

- Goodwill : Nature, factors affecting and methods of valuation - average profit, super profit and capitalisation.

[10 Mar

Introduction

There are different forms of business organisations. The three main forms of business organisations are : sole proprietorship, partnership and companies. Partnerships are similar to sole proprietorship except they have more than one owner. The accounting procedures of partnerships are similar to those of sole proprietorships. However, in case of partnerships more detailed records are maintained.

Partnership is a popular form of business because they are easy to form and allow several individuals to combine their talents and skills in a particular business venture. It provides means to obtain more capital than a single individual could have obtained.

Partnerships are very common in the service profession, particularly accounting, law and medicine. Partnerships are also common in wholesale businesses, and, in small retail stores. A few large industrial and merchandising enterprises also operate as partnerships.

Meaning of Partnership

Partnership is defined by The Indian Partnership Act, 1932 (Section 4) as :

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

In this definition, the term 'persons' includes individuals and other partnerships.

Persons who have entered into partnership with one another are called individually 'partners' and collectively 'a firm'. The name under which their business is carried on is called the 'firm name'.

From the above definition, it is to be noted that partnership consists of three essential elements:

1. there must be an agreement among all the persons concerned. The agreement may be oral or written.
2. the agreement must be to share the profit of the business.
3. the business must be carried on by all or any of them acting for all.

The partnership cannot be formed in the absence of any of the above three elements.

Features of Partnership

1. **Two or more persons:** In order to form a partnership minimum two persons are required. All the persons must be *legally* competent to enter into an agreement. However, the number of persons must not exceed 20, and in case of banking businesses, it must not exceed 10. It should be noted that if the number of persons exceeds the above limit, the partnership becomes illegal and it cannot enter into a contract with a third party or file a legal suit.
2. **Partnership agreement:** Partnership is the outcome of an agreement between two or more persons to do business and share its profits or losses in the agreed ratio. The partnership agreement may be a written agreement or oral agreement. To avoid litigation in future, it is advisable that partners have a written agreement.
3. **Business motive:** The main motive of the agreement is to do business. Joint ownership of property will not be treated as a partnership.
For example, if Ram and Shyam jointly purchase some shares of ITC for investment purpose they become the joint owner of the shares and not partners. However, if they purchase such shares for the purpose of trading and making profit, they will be treated as partners.
4. **Limited life:** The life of a partnership is limited. Death, retirement, bankruptcy or incapacity of a partner may terminate a partnership. Any one of the partners can also terminate a partnership at any time.
5. **Unlimited liability:** The liability of the partners is unlimited. A partner is both jointly and severally liable to third parties. At any point of time, if the assets of a partnership firm are not sufficient to pay its liabilities, creditors may take action against the personal assets of any or all the partners.
6. **Mutual agency:** Each partner is considered as an agent of the partnership firm capable of transacting in the name of the partnership. In effect, any partner can bind the other partners while acting within the scope of the partnership activities.
7. **Co-ownership of profits:** Every member of a partnership has an ownership right in the profits. The members must agree to share the profits or losses of the business, in fact, sharing of profits and losses is one of the proof or parameter of the existence of a partnership.
Sometimes, a manager is allowed a certain percentage of the profit as a bonus or in lieu of a salary. It does not give the manager an ownership right in the profits and does not make him a partner. To be a partner, one must have an ownership right in the profit.
8. **Co-ownership of partnership assets:** When individuals invest assets in a partnership, they retain no claim to those specific assets but acquire co-ownership in the net assets of the partnership. From the accounting viewpoint, a partnership is a separate business entity. From the legal viewpoint, however, a partnership, like sole proprietorship, is not separate from the owners.
9. **Status:** From the accounting viewpoint, a partnership is a separate business entity. From the legal viewpoint, however, a partnership, like sole proprietorship, is not separate from the owners.

As per Section 28 of the Partnership Act, anybody, who, by spoken or written words or by conduct represents himself or knowingly permits himself to be represented as a partner in a firm to a person who has on the faith of any such representation given credit to the firm. A person, who, thus represents himself or allows himself to be represented as a partner to be 'holding out' as a partner under the principle of estoppel.

Partnership Deed

Forming a partnership requires the agreement amongst the partners. It is not compulsory that the agreement must be in writing. A partnership can also be formed on the basis of oral agreement. However, when the agreement is in writing, it is called **Partnership Deed**.

