CHAPTER 5

PROFIT OR LOSS PRE AND POST INCORPORATION

LEARNING OUTCOMES

After studying this chapter, you will be able to–

- Understand the meaning of pre-incorporation profit or loss;
- Account for pre-incorporation profit or loss;
- Learn method for computing profit or loss prior to incorporation.

CHAPTER OVERVIEW

Pre and Post Incorporation Profits/ Losses	• Profit or loss of a business for the period prior to the date the company came into existence is referred to as Pre-Incorporation Profits or Losses. The chapter deal with the computation of such profits or losses and treatment thereof.

1. INTRODUCTION

When a running business is taken over by the promoters of a company, as at a date prior to the date of incorporation of company, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre-incorporation profits or losses. Such profits or losses, though belonging to the company or payable by it, are of capital nature; it is necessary to disclose them separately from trading profits or losses.

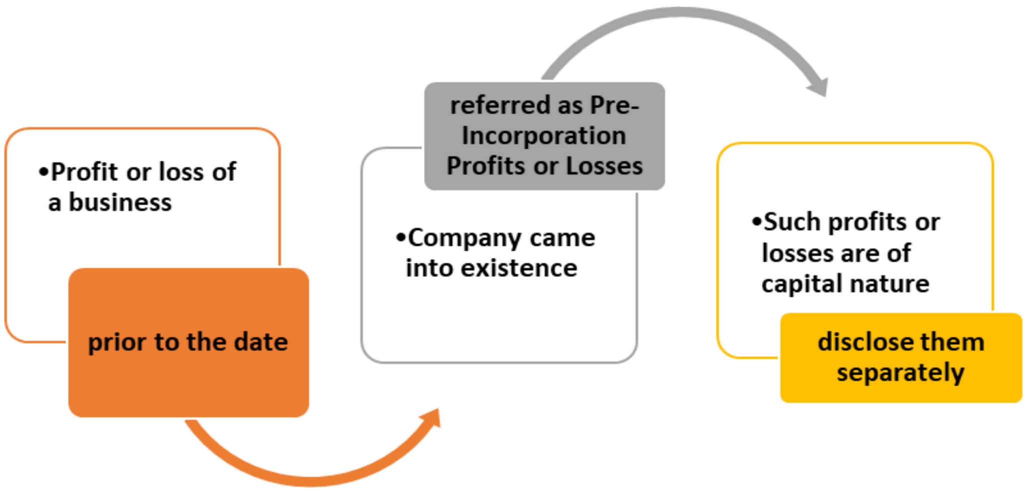
The general practice in this regard is that:

i. If there is a loss,

   (a) It is either written off by debit to the Profit and Loss Account or to a special account described as "Loss Prior to Incorporation" and show as an "asset" in the Balance Sheet,

   (b) Alternatively, it may be debited to the Goodwill Account.

ii. On the other hand, if a profit has been earned by business prior to the same being taken over and the same is not fully absorbed by any interest payable for the period, it is credited to Capital Reserve Account or to the Goodwill Account, if any goodwill has been adjusted as an asset. The profit will not be available for distribution as a dividend among the members of the company.



Example 1

Y Ltd was incorporated on 1/7/20X1 to take over the business of Z Ltd from 1/4/20X1. The year ended on 31/3/20X2.Calculate the pre incorporation period.

Solution

Business was taken over from 1/4/20X1 and incorporated on: 1/7/20X1

Pre Incorporation period = 1/4/20X1 to 1/7/20X1 (3 months)

Example 2

Q Ltd was incorporated on 1/8/20X1 to take over the business of W Ltd from 1/5/20X1. The year ended on 31/3/20X2. Which Period should be taken as the Pre-Incorporation Period and Post-Incorporation Period?

Solution

Date of Incorporation: 1/8/20X1

Date of take over : 1/5/20X1

Pre Incorporation Period = 1/5/20X1 to 1/8/20X1 (3 months)

Post Incorporation Period = 1/8/20X1 to 31/3/20X2 (8 months)

