

1. Details of Module and its structure

Module Detail	
Subject Name	Accountancy
Course Name	Accountancy 03 (Class XII, Semester - 1)
Module Name/Title	Dissolution of Partnership Firm – Part 1
Module Id	leac_10501
Pre-requisites	Basic knowledge of Partnership
Objectives	<p>After going through this lesson, the learners will be able to understand the following:</p> <ul style="list-style-type: none">• Define Dissolution• Explain Dissolution of partnership Firm• Explain Dissolution of partnership• Differentiate between Dissolution of partnership and Dissolution of a partnership firm• Settlement of Accounts• Private Debts and Firm's Debts
Keywords	Dissolution, Dissolution of Firm, Dissolution of partnership, Firm's Debts, Private Debts

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1.1. Introduction

Reconstitution of partnership firm takes place in case of 'Change in profit sharing ratio among existing partners', Admission of a partner, Retirement of a partner or Death of a partner. These situations lead to change in mutual relationship among the partners but do not affect the firm or do not lead to the discontinuation of the business. In case of reconstitution of old partnership comes to an end, it is termed as "Dissolution of Partnership".

On the other hand, "Dissolution of Firm" is complete closure of the firm. It not only ends the business relationship among all the partners but also leads to the closure of the business.

In the following topics, we will understand how the dissolution of the firm and partnership is understood at the time of settlement of accounts.

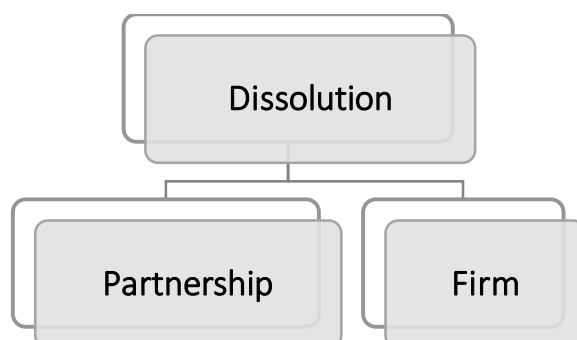
1.2. Meaning of Dissolution

According to the Cambridge English, Dissolution is defined as the act or process of ending an official organization or legal agreement.

In the books of accounts, dissolution can be either of partnership or of the firm. If the existing partnership is dissolved, the firm may continue under the same name if the partners so decide.

In other words, it results in the dissolution of a partnership but not that of the firm.

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



1.3 Dissolution of Partnership

Dissolution of partnership changes the existing relationship between partners but the firm may continue its business as before.

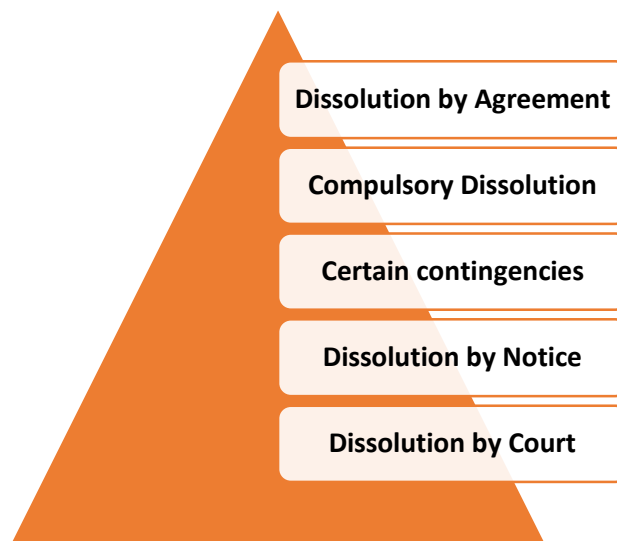
The dissolution of partnership may take place in any of the following ways:

- (i) Change in existing profit sharing ratio among partners
- (ii) Admission of a new partner
- (iii) Retirement of a partner
- (iv) Death of a partner
- (v) Insolvency of a partner

1.4 Dissolution of a Firm

The breaking or discontinuance of economic relationship between all the partners is termed as the dissolution of partnership firm. It is an end to the existence of firm and no business is transacted after dissolution except the activities related to closing of the firm like, disposing/selling firm's assets and discharging its liabilities and settlement of the claims of partners.

