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ACCOUNTING FOR DISSOLUTION OF PARTNERSHIP FIRMS

INSOLVENCY OF A PARTNER

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INSOLVENCY OF A PARTNER

On dissolution, the capital account balance of a partner may turn out to be debit balance because of the adjustments made. Such debit balance is called Deficiency. If the partner is solvent, he will make good the deficiency in his capital account bringing necessary cash in to the firm. Sometimes, a partner may not have sufficient funds with him to bring into the business to make good the deficiency. In such a case, he may be declared as "insolvent". Prior to the decision in Garner Vs. Murray, such a loss was treated as an ordinary loss and shared by solvent partners in their profit sharing ratio. But in Garner Vs. Murray, it was held that in the absence of any agreement to the contrary, the loss arising due to insolvency of a partner is capital loss and therefore must be shared by the solvent partners in the ratio of their capitals just prior to dissolution.

DECISION IN GARNER VS MURRAY

The judgement laid down the following rules:

1. The Realisation loss will be borne by all the partners including the insolvent partner in their profit sharing ratio.
2. The solvent partners should bring in cash equal to their share of loss on realisation.
3. The insolvency loss of the insolvent partner (capital account deficiency or debit balance in capital account) must be shared by the solvent partners in their capital ratio.

Capital Ratio will be determined on the basis of their capitals appearing in the Balance sheet of the firm just prior to dissolution

NB: While determining the capital Ratio of the solvent partners, it should be considered whether the capitals are maintained according to Fixed Capital Method or Fluctuating Capital Method.

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