

Unit – 5.1 Conversion of Partnership Firm into a Limited Company: Theory

Meaning – Objectives of Conversion – Purchase Consideration – Methods of Calculation of Purchase Consideration – Mode of Discharge of Purchase Consideration – Lump Sum Method – Net Assets Method – Net Payment Method – Ledger Accounts in the Books of Vendor – Incorporation Entries in the Books of Purchasing Company, Preparation of Balance Sheet in Vertical form.

Introduction:

Joint Stock Company form of organization has certain benefits like Limited Liability, Separate Legal Entity, Perpetual Succession, Tax Concessions, Scope for Collection of more Funds for Expansion, Economies of Large Scale Operations etc., over the partnership firms. So, sometimes the partners of an existing firm may wish to convert their partnership firm into a Limited Company to enjoy the benefits of a Limited Company.

Meaning:

Conversion of a Partnership Firm into a Limited Company means **changing the legal status of a partnership firm into a limited company**. A Partnership firm may convert itself into a joint stock company. However, for accounting purposes it shall be treated as the company taking over, partnership firm. Hence, conversion of partnership firm into a company, also amounts to 'Sale of Firm to a Company' for accounting purposes.

The sale of firm to a company will be for a consideration, payable in various forms. The firm which is being sold to the company is called the '**Vendor Firm**' and the company which is purchasing the firm is called '**Purchasing Company**'.

Objectives of Conversion or Sale of Partnership:

The main objectives of conversion of partnership firm into a limited company are:

1. To have a separate entity different from that of its members.
2. To enjoy the benefit of limited liability.
3. To enjoy tax concessions.
4. To have continuous existence.
5. To secure more capital for expansion of business.
6. To enjoy benefits of large-scale operations.
7. To increase the managerial skills.
8. To become a legal person under the law.
9. To avail more skilled labourers.

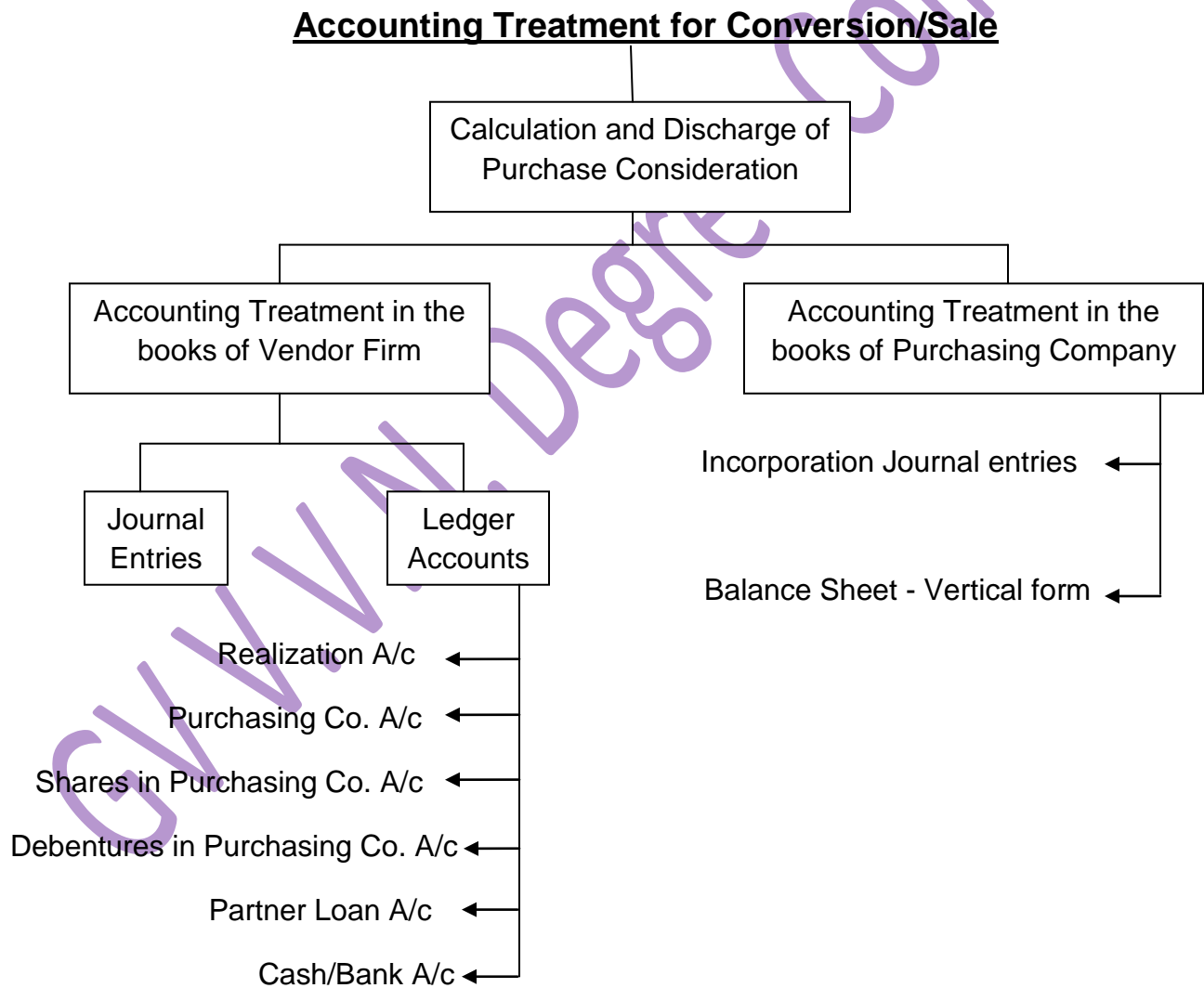
Accounting Treatment:

