



Chapter 2

Accounting for Partnership Firms

CBSE Syllabus

Topics

- Partnership: Features, Partnership Deed.
- Provisions of the Indian Partnership Act 1932 in the absence of partnership deed.
- Fixed v/s fluctuating capital accounts.
- Preparation of Profit and Loss Appropriation account-division of profit among partners, guarantee of profits.
- Past adjustments (relating to interest on capital, interest on drawing, salary and profit sharing ratio).

Note

Interest on partner's loan is to be treated as a charge against profits.

In Class XI, you have learnt about the preparation of final accounts (Trading and Profit & Loss Account and Balance Sheet) for a sole proprietary concern. If one man was intelligent enough and commanded all the resources that he needed and also the necessary power to do everything, he would have carried on his business as an individual. Alas, this is not true in real life. As the business expands, one needs more capital and larger number of people to manage the business and share its risks.

Nature of Partnership

Meaning of Partnership

When two or more persons join hands to set up a business and share its profits and losses, they are said to be in partnership.

Section 4 of the Indian Partnership Act 1932 defines **partnership** as 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**’.

Persons who have entered into partnership with one another are individually called ‘**partners**’ and collectively called ‘**firm**’. The name under which the business is carried is called the ‘firm’s name’.

Features/Characteristics of Partnership

The essential features/characteristics of partnership are:

1. **Two or More Persons:** In order to form partnership, there should be at least two persons coming together for a common goal. In other words, the minimum number of partners in a firm can be two. There is however, a limit on their maximum number. By virtue of *Section 464 of the Companies Act 2013*, the Central Government is empowered to prescribe maximum number of partners in a firm but the number of partners can not be more than 100. The Central government has prescribed the maximum number of partners in a firm to be 50 under Rule 10 of the *Companies (Miscellaneous) Rules, 2014*. Thus, a partnership firm cannot have more than 50 partners.
2. **Agreement:** Partnership is the result of an agreement between two or more persons to do business and share its profits and losses. The agreement becomes the basis of relationship between the partners.



Top Tip

Partnership agreement can be either oral or written. The Partnership Act does not require that the agreement must be in writing. In other words, it is not necessary that such agreement is in written form. An oral agreement is equally valid. But in order to avoid disputes, it is preferred that the partners have a written agreement.

Wherever partnership agreement is in writing, the document which contains terms of the agreement is called '**Partnership Deed**'. It generally contains the details about all the aspects affecting the relationship between the partners including the objective of business, contribution of capital by each partner, ratio in which the profits and the losses will be shared by the partners and entitlement of partners to interest on capital, interest on loan, etc.

Contents/Clauses of the Partnership Deed: The Partnership Deed usually contains the following details:

- Names and Addresses of the firm and its main business;
- Names and Addresses of all partners;
- Amount of capital to be contributed by each partner;
- The accounting period of the firm;
- The date of commencement of partnership;
- Rules regarding operation of Bank Accounts;
- Profit and loss sharing ratio;
- Rate of interest on capital, loan, drawings, etc;
- Mode of auditor's appointment, if any;
- Salaries, commission, etc, if payable to any partner;
- The rights, duties and liabilities of each partner;
- Treatment of loss arising out of insolvency of one or more partners;
- Settlement of accounts on dissolution of the firm;
- Method of settlement of disputes among the partners;
- Rules to be followed in case of admission, retirement, death of a partner; and
- Any other matter relating to the conduct of business.

The deed should be properly drafted and prepared as per the provisions of the 'Stamp Act' and preferably registered with the Registrar of Firms.



Top Tip

The clauses of partnership deed can be altered with the consent of all the partners.

3. **Business:** The agreement should be to carry on some business. Mere co-ownership of a property does not amount to partnership. For example, if Piyush and Yash jointly purchase a plot of land, they become the joint owners of the property and not the partners. But if they are in the business of purchase and sale of land for the purpose of making profit, they will be called partners.
4. **Sharing of Profit:** Another important element of partnership is that, the agreement between partners must be to share profits and losses of a business. Though the definition contained in the Partnership Act describes partnership as relation between people who agree to share the profits of a business, the sharing of loss is implied. Thus, sharing of profits and losses is important. If some persons join hands for the purpose of some charitable activity, it will not be termed as partnership.
5. **Mutual Agency:** The business of a partnership concern may be carried on by all the partners or any of them acting for all. *This statement has two important implications:*
 - First, every partner is entitled to participate in the conduct of the affairs of its business.
 - Second, that there exists a relationship of mutual agency between all the partners. Each partner carrying on the business is the principal as well as the agent for all the other partners. He can bind other partners by his acts and also is bound by the acts of other partners with regard to business of the firm.

