that the second ruling given in the *Garner vs. Murray* case is a useless ruling. The argument advanced by them against this ruling is that it is unreasonable to ask a solvent partner to bring in cash his share of loss on realisation when he already has a credit balance in his capital account. The only point to be kept in mind is that the deficiency of the insolvent partner should be borne by the solvent partners in proportion to their capitals which stood before debiting the loss on realisation.

Applicability of the Decision in Garner vs. Murray in India

In the absence of any specific provision in the Indian Partnership Act, 1932 and any decision of a court in India, it is a common practice to seek guidance from the English law. Therefore, it has become a practice in India to follow the decision in the *Garner vs. Murray* case in the absence of any specific agreement between the partners with regard to sharing the deficiency of an insolvent partner.

Fixed and Fluctuating Capitals:

While determining the capital ratio of the solvent partners, distinction should be observed between fixed and fluctuating capital. If the capitals of the partners have been agreed to be **fixed** then no adjustment is required for accumulated profits or losses, interest on capitals, drawings etc. and deficiency of the insolvent partner is borne by the solvent partners in proportion to their agreed fixed capitals. All adjustments relating to accumulated profits or losses, reserves, interest on capitals and drawings will be recorded in the current accounts of the partners. The deficiency of the insolvent partner will

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be ascertained after transferring the balance of the insolvent partner's current account to his capital account. The deficiency of the insolvent partner should be transferred to the current accounts of the solvent partners in proportion to their agreed fixed capitals. The entry is:

Solvent Partners' Current Accounts Dr.

To Insolvent Partner's Capital Account

(Being transfer of the deficiency of the insolvent partner to the solvent partners' current accounts in proportion to their agreed fixed capitals)

But is the capital accounts are maintained on **fluctuating** basis, then capital accounts should be adjusted for reserves, profits or losses, interest on capitals, drawings and unrecorded assets and liabilities on the date of the balance sheet just before the dissolution of the firm. The capitals thus arrived at should be the basis of ratio according to which the deficiency of the insolvent partner is to be borne by the solvent partners. It may be remembered that the loss on realisation is not to be taken into consideration while ascertaining the capital ratio of the solvent partners because deficiency of the insolvent partner is to be met by the solvent partners in proportion to their capitals which stood before the dissolution of the firm. The entry for meeting the deficiency is:

Solvent Partners' Capital Accounts Dr.

To Insolvent Partner's Capital Account

(Being transfer of the deficiency of the insolvent partner to the solvent partner's capital accounts).

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Criticism of the decision in *Garner vs. Murray:*

The criticism of the decision in *Garner vs. Murray* is that it violates the principles of natural justice and equity. If some solvent partner is having a debit balance in his capital account on the dissolution date, he will not have to bear the loss on account of the deficiency of the insolvent partner because capital ratios of the solvent partners are based on their respective credit balances. Thus, **solvent partners having a debit balance in his capital account is not to meet any share of the deficiency** even though he may be financially more sound as compared to other solvent partners.

Another criticism of this case is that **it puts more burden on partners who have helped the firm** by contributing more capital than other partners who have contributed less capital because loss on account of deficiency of a partner is to be divided among solvent partners in proportion to their capitals which stood before the dissolution date and not in proportion to their profit sharing ratio.

Also, a large majority of the accountants are of the view that the second ruling given in the *Garner vs. Murray* case is a useless ruling. The argument advanced by them against this ruling is that it is unreasonable **to ask a solvent partner to bring in cash his share of loss on realisation** when he already has a credit balance in his capital account.

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