In the context of conversion there are two entities involved. They are

1. Vendor Firm (a firm which sells its business to a limited company).
2. Purchasing Company (a company which purchases the business of vendor firm).

Therefore, the accounting treatment in conversion/sale of partnership firm into a limited company involves the following steps:

1. Identifying and Calculation of Purchase Consideration.
2. Discharge of Purchase Consideration.
3. Accounting treatment in the books of selling firm.
4. Accounting treatment in the books of purchasing company.
5. Preparation of Balance Sheet in Vertical Form.



STEP:1. Calculation of Purchase Consideration and its Settlement:

While converting the partnership firm into a limited company under the law, the vendor firm has to close its books of accounts and transfer the assets, liabilities and other items as agreed to the purchasing company. The vendor firm is also called as **Selling firm which sells its business (transfers its assets, liabilities and other properties) to the purchasing company.**

The purchasing company has to value the vendor firm to pay the consideration for the purchase. **The price or consideration payable by the purchasing company to the vendor firm or selling firm for the assets, liabilities and other items received is called as purchase consideration (PC).**

Methods of calculating Purchase Consideration:

There are three methods to calculate Purchase Consideration. They are

1. Lump sum Method.
2. Net Asset Method.
3. Net Payment Method.

1. Lump sum Method: Under this method, a fixed amount or a lump sum is paid by the purchasing company for the assets and liabilities taken over from the vendor firm. For ex: - Rs.50,00,000 is payable as Purchase Consideration to the vendor firm without considering value of each asset and liabilities of the firm.

2. Net Asset Method: Under this method, the purchase consideration is calculated through the difference in the value of assets taken over to the value of liabilities taken over at agreed rate by the purchasing company from the vendor firm.

Calculation of Purchase Consideration under Net Asset Method:

	Rs.
Total Assets taken over at an agreed value by the purchasing company	xxxx
Less: Total liabilities taken over at agreed value by the purchasing company	----
Total Purchase Consideration	xxxxx

3. Net Payment Method: Under this method Purchase Consideration will be the actual payment made by the purchasing company against each item of liability. The payment may be in cash or shares or debentures or in any combination of the above. The net payment may consider the following -

	Rs.
Equity/Preference Shares	xxxx
Debentures	xxxx
Cash	xxxx
Total Purchase Consideration	xxxxx

STEP: 2. Ascertaining the form of discharge of Purchase

Consideration:

The purchase consideration may be discharged by the purchasing company in any of the following ways –

1. Completely in Cash
2. Completely in Shares (Equity/Preference)
3. Completely in Debentures
4. Partly in Cash and Partly in Shares
5. Partly in Cash and Partly in Debentures
6. Partly in Shares and Partly in Debentures
7. Combination of Cash, Shares and Debentures

STEP: 3. Accounting Treatment in the books of Selling Firm:

When the firm is sold to a company or is converted into a company, its books of accounts have to be closed by passing journal entries and opening some ledger accounts. The following are the **Journal Entries** to be passed in the vendor firm.