Relationship of **mutual agency** is so important that one can say that there would be no partnership, if the element of mutual agency is absent.

6. **Liability of Partnership:** Each partner is liable jointly with all the other partners and also severally to the third party for all the acts of the firm done while he is a partner. Not only that the liability of a partner for acts of the firm is also unlimited. This implies that his private assets can also be used for paying off the firm's debts.



Top Tip

A partnership firm has no separate legal entity, apart from the partners constituting it.

However, a Limited Liability Partnership (LLP) is a legal entity separate from its partners.

Limited Liability Partnership (LLP) is an incorporated partnership formed and registered under the Limited Liability Partnership Act, 2008 with limited liability and perpetual succession.

It is viewed as an alternative corporate business vehicle that provides the benefits of limited liability but allows its partners the flexibility of organising their internal structure as a partnership based on a mutually arrived agreement.

Salient features:

1. Limited Liability Partnership is a corporate and a legal entity separate from its partners.
2. Every Limited Liability Partnership shall have at least two partners and shall also have at least two individuals as designated partners, of whom at least one shall be a resident in India.
3. The Indian Partnership Act, 1932, shall not be applicable to Limited Liability Partnership.
4. The Limited Liability Partnership has a perpetual succession.
5. The Central government has the power to investigate into the affairs of a Limited Liability Partnership, if required, by appointment of a Competent Inspector for the purpose.



Key Terms

Partnership: 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.

Partners: Persons who have entered into partnership with one another are individually called 'partners'.

Firm: When two or more persons enter into partnership with one another, they are collectively called 'firm'.

Partnership Deed: Wherever partnership agreement is in writing, the document which contains terms of the agreement is called 'Partnership Deed'.

Mutual agency: Relationship of mutual agency between the partners implies that each partner carrying on the business is the principal as well as the agent for all the other partners. He can bind other partners by his acts and also is bound by the acts of other partners with regard to business of the firm.

Limited Liability Partnership (LLP): It is an incorporated partnership formed and registered under the Limited Liability Partnership Act, 2008 with limited liability and perpetual succession.

Objective Type Questions 2.1

1. By virtue of Section 464 of the Companies Act, 2013 the Central Government is empowered to prescribe maximum number of partners in a firm but the number of partners cannot be more than _____. (Choose the correct alternative)
(a) 50 (b) 100
(c) 20 (d) 10
2. The partnership deed should be properly drafted and prepared as per the provisions of the _____ and preferably registered with the _____. (Fill in the blanks)
3. Persons who have entered into partnership with one another are individually called _____ and collectively called _____. (Fill in the blanks)
4. Partnership firm cannot have a separate legal entity. True/False? Give reason.
5. The central government has prescribed the maximum number of partners in a firm to be _____ under the act _____. (Fill in the blanks)
6. There cannot be a partnership with an oral agreement between the partners. True/False? Give reason.
7. Piyush and Yash purchase and sell land on a frequent basis for the purpose of making profits. They will be called partners. True/False? Give reason.
8. Roshni and Gloriya join hands to construct a charitable hospital to help the underprivileged section of the society. They are said to be in partnership. True/False? Give reason.
9. The business of a partnership concern may be carried on by all the partners or any of them acting for all. This is called the element of _____ between all the partners. (Fill in the blank)

10. "The business of a partnership concern may be carried on by all the partners or any of them acting for all." The above statement has two implications. First, that there exists a relationship of mutual agency between all the partners. Which of the following statement highlights the second implication of the given statement? *(Choose the correct alternative)*
- (a) The agreement between partners should be to carry on some business.
 - (b) A partner can bind other partners by his acts and also is bound by the acts of other partners with regard to business of the firm.
 - (c) Every partner is entitled to participate in the conduct of the affairs of its business.
 - (d) Each partner is liable jointly with all the other partners and also severally to the third party for all the acts of the firm done while he is a partner
11. Which of the following elements of the nature of partnership is so important that there would be no partnership, if this element is absent? *(Choose the correct alternative)*
- (a) Agreement
 - (b) Sharing of profit
 - (c) Lawful business
 - (d) Mutual agency
12. "The liability of a partner for acts of the firm is unlimited." Which of the following statement best describes the unlimited liability of a partner? *(Choose the correct alternative)*
- (a) Each partner is liable jointly with all the other partners and also severally to the third party for all the acts of the firm done while he is a partner.
 - (b) A partner's private assets can also be used for paying off the firm's debts.
 - (c) A partner can be declared insolvent on his failure to pay the firm's debts.
 - (d) All of the above