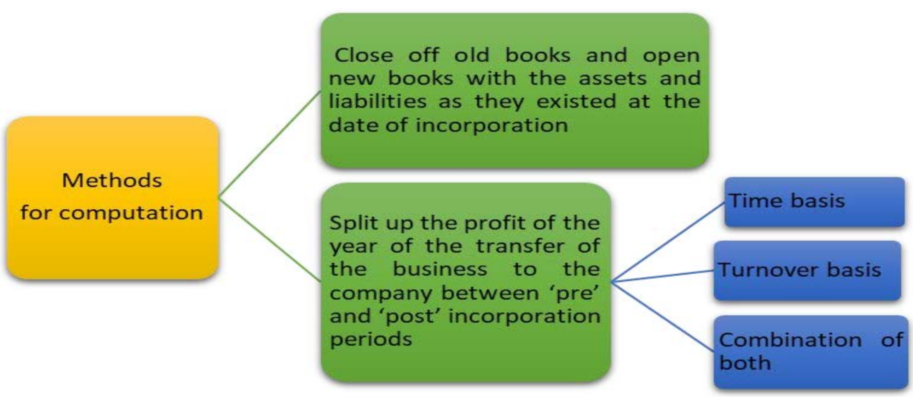
2. COMPUTING PROFIT OR LOSS PRIOR TO INCORPORATION

The determination of such profit or loss would be a simple matter if it is possible to close the books and take the stock held by the business before the company came into existence. In such a case, the trial balance will be abstracted from the books and the profit or loss computed. Thereafter, the books will be either closed off or the balance allowed continuing undistributed; only the amount of profit or loss so determined being adjusted in the manner described above.

The simplest, though not always the most expedient method is to close off old books and open new books with the assets and liabilities as they existed at the date of incorporation. In this way, automatically the result to that date will be adjusted, the difference between the values of assets and liabilities acquired and the purchase consideration being accounted for either as goodwill or as reserve. The accounts, therefore, would relate exclusively to the post-incorporation period and any adjustment for the pre-incorporation period, whether an adjustment of profit or loss, would not be required.

Since the decision to take over a business usually takes time from the date when it is agreed to be taken over it is practically not possible to follow any of the method aforementioned.

The only alternative left, in this condition is to split up the profit of the year of the transfer of the business to the company between 'pre' and 'post' incorporation periods. This is done either on the **time basis** or on the **turnover basis** or by a method which combines the two.



TIME BASIS

Under this method we calculate the Pre and Post Incorporation time Period and split some items of expenses and Incomes in the time ratio.

Let us see few examples to understand the time ratio.

Example 3 (Determination of pre and post incorporation periods)

The partners of Omega Ltd. decided to convert their partnership into a private limited company called Omega (P) Ltd. with effect from 1st April, 20X1. However, due to some procedural difficulties, the company could be incorporated only on 1st July, 20X1. The accounts of the business continued for the accounting year ended 31st March, 20X2. Determine the pre and post incorporation periods and corresponding time ratio.

Solution

Pre-incorporation period (1.4.20X1 to 1.7.20X1) = 3 months

Post incorporation period (1.7.20X1 to 31.3.20X2) =9 months

Time Ratio = 3:9 = 1:3

Example 4

M Ltd which was incorporated on 1st June 20X1, took over the business of N, a proprietary concern from 1st April 20X1. The accounts of the business continued for the accounting year ended 31st March, 20X2. Determine the time basis on which the amount of salaries will be split as pre and post incorporation periods.

Solution

Pre Incorporation period (1 April 20X1 to 1 June 20X1) = 2 months

Post Incorporation Period (1 June 20X1 to 31 March, 20X2) = 10 months

Time Ratio = 1:5

SALES BASIS

Some expenses and Incomes are divided between the pre and post period items on the basis of sales /Turnover.

Example 5 (Calculation of time ratio and sales ratio)

Lion Ltd. was incorporated on 1.8.20X1 to take over the running business of M/s Happy with assets from 1.4.20X1. The accounts of the company were closed on 31.3.20X2.

The average monthly sales during the first four months of the year (20X1-X2) was twice the average monthly sales during each of the remaining eight months.

Calculate time ratio and sales ratio for pre and post incorporation periods.

Solution

Time ratio:

Pre-incorporation period (1.4.20X1 to 1.8.20X1) = 4 months

Post incorporation period (1.8.20X1 to 31.3.20X2) = 8 months

Time ratio = 4:8 or 1 : 2

Sales ratio:

Average monthly sale before incorporation was twice the average sale per month of the post incorporation period. If x is the sales per month in post incorporation period, then sales per month of pre incorporation period will be 2x.

Weighted sales ratio = 4 × 2x: 8 × 1x =8x: 8x or 1: 1

Example 6

Calculate the time ratio in following cases:

	Date of Acquisition	Date of Incorporation	Dates of closing
(i)	1.4.20X1	1.7.20X1	31.3.20X2
(ii)	1.10.20X1	1.3.20X2	31.3.20X2

Solution

(i) 1:3; (ii) 5:1.

