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ଓଡ଼ିଶା ରାଜ୍ୟ ମୁକ୍ତ ବିଶ୍ୱବିଦ୍ୟାଳୟ,
ସମ୍ବଲପୁର, ଓଡ଼ିଶା

Odisha State Open University
Sambalpur, Odisha

DIPLOMA IN ACCOUNTING (DIA)

PARTNERSHIP ACCOUNTING

Dissolution of Partnership Firm

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Odisha State Open University, Sambalpur, Odisha
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Diploma in Accounting (DIA)

DIA 04: Partnership Accounting

Block 3

Dissolution of Partnership Firm

UNIT 01: DISSOLUTION OF PARTNERSHIP FIRM

Learning objectives:

After studying this lesson, you will be able to know:

Meaning of Dissolution, settlement of accounts between partners after dissolution, golden rule for dealing with the problem of dissolution, insolvency of a partner, Rule of Garner vs Murray applicability of this rule in India and piecemeal distribution.

Structure:

2.1 Introduction

2.2 Meaning of Dissolution

2.3 Causes of general dissolution

2.4 Dissolution of partnership vs. dissolution of firm:

2.5 Illustrations

2.1 Introduction:

The dissolution of partnership among all the partners of a firm is called the Dissolution of the Firm (Sec. 39 of the Partnership Act, 1932). Dissolution of firm means complete breakdown of the relation of partnership among all the partners. When all the partners resolve to dissolve the partnership, the dissolution of firm occurs, i.e. the firm is wound up. If the business comes to an end, it is said that the firm has been dissolved. Dissolution of firm means the closing down of the business. Firm's dissolution implies partnership dissolution but not vice versa.

2.2 Meaning and definition of dissolution:

2.3 Causes of general dissolution :

The general dissolution of a partnership will usually be instigated as a result one of the following events:

- The mutual agreement of the partners – which may be an ad hoc agreement, or an agreement enshrined in the partnership agreement, for example, it was agreed that the partnership would be dissolved after a particular date or after a certain event. Such an agreement may be implied rather than actual.
- By the serving of a notice by a partner where such an action provided for in partnership agreement.
- The exercise of a specific power in the partnership agreement – where, for example, the partnership agreement allowed a majority of the partners to seek dissolution.
- The exercise of a power in the legislation.
- One of the events provided for in the legislation e.g., the death or bankruptcy of a partner – subject to contrary agreement.
- Fraud, misrepresentation, rescission or illegal activity.
- By an order of court, for example, the mental incapacity or other ill-health of a partner.
- Where the business may only be carried on at a loss.

2.4 Dissolution of partnership vs. dissolution of firm: Dissolution of a partnership firm merely involves a change in the relation of partners; whereas the dissolution of firm amounts to a complete closure of the business. When any of the partners dies, retires or become insolvent but if the remaining partners still agree to continue the business of the partnership firm, then it is dissolution of partnership not the dissolution of firm. Dissolution of partnership changes the mutual relations of the partners. But in case of dissolution of firm, all the relations and the business of the firm comes to an end. On dissolution of the firm, the business of the firm ceases to exist since its affairs are would up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

Dissolution of a Firm

A firm may be dissolved in the following manner

(A) **Dissolution by Agreement** (Sec. 40): A firm may be dissolved at any time with the consent of all partners. For instance, when a firm does not expect good prospects in the future, a firm can be dissolved by mutual consent of all partners.

(B) **Compulsory Dissolution** (Sec. 41): A firm is compulsorily dissolved by operation of law when all the partners except one become insolvent or when all the partners become insolvent or when business becomes illegal or when the number of partners exceeds twenty in case of ordinary business or ten in case of banking.

(C) **Dissolution on the Happening of Certain Contingencies** (Sec. 42): A firm is dissolved, in the event of any of the following circumstances:

(i) The expiry of the term for which it was formed.

(ii) The completion of the venture for which the partnership was constituted.

(iii) The death of a partner.

(iv) The adjudication of a partner as an insolvent.

(D) **Dissolution by Notice of Partnership at Will** (Sec. 43): Where a partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

(E) **Dissolution by the Court** (Sec. 44): The court is empowered to order the dissolution of a firm consequent on a suit by a partner in the following cases:

(i) When a partner becomes insane or unsound of mind.

(ii) When a partner becomes permanently incapable of performing his duties, be it mental or physical.

(iii) When a partner is proved guilty of misconduct which is likely to affect adversely the business of the firm.

(iv) When a partner conduct himself in such a way that it is not possible for the other partners to carry on partnership with him.

(v) When a partner transfers his interest or share to third party.

(vi) When the business cannot be carried out except at a loss. (It must be remembered that the object of partnership is to earn profits and if that object is not fulfilled, the firm can be dissolved).

(vii) When it appears to be just and equitable. For instance, continued quarrelling, deadlock in the management, refusal to attend matters of business, absence of cooperation etc. among the partners. (The court has wide discretionary powers).

Settlement of Accounts (Sec. 48):

As soon as a firm is dissolved, it ceases to transact normal business. 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 as to the mode of settlement of accounts after the dissolution of the firm, the Partnership Act laid down the following provisions (Sec. 48) for settlement of accounts.

(a) Losses, including deficiencies of capital, shall be paid first out of profit, next out of capital, and lastly, if necessary, by the partners individually in their profit-sharing ratio.

(b) 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 each partner rateably what is due to him from the firm for advances.

(iii) In paying to each partner rateably what is due to him on account of capital, and

(iv)The surplus, if any, will be divided among the partners in their profit sharing ratio.

Firm’s Debt and Personal Debts:

Where debts owe both the firm and the partners individually, the rule under section 49 is:

(i) To apply the firm’s assets first in paying off the firm’s debts and out of the surplus left, if any, each partner’s share thereof is applied in meeting his personal debts, and

(ii) To apply the private property of each partner first in paying off his personal debts and the residue, if any, is applied to pay off the firm’s debts.

