"Work so hard that one day your signature will be called an ***Audited Financial Statement****"*

- Anonymous

Conversion of a Firm into Company

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Effects of conversion

- Corporatization
- Limited Liability
- Perpetual Succession
- Transferability of shares
- Easy access to funding
- Automatic Transfer of assets and liabilities
- No Stamp Duty (automatic vesting, no transfer instrument needed)
- No Capital Gain Tax
- Brand Value Continuation
- Carry forward and set off of Losses and unabsorbed depreciation

Mandatory Conditions

Every partner shall become shareholder in the company with the same proportion in which his/her capital accounts stood in the books of the firm as on the date of the conversion.

The partners receive consideration only by way of allotment of shares.

Requirements

- Registered Partnership firm with minimum 2 and 7 Partners for Pvt and Public respectively.
- Minimum Share Capital shall be Rs. 100,000 for conversion into a Private Limited Company.
- Minimum Share Capital shall be Rs. 500,000 for conversion into a Public Limited Co.
- Minimum 7 Shareholders
- Minimum 2 Directors (for Private Limited Co.) and
  3 Directors (for Public Limited Co.)
- The directors and shareholders can be the same.
- DIN (Director Identification Number) for all the Directors.
- DSC (Digital Signature Certificate) for two of the Directors. DIR 3

Process

- Filing of requisite form for Conversion with the ROC. (INC 7)
- Preparation of Foundation documents of the Company (Certified Copy of Partnership Deed, Latest Financials, Latest Income Tax Returns, All Partenrs Consent for conversion, any resolution passed)
- Filing for name approval (INC 1with Rs. 1,000)
- Filing of Incorporation documents
- Receiving certificate of incorporation
- Publishing the adverstisement in two newspapers

Things to be considered

i. Dissolution of the firm.
ii. Formation of a company by taking over the existing firm.
iii. Valuation of assets and liabilities.
iv. Determination of Purchase Consideration.
v. Disposal of assets and liabilities not taken over by the company.
vi. Settement of Purchase Consideration.
vii. Distribution of shares, cash and debentures among the partners appropriately.

Purchase Consideration

An agreed amount

Which the newly formed Company (Purchasing company) pays to the dissolved Firm (Vendor Firm)

In exchange of the ownership of the Firm.

May be in the form of cash, shares, debentures or any other assets as agreed.

Lump Sum Method

The purchasing company may agree to pay a lump-sum to the vendor firm on account of the purchase of its business.

This method is not based on any scientific thoughts and techniques.

This method is an unscientific and non-mathematical method of ascertaining purchase consideration.

Example:

A purchasing company agreed to take over a business of selling company for Rs. 5, 00,000. In such a case, the purchase consideration is Rs. 5,00,000. So, no calculations are needed.

Net Worth or Net Assets Method

Purchase consideration is calculated by adding up the agreed values of various assets taken over by the purchasing company and then deducting the values of various liabilities taken over by the purchasing company.

The values of assets and liabilities are not exchanged at the Balance Sheet Values.

Net Assets =

(Agreed value of Assets taken over) – (Agreed value of liabilities taken over)

Points to remeber while calculating Net Assets

- ✓ All assets include cash and bank balances.
- ✓ Assets does not include “fictitious assets like Debit balance of Profit and Loss A/c, Preliminary Expenses, Discount and other expenses on issue of shares and Debentures, etc.”
- ✓ Any asset not taken over by the Company should be ignored.
- ✓ Goodwill and Prepaid expenses should be included.
- ✓ Liabilities shall include all third party liabilities like Creditors, Payables, Loans, Bank Overdraft, etc.
- ✓ Liabilities do not include accumulated or undistributed profits like, General Reserve, Securities Premium, Workmen Accident Fund, Insurance Fund, Capital Reserve, Dividend Equilisation Fund, etc.

Net Payment Method

Purchase consideration is the total of shares, debentures and cash which are to be paid for claims of partners of the firm who later, become shareholders.

Always calculated at issue price, which may be at par or premium.

May also include dissolution expenses.

Note:

If PC cannot be calculated by Net Payment Method due to missing information, then Net Asset Method is to be used. The difference between values of both the methods will be the missing figure.

Accounting Procedure in the books of Firm

Step 1:

Transfer all recorded assets and liabilities (whether or not taken over by the purchasing company) to Realization account, except cash and bank balance if not taken over by the purchasing company.