3. BASIS OF APPORTIONMENT

Item	***Basis of Apportionment between pre and Post incorporation period***
Gross Profit or Gross Loss	Sales Ratio-On the basis of turnover in the respective periods (first preference)

	Or On the basis of cost of goods sold in the respective periods in the absence of any information regarding turnover (second preference) Or Time Ratio-On the basis of time in the respective periods in the absence of any information regarding turnover and cost of goods sold (third preference)
Variable expenses linked with Turnover [e.g. Carriage / Cartage outward, Selling and distribution expenses, Commission to selling agents/travelling agents, advertisement expenses, Bad debts, Brokerage, Sales Promotion]	Sales Ratio
Fixed Common charges [e.g., Salaries, Office and Administration Expenses, Rent, Rates and Taxes, Printing and Stationery, Telephone, Telegram and Postage, Depreciation, Miscellaneous Expenses]	Time Ratio
Expenses exclusively relating to pre-Incorporation period [e.g. Interest on Vendor's Capital]	Charge to Pre-incorporation period (but if the purchase consideration is not paid on taking over of business, interest for the subsequent period is charged to post incorporation period)
Expenses exclusively relating to post-incorporation period [e.g. Formation expenses, interest on debentures, director's fees, Directors' remuneration, Preliminary Expenses, Share issue Expenses, Underwriting commission, Discount on issue of securities.	Charge to Post-incorporation period

Audit Fees *(i) For Company's Audit under the Companies Act.* *(ii) For Tax Audit under section 44AB of the Income tax Act, 1961*	Charge to Post-incorporation period On the basis of turnover in the respective periods
Interest on purchase consideration to vendor: (i) For the period from the date of acquisition of business to date of incorporation. (ii) From the date of incorporation	Charge to Pre-incorporation period Charge to Post-incorporation period

4. PRE-INCORPORATION PROFITS & LOSSES

S. No	Pre-incorporation Profits	Pre-incorporation Losses
1.	It is transferred to **Capital Reserve Account** (i.e. capitalised).	It is treated as a part of **business acquisition cost** (Goodwill).
2.	It can be used for : • writing off Goodwill on acquisition • writing off Preliminary Expenses • writing down over-valued assets • issuing of bonus shares • paying up partly paid shares	It can be used for : • setting off against Post-incorporation Profit • addition to Goodwill on acquisition • writing off Capital Profit

Illustration 1

Rama Udyog Limited was incorporated on August 1, 20X1. It had acquired a running business of Rama & Co. with effect from April 1, 20X1. During the year 20X1-X2, the total sales were ₹ 36,00,000. The sales per month in the first half year were half of what they were in the later half year. The net profit of the company, ₹ 2,00,000 was worked out after charging the following expenses:

(i) Depreciation ₹ 1,23,000, (ii) Directors' fees ₹ 50,000, (iii) Preliminary expenses ₹ 12,000, (iv) Office expenses ₹ 78,000, (v) Selling expenses ₹ 72,000 and (vi) Interest to vendors upto August 31, 20 X1 ₹ 5,000.

Please ascertain pre-incorporation and post-incorporation profit for the year ended 31st March, 20X2.

Solution

Statement showing pre and post incorporation profit for the year ended 31st March, 20X2

Particulars	***Total Amount ₹***	***Basis of Allocation***	***Pre-incorporation ₹***	***Post-Incorporation ₹***
Gross Profit (W.N.3)	5,40,000	2:7	1,20,000	4,20,000
Less: Depreciation	1,23,000	1:2	41,000	82,000
Director's Fees	50,000	Post	-	50,000
Preliminary Expenses	12,000	Post	-	12,000
Office Expenses	78,000	1:2	26,000	52,000
Selling Expenses	72,000	2:7	16,000	56,000
Interest to vendors	5,000	Actual	4,000	1,000
Net Profit (₹ 33,000 being pre-incorporation profit is transferred to capital reserve Account)	2,00,000		33,000	1,67,000

Working Notes:

1. Sales ratio

The sales per month in the first half year were half of what they were in the later half year. If in the later half year, sales per month is x then it should be .5 x per month in the first half year. So sales for the first four months (i.e. from 1st April, 20X1 to 31st July, 20X1) will be 4 × .50 = ₹ 2 and for the last eight months (i.e. from 1st August, 20 X1 to 31st March, 20X2) will be (2 × .50 + 6 × 1) = ₹ 7. Thus, sales ratio is 2:7.

2. Time ratio

1st April, 20X1 to 31st July, 20X1 : 1st August, 20X1 to 31st March, 20X2

= 4 months: 8 months = 1:2

Thus, time ratio is 1:2.

3. Gross profit

Gross profit = Net profit + All expenses

= ₹ 2,00,000 + ₹ (1,23,000+50,000+12,000+78,000+72,000+5,000)

= ₹ 2,00,000 +₹ 3,40,000 = ₹ 5,40,000.