Dissolution Accounts:

When a business is discontinued, the firm is said to be dissolved. As a result, all the accounts be closed. It is, therefore, necessary to open Realization Account, Cash or Bank Account and Partners Capital Accounts.

(i) Realisation Accounts is opened for all transactions relating to realisation of assets and payment of liabilities. That is, on dissolution, it is essential to make sale of assets of the firm, realize cash and paying off the liabilities.

Realisation of assets and settlement of liabilities are centered round the Realisation Account. It is a nominal Account. The difference, being gain or loss will be transferred to Capital Accounts.

(ii) Cash/Bank Account is opened to record all cash transactions. When the purpose is over the Cash Account shows a balance, which is equal to the amounts due to partners.

(iii) Capital Accounts are opened to make all entries connected with the partners' accounts. Current Accounts, if any, are transferred to Capital Accounts. Finally the Capital Accounts are closed by receiving or paying cash.

The Six Golden Rules:

There are six golden rules about dealing with the problem of dissolution of firm:

(i) If a balance sheet on the date of dissolution is not given in the question first of all, the balance sheet should be prepared in proper form.

(ii) At the time of dissolution of firm, balances of accounts given in the Balance Sheet are once shown in Realisation account or Partner's Loan Account or Partners' Capital Accounts of Cash/ Bank Account but the transactions given outside the balance sheet are shown twice in said mentioned accounts.

(iii) All the assets must be sold or otherwise disposed of.

(iv) All of the creditors must be paid. Partners, who have contributed beyond their capital i.e. partner's loan must also be included in this category.

(v) The amount due to each partner must be paid.

(vi) The total of both the sides of cash/ bank account must be equal.

Illustration 1. The Balance Sheet of R and S as on 31st December, 1998 was as under:

Balance Sheet

Liabilities	**Rs.**	**Assets**	**Rs.**
Creditors	20,000	Goodwill	18,000
R's Loan	10,000	Building	60,000
R's Brother's Loan	30,000	Stock	45000
Capital Account		Debtors	18000
R 30,000		Cash in Hand	6000
S 60,000		Cash at Bank	3000
	90,000		
	1,50,000		**1,50,000**

The firm was dissolved on 1st January, 1999. Rs.1, 500 became bad out of debtors and nothing could be realized of good will. Stock was sold at 10% less than book value and Building realized at Rs.90, 000. Creditors were paid off at discount of 3%. Dissolution expenses amounted to Rs.1, 500.00

Pass journal entries and prepare necessary accounts to close the books of the firm.

Solution

Journal

Realization on A/c Dr. To Goodwill A/c To Building A/c To Stock A/c To Debtors A/c (For transfer of various assets to realization a/c at their book value)	Rs.1,41, 000	
		Rs.18, 000
		Rs.60, 000
		Rs.45, 000
		Rs.18, 000
Cash A/c Dr. To Bank A/c (For cash withdrew from bank)	3,000	
		Rs.3,000

Creditors A/c Dr.	Rs. 20,000	
R's Brother's Loan A/c Dr.	Rs.30,000	
To Realization A/c		50,000
(For transfer of outside liabilities to realization a/c at their book value)		
Cash A/c Dr.	1,47,000	
To Realization A/c		1,47,000
(For assets realized in cash)		
Realization A/c Dr.		
To Cash A/c		
(For payment of dissolution expenses)		
Realization A/c Dr.	1,500	
To Cash A/c		1,500
(For payment of dissolution expenses)		
Realization A/c Dr.	49,400	
To Cash A/c		49,400
(for payment of outside liabilities)		
R's Loan A/c Dr.	10,000	
To Cash A/c		10,000
(For partner R's loan paid off)		
Realization A/c Dr.	5,100	
To R's Capital A/c		2,550
To S's Capital A/c		2,550
(For profit on realization transferred to partners' capital a/c s in their profit sharing ratio)		
R's Capital A/c Dr.	32,550	
S's Capital A/c Dr.	62,550	
To Cash A/c		95,100
(For final payment made to the partners		

Accounting Treatment of Provision or Undistributed Profits/ Losses

(1) Transfer of provision to realization account : Provision means it is created for a specific purpose and can be utilized for that purpose e.g. provision for bad debts, joint life policy fund, investment fluctuation fund etc.

(a) If there exists a provision against any assets should be transferred to the credit side of realization account and the foll9owing entry will be passed :

Provision for Bad Debts A/c	Dr.
Provision for Discount on Debtors A/c	Dr.
Investment Fluctuation Fund A/c	Dr.
Joint Life Policy Fund A/c	Dr.
Provision for Depreciation A/c	Dr.
To Realization A/c	
(For transfer of specific reserve to realization a/c)	

Note: Provision is not to be paid as these are not the liabilities.

(b) Provision which has a debit balance should be transferred to the debit side of realization account and entry will be:

Realization A/c

To Provision for Discount on Creditors A/c

(For transfer of specific reserve to realization a/c)

(2) Transfer of undistributed profits / losses to partners' capital accounts:

(a) Undistributed profits such as General Reserve, Reserve Fund, and Credit balance of Profit & Loss Account etc. are not to be transferred to Realization Account. These accounts are transferred to partners' capitals are transferred to partners' capital accounts in their profit sharing ratio. The following entry will be passed:

General Reserve A/c Dr.

Reserve Fund A/c Dr.

Profit & Loss A/c Dr.

Workmen’s' Compensation Fund Dr.

