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Fundamentals of Partnership- Basics

FUNDAMENTALS OF PARTNERSHIP

WHAT IS PARTNERSHIP?

According to the **Indian Partnership Act, 1932:**

Partnership is the

- **relation between persons who have**
- **agreed to**
- **share the profits of a**
- **business**
- **carried on by all or any of them acting for all.**

The persons who have entered into the partnership individually are called as **partners** and collectively a **firm**.

The partnership is started **with contract or without contract**. The contract can be written or oral. The written contract is termed as **partnership deed**.

FIRM NAME : ABC LTD.

Partner A **Partner B** **Partner C**

The persons who have entered into the partnership individually are called as **partners** and collectively a **firm**.

Features/Characteristics/ Elements of Partnership:

1. **There must be 2 or more persons.**(Minimum 2 and Maximum 50)

2. **There must be an agreement** between the partners. The agreement can be Oral or Written. A written agreement is called a Partnership Deed.

3. **There must be a lawful business.**

4. **There must be a sharing of profits of the business.**

5. **There must be a mutual agency** i.e. the business must be carried on by all OR any of them acting for all.

6. **Unlimited liability of partners:-**Every partner in a partnership has unlimited liability**.**

SOME MORE FEATURES:

- The partnership can be **Registered or Unregistered**.
  (It means registration of partnership is optional and not compulsory.)

- There must be a **relationship of Principal and Agent**: There exists a relationship of Principal and Agent between the Partners and the Firm AND among the partners themselves. A partner can bind the firm (other partners) by his acts, and a partner can be bound by the acts of the firm (other partners).

WHY PARTNERSHIP?

Generally there are three ways to start/do a business.
Sole Proprietorship, Partnership and Company.

Partnership is the most convenient one as the risk and responsibilities are distributed among partners unlike Sole proprietorship where all the risk and responsibility will be shared by one single owner only. Unlike Company there are less legal hassles in the partnership. So partnership is the most preferred one.

ADVANTAGES OF PARTNERSHIP

1.Easier formation: It is straightforward to form a partnership business. It requires fewer legal formalities, and the cost is also low. The registration of the firm is also not required to create a partnership business. Only the partners should have an agreement between them.

2.Flexibility: A partnership firm has minimum legal formalities and is also free from government control. Hence, the partners can make changes in the firm according to their preferences. They can make changes in the size of the capital, the size of the business, and the management structure without any excess legal procedures.

3.Risk sharing: A partnership firm usually has a lot of members. Since the members agree to share profits and losses equally, the risk is also shared by all the members. As a result, compared to a sole proprietor, the burden of risk on each partner is much lower.

4.Privacy: It is not required for a partnership firm to publish its accounts. As a result, the affairs taking place in the business remain within the business. There is no chance of leakage of trade secrets, and the privacy of the firm is maintained.

ADVANTAGES OF PARTNERSHIP

5. **Division of work:** In a partnership, all the firm's work is divided among the partners based on their knowledge and skills. Division of labor is possible in partnership. This division of work leads to efficient management, which results in higher profits.

6. **More expansion scope:** A partnership has a more expansive scope than a sole proprietorship business. In a partnership firm, the partners can arrange more considerable funds and they also have good managerial skills which are also used for expansion and efficiency.

7. **Easier dissolution:** The dissolution of a partnership does not require any legal procedure. Therefore, it is easy and cheap to dissolve a partnership.

DIS-ADVANTAGES OF PARTNERSHIP

1. **Unlimited liability:** Every partner is jointly and severally liable for the debts of the firm. The liability of all the partners is unlimited. That means their personal assets can be used in case the firm's assets are insufficient to pay the firm's debts.

2. **Blocking of capital:** If a partner wishes to withdraw their capital from the firm, they can not do so alone. If all the partners agree to it, only then it is possible. The partners are also not allowed to transfer their shares to someone else. As a result, they lose the liquidity of their investment.

3. **Uncertainty:** A partnership business suffers from instability. Insanity, insolvency, retirement, and the death of a partner may result in the sudden end of the business.

