CONVERSIONS

The discussion will generally deal with the conversion of a partnership to a private company.

There are five issues at stake when a partnership has to be converted to a private company:

1. FINALISATION OF CAPITAL ACCOUNTS IN THE RECORDS OF THE PARTNERSHIP
2. DETERMINATION OF EQUITY CAPITAL
3. CALCULATING AND DEALING WITH EXCESSES ON CAPITAL ACCOUNTS
4. CASH FLOW
5. VOTE RIGHTS

1. FINALISATION OF CAPITAL ACCOUNTS IN THE RECORDS OF THE PARTNERSHIP

It is of the utmost importance to finalise balances on capital accounts of partners prior to starting with the conversion to a different legal entity.

Adjustments to these accounts will be made according to information given in a question. Normally it would relate to transactions not yet recorded in the records of the partnership, the revaluation of assets and goodwill, etc.

Capital of partners should be converted to a form of shareholders interest to ensure that creditors retain the same entitlement to a liquidation dividend, should the company be liquidated at any point in the future, as what they are enjoying in the partnership. Should the accounts of partners be converted to loans, for example, such loans would also constitute a concurrent claim in the event of the company being liquidated. Creditors would in such a case be worse off since they would have to share their concurrent claims with ex-partners.

The first capital which is issued is equity capital. Equity capital is risk capital. In case of liquidation equity shareholders would be the last to receive a liquidation dividend, if any. If the liquidation realises a profit, however, equity shareholders would be entitled to the profit.

Capital accounts of partners seldom reflect the profit-sharing ratio since profit is shared according to the stipulations in the partnership agreement. In a company, dividends are paid, and profits accrue, according to the number of shares held. It is therefore crucial that the shareholding in a company reflects the profit-sharing ratio.

In this module we assume that the purpose of a conversion is not to change the terms of the existing partnership agreement, but to convert to obtain the limited liability that a private company offers. A financial structure for the newly incorporated company should therefore be proposed in a manner that existing rights remain the same. Suitable financial instruments should be utilized to achieve this.

2. DETERMINATION OF EQUITY CAPITAL

The maximum equity capital needs to be determined in a manner in terms of which partners would neither have to pay in additional capital, nor get some back. The **calculation** of this capital should be about achieving just that.

Every partner must contribute to equity according to his/her profit share. The number of ordinary shares issued to each partner should therefore reflect the profit-sharing ratio. The procedure to achieve this is as follows:

Divide the balance on each capital account by the profit share of the person whose account it is. Consider the resulting figure as "one portion of capital" in terms of that person's account. Select the lowest "one portion of capital" and multiply it by each partner's profit share to determine equity capital.

TEXTBOOK – QUESTION 2 ON PAGES 384 – 389 - REFER TO PAGE 385

Partners share profit in the ratio 4 : 3 : 2 : 1.

"One portion of capital" according to the balance on each partner's capital account amounts to:

Adams:	R710 000 ÷ 4	=	R177 500
Botha:	R285 000 ÷ 3	=	R95 000
Campher:	R306 000 ÷ 2	=	R153 000
Davis:	R165 000 ÷ 1	=	R165 000

The lowest "one portion of capital" is that of Botha and amounts to R95 000.

Determine the maximum equity capital as follows:

Adams:	R95 000 X 4	=	R380 000
Botha:	R95 000 X 3	=	R285 000
Campher:	R95 000 X 2	=	R190 000
Davis:	R95 000 X 1	=	R95 000

Total equity amounts to the sum of the above, namely R950 000.

3. CALCULATING AND DEALING WITH EXCESSES ON CAPITAL ACCOUNTS

3.1   CALCULATION OF EXCESS

First excesses on capital accounts are calculated by deducting equity capital (as calculated above) from final balances on capital accounts. Note that the partner whose "one portion of capital" was the lowest wouldn't have any excess on his/her capital account.

TEXTBOOK – QUESTION 2 ON PAGES 384 – 389 OF REFER TO PAGE 385

FIRST EXCESSES: Deduct equity from final balances on capital accounts

Adams:	R710 000 – R380 000	=	R330 000
Botha:	R285 000 – R285 000	=	RNIL
Campher:	R306 000 – R190 000	=	R116 000
Davis:	R165 000 – R95 000	=	R70 000

SECOND EXCESS

Apply the same procedure which has been followed to determine equity capital.

➢ Calculate "one portion of capital" for each of the amounts comprising first excesses

Adams:	R330 000 ÷ 4	=	R82 500
Campher:	R116 000 ÷ 2	=	R58 000
Davis:	R70 000 ÷ 1	=	R70 000

Note that Botha is excluded since there is not any excess on his account.

➢ Identify the account with the "lowest one portion of capital". It is Campher's and the lowest "one portion of capital" amounts to R58 000.

➢ Determine the **value of the next round of capital**, using R58 000 as "one portion of capital":

Adams:	R58 000 X 4	=	**R232 000**
Campher :	R58 000 X 2	=	**R116 000**
Davis:	R58 000 X 1	=	**R58 000**

➢ Determine the **second excesses** by deducting the abovementioned values from the values comprising the first excesses:

Adams:	R330 000 – R232 000	=	R98 000
Campher	R116 000 – R116 000	=	RNIL
Davis:	R70 000 – R58 000	=	R12 000

THIRD EXCESS

Repeat the procedure used to determine second excesses. Note that in each round one capital account is eliminated.

