Lesson 7

Partnership

Suppose you want to open a restaurant in your locality. You will need to gather together a lot of things. You may find that it is not possible to arrange the money required to start and run the business alone. You may then talk to your friends and all of you agree to run the restaurant by contributing a certain amount of money and the other things required. So all of you join hands together to become the owners and share the profits and losses. This is another form of business organisation. It is different from what you have learnt in the previous lesson. In this lesson let us learn more about it.

7.1 Objectives

After studying this lesson, you will be able to :

- define partnership;
- identify the features of partnership form of business organisation;
- state the advantages and disadvantages of partnership form of business organisation;
- recognise the different types of partners;
- distinguish between partnership and sole proprietorship form of business organisation; and
- suggest the suitability of partnership form of business organisation.

7.2 Meaning of Partnership

You have studied that sole proprietorship form of business organisation has certain limitations. Its financial and managerial resources are limited. It is also not possible to expand the business activities beyond a certain limit. In order to overcome these drawbacks, another form, i.e., partnership form of business has come into existence. Let us first find out what is 'partnership'.

It is basically a relation between two or more persons who join hands to form a business organisation with the objective of earning profit. The persons who join hands are individually known as ‘Partner’ and collectively a ‘Firm’. The name under which the business is carried on is called ‘firm name’. Sultan Chand & Co, Ram Lal & Co, Gupta & Co are the names of some partnership firms.

The partners provide the necessary capital, run the business jointly and share the responsibility. You must be thinking how much capital each partner contributes? Do all the partners jointly manage the business or can any of them manage the business on behalf of others? Who will take the profits? If there is any loss then who will suffer the loss? Yes, these are the few questions that might be coming to your mind. Actually, when you invite your friends to start such a business, it should be the duty of all of you to decide (i) the amount of capital to be contributed by each one of you; (ii) who will manage; (iii) how will the profits and losses be shared. Thus, there must be some agreement between the partners before they actually start the business. This agreement is termed as ‘Partnership Deed’, which lays down certain terms and conditions for starting and running the partnership firm. This agreement may be oral or written. Actually, it is always better to insist on a written agreement among partners in order to avoid future controversies.

A partnership firm is governed by the provisions of the Indian Partnership Act, 1932. Section 4 of the Indian Partnership Act, 1932, defines partnership as “a relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all”.

Intext Questions 7.1

Fill in the blanks with the appropriate word.

i. Partnership is basically a ________ between persons.

ii. The name under which the business of partnership is carried on is called ________.

iii. The agreement which lays down terms and conditions of partnership is termed as _________.

iv. Section 4 of the _________ Act 1932 defines partnership.

v. Partners agree to share ____________ of business.

7.3 Features of Partnership form of business organisation

After having a brief idea about partnership, let us identify the various features of this form of business organisation.

i. **Two or more Members -** You know that the members of the partnership firm are called partners. But do you know how many persons are required to form a partnership firm? At least two members are required to start a partnership business. But the number of members should not exceed 10 in case of banking business and 20 in case of other business. If the number of members exceeds this maximum limit then that business cannot be termed as partnership business. A new form of business will be formed, the details of which you will learn in your next lesson.

ii. **Agreement:** Whenever you think of joining hands with others to start a partnership business, first of all, there must be an agreement between all of you. This agreement contains-

- o the amount of capital contributed by each partner;
- o profit or loss sharing ratio;
- o salary or commission payable to the partner, if any;
- o duration of business, if any ;
- o name and address of the partners and the firm;
- o duties and powers of each partner;
- o nature and place of business; and
- o any other terms and conditions to run the business.

iii. **Lawful Business -** The partners should always join hands to carry on any kind of lawful business. To indulge in smuggling, black marketing, etc., cannot be called partnership business in the eye of the law. Again, doing social or philanthropic work is not termed as partnership business.

iv. **Competence of Partners -** Since individuals join hands to become the partners, it is necessary that they must be competent to enter into a partnership contract. Thus, minors, lunatics and insolvent persons are not eligible to become the partners. However, a minor can be admitted to the benefits of partnership i.e., he can have a share in the profits only.

v. **Sharing of Profit -** The main objective of every partnership firm is sharing of profits of the business amongst the partners in the agreed proportion. In the absence of any agreement for the profit sharing, it should be shared equally among the partners. Suppose, there are two partners in the business and they earn a profit of Rs. 20,000. They may share the profits equally i.e., Rs. 10,000 each or in any other agreed proportion, say one forth and three fourth i.e. Rs 5,000/- and Rs. 15000/-.