4. **Lack of public trust:** The public has less confidence in partnership firms since their annual reports and accounts are not published.

DIS-ADVANTAGES OF PARTNERSHIP

5. **Difficulty in decision making:** In a partnership business, the consent of every partner is needed before making a decision. From minor to major, all decisions require the approval of all partners. As a result, the partners are unable to make spontaneous or quick decisions.

6. **Mutual differences:** The details, records, and secrets of a partnership firm are known by all the partners. If a mutual conflict arises among the partners, there is a high chance of information leakage regarding the firm. The partners may pass the secrets of their firm to other competitors.

PARTNERSHIP DEED

PARTNERSHIP DEED

1. The document which contains the terms of the agreement is called the partnership deed.

2. The document can be either oral or written.

3. It contains all the rights, duties and liabilities of the partners.

4. It is helpful in preventing and resolving misunderstandings and disputes among the partners.

5. A partnership deed can be altered at any time with the consent of all the partners. The deed must be properly stamped and signed by all the partners **except a minor** who has been admitted **for the benefits of partnership.**

6. The Partnership deed is **not a public document** like the Memorandum of Association of a Company.

In the absence of a partnership deed., **Provisions of the Indian Partnership Act 1932 would apply** which states as follows:-

RULES APPLICABLE IN THE ABSENCE OF PARTNERSHIP DEED	
Profit sharing Ratio	**EQUAL,** Irrespective of capital contribution.
Interest on Capital	NO Interest on Capital is to be allowed.
Interest on Drawings	NO interest on Drawings is to be charged
Salary or Commission to a Partner	NOT allowed to any partner
Interest on loan by a Partner	Interest is allowed **@ 6% PER ANNUM**.

Apart from the above, the Indian partnership act specifies that subject to a contract between the partners:

- If a partner derives any profit for himself from any transaction of the firm or from the use of property or business connection of the firm or firm name, he shall account for the profit and pay it to the firm.

- If a partner carries on any business of the same nature as and competing with that of the firm, he shall account for and pay to the firm, all profit made by him in that business.

Question:-

Following difference has arisen among P, Q, and R. State who is correct in each case:

a) P used ₹ 50,000 belonging to the firm and earned a profit of ₹ 5000. Q and R want the amount to be given to the firm.

b) Q used ₹ 10,000 belonging to the firm and incurred a loss of ₹ 1,000. He wants the firm to bear the loss.

c) P and Q want to purchase goods from Star Ltd. R does not agree.

d) Q and R want to admit W as a partner, but P does not agree.

e) R had given a loan of ₹ 2,00,000 to the firm and demanded interest @ 10%. P and Q do not want to pay the interest.

Here is the solution of it.

a) If any partner uses the money of the firm and earned a profit. He has to pay back the used money with profit. hence, p has to back ₹ 55,000 to the firm.

b) If any partner uses the firm money and incurred a loss. He has to bear the loss and the full amount of money taken by the partner has to return back the firm. hence Q has to pay ₹ 10,000 to the firm.

c) any business decision is decided by the majority. Hence P and Q want to purchase goods from star Ltd is accepted as there are only 3 partners and the majority win.

d) W as a partner can not be admitted as to admit a new partner, all partners must agree.

e) In the absence of a partnership deed. Provisions of the Indian Partnership Act 1932 would apply. Only a 6% p.a rate of interest on the loan of partners to the firm would be charged. Hence. In the place of 10% p.a, only a 6% p.a rate of interest would be charged.

The following are the **MAIN PROVISIONS OF THE INDIAN PARTNERSHIP ACT, 1932** that are relevant to the partnership accounts in absence of partnership deed.

1. **Profit Sharing Ratio:** If the partnership deed is **SILENT** on sharing of profit or losses among the partners of a firm, then according to the Partnership Act of 1932, profits and losses are to be shared **EQUALLY** by all the partners of the firm.