To Partners' Capital A/cs

(For the transfer of undistributed profits to partners' capital accounts in their profit sharing ratio)

(b) If undistributed loss i.e. Dr. Balance of Profit & Loss Account, advertisement expenses etc. is given in the assets side of balance sheet, the following entry will be passed :

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

(For the transfer of undistributed loss to partners' capital accounts in their profit sharing ratio)

Illustration. A, B and C are sharing profits and losses in the ratio of 5: 3: 2. On 31st March, 1999 their balance sheet was as under

Liabilities	**Rs**	**Assets**	**Rs**
Creditors	15000	Cash at Bank	13000
General Reserve	10000	Debtors Less : Provision for B/D	24000
A’s Loan	16000	Investment	8000
Joint Life Policy Fund	8000	Joint Life Policy	15000
Investment Fluctuation Fund	2000	Plant	80000
A’s Capital	60,000	Stock	36000
B’s Capital	40,000		
C’s Capital	25,000		
	176000		**176000**

The firm was dissolved on the above date. The joint life policy is surrendered for Rs.10, 000. The investments are taken over by B at Rs.7, 5000. C takes over the debtors amounting to Rs.12, 000 at Rs.10, 000. Plant is sold for Rs.63, 600 and the Stock for Rs.42, 000. The remaining debtors realized 60% of the book value. A agreed to accept Rs.15, 100 in full settlement of his loan. The expenses of realization amounted to Rs.800.

Give journals entries and draw up the necessary ledger to close the books of the firm.

Solution

Journal

	Particulars			**Debit - Amount**	**Credit - Amount**
	Realisation A/c	Dr		. 164, 000	
	To Debtors A/c				25, 000
	To Stock A/c				36, 000
	To Investment A/c				8, 000
	To Joint Life Policy A/c				15, 000
	To Plant				80,000
(For transfer of various assets to realization a/c at their book value)					
	Creditors A/c	Dr.		15, 000	
	To Realization A/c				15,000
	(For transfer of liabilities to realization a/c at book value)				
	Provision for Bad Debts A/c	Dr.		1, 000	
	Joint Life Police Fund A/c	Dr.		8, 000	
	Investment Fluctuation Fund A/c	Dr.		2, 000	
	To Realization A/c				11, 000
	(For transfer of special reserve to realization account.				
	General Reserve A/c	Dr.		10, 000	
	To A's Capital A/c				5, 000
	To B's Capital A/c				3, 000
	To C's Capital A/c				2, 000
(For transfer of general reserve to Partners' Capital a/c s in their profit sharing ratio 5 : 3 :2)					
	Bank A/c	Dr.		1,23,400	
	To Realization A/c				1, 23,400
(For assets realized)					
	B's Capital A/c	Dr.		7, 500	
	C's Capital A/c	Dr.		10, 000	
	To Realization A/c				17,500

(For assets taken over by the partners)		
Realisation A/c Dr. To Bank A/c (For payment of realization expenses)	800	800
Realization A/c Dr. To Bank A/c (For payment of outside liability)	15, 000	15, 000
A's Loan A/c Dr. To Bank A/c To Realisation A/c (For A's loan paid off under discount Rs.900)	16, 000	15, 100 900
A's Capital A/c Dr. B's Capital A/c Dr. C's Capital A/c Dr. To Realisation A/c (For loss on realization transferred to capital a/c)	6, 000 3, 600 2, 400	12, 000
A's Capital A/c Dr.	59, 000	
B's Capital A/c Dr.	31, 900	
C's Capital A/c Dr.	14, 600	
To Bank A/c		1, 05, 500
(For final payment of partner's capital)		

Ledger Accounts

Realization Account

	Rs.		Rs.
To Debtors	25,000	By Creditor s A/c	15,000
To Stock	36,000	By Provision for Bad Debts A/c	1,000
To Investments	8,000	By Life Policy Fund A/c	8,000
To Joint Life Policy	15,000	By Bank A/c (asserts realized i.e. 10,000 + 63,600 + 42,000 + 7,800)	2,000
To Plant	80,000	By Bank A/c (Assets Realized i.e. 10,000+63,600 + 42,000 + 7,800	1,23,400
To Bank A/c (expense)	800	By B's Capital A/c (Assets, Taken)	7,500
To Bank A/c (liability paid)	15,000	By C's Capital A/c (Assets Taken)	10,000
		By A's Loan A/c (Discount)	900
Total (Dr.)	1,79.800	Total (Cr.)	1,67,800
		By Loss Transferred to Capital A/c s.	
		A 5/10 6,000	
		B 3/10 3,600	
		C 2/10 2,400	12,000
	1,79,800		**1,79,800**

A/s Loan Account

	Rs.		Rs.
To Bank A/c	15,100	By Balance b/d	16,000
To Realization A/c	900		
	16,000		**16,000**

Partner's Capital Account

Particulars	A	B	C	Particulars	A	B	C
To Realization A/ c (assets taken)	-	7, 500	10,000	By Balance b/ d	60, 000	40, 000	25, 000
To Realization A/ c (loss)	6, 000			By General Reserve A/ c	5, 000	3, 000	2, 000
To Bank (Final Payment)	59, 000	31, 900	14, 600				
	65, 000	**43, 000**	**27, 000**		**65, 000**	**43, 000**	**27, 000**

Bank Account

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Bank b/d	13,000	By Realization A/c (Expenses)	800
To Realization (Assets Realized)	1,23,400	By Realization A/c (Liability)	15,000
		By A's Loan A/c	15,100
		By A's Capital A/c	59,000
		By B's Capital A/c	31,900
		By C's Capital A/c	14,600
	1,36,400		**1,36,400**

Note: (1) Since nothing is mentioned about creditors, it is assumed that this is paid in full.

(2) Provision for Bad debts, Joint Life Policy Fund, Investment Fluctuation Fund being special reserve has been transferred to the credit side of Realization Accounts. At they are not outside liabilities, hence their payment will not be made.

(3) Sundry Debtors and Provision for Bad debts account are two separate accounts and these accounts should be transferred separately to realization a/c.