vi. **Unlimited Liability -** Just like the sole proprietor the liability of partners is also unlimited. That means, if the assets of the firm are insufficient to meet the liabilities, the personal properties of the partners, if any, can also be utilised to meet the business liabilities. Suppose, the firm has to make payment of Rs. 25,000/- to the suppliers of goods. The partners are able to arrange only Rs. 19,000/- from the business. The balance amount of Rs. 6,000/- will have to be arranged from the personal properties of the partners.

vii. **Voluntary Registration** - It is not compulsory that you register your partnership firm. However, if you don't get your firm registered, you will be deprived of certain benefits, therefore it is desirable. The effects of non-registration are:

- o Your firm cannot take any action in a court of law against any other parties for settlement of claims.
- o In case there is any dispute among partners, it is not possible to settle the disputes through a court of law.
- o Your firm cannot claim adjustments for amount payable to or receivable from any other parties.

viii. **No Separate Legal Existence -** Just like sole proprietorship, partnership firm also has no separate legal existence from that of it owners. Partnership firm is just a name for the business as a whole. The firm means the partners and the partners collectively mean the firm.

ix. **Principal Agent Relationship -** All the partners of the firm are the joint owners of the business. They all have an equal right to actively participate in its management. Every partner has a right to act on behalf of the firm. When a partner deals with other parties in business transactions, he/she acts as an agent of the others and at the same time the others become the principal. So there always exists a principal agent relationship in every partnership firm.

x. **Restriction on Transfer of Interest -** No partner can sell or transfer his interest to any one without the constent of other partners. For example - A, B, and C are three partners. A wants to sell his share to D as his health does not permit him to work any more. He can not do so until B and C both agree.

xi. **Continuity of Business -** A partnership firm comes to an end in the event of death, lunacy or bankruptcy of any partner. Even otherwise, it can discontinue its business at the will of the partners. At any time, they may take a decision to end their relationship.

Intext Questions 7.2

Which of the following statements are true.

i. The number of partners should not exceed 20 in case of Banking business.

ii. There must be a written agreement between all the partners.

iii. It is compulsory to register a partnership firm.

iv. No partner can transfer his interest to any other without the consent of the other partners.

v. Partnership firm has no separate legal existence.

7.4 Advantages of partnership form of business organisation

Partnership form of business organisation has certain advantages, which are as follows -

a) **Easy to form:** Like sole proprietorship, the partnership business can be formed easily without any legal formalities. It is not necessary to get the firm registered. A simple agreement, either oral or in writing, is sufficient to create a partnership firm.

b) **Availability of large resources -** Since two or more partners join hand to start partnership business it may be possible to pool more resources as compared to sole proprietorship. The partners can contribute more capital, more effort and also more time for the business.

c) **Better decisions -** The partners are the owners of the business. Each of them has equal right to participate in the management of the business. In case of any conflict they can sit together to solve the problems. Since all partners participate in decision-making, there is less scope for reckless and hasty decisions.

d) **Flexibility in operations -** The partnership firm is a flexible organisation. At any time the partners can decide to change the size or nature of business or area of its operation. There is no need to follow any legal procedure. Only the consent of all the partners is required.

e) **Sharing risks -** In a partnership firm all the partners share the business risks. For example, if there are three partners and the firm suffers a loss of Rs. 12,000 in a particular period, then all partners may share it and the individual burden will be Rs. 4,000 only.

f) **Protection of interest of each partner -** In a partnership firm every partner has an equal say in decision making. If any decision goes against the interest of any partner he can prevent the decision from being taken. In extreme cases a dissenting partner may withdraw himself from the business and can dissolve it.

g) **Benefits of specialization -** Since all the partners are owners of the business they can actively participate in every aspect of business as per their specialisation and knowledge. If you want to start a firm to provide legal consultancy to people, then one partner may deal with civil cases, one in criminal cases, another in labour cases and so on as per their specialization. Similarly two or more doctors of different specialization may start a clinic in partnership.

Intext Questions 7.3

Fill in the blanks by choosing suitable word(s) from the brackets.

i. It is _______ (not necessary, necessary) to get the partnership firm registered.

ii. The partnership firm is a ________ (flexible, rigid) form of business organisation.

iii. In partnership, business risk is ________ (shared, not shared) by all the partners.

iv. Partnership is a _______ (group, individual) effort.

v. In comparison to sole proprietorship, it may be possible for partnership firm to pool __________ (more, less) resources.