2. **Interest on Capital:** If the partnership deed is **SILENT** on interest on partner's capital, then according to the Partnership Act of 1932, **NO INTEREST ON CAPITAL** should be given to the partners of the firm. However, interest on capital is given only out of the profits, if mutually agreed by all the partners.

3. **Interest on Drawings:** If the partnership deed is **SILENT** on interest on partner's drawings, then according to the Partnership Act of 1932, **NO INTEREST ON DRAWING** should be charged from the partners of the firm for the amount of capital withdrawn in the form of drawings.

4. **Interest on Partner's Loan:** If the partnership deed is **SILENT** on interest on partner's loan, then according to the Partnership Act of 1932, the partners are entitled for **6% p.a**. interest on the loan forwarded by them to the firm.

5. **Salary to Partner:** If the partnership deed is **SILENT** on salary to a partner, then according to the Partnership Act of 1932, **NO SALARY** should be given to any partner.

TYPES OF PARTNERS

Types of Partner

ACTIVE/MANAGING PARTNER

1. An active partner mainly takes part in the day-to-day running of the business and also takes active participation in the conduct and management of the business firm.

2. He gives a public notice in order to absolve himself from liability and acts done by the other partner. If he doesn't issue a public notice declaring his retirement he would be held liable for the acts done by other partners post-retirement also.

SLEEPING PARTNER

1. Also known as dormant or Inactive partner. This partner does not participate in the day-to-day functioning activities of the partnership firm.

2. He has sufficient money or interest in the firm, but cannot devote his time to the business. However, he is bound by all the acts of the other partners.

3. If he makes a decision to retire from the partnership firm, then it is not mandatory for him to give a public notice for the same.

PARTNER BY ESTOPPEL

1. A partner by estoppel is a partner who displays by his words, actions or conduct that he is the partner of the firm.

2. In simple words, even though he is not the partner in the firm but he has represented himself in such a manner which depicts that he has become a partner by estoppel or partner by holding out.

3. On the basis of his representation in the firm he is liable for the credits and loans obtained by the firm. Usually this arises, when the outgoing partner fails to give notice about his retirement.

MINOR AS PARTNER

1. A minor is a person who is yet to attain the age of majority in the law of the land.

2. A minor can become a partner to claim the benefits of the Partnership.

3. A minor can share the profits of the firm, however, his liability for losses is only limited to his share of the firm.

4. A minor person after attaining the age of majority (i.e. 18 years of age) needs to decide within 6 months if he is willing to become a partner for the firm. If at all a minor partner decides to continue as a partner or wishes to retire, in both the cases he needs to make such a declaration by a public notice.

PARTNER IN PROFITS ONLY

1. This partner of a firm will only share the profits of the firm and won't be liable for any losses of the firm but his liability for the firm's debts is unlimited.

2. He is not allowed to take part in the management of the firm.

NOMINAL PARTNER

1. A nominal partner does not have any real or significant interest in the partnership firm. In simple words, he is only lending his name to the firm and does not have a voice in the management of the firm. On the strength of his name, the firm can promote its sales in the market or can get more credit from the market.

2. This partner does not share any profit and losses in the firm because he does not contribute any capital to the firm. However, it is pertinent to note that a nominal partner is liable to the outsiders and third parties for the acts done by other partners.

TERMS: MEANING

CAPITAL	AMT. INVESTED BY THE PARTNERS INTO THE BUSINESS.
INTEREST ON CAPITAL	Amount provided by business to the partners on the capital invested by them into the business. IT IS AN EXPENSE TO THE FIRM AND INCOME TO THE PARTNER
Drawings	AMT. INVESTED BY THE PARTNERS INTO THE BUSINESS.
INTEREST ON DRAWINGS	Amount charged by business from the partners on the capital withdrawn by them from the business. IT IS AN EXPENSE TO THE PARTNER AND INCOME TO THE FIRM
PROFIT SHARING RATIO	The ratio in which profit of the firms will be distributed among the partners.
INTEREST ON LOAN	Amount provided by the business on the loan provided by any partner.