Accounting Treatment for Unrecorded Assets and Unrecorded Liabilities

(i) **Unrecorded assets:** Sometimes it may happen at the time of dissolution of the firm that there are some assets in the business which do not appear in the books. These assets are known as unrecorded assets. For example, at the time of dissolution, firm had a scooter which was not shown in the books. It can be sold for Rs. 4,500. In this case accounting entries will be passed as follows :

(a) If cash realization from unrecorded assets :

Cash/Bank A/c	Dr.	4,500	
To Realisation A/c			4,500

(b) If unrecorded assets taken over by a partner:

Partner's Capital A/c	Dr.	4,500	
To Realisation A/c			4,500

(2) Unrecorded liabilities: It may sometimes happen at the time of dissolution of the firm that there are certain liabilities which do not appear in the books. These liabilities are known as unrecorded liabilities. For example at the time of dissolution of firm compensation to employees paid by the firm amounted to Rs. 10,000. This liability was not provided in the books. For this purpose, the following accounting entries will be passed:

(a) If Cash payment is made for unrecorded liability:

Realisation A/c	Dr.	10,000	
To Cash/Bank A/c			10,000

(b) If unrecorded liability taken over by a partner:

Realisation A/c	Dr.	10, 000	
To Partner's Capital A/c			10,000

Note: Both unrecorded assets and unrecorded liabilities are not transferred to realization

Account because they have no account in the books.

Accounting Treatment of Good will

In the case of dissolution of a firm, goodwill should be treated just like other assets. If nothing is mentioned about the realization of goodwill, it can be assumed that the goodwill is valueless and as such, nothing is received or realized for it.

Illustration: (Unrecorded assets and unrecorded liabilities) A, B and C are partners sharing profits and losses equally. Their Balance Sheet as on June 30, 1999 is as follows:

Balance sheet

Liabilities	**Rs.**	**Assets**	**Rs.**
Creditors	25000	Cash at Bank	2000
Bills Payable	10000	Debentures	18000
Mrs A’s Loan	5000	Stock	25200
B’s Capital	60000	Bills Receivable	8000
C’s Capital	40000	Machinery	60000
		Goodwill	6000
		P/L A/c	10800
		C’s Capital	10000
	1,40,000		**1,40,000**

They decided to dissolve the firm. Following was the position:

(1) Assets were realized as follows: Stock Rs. 27,200, Debtors Rs. 15,000 and machinery at Rs. 60,000.

(2) B took away all the Bills Receivable at Rs. 7,000 and also agreed to make the payment of Bills Payable.

(3) There was an unrecorded asset of Rs.4, 000 which was taken over by C at Rs. 1,200.

(4) A bills receivable for Rs. 2,000 was received from a customer Sanjay which was discounted from bank. Sanjay became insolvent and 60 paise per rupee have been received from his estate.

(5) A agreed to pay off his wife's loan.

(6) Creditors were settled at 10% discount.

(7) Realisation expenses amounted to Rs. 900 are met by B.

Pass journal entries and prepare necessary ledger accounts to close the books of the firm.

Partner's Capital Accounts

	A	**B**	**C**		**A**	**B**	**C**
To Balance b/d		3600	10,000	By balance b/d	60000	40000	
To Profit & Loss	3600	7000	3600	By Realization A/c (Expenses)		900	
To Realization A/c	2000	2000	1200	By Realization A/c (Liabilities Taken)		10000	
To Bank A/c	59400	38300	2000	By Bank A/c (Deficit)			16800
	65000	**50900**	**16800**		**65000**	**50900**	**16800**

Bank Account

Receipts	**Rs.**	**Payments**	**Rs.**
To Balance b/d	2000	By Realization A/c	24500
To Realization A/c	103400	(Liabilities Paid)	
(Sale Proceeds)	16800	By A's Capital A/c	59400
To C's Capital A/c		By B's Capital A/c	38300
	122200		**122200**

Note: (1) Goodwill being intangible assets has been treated as valueless.

(2) There is deficit in the capital account of C. If it is not mentioned in the question that partner is insolvent, it is assumed that he will bring required cash.

Illustration: A, B and C are three partners sharing profits in the ratio 3: 1: 1. On 31^{st} March, 1999, they decided to dissolve their firm. On that date, their balance sheet was as under:

Liabilities	**Rs.**	**Assets**	**Rs.**
Creditors	6,000	Cash	3,200
Loan	1,500	Debtors 24,200	
Capital A/c	44,500	Less : Provision for Bad Debts 1,200	23,000
A 27,500		Stock- in- Trade	7,800
B 10,000		Furniture	1,000
C 7,000		Sundry Assets	17,000
	52,000		**52,000**

It is agreed that:

(i) A is to take over Furniture at Rs. 800 and Debtors amounting to Rs. 20,000 at Rs. 17,200; the Creditors of Rs. 6,000 to be paid by him at this figure.

(ii) B is to take over all the Stock-in-Trade at Rs. 7,000 and some of the Sundry Assets at Rs.7, 200 being 10% less than book value.

(iii) C is to take over the remaining Sundry Assets at 90% of the book value, less Rs. 100 as discount and assume the responsibility for the discharge of the loan together with accrued interest of Rs. 30 which has not been recorded in the books.

(iv) The expenses of dissolution were Rs. 270 the remaining debtors were sold to a debt collecting agency for 50% of the book value.

Prepare necessary accounts to close the books of the firm.

(ix)	Realization A/c Dr. To Cash A/c		9,000	9,000

	(For compensation to employees paid)			
(x)	Realization A/c Dr.		13500	
	To A's Capital A/c			5,400
	To B's Capital A/c			4,050
	To C's Capital A/c			4,050
	(For profit on dissolution credited to partner's capital A/c s)			

Insolvency of a Partner:

The Capital Account of a partner may show a debit balance because of excess drawls or losses on account of realization or some other reasons. Such a debit balance is called Capital Deficiency. If the Capital Account of a partner shows a debit balance as a result of various entries passed on account of dissolution of the firm, it is expected that he will pay the money from his estate. If this is done, the other partners will be able to get in full what is due to them.