1.1 <u>For Transferring all book assets</u>:

Realization A/C..................Dr.

To sundry assets

1.2 <u>For transferring book liabilities</u>

Sundry liabilities.................Dr.

To Realization A/C

Step 2:

Make purchase consideration due.

2.1 <u>For purchase price due:</u>

Purchasing company...........Dr.

To Realization A/C

Step 3:

If, there remain any assets (whether or not recorded) not taken over by the purchasing company; it may be sold, or may be taken by one of the partners or may be shared among the partners.

3.1 On sale of assets not taken over by the purchasing company:

Bank A/C..................Dr.

To realization A/C

3.2 Such assets taken over by any one of the partners:

Partner's capital A/C...............Dr.

To Realization A/C

3.3 On sharing such assets among the partners:

Partners' capital A/C(capital ratio)............Dr.

To realization A/C

Note: If such unsold assets are considered worthless, they should be shared among the partners in profit sharing ratio.

Step 4:

The liabilities (whether or not recorded) by the purchasing company may be discharged or may be absorbed by any one of the partners, or must be shared by the partners in their capital ratio.

4.1 On discharge of any liability not taken over by the purchasing company:

Realization A/C ....Dr.

To Bank A/C

4.2 If such liability absorbed by any one of the partners:

Realization A/C...............Dr.

To Partner's capital A/C

4.3 If such liability has to be absorbed by all partners:

Realization A/C................Dr.

To Partners' capital A/C(capital ratio)

Step 5:

When the realization expenses is paid

5.1 <u>For payment of realization expenses:</u>

Realization A/C.............Dr.

To Bank

If Realization expenses paid by New Company, then No Entry!

Step 6:

Close the realization account by transferring the balance (profit or loss) to Partners Capital a/c in profit sharing ratio.

6.1 <u>For profit on realization account:</u>

Realization A/C..............Dr.

To Partners' capital A/C (profit sharing ratio)

6.2 <u>For loss on realization account:</u>

Partners' capital A/C...........Dr.

To realization A/C

Step 7:

On receipt of purchase consideration

7.1 <u>For the receipt of purchase price:</u>

Cash/bank A/C...................................Dr.

Equity share in purchasing Co...........Dr.

Preference share in purchasing Co....Dr.

Debentures share in purchasing Co...Dr.

To purchasing Co.

Step 8:

Transfer all accumulated reserves/profits/losses to the capital accounts of partners in profit sharing ratio.

8.1 <u>For accumulated reserves, profits:</u>

Reserve A/C.................Dr.

Profit and loss A/C.......Dr.

To partners' capital A/C

8.2 <u>For accumulated losses:</u>

Partners' capital A/C.............Dr.

To profit and loss A/C

Step 9:

Transfer the current account, if any, in the books, to the capital accounts of the partners.

9.1 <u>For transferring current account to the capital account:</u>

Partners' current Account................Dr.

To partners' capital Account

Step 10:

Pay off the partner's loan if any.

10.1 <u>For the payment of Partner's loan account:</u>

Partner's loan A/C ....Dr.

To bank A/C

10.2 <u>For payment of interest on Partner's loan:</u>

Realization A/C.................Dr.

To Cash A/C

10.3 <u>Discount allowed on Loan Repayment</u>

Partner's Loan A/C...............Dr.

To Realization A/C

10.4 <u>For Partner's LOan repayed by issue of shares or debentures:</u>

Partner's Loan A/C................Dr.

To Shares in New Company

To Debentures in New Company

Step 11:

Make final settlement by paying off balances in capital accounts. In the absence of an agreement as to the division of shares (from purchasing company) among partners, such shares are distributed in the ratio of their final claims (i.e. in the ratio of capitals after all the adjustments).

11.1 <u>For final settlement:</u>

Partners' Capital A/C ....Dr.

To equity shares in purchasing Co.

To preference shares in purchasing Co.

To Bank A/C

Accounting Procedure in the books of New Company

Step 1:

Record take over of assets and liabilities

1.1 **For take over of assets and liabilities**

Assets A/C……………Dr.

To Liabilities A/C

To Vendor Firm's A/C

Note:

Any difference in the above shall be treated as Goodwill or Capital Reserve.

Step 2:

Settlement of Purchase Consideration

2.1 Settling Purchase Consideration

Vendor Firm’s A/C………….Dr.