➢ "One portion of capital":

Adams:	R98 000 ÷ 4	=	R24 500
Davis:	R12 000 ÷ 1	=	R12 000

➢ Select lowest amount of R12 000 to use as basis for the calculation of the next round of capital.

➢ Determine **the value of next round of capital**, using R12 000 as "one portion of capital":

Adams:	R12 000 X 4	=	**R48 000**
Davis:	R12 000 X 1	=	**R12 000**

➢ Determine the **third and final excess** by deducting the abovementioned values from those comprising the second excesses:

Adams:	R98 000 – R48 000	=	R50 000
Davis:	R12 000 – R12 000	=	RNIL

The third and final excess of R50 000 belongs to Adams.

THERE ARE NO FURTHER EXCESSES.

3.2   ISSUING OF PREFERENCE SHARE CAPITAL

Preference share capital is issued to partners who have contributed more to capital than they should have, in terms of the profit-sharing ratio.

When capital accounts are analysed and there are more than one excess on capital accounts, **different classes of preference share capital** could be issued to indicate the priority for repayment of capital.

When more than one class preference shares is issued, each class should be granted a right to repayment to indicate the priority for repayment in the event of the company being liquidated.

The first excesses could be issued as preference share capital which enjoys priority for repayment above that of equity capital. It could be described as Class 1 Preference share capital, issued with a right to repayment in the event of liquidation, above equity capital.

The second excesses could, likewise, be issued as Class 2 Preference share capital, issued with the right to repayment in the event of liquidation above equity, as well as above Class 1 Preference share capital.

The third excesses could be issued as Class 3 preference share capital, issued with the right to repayment in the event of liquidation above equity, as well as above Class 1 and 2 Preference share capital.

The analysis of capital accounts is done "from top to bottom". The priority of rights about repayment of capital, however, is done "from bottom to top".

In the case of the example on page 385, a loan of R50 000 is granted to Adams. This could be justified since that amount represents already his third excess.

For purposes of the exam, rather keep to preference share capital as financial instrument, except if the question explicitly suggests different financial instruments.

3.3 DETERMINATION OF A DIVIDEND RATE TO ATTACH TO PREFERENCE SHARES

A dividend percentage has to be attached to preference shares in such a manner that the interest that partners used to receive (in the partnership) is matched. For purposes of conversions we assume that the partners did pay tax on their interest (in other words, the tax-free portion of interest received had already been utilized before they received interest on their capital accounts).

Dividends are not taxable. If the dividend rate would equal the interest rate, the new shareholders would actually receive MORE income as before, which is not the intention with the conversion. The interest rate applicable to capital accounts in the partnership, therefore, must be adjusted to reflect the interest "retained" by the partner.

Each partner would have paid tax on interest received according to his marginal tax rate. In the company the dividend rate should be equal to the percentage interest that each partner "retained".

In the example on page 386 of the textbook, the interest rate on capital accounts used to be 12,5%. The marginal tax rate of partners was 44%. Partners would have retained 56% (100% - 44%) of the interest that they received, namely 7%. The dividend rate which should be attached to preference shares should therefore be 7%.

4   CASH FLOW

The cash flow that partners used to receive in the partnership must be retained in the new legal entity. Income that partners would be entitled to in the new company, in terms of the proposed financial structure of the company, should therefore match the income that they used to receive in the partnership. The difference must be rectified in an appropriate manner, for example, be paid as directors' remuneration.

Refer to part (b) of question 2 on pages 388 – 399 in this regard.

5   VOTING RIGHTS

In a partnership partners normally have an equal vote. The conversion to a private company should reflect this since the partners have agreed to maintain existing vote rights.

In a company, voting takes place according to the number of ordinary shares held.   Since one cannot have a fraction of a vote, one has to use a basic mathematical concept to determine how to structure things to achieve equal vote rights without ending up with fractions of votes.

The issue is addressed by making use of the least common multiple of figures in the profit-sharing ratio.

For those of you who may have forgotten the definition of the least common multiple: It is the smallest multiple that is **exactly divisible** by every member of a set of numbers. For our purpose, the set of numbers would be the numbers of the profit-sharing ratio.

Profit is shared in the ratio 4 : 3 : 2 : 1. The least common multiple will be determined by finding the smallest value in which each of these figures can be divided into, without leaving a rest value. In this case the value is 12.

Different vote rights have to be attached to ordinary shares. This is possible if you issue ordinary share capital in different classes, where every class has a different vote right attached to it.

Using question 2 on page 389 as basis, the number of votes attached to a specific class of ordinary shares is 12, divided by the profit share figure. Adams will therefore have 3 (12 ÷4) votes per share. Botha will have 4 (12 ÷ 3) votes per share. Campher will have 6 (12 ÷ 2) votes per share. Davis will have 12 (12 ÷ 1) votes per share.

If you do the calculations for the above, as has been done on page 389 in the textbook, it will be clear that each partner retain equal vote rights, namely 1 140 000 votes each.

Bear in mind that all the partners are in agreement that the previous voting status must be maintained.