If the partner is solvent, he will have to make good such capital deficiency by bringing cash. But if the partner is unable, he may not be able to pay off even his own private liabilities. In some cases, after paying the private liabilities, a small sum which is lesser than the amount due to the firm, may be given by the partner, whose capital account shows a debit balance.

When a partner is insolvent, then such a capital deficiency will be a loss to other solvent partners. For example, if there are two partners in a firm and if one of them is insolvent, then the capital deficiency will be borne by the other partner, who is solvent. But, when there are more than 2 partners, there arise problems as to the ratio in which the capital deficiency be borne by the remaining partners.

In such a case, the deficiency shown by the insolvent partner's capital account should be divided among the solvent partners in the ratio which has already been agreed upon by them for the purpose.

Prior to the decision in the leading case of Garner vs. Murray, this loss was borne by the solvent partners in the profit sharing ratio just like trading losses. No distinction was observed between trading loss and capital loss. The rule was laid down by Justice Joyce, in November 1903, in Garner vs. Murray.

Garner vs. Murray Decision:

Garner, Murray and Wilkins were partners, in a firm, sharing profits and losses equally. Their capitals were not equal. There was no partnership deed. The firm dissolved on 30th June 1900.

The position was as follows, after dissolution:

Balance Sheet as on 30th June 1900

Liabilities	**Amount**	**Assets**	**Amount**
		Cash	
Garner's Capital	2,500	Wilkin`s Capital	1,916
Murray's Capital	314	Loss on Realisation	263
	2814		635 2814

Mr. Wilkins became insolvent and could not pay anything against the capital deficiency. When the loss on realization is distributed, Garner Capital account would be reduced of £2,288 (£ 2,500 – 212), Murray's capital would be reduced to £ 102 (314-212) and Wilkins' capital deficiency would be increased to £ 474 (£ 263 + 211).

Such a loss which is due to capital deficiency, prior to Garner vs. Murray decision, was to be borne by the solvent partners in profit sharing ratio. But, here, Murray had raised an objection and claimed that the loss is a capital loss and not a business loss. Therefore, such loss due to capital deficiency of a partner to be borne in capital ratio and not in profit sharing ratio. Murray got the decision in his favor.

In Garner vs. Murray, a historic decision was given by Justice Joyce, upholding the contention of Murray i.e. capital deficiency of insolvent partner is a capital loss and is to be shared by the solvent partners, in capital ratio, just before dissolution.

Main Points of Garner vs. Murray Decision:

1. Loss due to insolvency is a capital loss.

2. Such loss, due to insolvency, is to be shared by solvent partners in their capital ratio just before dissolution.

3. All solvent partners should bring in their share or realization loss in cash.

4. If a partner’s capital account shows a debit balance, he need not share the capital loss of the insolvent partner.

It is noteworthy that the decision in Garner versus Murray violates the principles of 'natural justice' and 'equity'. For instance, if a partner is having a debit balance of his capital account on the relevant date (just prior to dissolution) he will not bear the loss on account of insolvency of partner's even though he may be financially more sounded as compared to other solvent partners.

Application of this Rule in India

Indian Partnership Act, 1932 has no objection regarding the decision given in the case of ‘Garner Versus Murray'. Thus in the absence of any rule or instruction, this rule should be followed while attempting the question. But the solvent partners may not be required to bring the loss on realization in cash because this amount is paid back to the solvent partners. It is against the principle of accountancy. Hence,

(i) Debit balance of insolvent partner's capital account (deficiency) should be divided amongst the solvent partners in the ratio of their capitals.

(ii) Where in examination question specifies that the rule in 'Garner vs. Murray' is to be applied, the solvent partners should be required to bring the loss on realization in cash otherwise not.

Application of Garner vs. Murray Rule in India:

The rule of Garner vs. Murray is applicable in India only if:

(a) There is no agreement to the contrary.’

(b) The capitals of partners are not in profit sharing ratio.

(c) There must be capital deficiency in a partner’s capital account.

Illustration: Taking facts of the case Garner versus Murray, you are required to give ledger accounts so as to show the final distribution among partner as per decision of case.

Solution

Realisation Account

Particulars	Rs	Particulars	Rs
To Balance b/d (Loss)	636	By Loss transferred to Capital A/c Garner 1/3 212 Murray 1/3 212 Wilkins 1/3 212	636
	636		**636**

Partner's Capital Accounts

Particulars	Garner	Murray	Wilkins	Particular	Garner	Murray	Wilkins
To Balance b/d To Realization A/c (Loss) To Wilkins Capital A/c (Deficit) To Cash A/c (F. Payment)	212 422 2, 078	– – – – 212 532 61	2 6 3 212 –	By Balance b/d By Cash A/c By Garner's Capital A/c By Murray' s Capital A/ c	2,500 212	314 212	– – – – – 422 53
	2,712	**526**	**475**		**2712**	**526**	**475**

Cash Account

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Balance b/d	1915	By Garner's Capital	2078
To Garner's A/c	212	By Murray's Capital	261
To Murray's A/c	212		
	2339		**2339**

Note: (1) Garner and Murray being solvent partners have brought their share of realization loss in cash.

(2) Wilkins capital deficiency of Rs 475 is borne by Garner and Murray in their capital ratio (before dissolution), i.e., Rs 2,500: Rs 314 or 8: 1 Garner: 475 x 8/9 = 422, Murray: 475 x 1/9 = Rs. 53

Illustration 6. (Capitals are fluctuating) A, B and C were in partnership sharing profits and losses in the ratio of 2: 2: 1. Their Balance Sheet on the date of dissolution was as follows:

Liabilities	Amount (Rs)	Assets	Amount (Rs)
Sundry Creditors	7,400	Cash at Bank	2100
General Reserve	10,000	Sundry Debtors Less : Provision for Bad Debts	15300
Capital Accounts A - 50,000 B - 32,000	82,000	Stock in Trade	28600
		Furniture	4000
		Building	40000
		Capital Account of C	9400
	99,400		**99,400**

Assets Realized: Debtors Rs. 12,500: Stock Rs. 16,000; and Building Rs. 42,000. Furniture is taken over by A for Rs. 1,500. Discount of Rs. 400 are secured on payments due to creditors. Outstanding creditors not provided for amounting to Rs. 1,700 were also paid. The expenses of realization amounted to Rs. 625.C was declared insolvent but Rs. 965 were recovered from his private estate. Write up the necessary accounts to close the books of the firm. Make final payment to the partners according to the decision in Garner versus Murray.

