Dr. NEYAZ AHMAD
RDS COLLEGE, MUZ.

Chapter- One
Admission of Partner in Partnership Firms

Objective of this chapter is to provide basic and theoretical background and numerical knowledge for partnership firm business.
Topics that must be read to cover your syllabus.

- ✓ **Meaning and Characteristic of Partnership Firm.**
- ✓ **Partnership Deed and its Contents**
- ✓ **What are the reasons for admission of new partners**? Answer- See Limitation of sole proprietorship- chapter 1, Why partnership business and admission of partners
- ✓ Registration procedure and Particulars of registration
- ✓ **Merits and Demerits of Partnership Firm Business**
- ✓ Meaning, Characteristics, Merit and Demerit of LLP (May be skipped, but important for NET/JRF etc.

Basic: Formation of Partnership and Admission of Partners

Introduction. When an idea of starting a business comes to our mind, we think of starting a new business or joining an already existing business based on resources we have and the long-term objectives we want to achieve. There are different forms of business one can venture into based on resources and objectives set before him. Therefore, we need to learn various forms of business organization and their advantages and disadvantages.

Forms of Business Organizations

There are mainly three forms of business organization on the basis of ownership as follows.

1) Sole Proprietorship or Sole trading business

2) Partnership Firm and

3) Corporation or Company

1. **Sole Proprietorship:** A sole proprietorship or an individual entrepreneur is a form of business owned, operated and managed by a single person also referred to as a sole trader. It is an unincorporated business that is owned privately and has not been formally or legally registered as partnership firm or corporation-company. The owner pays personal income tax on profits earned from the sole proprietorship business. A

   A sole proprietorship is the easiest type of business to establish, due to a lack of government regulation. These types of businesses are very popular among individual in the form of self-contractors, sole or single owners of business, and consultants. Many sole proprietors do business under their own names because creating a separate business or trade name is not necessary.

I. Characteristics of Sole Proprietorship Business

A sole proprietorship is very different from companies and partnerships due to the following characteristics or features.

a. **Single Ownership.** Sole Proprietorship business has a single owner who operates and looks after the business.

b. **Single Person Control.** The owner of the business has full control over operating, managing and making decisions with respect to business needs and requirement.

c. **No Separate entity of business.** This means that the owner and the businessman are not two different entity but they are the same. Due to this, the assets, the debts and the profits of the sole proprietorship business are also of the owner. In case of partnership and companies, there is a separate entity of business.

d. **Unlimited Liability.** The owner legally responsible for all the debts and liabilities incurred by the sole proprietorship beyond the extent of the business assets. This means, the personal and private properties of owner can be used legally to pay the liabilities of the business.

e. **Undivided Risk and Profit.** All the business risk of sole proprietorship is individually born by the owner alone and all the profit goes to sole proprietor only.

f. **Personal Income Tax**. One of the main benefits of the sole proprietorship is that it does not pay taxes in its business name, but the sole owners is liable to pay personal income tax on such profit.

II. Advantages or Merits of Sole Proprietorship

The main Advantages of sole proprietorship business are as follows.

i) Simplicity,

ii) Flexibility

iii) Secrecy of information

iv) Quick Decision

v) Direct Motivation and

vi) Personal Touch

III. Disadvantages or Demerits of Sole proprietorship

The main disadvantages or demerit of a sole proprietorship is that it does not get sufficient capital funding, specifically through established channels, such as issuing equity shares for cash and obtaining bank loans or lines of credit. It begins as an entity with unlimited liability, as the business grows and expands, it is mostly converted into either a Partnership firms or company or corporation. The following points highlight the demerit of Sole Proprietorship business.

a) **Limited Fund.** A proprietor can raise limited financial resources. As a result, the size of business remains small. There is limited scope for growth and expansion. Economies of scale are not available.

b) **Limited Skills.** Proprietorship is a one man show and one man cannot be an expert in all areas (production, marketing, financing, personnel etc.) of business. There is no scope for specialisation and the decisions may not be balanced.

c) **Unlimited Liability.** The liability of the proprietor is unlimited. In case of loss his private assets can also be used to pay off creditors. This discourages expansion of the enterprise.

d) **Uncertain life of business.** The life of proprietorship depends upon the life of the owner. The enterprise may die premature death due to the incapacity or death of the proprietor. The proprietor has a low status and can be lonely.

e) **No Separate Business Entity**. Sole Proprietorship has no separation between business entity and its owners that differentiate it from partnership firms and companies.

1. Partnership Firm

Partnership is a relationship (agreement or contract) between to or more persons who have agreed to share the profit or loss of business, carried on by all or any of them, acting for all (Indian Partnership Act 1923, Section 4).

In other words, a partnership is an agreement among two or more persons to carry on jointly a lawful business and to share the profits arising there from. Persons who enter into such agreement are individually known as 'partners' and collectively as 'firm'.

