Unit-1 Profits/Loss Prior to Incorporation

Meaning

Sometimes a company may purchase a running business from a date prior to its incorporation. E.g. a company may purchase a running business from 1st January, 2019 and may get itself incorporated on 1st May 2019. In that case the profit made by the business up to the date of incorporation is called profit prior to incorporation. Such profit is a capital profit and hence not available for the distribution as dividend. It is credited to Capital Reserves Account. In case there is a loss prior to incorporation, it is a capital loss. Hence debited to goodwill on the purchase of business. For calculation of such profits the date of incorporation is to be taken into consideration and not the date of commencement of business. Moreover, the profit earned by a company after the date of incorporation is a revenue profit available for distribution as dividend to shareholders.

Procedure

In order to ascertain the profit or loss prior to and after incorporation, the following followed:

1. Prepare a Trading Account and ascertain the Gross Profit for the whole year.

2. Calculate the Time and Sales Ratio, prior to and after incorporation.

Time ratio is the ratio of the period falling before and after the date of incorporation. For ex- ample, if the company is incorporated on 1st April, 2019 and it has acquired the running business on 1st January, 2019 and final accounts are being prepared on 31st December 2019, then the time ratio is as under.

1.1.2019 Date of acquisition of business

1.4.2019 Date of Incorporation

31.12.2019 Date of Final Accounts

Time Ratio:-3 months 9 months = 1:3.

Sale Ratio is calculated on the basis of sales of pre-incorporation and of post incorporation period. For example, if sales for pre-incorporation period is Rs. 5 lakh and that of post- incorporation period is Rs. 25 lakh, the sales ratio is Rs.5 lakh: Rs. 25 Lakh or 1:5.

3. Prepare the profit and loss account for the pre-incorporation period and post-incorporationperiod separately in columnar form. For doing this:

i) Apportion the gross profit between the two periods on the basis of their respective sales ratio or in a given ratio.

ii) Divide the expenses directly related to the sales in the ratio of sales and charge against the respective gross profits. The examples of such sales expenses are commission on sales, discount allowed, bad debts, advertising publicity, carriage outward, etc.

iii) Divide common expenses of fixed nature in time ratio. The examples of such common expenses are rent, salaries, depreciation, interest, insurance etc.,

iv) Expenses incurred after the incorporation of the company such as director fees, debenture interest, loss or discount on issue of debentures or shares, preliminary expenses written off, etc. should be entirely charged to post incorporation period. Similarly expenses solely incurred before incorporation such as salaries of partners should be debited entirely to the pre incorporation period.

v) Audit fees may be divided on time basis as it is paid for auditing the accounts of entire

year. Alternately, it may also be charged entirely to the post incorporation period as audit is compulsory under company law. However, a footnote should be appended.

vi) Interest paid to vendors on purchase consideration should be divided into two parts, Actual interest from the date of purchase to the incorporation period should be charged to the pre-incorporation period. The rest of the interest should be charged to the post incorporation period.

The balancing figure between pre-incorporation gross profit or income and pre-incorporation expensesis pre-incorporation profit (or loss). If it is a profit, it is credited to capital reserve and if it is a loss, it is debited to goodwill A/C.

Tables showing allocation of income and expenses items:

A. Allocation of Income Items

1	Gross Profit (or Loss)	Turnover or Sales Ratio (Sometimes in given ratio)
2	Rent Received	Time Ratio
3	Interest Received	Time Ratio
4	Commission Received	Sales Ratio (Net Turnover)
5	Discount Received	Net Sales, or Turnover Ratio
6	Bad Debts Recovered	On the basis of the period to which they belong

B. Allocation of Expenses and Losses

No.	Nature of expenses	Name of Expenses	Basis for allocation
1	Sales Expenses (variable))	Commission, carriage out, discount allowed, bad debts, advertisement, brokerage, travelling expenses etc.	In Sales Ratio
2	Standing Expenses (Fixed)	Rent, Salaries, interest, taxes, depreciation, insurance postage, printing, stationery, general expenses	On Time Basis
3	Exclusively Pre-incorp.Expenses	Salaries, taxes, insurance rent pertaining to pre-incorporation period	Wholly to pre-incor- poration period.
4	Post Incorpor- ation Expe. (Exclusively auditor's	Preliminary expenses, Directors fees, Interest on - debentures, commission to managing agent Auditor's Fees	Wholly to post-incor, poration period

	fees etc. relating to company business)		
5	Interest on purchase consideration	a. If paid before incorporation b. If paid after incorporation	1.To pre-incorporation period 2.To both the periods proportionately

Pre-incorporation losses are either added to goodwill or carried forward to post-incorporation loss or deducted from capital reserves. In case any interest, salaries etc. are paid to the vendors, partners of the existing business, such items are to be charged to pre-incorporation period.

Auditor's Fees (Audit Fees)

There are two opinions on the treatment of auditor's fees. According to some, it is purely a post-incorporation expenditure, because auditor's appointment in a joint stock company is statutory under the provisions of the Companies Act. Hence any expenditure on the auditor is clearly a company expenditure. However according to others, audit fees are to be charged to both the periods on time basis or any other appropriate basis assuming that the auditor though appointed by a company after incorporation, must have audited the accounts of the entire period. The second assumption sounds to be more logical. Hence, in all examples audit fees, though exclusively a company expenditure, has been allocated over the two periods.

Illustration 1

Sagar Electronics Ltd., was registered on 1st April, 2019 to take over the business of M/s Patil and Bhosale as from 1st January, 2019, Given below is the Profit & Loss Account of the Company for the year ending 31st December, 2019.

Profit & Loss Account for the year ending 31st December, 2019.

Particulars	Rs.	Particulars	Rs.
To Salary	24000	By Gross Profit	
To Rent	4500		
To Office Expenses	12000		
To Directors Fees	3000		
To Travelling Expenses	2500		
To Discount	500		
To Bad debts	1500		
To Audit Fees	1000		
To Depreciation	1800		
To Debenture Interest	1200		
To Interest to vendors 31-8-2019	8000		
To Net Profit	15000		
Total	75000		

Total turnover for the year amounted to Rs. 2,50,000 of which turnover up to 1st April, 2019 was Rs. 50,000. Rent for the first 3 months was paid at Rs. 300 per month and thereafter at the rate increased by Rs. 100 per month.

Find out the profits prior to and after incorporation