Dissolution of a firm takes place in any of the following ways:



i. Dissolution by Agreement: A firm is dissolved:

- (a) With the consent of all the partners;
- (b) In accordance with a contract between the partners.

ii. Compulsory Dissolution: A firm is dissolved compulsorily in the following cases:

- (a) When all the partners or all but one partner, become insolvent, rendering them incompetent to sign a contract;
- (b) When business of the firm becomes illegal;

- (c) When some event has taken place which makes it unlawful for the partners to carry on the business of the firm in partnership;

iii. Certain contingencies: A firm is dissolved subject to contract between the partners:

- (a) If constituted for a fixed term, by the expiry of that term;
- (b) If constituted to carry out one or more ventures, by the completion thereof;
- (c) By death of all the partners or all of them but one;
- (d) By adjudication of all the partner insolvent or all of them but one.

iv. Dissolution by Notice: In case of partnership at will, the firm may be dissolved if anyone of the partners gives a notice in writing to the other partners, signifying his intention of seeking dissolution of the firm.

v. Dissolution by Court: At the suit of a partner, the court may order a partnership firm to be dissolved on any of the following grounds:

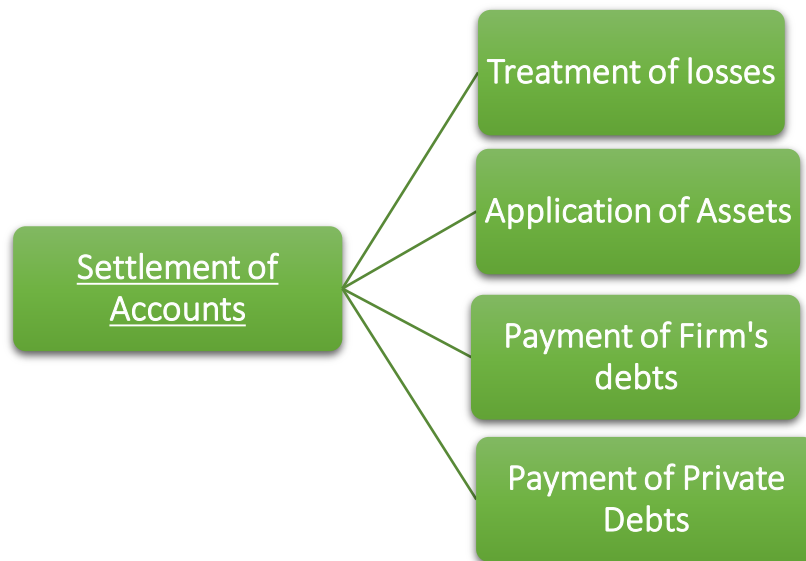
- (a) When a partner becomes insane;
- (b) When a partner becomes permanently incapable of performing his duties as a partner
- (c) When a partner is guilty of misconduct which is likely to adversely affect the business of the firm;
- (d) When a partner persistently commits breach of partnership agreement;
- (e) When a partner has transferred the whole of his interest in the firm to a third party;
- (f) When the business of the firm cannot be carried on except at a loss;
- (g) When, on any ground, the court regards dissolution to be just and equitable.

1.5 Distinction between Dissolution of a Firm and Dissolution of Partnership

<u>S.No</u>	<u>Basis</u>	<u>Dissolution of a Firm</u>	<u>Dissolution of Partnership</u>
1.	Meaning	Closure of the firm and end of relationship among all the partners.	Firm continues and there is only a change in the business relationship among the partners.
2.	Termination of business	The business of the firm is closed.	The business is not terminated.
3.	Assets and Liabilities	Assets are disposed and liabilities are discharged.	Assets and liabilities are revalued and new Balance Sheet is drafted.
4.	Closure of Books of Accounts	Required	Not Required

5.	Economic Relationship	Comes to an end.	Changes between the partners.
6.	Court's intervention	May or may not involve court.	It is Voluntary & with mutual consent.
7.	Effect	Leads to dissolution of partnership.	It may or may not lead to the dissolution of the firm.

1.6 Settlement of Accounts



1.6.1 Settlement of Accounts

The following rules as provided in Section 48 of the Partnership Act 1932 shall apply for settlement of accounts:-

1.6.1.1 Treatment of Losses:

Losses, including deficiencies of capital, shall be paid through either of the methods:

- i. First out of profits
- ii. Next out of capital of partners
- iii. Lastly, if necessary, by the partners individually in their profits sharing ratio.

1.6.1.2 Application of Assets

The assets of the firm, including any sum 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 the third parties.
- ii. In paying each partner proportionately what is due to him/her from the firm for advances as distinguished from capital (i.e. partner' loan).
- iii. In paying to each partner proportionately what is due to him on account of capital.
- iv. The residue, if any, shall be divided among the partners in their profit sharing ratio.

Thus, the amount realized from assets along with contribution from partners, if required, shall be utilized first to pay off the outside liabilities of the firm such as creditors, loans, bank overdraft, bill payables, etc., then for partners' loan (if any), after that for Partners Capitals and finally the balance left if any is distributed among the partners in their profit sharing ratio.