1. For transfer of assets including cash at book value:

Realization a/c Dr
 To, Concerned Asset a/c

2. For transfer of liabilities at book value:

Concerned liabilities a/c Dr
 To, Realization a/c

3. For amount of Purchase Consideration due:

Purchasing Co. a/c Dr
 To, Realization a/c

4. For Receipt of Purchase Consideration:

Cash/Bank a/c Dr
Shares in Purchasing Co. a/c Dr
Debentures in Purchasing Co. a/c Dr
 To, Purchasing Co. a/c

5. For payment of realization expenses:

Realization a/c Dr
 To, Cash/Bank a/c

6. For sale of assets not taken over by the purchasing Co.

Cash/Bank a/c Dr
 To, Realization a/c

7. For payment of liabilities not taken over by the purchasing Co.

Realization a/c Dr
 To, Cash/Bank a/c

8. For assets taken over by the partners:

Partner's Capital a/c Dr
 To, Realization a/c

9. For liabilities taken over by the partners:

Realization a/c Dr
 To, Partner's Capital a/c

10. For closing the realization account:

(a) In case of profit:

Realization a/c Dr
 To, Partner's Capital a/c

(b) In case of loss:

Partner's Capital a/c Dr
 To, Realization a/c

11. For transfer of Reserve:

Reserve a/c Dr
 To, Partner's Capital a/c or Current a/c

12. For transfer of Undistributed Profit:

Profit and Loss a/c Dr
 To, Partner's Capital a/c or Current a/c

13. For transfer of Undistributed Loss:

Partner's Capital a/c or Current a/c Dr
 To, Profit and Loss a/c

14. For payment of Partner's Loan:

Partner's loan a/c Dr
 To, Cash/Bank a/c

15. For distribution of Cash/Shares/Debentures:

Partner's Capital a/c Dr
 To, Cash/Bank a/c

 To, Shares in purchasing Co. a/c

 To, Debentures in purchasing Co. a/c

(In Final Claim Ratio or Final Capital Balance Ratio)

Ledger Accounts to be opened in the Vendor Firm:

1. Realization Account.
2. Purchasing Company Account.
3. Shares in Purchasing Company Account. (Equity/Preference) if any.
4. Debentures in Purchasing Company Account if any.
5. Partner's Loan Account if any.
6. Partner's Capital Accounts.
7. Cash/Bank Account.

Realization Account:

It is an account prepared in the books of vendor firm to find out the profit or loss on realization. Realization account is debited with all assets at Book Values and credited with all the liabilities at Book Value except partner' loan. If the purchasing company does not take over certain assets then they are sold away in the market or it may be taken over by the partner through realization account. In the same way, if the purchasing company does not take over some liabilities of the firm, then such liabilities are paid or taken over by the partners through realization account.

It must be noted that generally all assets including cash and bank balances are taken over by the purchasing company. If it is specifically mentioned that the purchasing company has not taken over cash then, cash cannot be transferred to realization account.

Pro-forma of Realization Account:

Dr.		Realization A/c		Cr.	
Particulars	Amount	Particulars	Amount		
To, Concerned Asset a/c	xxx	By, Concerned Liability a/c	xxx		
To, Cash/Bank a/c (Expense)	xxx	By, Purchasing Co. a/c (PC)	xxx		
To, Cash/Bank (Liability paid)	xxx	By, Cash/Bank a/c (Assets sold)	xxx		
To, Partners a/c (Liability taken)	xxx	By, Partners a/c (Assets taken)	xxx		
To, Partners a/c (Share of Profit)	xxx	By, Partners a/c (Share of Loss)	xxx		
	xxxxx				xxxxx

Purchasing Company Account:

This account is debited with the purchase price and credited with the mode of payment of purchase consideration i.e., Cash, Shares and Debentures.

Pro-forma of Purchasing Company Account:

Dr.		Purchasing Company A/c		Cr.	
Particulars	Amount	Particulars	Amount		
To, Realization a/c (Total PC)	xxx	By, Equity Shares in purchasing co.	xxx		
		By, Pre. Shares in purchasing co.	xxx		
		By, Debentures in purchasing co.	xxx		
		By, Cash/Bank a/c	xxx		
	xxxxx				xxxxx

Shares (Equity/Preference) in Purchasing Company Account:

This account is debited with the shares (Equity/Preference) received from purchasing company and credited with share amount divided among partners.

Debentures in Purchasing Company Account:

This account is debited with the Debentures received from purchasing company and credited with Debenture amount divided among partners.

Distribution of Shares and Debentures among Partners:

It must be noted that the shares and debentures received from purchasing company as purchase consideration are divided among the partners in the absence of any specific agreement among the partners, in '**Final Capital Balance Ratio**' or '**Final Claim Ratio**'.

NOTE: It should be noted that shares and debentures should be distributed to the nearest whole number because fraction of a share or debenture cannot be issued.

Partners Loan Account:

Partner's Loan should be paid-off before paying partner's capital by debiting partner's loan account and crediting cash or bank account.