It is a document prepared with the mutual consent of all the partners, covering all the details of the partnership. Each partner should sign this document to indicate acceptance of the terms. A carefully prepared partnership deed can eliminate many of the more common types of problems and disputes that may arise in the future operations of the partnership. The most important points covered in a partnership deed are the following:

1. the date of formation and the duration of the partnership;
2. the names and addresses of the partners;
3. the name of the firm;
4. the nature of business to be carried on by the firm;
5. the authority of each partner and the rights and duties of each partner;
6. the amount of capital to be contributed by each partner;
7. the method by which the value of goodwill shall be determined in case of admission, retirement or death of a partner;
8. the accounting period to be used;
9. methods of keeping books of account;
10. provision for periodic audit;
11. the plan for sharing of profits or losses;
12. interest on loan payable to the partners;
13. salary, commission, interest on capital payable to the partners;
14. interest on drawings to be charged on withdrawals by the partners;
15. the extent to which each partner can bind the other partners;
16. provision for arbitration of disputes, i.e. the procedure to be followed in the event of dispute;
17. mode of settlement of dues of deceased or retired partner;
18. procedures to be followed in case of dissolution of the firm.

Importance of Partnership Deed

- Partnership deed is invaluable in settling any disputes relating to partners' rights and duties.
- On matters such as partners' rights and entitlements, the partnership deed can override the provisions of the Partnership Act.

Provisions of the Indian Partnership Act, 1932 in the Absence of Partnership Deed

If there is no partnership deed or the partnership deed is silent in respect of the following matters, the provisions of the Indian Partnership Act, 1932 will be applied :

(i) Sharing of Profits and Losses

The profits / losses of the firm should be distributed *equally* amongst the partners irrespective of their capital contribution or time devoted by the partners.

Example : A, B and C formed a partnership by contributing ₹ 1,00,000, ₹ 2,00,000 and ₹ 3,00,000 respectively as capital. Only A is devoting full time for the partnership. The firm earned a profit of ₹ 30,000. There is no partnership deed.

In this case, A will get ₹ 10,000 of the profit (1/3rd of ₹ 30,000); B will also get ₹ 10,000 (1/3rd of ₹ 30,000) and C will also get ₹ 10,000 (1/3 of ₹ 30,000).

It is to be noted that in case of absence of a partnership deed, the profit will be shared equally, although A contributed lesser capital and C contributed higher capital.

(ii) Interest on Capital

If the partnership deed is silent with respect to interest on capital or there is no partnership deed, no interest on capital is to be paid to any partner.

(iii) Remuneration to Partners *(Salary)*

If there is no partnership deed or deed is silent on this matter, then no remuneration is to be paid to any partner (in the form of salary, fees or commission, etc.) for taking part in the business of the firm.

(iv) Interest on Loan / Advance

If the partnership deed is silent on this matter or there is no partnership deed, the interest on loan / advance is to be paid @ 6% p.a.

Example : A and B are partners in a firm sharing profits in the ratio of 3 : 2 respectively. They had advanced to the firm a sum of ₹ 30,000 as a loan in their profit sharing ratio on 1st July, 2013. The partnership deed is silent on the question of interest on loan from partners. Compute the interest payable by the firm to the partners, assuming the firm closes its books on 31st December, 2013. In this case, partnership deed is silent on the question of interest on loan. Therefore, interest on loan to be paid @ 6% p.a. The interest payable to the partners will be calculated as follows :

A : $(30,000 \times \frac{3}{5}) \times 6\% \times \frac{6}{12} = ₹ 540$

(v) Interest on Drawings

If the partnership deed is silent on this matter or there is no partnership deed, then no interest on drawings is to be charged.

1.6 Introduction to Partnership

(vi) Introduction of A New Partner

In the absence of a partnership deed, no new partner can be admitted without the consent of all existing partners.

(d) Profit will

i. $\frac{\text{Profit}}{\text{Total Investment}} \times \text{Investment} = \text{Share}$
 i.e. $\frac{3000}{10000} \times 6000 = 1800$

ii. $\frac{2000}{10000} \times 6000 = 1200$

iii. $\frac{1000}{10000} \times 6000 = 600$

iv. $\frac{500}{10000} \times 6000 = 300$

Profit before introduction = 3000
 Profit after introduction = 3000 + 300 = 3300
 Total Investment = 10000 + 6000 = 16000
 Profit : Investment = 3300 : 16000 = 33 : 1600
 Share of A = $\frac{33}{1600} \times 6000 = 1237.5$
 Share of B = $\frac{33}{1600} \times 6000 = 1237.5$
 Share of C = $\frac{33}{1600} \times 6000 = 600$
 Share of D = $\frac{33}{1600} \times 6000 = 300$