13. The document containing terms of the agreement among the partners of a firm is called _____. (Fill in the blank)
14. The clauses of a partnership deed can be altered. *True/False? Give reason.*
15. Which of the following cannot be a content of the partnership deed? *(Choose the correct alternative)*
- (a) Rules regarding operation of Bank Accounts
 - (b) The rights, duties and liabilities of each partner
 - (c) Method of settlement of disputes among the partners
 - (d) None of the above
16. Can a partner be exempted from sharing the losses in a firm? If yes, under what circumstances?
17. Ritesh and Hitesh are childhood friends. Ritesh is a consultant whereas Hitesh is an architect. They contributed equal amounts and purchased a building for ₹2 crores. After a year, they sold it for ₹3 crores and shared the profits equally. Are they doing the business in partnership? Give reason in support of your answer.
18. A partnership firm has 50 members. All the partners have agreed to admit Ram and Mohan as new partners. Can Ram and Mohan be admitted? Give reason in support of your answer.
19. Valid partnership can be formulated even without a written agreement between the partners. *True/False? Give reason.*
20. Each partner carrying on the business is the principal as well as the agent for all the other partners. *True/False? Give reason.*
21. Methods of settlement of dispute among the partners can't be part of the partnership deed. *True/False? Give reason.*
22. The business of the firm can be conducted even by one partner. *True/False? Give reason.*
23. A, B and C decided that interest on capitals will be provided to each partner @ 5% p.a. But after one year C wants that no interest on capital is to be provided to any partner. State how ₹C' can do this?
24. A firm should have a partnership deed because _____. *(Complete the sentence)*
25. A group of people wants to form a partnership firm. The maximum number of partners can be _____ and the name of the Act is _____. *(Fill in the blanks)*

ANSWER

Objective Type Questions 2.1

1. (b)
2. Stamp Act, Registrar of firms.
3. (i) partners (ii) firm
4. False: A Limited Liability Partnership (LLP) is a corporate and a legal entity separate from its partners.
5. (i) 50 (ii) The Indian Companies Act, 2013
6. False: It is not necessary that partnership agreement is in written form. An oral agreement is equally valid. But in order to avoid disputes, it is preferred that the partners have a written agreement.
7. True: They regularly deal in the business of purchase and sale of land and share the profits/losses of the business. So they are partners.
8. False: to be in partnership, the agreement between the partners must be to share profits and losses of a business, and not a social service or some charitable activity.

10. (c)
11. (d)
12. (b)
13. Partnership Deed
14. True: The clauses of a partnership deed can be altered with the consent of all the partners.
15. (d)
16. Yes, if partnership deed so provides. For example, in case of guarantee of minimum profit to a partner.
17. No, they are not doing business in partnership because they are not involved in doing sale and purchase of land/plot on a regular basis/Mere co-ownership of a property does not amount to partnership.
18. No, Ram and Mohan can't be admitted as partners.
Reason: As per the Companies Miscellaneous Rules, 2014 the Maximum number of partners in a partnership firm can be 50.
19. True: An oral agreement is equally valid. The partnership Act does not require that the agreement must be in writing.

20. True: There exists a relationship of mutual agency between all the partners. Each partner can bind other partners by his acts and also is bound by the acts of other partners with regard to business of the firm.
21. False: The partnership Deed also contains the details regarding settlement of disputes among partners.
22. True: The definition of partnership as per section 4 of the Indian Partnership Act, 1932 clearly states that the business of a partnership firm may be carried on by all the partners or any of them acting for all. There exists a relationship of mutual agency between all the partners. Each partner carrying on the business is the principal as well as agent for all the other partners. So, he can bind other partners by his acts with regard to business of the firm.

23. Yes, C can do so by altering the provisions of partnership deed, i.e., redrafting the deed, provided all the partners unanimously agree for it.
24. a carefully prepared partnership deed can eliminate many problems and disputes that may arise in the future operations of the partnership. It specifies the terms and conditions of the agreement for smooth functioning.
25. 50, The Companies Act, 2013