7.5 Limitations of Partnership form of Business Organisation

Inspite of all these advantages as discussed above, a partnership firm also suffers from certain limitations. Let us discuss all these limitations.

a) **Unlimited Liability:** All the partners are jointly as well as separately liable for the debt of the firm to an unlimited extent. Thus, they can share the liability among themselves or any one can be asked to pay all the debts even from his personal properties.

b) **Uncertain Life:** The partnership firm has no legal entity separate from its partners. It comes to an end with the death, insolvency, incapacity or the retirement of any partner. Further, any dissenting member can also give notice at any time for dissolution of partnership.

c) **Lack of Harmony:** You know that in partnership firm every partner has an equal right to participate in the management. Also every partner can place his or her opinion or viewpoint before the management regarding any matter at any time. Because of this sometimes there is a possibility of friction and quarrel among the partners. Difference of opinion may lead to closure of the business on many occasions.

d) **Limited Capital:** Since the total number of partners cannot exceed 20, the capital to be raised is always limited. It may not be possible to start a very large business in partnership form.

e) **No transferability of share:** If you are a partner in any firm you cannot transfer your share of interest to outsiders without the consent of other partners. This creates inconvenience for the partner who wants to leave the firm or sell part of his share to others.

7.6 Types of Partners

In a partnership firm you can find different types of partners. Some may actively participate in the business while others prefer not to keep themselves engaged actively in the business activities after contributing the required capital. Also there are certain kinds of partners who neither contribute capital nor actively participate in the day-to-day business operations. Let us learn more about them.

a) **Active partners -** The partners who actively participate in the day-to-day operations of the business are known as active or working partners. They contribute capital and are also entitled to share the profits of the business. They are also liable for the debts of the firm.

b) **Dormant partners -** Those partners who do not participate in the day-to-day activities of the partnership firm are known as dormant or sleeping partners. They only contribute capital and share the profits or bear the losses, if any.

c) **Nominal partners -** These partners only allow the firm to use their name as a partner. They do not have any real interest in the business of the firm. They do not invest any capital, or share profits and also do not take part in the conduct of the business of the firm. However, they remain liable to third parties for the acts of the firm.

d) **Minor as a partner -**You learnt that a minor i.e., a person under 18 years of age is not eligible to become a partner. However in special cases a minor can be admitted as partner with certain conditions. A minor can only share the profit of the business. In case of loss his liability is limited to the extent of his capital contribution for the business.

e) **Partner by estoppel -** If a person falsely represents himself as a partner of any firm or behaves in a way that somebody can have an impression that such person is a partner and on the basis of this impression transacts with that firm then that person is held liable to the third party. The person who falsely represents himself as a partner is known as partner by estoppel. Take an example. Suppose in Ram Hari & Co firm there are two partners. One is Ram, the other is Hari. If Giri- an outsider represents himself as a partner of Ram Hari & Co and transacts with Madhu then Giri will be held liable for any loss arising to Madhu. Here Giri is partner by estoppel.

f) **Partner by holding out -** In the above example, if either Ram or Hari declares that Gopal is a partner of their firm and knowing this declaration Gopal remains silent then Gopal will be liable to those parties who suffer losses by transacting with Ram Hari & Co with a belief that Gopal is a partner of that firm. Here Gopal is liable to those parties who suffer losses and Gopal will be known as partner by holding out.

Intext Questions 7.4

A. Match the followings

A		B
1. Active partner	(i)	Is one who lends his name to the firm
2. Dormant partner	(ii)	Is one who takes part in day-to-day business of the firm.

3. Nominal partner	(iii)	Is one who represents as a partner
4. Partner by estoppel	(iv)	Is one who is below 18 years
5. Minor partner	(v)	is one who does not take part in day to day business of the firm.

7.7 Difference between Partnership and Sole proprietorship form of Business Organisation

In the previous lesson you learnt about sole proprietorship form of business organisation. Now you have gone through the partnership form of business organisation. Both of these forms have their own features, advantages and limitation. Let us compare them to find out the difference between them.