2. Characteristics of Partnership

a. **Association of two or more persons**. The maximum number of partners is 10 in banking business and 20 in non-banking business.
b. **Contractual relationship**. There is written or oral agreement among the partners.
c. **Existence of a lawful business.** The partnership business must not be illegal business which are prohibited by laws.
d. **Sharing of profits and losses.** Profit and losses are shared among the partners in agreed ratio.
e. **Mutual agency among partners.** Each partner work as principal in his capacity and as an agent for other partners in their capacities.
f. **No Separate Legal Entity of the firm.** The partnership business has no separate legal entity like a company.
g. **Unlimited liability.** The partnership business has unlimited liability like sole proprietor. This means the personal properties of partners can be used to pay of partnership liabilities of the firm.

3. Why a partnership business?

When the sole proprietor business grows and develops, it needs addition human and financial resources to meet the expanding requirement of capital and partners or employees to manage and have control over operation of the business. The sole proprietor can choose an employee or a partner depending on the requirement of business.

4. Formation of Partnership

A partnership firm can be formed through an agreement among two or more persons. The agreement may be oral or in writing. But it is desirable that all terms and conditions of partnership are put in writing, so as to avoid any misunderstanding and disputes among the partners. A written agreement among partners is known as **Partnership Deed**. It must be signed by all the partners and should be properly stamped. It can be altered with the mutual consent of all the partners.

5. Contents of Partnership Deed

A Partnership deed usually contains the following details:

1) Name of the firm.
2) Names and address of all the partners.
3) Nature of the firm's business.
4) Date of the agreement.
5) Principal place of the firm's business.
6) Duration of partnership, if any.
7) Amount of capital contributed by each partner.
8) The proportion in which the profits and losses are to be shared.
9) Loans and advances by partners and interest payable on them.
10) Amount of withdrawal allowed to each partner and the rate of interest.
11) Amount of salary or commission payable to any partner.
12) The duties, powers and obligations of all the partners.
13) Maintenance of accounts and audit.
14) Mode of valuation of goodwill on admission, retirement or death of a partner.
15) Procedure for dissolution of the firm and settlement of accounts.
16) Arbitration for settlement of disputes among the partners.
17) Arrangements in case a partner becomes insolvent.
18) Any other clause(s) which may be found necessary in particular kind of business.

6. Registration of Firms

The Partnership Act, 1932 provides for the registration of firms with the Registrar of Firms appointed by the Government. The registration of a partnership firm is not compulsory. But an unregistered firm suffers from certain disabilities or may not be able to enjoy government financial concession and tax incentives. Therefore, registration of a partnership is desirable.

7. Procedure for Registration

A partnership firm can be registered at any time by filing a statement in the prescribed form. The form should be duly signed by all the partners. It should be sent to the Registrar of Firms along with the prescribed fee. The statement should contain the following particulars.

1. Name of the firm.
2. Principal place of its business.
3. Name of other places where the firm is carrying on business.
4. Names in full and permanent addresses of all the partners.
5. Date of commencement of the firm's business and the dates on which each partner joined the firm.
6. Duration of the firm, if any
7. Nature of the firm's business.

On receipt of the statement and the fees, the Registrar makes an entry in the Register of Firms. The firm is considered to be registered when the entry is made. The Registrar issues a Certificate of Registration. Any change in the above particulars must be communicated to the Registrar of Firms within a reasonable period of time so that necessary alterations may be made in the Register of Firms. The register is open for inspection on payment of a nominal fee.

8. Advantages of Admission of Partners

New Partners are admitted into existing business due to the following reasons.

1) To meet additional capital requirement,
2) To share the undivided business risks
3) Sharing of managerial responsibilities
4) Pooling of knowledge, experience and judgment
5) Increase in goodwill and connections.
6) Direct relation between effort and reward
7) Personal incentive and interest.

8) Secrecy of business is ensured.

9) Benefits of specialisation and

10) Economy of costs.

9. Disadvantages of Admission of Partner

1. Sharing of control results Loss in freedom of action
2. Division of authority-lack of independent decisions
3. Increase in liability and risk
4. Danger of dishonesty and negligence
5. Possibility of dispute and differences
6. Sharing of profits
7. Blocking of individual capital
8. Difficulty in removing the partner
9. Lack of stability

10. Merits of Partnership Firm Business

The partnership firm form of business ownership enjoys the following advantages

1. Ease of Formation

A partnership is easy to form as no cumbersome legal formalities are involved. An agreement is necessary and the procedure for registration is very simple. Similarly, a partnership can be dissolved easily at any time without undergoing legal formalities. Registration of the firm is not essential and the partnership agreement need not essentially be in writing.

2. Larger Financial Resources

As a number of persons or partners contribute to the capital of the firm, it is possible to collect larger financial resources than is possible in sole proprietorship. Creditworthiness of the firm is also higher because every partner is personally and jointly liable for the debts of the business. There is greater scope for expansion or growth of business.

3. Specialisation and Balanced Approach

The partnership form enables the pooling of abilities and judgment of several persons. Combined abilities and judgment result in more efficient management of the business. Partners with complementary skills may be chosen to avail of the benefits of specialisation. Judicious choice of partners with diversified skills ensures balanced decisions. Partners meet and discuss the problems of business frequently so that decisions can be taken quickly.