Partner's Capital Account:

Partner's capital account is opened to ascertain the amount due to partners before making payment to partners in the dissolution of firm. While paying off the partner's capital, first shares or debentures received from purchasing company should be issued to the partners as per the agreement, if no specific agreement among the partners it is to be distributed in the **final claim ratio** and then the balance is **paid in cash**.

Pro-forma of Partner's Capital Account:

Dr.		Partner's Capital A/c		Cr.	
Particulars	Rs.	Particulars	Rs.		
To, Profit & Loss a/c (loss balance)	xxx	By, Balance b/d (capitals)	xxx		
To, Realization a/c (assets taken)	xxx	By, Reserve Fund a/c (profit ratio)	xxx		
To, Realization a/c -realization loss	xxx	By, Profit & Loss a/c (profit balance)	xxx		
To, Cash/Bank a/c (surplus)	xxx	By, Realization a/c (liability taken)	xxx		
		By, Realization a/c -realization profit	xxx		
		By, Cash/Bank a/c (deficit)	xxx		
	xxxx				xxxx

Cash/Bank Account:

Finally, cash or bank account is opened to record all cash receipts and cash payments. Normally payments will be equal to receipts.

Pro-forma of Cash/Bank Account:

Dr.		Cash/Bank A/c		Cr.	
Particulars	Rs.	Particulars	Rs.		
To, Balance b/d (opening balance)	xxx	By, Realization a/c -cash transferred	xxx		
To, Realization a/c (assets sold)	xxx	By, Realization a/c (expense paid)	xxx		
To, Purchasing Co. a/c (PC in cash)	xxx	By, Realization a/c (liability paid)	xxx		
To, Partners Capital a/c (deficit)	xxx	By, Partner's loan a/c (loan paid)	xxx		
		By, Partners Capital a/c (surplus)	xxx		
	xxxx				xxxx

STEP: 4. Accounting Treatment in the books of Purchasing Company:

When the books of vendor firm are closed and the business has been transferred to the purchasing company, then the company should incorporate the vendor firm business assets, liabilities and properties received, purchase consideration paid and final settlement of vendor firm for which it has to pass some incorporation entries in its books. The following are the incorporation entries in the books of purchasing company.

Incorporation Entries:

1. For Purchase consideration due:

Business Purchase a/c	Dr
(Goodwill a/c	Dr)
To, Vendor Firm a/c	

2. For Assets and Liabilities taken over (at agreed value):

Individual Asset a/c	Dr
To, Individual Liabilities a/c	
To, Business Purchase a/c	
(To, Capita Reserve a/c)	

NOTE: When the total of liabilities and business purchase is more than assets, the difference is treated as Goodwill and when the total assets are more than total of liabilities and business purchase, the difference is treated as Capital Reserve.

3. For Discharge of Purchase Consideration:

Vendor Firm a/c	Dr
To, Cash/Bank a/c	
To, Share Capital a/c	
To, Share Premium a/c (if any)	
To, Debenture a/c	

NOTE: When the shares or debentures are issued at a premium to the vendor firm it should be transferred to share premium a/c and if it were issued at a discount then, it should be transferred to discount on issue of shares or debenture a/c.

4. For Realization/Dissolution expenses of Vendor Firm if paid by the Company:

Goodwill a/c	Dr
To, Cash/Bank a/c	

5. For issue of Shares/Debentures to meet additional capital:

Cash/Bank a/c	Dr
To, Equity/Preference Share Capital a/c	
To, Debentures a/c	

6. For Purchase of Additional Assets:

Assets a/c	Dr
To, Cash/Bank a/c	

STEP: 5. Preparation of Balance Sheet in Vertical Form:

In the books of the Purchasing Company, a Balance Sheet is prepared to incorporate the Assets, Liabilities received and Purchase Consideration settlement to Vendor Firm along with the Assets, Liabilities and Capital of Purchasing Company. This is the final step in the accounting treatment of conversion.

Pro-forma of Balance Sheet: (Vertical Form)

In the books of Purchasing Company:

Balance Sheet as on _____

Particulars	Amount Rs.
A. Capital and Liabilities:	
Share Capital	XXXX
Reserves and Surplus	XXXX
Secured Loans	XXXX
Unsecured Loans	XXXX
Current Liabilities and Provisions	XXXX
Total Capital and Liabilities	XXXX
B. Assets and Properties:	
Fixed Assets	XXXX
Investments	XXXX
Current Assets, Loans and Advances	XXXX
Miscellaneous Expenses and Losses	XXXX
Total Assets	XXXX