Solution.

Realisation Account

Particulars	Amount	Particulars	Amount
To Debtors	16,000	By Provision for Bad Debt	700
To Stock in Trade	28,600	By Sundry Creditors	7,400
To Furniture	4,000	By Bank (Assets Realized)	70,500
To Building	40,000	By A's Capital (Assets Taken)	1,500
To Bank (Expenses)	625	By Loss Transferred to Capital A/c A - 7130 B - 7130 C - 3565	17,825
To Bank (Liabilities Paid)	8,700		
	97925		**97925**

Partners' Capital Accounts

Particulars	**A**	**B**	**C**	**Particulars**	**A**	**B**	**C**
To Balance b/d To Realization A/c (Loss)	Rs. – – – – 1, 500 7, 130 52, 500	Rs. – – – – – – 7, 130 36, 000	Rs. 9, 400 – – – – 3, 565 –	By Balance b/d By Gen. Reserve A/c By Bank A/c By Bank A/c (Recovery) By Balance c/d	Rs. 50, 000 4, 000 7, 130 – – – – – – –	Rs. 32, 000 4, 000 7, 130 – – – – – – –	Rs. – – – – 2, 000 – – – – 965 10, 000
	61, 130	43, 130	12, 965		61, 130	43, 130	12, 965
To Balance b/d To C's Capital To Deficiency	6, 000 46, 500	4, 000 32, 000	10, 000	By Balance b/d By A's Capital A/c By B's Capital A/c	52, 500	36, 000	6, 000 4, 000
	52, 500	**36, 000**	**10, 000**		**52, 500**	**36, 000**	**10, 000**

Bank Account

Particulars	**Amount**	**Particulars**	**Amount**
To Balance b/d	2100	By Realisation A/c (Expenses Paid)	625
To Realisation A/c	70500	By Realisation A/c (Liabilities Paid)	8700
To A's Capital	7130	By A's Capital	46500
To B's Capital	7130	By B's Capital	32000
To C's Capital	9654		

Note: (1) Total Amount realized from assets = Rs. 12,500 (debtors) + Rs. 16,000 (stock) + Rs. 42, 000 (building) = Rs. 70,500.

(2) Payment of total outside liabilities = Rs. 7,000 (creditors) + Rs. 1,700 (outstanding creditors) = Rs. 8,700.

(3) In above illustration, the rule in Garner vs. Murray is to be applied. Thus, solvent partners will bring in cash their share of loss on realization. The entry will be :

Bank A/c Dr. 14,260
To A's Capital A/c 7,130
To B's Capital A/c 7,130

(4) On C's insolvency Rs. 965 are recovered from his private estate. The following entry will be made:

Bank A/c Dr. 965

To A's Capital A/c
965

(5) C's Capital account shows a debit balance of Rs. 10,000 being capital loss will be borne by A and B in their capital, ratio. In case of fluctuating capital, capital ratio will be ascertained as follows:

A
B

Rs.
Rs.

Opening Capital 50,000
32,000

(+) Share of General Reserve	4,000	4,000
Adjusted Opening Capital	54,000	36,000

Thus, capital ratio = 54,000: 36,000 or 3: 2.

Above - mentioned C's deficiency Rs. 10,000 should be borne by A and B in their capital ratio of 3: 2 which will be recorded as follows:

A's Capital a/c	Dr.	6,000	
B's Capital A/c	Dr.	4,000	
To C's Capital A/c			10,000

IIIustration 20. (Capitals are fixed) X, Y, and Z are partners sharing profits and losses in the ratio of 3: 2: 1. On 30th June, 1999, they agreed to dissolve the partnership. They appointed Y to realize the assets and distribute the proceeds. Y is to receive 5% commission on the sale of asset except cash as his remuneration and is to bear all expenses of realization. Their Balance Sheet was as follows:

When all Partners become Insolvent or Insolvency of a firm

When the partners become insolvent; creditors will not be able to get their amounts in full In such a case, outside liabilities are not to be transferred to Realisation Account but it is to be shown separately in their respective account. At the time of accounting treatment, the following points should be taken into consideration:

(i) Cash Account should be prepared after Realisation Account :

(ii) After recording the amount realized from assets together with the amounts which at received from the estate of the partners in Cash Account, first realization expenses to the paid and then remaining balance will be paid ratably to the creditors. Thus, Cash Account shows a zero balance.

(iii) After that, balance of Creditors Account which cannot be paid, should be transferred the credit side of Deficiency Account. Similarly, partner's loan will be treated.

(iv) At the end, debit balance of partners' capital accounts should be transferred to the credit side of Deficiency Account and vice-versa. Both the sides of Deficiency Account must equal.

IIIustration 25. (All partners become insolvent) Below is the Balance Sheet of M/s ABC and on 31st December, 1999:

Particulars	**Rs.**	**Particulars**	**Rs.**
Sundry Creditors	18,000	Cash	450
A's Loan	4,500	Stock	10,000
A's Capital	2,250	Debtors	3,000
B's Capital	1,350	Furniture	1350
		Building	6800
	26100		**26100**

Due to the inability to pay the creditors, the firm is dissolved. B and cannot pay anything. Can contribute only Rs. 675 from his private estate. Stock, debtors, furniture and buildings realized Rs. 14,400. Realisation expenses amounted to Rs. 1,350. Prepare accounts to close the books of the firm.