To Share Capital

To Debentures

To Cash

To Share Premium

Step 3:

Payment of Realization Expenses

3.1 Realization Expenses paid by the Company

Goodwill A/C………………Dr.

To Cash

Illustration 1:

A, B and C carry on business in partnership sharing profits and losses in the proportions of 1/2, 3/8 and 1/8 respectively. On 31st March, 2012, they agreed to sell their business to a limited company.

Their position on that date was as follows:

	₹		₹
A's Capital	40,000	Machinery	48,000
B's Capital	30,000	Furniture	42,000
C's Capital	26,000	Stock	23,000
Loan on Mortgage	16,000	Book Debts	15,000
Sundry Creditors	18,000	Cash	2,000
	1,30,000		1,30,000

The company took the following assets at the valuation shown below:—

	₹
Machinery	61,000
Furniture	31,800
Stock	22,000
Book Debts	14,000
Goodwill	10,000

The company also agreed to pay the creditors which was agreed at ₹ 17,700. The company paid ₹ 67,000 in fully paid shares of ₹ 10 each and the balance in cash. The expenses amounted to ₹ 1,500.

Prepare ledger accounts in the books of the firm.

Source: www.youarticlelibrary.com

Solution:

Dr. **Realisation Account** *Cr.*

2012		₹	₹	2012		₹	₹
Mar. 31	To Sundry Assets—			Mar. 31	By Loan on Mortgage		16,000
	Machinery	48,000		Mar. 31	By Sundry Creditors		18,000
	Furniture	42,000		Mar. 31	By Ltd. Company's A/c—		
	Stock	23,000			Machinery	61,000	
	Book Debts	15,000	1,28,000		Furniture	31,800	
Mar. 31	To Cash—expenses		1,500		Stock	22,000	
Mar. 31	To Cash—loan paid		16,000		Book Debts	14,000	
Mar. 31	To Profits transferred to:				Goodwill	10,000	
	A's Capital, 1/2	4,800					
	B's Capital, 1/2	3,600				1,38,800	
	C's Capital, 1/2	1,200	9,600		*Less:* Creditors	17,700	1,21,1000
			1,55,100				1,55,100

Dr. **Limited Company's Account** *Cr.*

2012		₹	2012		₹
Mar. 31	To Realisation A/c—		Mar. 31	By Shares in Ltd.	67,000
	— consideration	1,21,100	" "	By Cash	54,100
		1,21,100			1,21,100

Source: www.youarticlelibrary.com

Cash Account

Dr.			₹		Cr.	₹	₹
2012				2012			
Mar. 31	To Balance *b/fd*		2,000	Mar. 31	By Realisation A/c—		
Mar. 31	To Ltd. Company		54,100		Expenses		1,500
					Loan		16,000
				Mar. 31	By Capital Accounts:—		
					A	16,380	
					B	12,280	
					C	9,940	38,600
			56,100				56,100

Shares in Ltd. Co.

Dr.			₹		Cr.	₹
2012				2012		
Mar. 31	To Ltd. Company		67,00	Mar. 31	By *A*'s Capital A/c	28,420
				Mar. 31	By *B*'s Capital A/c	21,320
				Mar. 31	By *C*'s Capital A/c	17,360
			67,000			67,000

Capital Accounts

Dr. Cr.

Particulars	*A*	*B*	*C*	*Particulars*	*A*	*B*	*C*
	₹	₹	₹		₹	₹	₹
To Shares in... Ltd. Co.	28,420	21,320	17,360	By Balance *b/fd*	40,000	30,000	26,000
To Cash— settlement, balancing figure	16,380	12,280	9,940	By Realisation A/c— profits	4,800	3,600	1,200
	44,800	33,600	27,200		44,800	33,600	27,200

Note:

Total number of shares received from the limited company is 6,700. Theses have been divided among A, B and C in the ratio of 448, 336 and 272 or 28, 21 and 17 respectively, namely, in the ratio of the amount finally due to them.

A gets $\frac{6,700}{66} \times 28$ or 2,842 shares of ₹ 28,420;

B gets $\frac{6,700}{66} \times 21$ or 2,132 shares of ₹ 21,320; and

C gets $\frac{6,700}{66} \times 17$ or 1,736 shares of ₹ 17,360;

Source: www.youarticlelibrary.com

Thank You