TOPICS:-MAIN

1. INTEREST ON CAPITAL
2. INTEREST ON DRAWINGS
3. P & L APPROPRIATION A/C
4. PAST ADJUSTMENTS
5. GUARANTEE TO A PARTNER

P & L APPROPRIATION A/C

P & L APPROPRIATION A/C :

In partnership, Net Profit to the partners is ascertained through P & L appropriation A/c.

It is an **extension** to the P & L A/c i.e. it is prepared after preparing the P & L A/c.

All the appropriation (i.e. what we give to the partners in the form of Salary, Interest on capital etc.) to the partners will appear in this account. Besides that, any interest on drawings to be charged from the partners will also appear in this account.

P & L Appropriation A/c			
INTEREST ON CAPITAL		NET PROFIT	
SALARY		**INTEREST ON DRAWINGS**	
COMMISSION			
RESERVE FUND			
NET PROFIT DISTRIBUTED			
	TOTAL		**TOTA L**

INTEREST ON DRAWINGS

Interest on Partners' Drawings:

- Drawings are the amounts that are withdrawn, in cash or in kind, by partners for their personal use.
- These drawings can be out of capital or out of profits.
- When the amount is withdrawn from capital, it is referred to as drawings out of capital and when the amount is withdrawn from profit earned during the year it is termed as drawings out of profits.
- If the Partnership Deed provides for charging interest on such amounts withdrawn by the partners against profits, such interest is termed as interest on drawings. **It is important to note that interest on drawings is not charged on the drawings that are made against capital.**
- Such Interest charged on Drawings is credited to the Profit and Loss Appropriation Account and debited to Partners' Capital Accounts or Partners' Current Accounts.
- Calculation of such interest is to be done taking into consideration the time from the date of withdrawal till the end of the financial year.

CASE 1: WHEN DRAWINGS ARE GIVEN FOR 12 MONTHS

MIDDLE of every month	$1{,}000 \times 12 \times 10\% \times \frac{6}{12}$	$= 600$
BEGINNING of every month	$1{,}000 \times 12 \times 10\% \times \frac{6.5}{12}$	$= 650$
END of every month	$1{,}000 \times 12 \times 10\% \times \frac{5.5}{12}$	$= 550$

CASE 2: WHEN DRAWINGS ARE GIVEN FOR 6 MONTHS

BEGINNING of every month	$1,000 \times 6 \times 10\% \times \frac{3.5}{12}$	175
MIDDLE of every month	$1,000 \times 6 \times 10\% \times \frac{3}{12}$	150
END of every month	$1,000 \times 6 \times 10\% \times \frac{2.5}{12}$	125

CASE 3: WHEN DRAWINGS ARE GIVEN -QUARTERLY

BEGINNING of every quarter	$1,000 \times 4 \times 10\% \times \frac{7.5}{12}$	**250**
MIDDLE of every quarter	$1,000 \times 4 \times 10\% \times \frac{6}{12}$	**200**
END of every quarter	$1,000 \times 4 \times 10\% \times \frac{4.5}{12}$	**150**

IF DATE OF DRAWINGS IS NOT GIVEN: INTEREST WILL BE CALCULATED FOR 6 MONTHS.	$12,000 \times 10\% \times 6/12 = 600$
IF P.A. IS NOT MENTIONED: INTEREST WILL BE CALCULATED FOR 12 MONTHS.	$12,000 \times 10\% = 1,200$

PRODUCT METHOD

This method is used to calculate interest on drawings

- **when different amounts are withdrawn**
- **without following any fixed pattern.**

PRODUCT METHOD			
DATE OF DRAWINGS	AMOUNT OF DRAWINGS (A)	MONTHS (B)	PRODUCT (A*B)
1-Feb	5,000	11	55,000
30-Apr	15,000	8	120,000
1-Sep	10,000	4	40,000
1-Dec	15,000	1	15,000
31-Dec	5,000	0	-
			230,000

INTEREST ON DRAWINGS = 230,000 $\times$ **10%** $\times \frac{1}{12}$ **=1917**