Solution:

Realization Account

To Stock	10,000	By Cash A/c (Assets Realized)	14,400
To Debtors	3,000	By Loss (Transferred to Capital A/c)	8,100
To Furniture			
To Building			
	22500		22500

Cash Account

Particulars	**Rs.**	**Particulars**	**Rs**
To Balance b/d	450	By Realization (Expenses)	1,350
To Realization A/c (Assets Realized)	14,400	By Sundry Creditors (Balancing figure being available cash paid to them)	14,175
To A's Capital A/c (Amount Received)	675		
	15,525		**15,525**

Sundry Creditors Account

	Rs.	By	Rs.
To Cash A/c	14,175	Balance b/d	18,000
To Deficiency A/c	3,825		
(Balance transferred)			
	18,000		**18,000**

Deficiency Account

To B's Capital A/c (Amount Received)	1350	By S. Creditors (Amount Paid)	3825
To C's Capital A/c (Amount Received)	7200	By A's Loan A/c (Amount unpaid)	4500
		By A's Capital A/c (Amount unpaid)	525
	8550		**8550**

Note: (1) Due to the Inability to pay the creditors means firm is insolvent.

(2) In deficiency account, loss to the firm is debited and profit to the firm is credited from the insolvency point of view.

Piece-Meal Distribution:

It has so far been presumed that the assets are disposed of on the same day of dissolution and liabilities are also simultaneously discharged. But in actual practice, the sale of assets realize gradually unless the business is sold to a buyer (vendee).

The dissolution process takes some time during which period assets are gradually realised. This is because assets are sold piece by piece and the realisation of assets will be slow and gradual.

Similarly the liabilities are paid gradually depending upon amount realized from the sale of assets. Therefore, the final results are known only when all assets are completely realized and all liabilities are completely discharged.

On realisation of assets, the cash realized is distributed in the following order:

1. Payment of realisation expenses.

2. Payment to outside liabilities i.e. Creditors, Overdraft, Bills Payable, Outstanding expenses etc.

3. Payment of Partner’s loans and advances.

4. Payment of Partners’ balance in Capital Accounts.

After making payments to outside liabilities and partner’s loan, the capitals of the partners are returned. Unless the profit or loss on realisation is known, the amount payable to partners cannot be ascertained.

If it is so, it means that the partners should not be paid till the realisation is complete. This creates a problem. This is because the profit or loss on account of realisation is to be credited or debited to Partners’ Capital Account.

It is also necessary to see that all partners have been paid and the unpaid balance of each partner being a loss must be in the ratio of profit and loss sharing ratio. It is, therefore, necessary to find out a method by which the partners are paid, as and when cash is received, without waiting till the realisation of all assets and at the same time to ensure that no partner is paid in excess and amounts left unpaid are in profit and loss sharing ratios.

Basis of Distribution:

When a firm decides to make distribution of cash as and when received, there arises a problem of determination of basis i.e. ratio in which the available cash is to be distributed, keeping share of loss to each partner in profit and loss sharing ratio. The capital contribution or balance in the Capital Account of the Partners may not be in their profit and loss sharing ratio.

The ultimate realisation loss cannot be ascertained when the distribution of cash is made on the interim basis. In such case, when the Capital is not in profit and loss sharing ratio, whichever ratio is followed, the loss shared by the partners will not be in profit and loss sharing ratio. See Illustration 17.

Out of the available cash (as mentioned above), distribution of cash may be done in the following manner:

1. First, outside liabilities are to be paid

2. Secondly, Partners Loans or Advances are to be paid

3. Thirdly and lastly, Partners’ Capital are to be paid

Now the question arises how the available cash to be distributed to the partners. The balance in the Capital Accounts of Partners may not be in profit sharing ratio. It is necessary to see that after making payments to partners, the unpaid balance of each partner, being a loss must be in Profit Sharing Ratio.

Therefore, if the Capitals of the Partners are not in profit sharing ratio, then in order to make the Partners’ Loss on realisation in their profit and loss sharing ratio and to make equitable distribution of cash, on piece-meal basis, without affecting the interest of Partners, either of the following two methods can be adopted:

1. Surplus capital Method (Proportionate Capital Method)

(or) 2. Maximum Possible Loss

I. Surplus Capital Method (Proportionate Capital Method):

When the Capitals of the Partners are not in proportion to their profit and loss ratio, the partner who has contributed more than his proportionate share of capital is paid first, in priority to the other partners.

For this purpose, the Surplus Capitals are to be found out on the basis of profit and loss sharing ratio. Thus, the initial payments are made in such a way that the capitals of all the partners are adjusted to their profit and loss sharing ratio. When this is done, the capitals will be in proportion to the profit and loss sharing ratio.

The steps are detailed below:

1. Divide undistributed profit, if any, among the Partners, in profit and loss sharing ratio.

2. Pay off realisation expenses or make a provision for it.

3. Pay off outside liabilities. If the amount is insufficient, then apportion the amount in the ratio of their claims.

4. After paying off the outside liabilities, pay off Partners' Loans when more than two partners are there and available cash is insufficient, then apportion the amount in the ratio of their claims.

5. Now partners' capitals are to be refunded. Find out the amount payable to Partners whose capitals are relatively in excess of their profit and loss sharing ratios. When the excess amounts have been paid off, the ratio of remaining balances in the Capital Account and profit and loss sharing ratio are one and the same.

To find out the excess capital, the following steps are needed:

(a) Partners' actual capitals are divided with their respective ratio figures.

(b) Take the relatively lowest capital as the base and find out notionally adjusted capital.

(c) Find out the excess of capital by comparing actual capital and notional capitals.

(d) Repeat these above steps till the number thereof reduced to one partner.

(e) Then, start paying off from the last ultimate excess first, then preceding excess till all the excesses are paid off.