Basis of Difference	Partnership	Sole Proprietorship
1. Formation	It can be formed only on the basis of an agreement among the partners.	No agreement is required to start the business. It is formed at any time whenever desired by the sole proprietor.
2. Governing Act	It is governed by Indian Partnership Act, 1932	There is no specific Act that governs a sole proprietorship business.
3. No. of members	Minimum two and maximum 10 in banking and 20 in other businesses.	Only one member.
4. Capital	Capital is provided by partners in an agreed ratio.	Capital is arranged by sole proprietor alone.
5. Decision-making	It takes time to decide upon important matters because all the partners must be consulted for taking decision.	Decision-making is very quick because there is no need to consult any one else for taking decision.
6. Sharing of profit and loss	Profits and losses are shared by partners as per agreement	The question of sharing of profits or losses does not arise. The sole proprietor alone takes all profits and bears all losses.
7. Ownership and Management	Owned, controlled and managed by partners.	This is completely owned, controlled and managed by the sole proprietor.

7.8 Suitability of Partnership form of business organisation

We have learnt that partnership form of business has its own advantages and disadvantages. But at times we find that partnership form of business organisaion is most suitable for us to run a small business. Let us look into such instances:

a. A partnership firm is suitable in case of business where the capital requirement is medium i.e. it is neither too large nor too small. Business like retail and wholesale trade or small manufacturing units can be successfully started by partners.

b. You learnt that in a partnership firm persons having different ability, managerial talent, skill and expertise join together. So it is most suitable for construction business, legal firms etc. where each partner contributes the best as per his specialization.

7.9 What You Have Learnt

- Partnership is the relation between two or more 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 join hands are individually known as 'Partner' and collectively a 'Firm'. The name under which the business is carried on is called 'Firm name'.
- It is a form of business in which two or more competent persons join together to carry on any lawful business after entering into an agreement to share the profit and loss of the business. They are free to get their firm registered under the Act of the government.
- A partnership firm does not have any legal entity separate from its partners. It can continue for a long period of time and can also come to an end at any time if the partners so desire. It automatically comes to an end in the event of death, lunacy and insolvency of any partner.
- The relationship amongst the partners can be compared with that of Principal and Agent.
- No partner can transfer or sell his interest in the business without the consent of others and the liability of each partner is unlimited.
- A partnership firm is very easy to form and also flexible in its operation. It pools resources from the partners, makes their optimum utilization by taking better decisions. It protects the interest of each and every partner and gets benefit out of the specialized knowledge and skill of individual partners.
- A partnership firm suffers from many limitations like- uncertain life, disharmony among partners, inability to pool large resources because of restriction on number of members, and it does not permit the transfer of the interest of individual partners.
- Different types of partners are - Active Partner, Dormant Partner, Nominal Partner, Minor as a Partner, Partner by Estoppel and Partner by Holding out.
- Partnership form of business is most suitable for retail or wholesale trade and for small manufacturing units. Persons having different specialization can also form partnership firm like construction firm or legal firm.

7.10 Terminal Exercise

1. State the maximum number of partners in case of banking and other business.
2. Define Partnership.
3. Differentiae between active and dormant partners on the basis of participation in business.
4. Distinguish between partnership and sole proprietorship form of business organisation.
5. "Principal Agent relationship is must for partnership". Do you agree? Give reason?
6. State any four features of a partnership form of business organisation.
7. Described unlimited liability and uncertain life as limitations of partnership form of business.
8. Explain different type of partners.
9. "If you do not register your partnership firm you will be deprived of certain benefits". In the light of this statement, state the effects of non-registration of a partnership firm.
10. Explain the advantage of specialization for a partnership firm.
11. Define partnership and state any four features of it.
12. Give any six points of difference between partnership and sole proprietorship.
13. "Partnership form of business is suitable for every type of business organistion". Do you agree? Give reasons.
14. Who is a partner by holding out? Explain with the help of an example.
15. Your friend approaches you and seeks your help, as he wants to specify important contents of a partnership agreement. What contents would you consider important for a partnership agreement? State any six

7.11 Key to Intext Questions

7.1 (i) relation, (ii) firm name, (iii) partnership deed, (iv) Indian Partnership, (v) profit and loss

7.2 (i) False, (ii) False, (iii) False, (iv) True, (v) True

7.3 (i) not necessary, (ii) flexible, (iii) shared, (iv) group, (v) more

7.4 1-ii, 2-v, 3-i, 4-iii, 5-iv

Activity For You

Ask any sole proprietor of your locality whether he/she is interested in converting his/her business to a partnership firm. Note down the reasons given by the sole proprietor.