4. Flexibility of Operations

Though not as versatile as proprietorship, a partnership firm enjoys sufficient flexibility in its day-to-day operations. The nature and place of business can be changed whenever the partners desire. The agreement can be altered and new partners can be admitted whenever necessary. Partnership is free from statutory control by the Government except the general law of the land.

5. Protection of Minority Interest

No basic changes in the rights and obligations of partners can be made without the unanimous consent of all the partners. In case a partner feels dissatisfied, he can easily retire from or he may apply for the dissolution of partnership.

6. Personal Incentive and Direct Supervision

There is no divorce between ownership and management. Partners share in the profits and losses of the firm and there is motivation to improve the efficiency of the business. Personal control by the partners increases the possibility of success. Unlimited liability encourages caution and care on the part of partners. Fear of unlimited liability discourages reckless and hasty action and motivates the partners to put in their best efforts.

7. Capacity for Survival

The survival capacity of the partnership firm is higher than that of sole proprietorship. The partnership firm can continue after the death or insolvency of a partner if the remaining partners so desire. Risk of loss is diffused among two or more persons. In case one line of business is not successful, the firm may undertake another line of business to compensate its losses.

8. Better Human and Public Relations

Due to number of representatives (partners) of the firm, it is possible to develop personal touch with employees, customers, government and the general public.

Healthy relations with the public help to enhance the goodwill of the firm and pave the way for steady progress of the business.

9. Business Secrecy

It is not compulsory for a partnership firm to publish and file its accounts and reports. Important secrets of business remain confined to the partners and are unknown to the outside world.

11. Demerits of Partnership Firm Business

1. Unlimited Liability:

Every partner is jointly and severally liable for the entire debts of the firm. He has to suffer not only for his own mistakes but also for the lapses and dishonesty of other partners. This may curb entrepreneurial spirit as partners may hesitate to venture into new lines of business for fear of losses. Private property of partners is not safe against the risks of business.

2. Limited Resources:

The amount of financial resources in partnership is limited to the contributions made by the partners. The number of partners cannot exceed 10 in banking business and 20 in other types of business. Therefore, partnership form of ownership is not suited to undertake business involving huge investment of capital.

3. Risk of Implied Agency:

The acts of one partner are binding on the firm as well as on other partners. An incompetent or dishonest partner may bring disaster for all due to his acts of commission or omission. That is why the saying is that choosing a business partner is as important as choosing a partner in life.

4. Lack of Harmony:

The success of partnership depends upon mutual understanding and cooperation among the partners. Continued disagreement and bickering among the partners may paralyse the business or may result in its untimely death. Lack of a central authority may affect the efficiency of the firm. Decisions may get delayed.

5. Lack of Continuity:

A partnership comes to an end with the retirement, incapacity, insolvency and death of a partner. The firm may be carried on by the remaining partners by admitting new partners. But it is not always possible to replace a partner enjoying trust and confidence of all. Therefore, the life of a partnership firm is uncertain, though it has longer life than sole proprietorship.

6. Non-Transferability of Interest:

No partner can transfer his share in the firm to an outsider without the unanimous consent of all the partners. This makes investment in a partnership firm non-liquid and fixed. An individual's capital is blocked.

7. Public Distrust:

A partnership firm lacks the confidence of public because it is not subject to detailed rules and regulations. Lack of publicity of its affairs undermines public confidence in the firm.
The foregoing description reveals that partnership form of organisation is appropriate for medium-sized business that requires limited capital, pooling of skills and judgment and moderate risks, like small scale industries, wholesale and retail trade, and small service concerns like transport agencies, real estate brokers, professional firms like chartered accountants, doctor's clinics or nursing homes, attorneys, etc.

12. Limited Liability Partnership Firms (LLP)

According to the Limited Liability Partnership Act, 2008, an LLP is a body corporate formed and incorporated under this Act. It is a legal entity separate from that of its members.

13. Features of LLP

(i) An LLP must be registered under the LLP Act, 2008.
(ii) It is a body corporate having a separate entity of its own.
(iii) It has perpetual succession. Any change in its members does not affect its existence, rights and liabilities,
(iv) Any individual or a body corporate can be a partner in an LLP.
(v) Every LLP must have at least two partners.
(vi) There must be at least two designated partners and one of them must be a resident in India.
(vii) An LLP must maintain proper books of accounts as per the double entry system.
(viii) An LLP must file with the Registrar a Statement of Account and solvency along with its annual return in the prescribed form.

14. Merits of LLP

a. An LLP enjoys stability as changes in partners do not affect its existence.
b. The liability of an LLP and its partners are Limited.
c. A body corporate and a foreigner can be partners in an LLP.
d. An LLP can raise, large amount of funds as there is no restriction on the number of members and risk involved is limited.

15. Demerits of LLP

a. Time and money are involved in the formation and registration of an LLP.
b. There is less flexibility of operations because an LLP has to comply with certain legal formalities.
c. There is lack of business secrecy as an LLP has to file the prescribed documents with the Registrar. Its accounts are open to the public for inspection.

The LLP gives an entrepreneur the twin benefits of limited liability and a flexible internal structure. It is also free from dividend distribution tax and minimum alternative tax (MAT).

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