(f) The balance i.e. the unpaid capitals (or losses) will be in profit and loss sharing ratio. Generally the unpaid balance would be loss on realization.

II. Maximum Possible Loss:

Under this method, it is assumed that at every stage of realization of assets; think that the remaining unrealized assets are worthless. Therefore, at every stage loss can be ascertained and this loss is distributed among the partners in profit and loss sharing ratio. The balance in the capital accounts and the cash available will be equal and the cash is paid.

The steps are:

1. Pay off Creditors first and then partners' loan account if any, out of the realized amounts.

2. Now the capitals are there to be paid. Whenever any cash is received, find out the difference between the available cash and the balance in the capital accounts. This difference is maximum loss.

3. The Maximum Loss is distributed to Capital Accounts in profit and loss sharing ratio that is from the Capital Account, the share of losses are deducted.

4. Now distribute the available cash among the partners according to their Capital Accounts as adjusted above. Here the cash available equals the sum of the partners' adjusted credit balance.

5. If any partners' capital shows a debit balance, write it off according to Garner vs. Murray ruling.

As and when further realizations are made and cash is to be distributed, the above procedure is to be followed, in all subsequent payments among the partners.

LET US SUM UP

Dissolution of firm means complete breakdown of the relation of partnership among all the partners. When all the partners resolve to dissolve the partnership, the dissolution of firm occurs, i.e. the firm is wound up. If the business comes to an end, it is said that the firm has been dissolved. Dissolution of firm means the closing down of the business. Firm's dissolution implies partnership dissolution but not vice versa. As soon as a firm is dissolved, it ceases to transact normal business. The mode of settlement of accounts between partners after the dissolution of a firm is determined by the

Partnership agreement. In paying each partner rateably what is due to him from the firm for advances

SELF-ASSESSMENT QUESTIONS

Illustration 1:

The following is the Balance Sheet of a firm as on 31st December 2005:

Liabilities	Rs	Assets	Rs
Rajs's Capital A/c	20,000	Building	20,000
Sonu's Capital A/c	12,000	Machinery	20,000
Creditors	18,000	Debtors	10,000
Bills Payable	10,000	Cash	10,000
Bank Overdraft	5,000	Profit & Loss Account	5,000
	65,000		**65,000**

The firm was

dissolved on 31st

December 2005. The

assets were realized

as follows:

Debtors Rs. 1,500; Machinery Rs. 3,000; Stock Rs. 1,200 and Factory Premises Rs, 10,000.

Bank overdraft and Bills Payable were paid in full. Creditors were settled in Rs 7,800. Realisation expenses amounted to Rs. 200.

Pass journal entries and prepare ledger accounts to close the books of the firm assuming that the profit sharing ratio between Raja and Sonu is 3: 2.

Illustration 2:

A, B and C sharing profits in the ratio of 3: 2: 1, agreed upon dissolution of firm. A was appointed to realize the assets and pay off the liabilities for which he was entitled to a lump-sum amount of Rs. 1,000.

The Balance Sheet of the firm on 31st December 2005 was as under:

Liabilities	**Rs**	**Assets**	**Rs**
Capital:		Fixed Assets	40,000
A	50,000	Inventory	20,000
B	20,000	Debtors	10,000
Creditors	30,000	C`s Capital A/c	30,000
Workman Compensation Fund	10,000	Cash	10,000
	1, 10,000		**1, 10,000**

The investments are taken over by A for Rs 18,000. B takes over all the stocks at Rs, 7,000 and debtors amounted to Rs 5,000 at Rs 4,500. Machinery is sold for Rs 55,000. The remaining debtors realize 50% of the book value. Prepare necessary ledger account on completion of the dissolution of the firm.

Illustration 3:

Chopra, Shah and Patel were carrying on business as manufacturers of sports goods. The profit-sharing ratio was 3:2:1 respectively.

Their Balance Sheet on 30th June 2005 was as under:

Liabilities	**Rs**	**Assets**	**Rs**
Capital Account		Machinery	2,00,000
Chopra	1,50,000	Closing Stock	1,00,000
Shah	2,00,000	Debtors	1,50,000
Patel	50,000	Marketable Securities	1,50,000
Creditors	2,00,000	Cash	1,00,000
Mr. Chopra’s Loan	1,00,000	Prepaid Expenses	20,000
Reserve	20,000		
	7,20,000		**7,20,000**

On this date the firm was dissolved.

The assets realized as under:

Plant and Machinery – Rs. 1, 00,000

Stock – Rs. 1, 20,000

Sundry Debtors – Rs. 1, 60.000

The investments were taken over by Chopra at a value of Rs. 20,000. He also agreed to pay Mrs. Chopra's loan. During the course of realisation it was found that a bill for Rs 50,000 previously discounted by the firm was dishonored and had to be paid.

Expenses of realization come to Rs 8,000.

Prepare Realization Account, Partners' Capital Account and Cash Account.

MODEL QUESTIONS

1. What do you mean by dissolution of firm? How dissolution of partnership differs from dissolution of firm?

2. How are accounts settled at the time of dissolution of firm?

3. What are the golden rules dealing with the problem of dissolution of firm?

4. What do you mean by insolvency of a partner what will be if all the partners become insolvent?

5. What are the propositions of Garner vs Murray? Is this rule applicable in India?

FURTHER READINGS

1. Modern Accountancy: Hanif and Mukherjee, volume –I, Tata Mcgrewhill.

2. Higher secondary Accounting: Biswal and Sharma.

3. Financial Accounting: P.C. Tulsian, Pearson.

4. An Introduction to Accountancy: S.N. Maheshwari, S.K. Maheshwari. Vikas.

ଓଡ଼ିଶା ରାଜ୍ୟ ମୁକ୍ତ ବିଶ୍ୱବିଦ୍ୟାଳୟ, ସମ୍ବଲପୁର
Odisha State Open University, Sambalpur
www.osou.ac.in
e-mail: info@osou.ac.in