1.6.1.3 Firm's Debts and Private Debts:

Difference between Firm's Debts and Private Debts:

S.No	Basis	Firm's Debts	Private Debts
1.	Meaning	Debts owed by the firm to the outsiders.	Debts owed by a partner to any other person on personal account.
2.	Liability	All partners are jointly liable.	Concerned partner is liable personally for his private debts.
3.	Application of firm's Property	Firm's property is applied first for settling firm's debts.	Only share of the concerned partner in excess of firm's property over firm's debts can be applied for his personal debts.
4.	Application of Private Property	Excess of partner's private property over his private debt can be applied for firm's debts.	Private property is applied first for private debts then towards firm's liability.

1.6.1.4 Payment of Firm's Debts and Private Debts

Where both debts of the firm and private debts of a partner co-exist, the following rules, as stated in Section 49 of the Partnership Act 1932 shall apply:

- (a) The property of the firm shall be applied first in the payment of debts of the firm and then the surplus, if any, shall be divided among the partners as per their claims, which can be utilized for payment of their private liabilities.
- (b) The private property of any partner shall be applied first in payment of his private debts and then the surplus, if any, may be utilized for payment of the firm's debts, in case the firm's liabilities exceed the firm's assets. It may be noted that the private property of the partners does not include the personal property of spouse and children.

Thus, if the assets of the firm are not adequate enough to pay off firm's liabilities, the partners have to contribute out of their net private assets (private assets minus private liabilities).

Examples:

1. The firm of A, B and C was dissolved on Mar 31st 2020. B demands that his loan of ₹ 25,000 should be paid before payment of capitals of the partners. But A and

C demand that capital should be paid before the payment of B's loan. Who is correct?

Answer: 'B' is correct because as per Sec. 48 of the Partnership Act 1932, a partner's loan must be paid before payment of partners' capital.

2. X and Y are partners in a firm sharing profits in the ratio 3:2. Mrs. X has given a loan of ₹10,000 to the firm and the firm had also taken a loan of ₹10,000 from Y. The firm was dissolved and its assets were realized for ₹15,000. State the order of payment of Mrs. X's loan and Y's loan.

Answer: As per Sec. 48 of the Partnership Act 1932, Mrs. X's loan of ₹10,000 being an external liability will be paid first and then the balance of ₹.5000 will applied towards Y's Loan, being a partner's loan.

3. All the partners decide to dissolve the firm on 31st March 2020. Y, a partner, demands that his loan of ₹ 60,000 should be paid before the payment of Mrs. X's loan of ₹ 20,000. But X, another partner, demands that Mrs. X's loan should be paid before payment of Y's loan. Who is correct?

Answer: 'X' is correct because according to Sec. 48 of the Partnership Act 1932, outside party's debts are paid before the payment of partner's loan. Mrs. X is not a partner in the firm.

4. Mrs. A has given a loan of ₹20,000 to the firm and the firm had also taken a loan of ₹ 10,000 from B. The firm was dissolved and its assets were realised for ₹25,000. State the order of payment of Mrs. A's Loan and B's Loan with reasons and if there were no more creditors to the firm.

Answer: According to the section 48 of the Indian Partnership Act 1932, Mrs. A's Loan of ₹20,000, being outside party's debt will be paid before payment of B's loan. B will be paid up to the available cash i.e. ₹5,000.

Summary

Dissolution of a firm implies the discontinuance of partnership business and separation of economic relations between the partners. In the case of a dissolution of a firm, the firm closes its business altogether and realizes all its assets and pays all its liabilities. The payment is made to the creditors first out of the assets realized and, if necessary, next out of the contributions made by the partners in their profit sharing ratio. When all the accounts are settled and the final payment is made to the partners, the books of the firm are closed.

A partnership gets dissolved in case of reconstitution i.e. admission, retirement, death of a partner and change in profit sharing ratio among existing partners. It does not involve dissolution of the firm.

Dissolution of a firm takes place in any of the ways - Dissolution by Agreement, Compulsory Dissolution, Certain contingencies like firm is dissolved subject to contract between the partners: If constituted for a fixed term, by the expiry of that term; If constituted to carry out one or more ventures, by the completion thereof; By death of all the partners or all of them but one; By adjudication of all the partner insolvent or all of them but one, Dissolution by Notice and Dissolution by Court.

Debts owed by the firm to the outsiders are known as Firm's Debts and Debts owed by a partner to any other person on personal account are known Private Debts.

The accounts are settled in any of the categories that they fall under: treatment of Losses, Application of Assets, Firm's Debts and Private Debts.