Illustration 2

Lotus Ltd. was incorporated on 1st July, 20X1 to acquire a running business of Feel goods with effect from 1st April, 20X1. During the year 20X1-20X2, the total sales were ₹ 48,00,000 of which ₹ 9,60,000 were for the first six months. The Gross profit of the company ₹ 7,81,600. The expenses charged to the Profit & Loss Statement included:

(i) Director's fees ₹ 60,000

(ii) Bad debts ₹ 14,400

(iii) Advertising ₹ 48,000 (under a contract amounting to ₹ 4,000 per month)

(iv) Salaries and General Expenses ₹ 2,56,000

(v) Preliminary Expenses written off ₹ 20,000

(vi) Donation to a political party given by the company ₹ 20,000.

Prepare a statement showing pre-incorporation and post-incorporation profit for the year ended 31st March, 20X2.

Solution

Statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods for the year ended 31st March, 20X2

Particulars	***Total Amount***	***Basis of Allocation***	***Pre-incorporation***	***Post-incorporation***
Gross Profit	7,81,600	Sales	78,160	7,03,440
Less: Directors' fee	60,000	Post		60,000

Bad debts	14,400	Sales	1,440	12,960
Advertising	48,000	Time	12,000	36,000
Salaries & general expenses	2,56,000	Time	64,000	1,92,000
Preliminary expenses	20,000	Post		20,000
Donation to Political Party	20,000	Post		20,000
Net Profit	3,63,200		720	3,62,480

Working Notes:

1. Sales ratio

Particulars	₹
Sales for period up to 30.06.20X1 (9,60,000 x 3/6)	4,80,000
Sales for period from 01.07.20X1 to 31.03.20X2 (48,00,000 – 4,80,000)	43,20,000

Thus, Sales Ratio = 1 : 9

2. Time ratio

1st April, 20X1 to 30 June, 20X1: 1st July, 20X1 to 31st March, 20X2

= 3 months: 9 months = 1: 3

Thus, Time Ratio is 1: 3

Illustration 3

The promoters of Glorious Ltd. took over on behalf of the company a running business with effect from 1st April, 20X1. The company got incorporated on 1st August, 20X1. The annual accounts were made up to 31st March, 20X2 which revealed that the sales for the whole year totalled ₹ 1,600 lakhs out of which sales till 31st July, 20X1 were for ₹ 400 lakhs. Gross profit ratio was 25%.

The expenses from 1st April 20X1, till 31st March, 20X2 were as follows:

	(₹ in lakhs)
Salaries	*69*
Rent, Rates and Insurance	*24*

Sundry Office Expenses	*66*
Travellers' Commission	*16*
Discount Allowed	*12*
Bad Debts	*4*
Directors' Fee	*25*
Tax Audit Fee	*9*
Depreciation on Machinery	*12*
Debenture Interest	*11*

Prepare a statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods.

Solution

Statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods

Particulars	***Total Amount***	***Basis of Allocation***	***Pre-incorporation***	***Post-incorporation***
	(₹ in lakhs)		***(₹ in lakhs)***	***(₹ in lakhs)***
Gross Profit (25% of ₹ 1,600)	400	Sales	100	300
Less: Salaries	69	Time	23	46
Rent, rates and Insurance	24	Time	8	16
Sundry office expenses	66	Time	22	44
Travellers' commission	16	Sales	4	12
Discount allowed	12	Sales	3	9
Bad debts	4	Sales	1	3
Directors' fee	25	Post	-	25
Tax Audit Fees	9	Sales	2.25	6.75
Depreciation on Machinery	12	Time	4	8

Debenture interest	11	Post	-	11
Net profit	152		32.75	119.25

Working Notes:

1. Sales ratio

	(₹ in lakh)
Sales for the whole year	1,600
Sales up to 31st July, 20X1	400
Therefore, sales for the period from 1st August, 20X1 to 31st March, 20X2	1,200

Thus, sale ratio = 400:1200 = 1:3

2. Time ratio

1st April, 20X1 to 31st July, 20X1 : 1st August, 20X1 to 31st March, 20X2

= 4 months: 8 months = 1:2

Thus, time ratio is 1:2.

Illustration 4

Inder and Vishnu, working in partnership registered a joint stock company under the name of Fellow Travellers Ltd. on May 31, 20X1 to take over their existing business. It was agreed that they would take over the assets of the partnership from January 1st, 20X1 for a sum of ₹ 3,00,000 and that until the amount was discharged they would pay interest on the amount at the rate of 6% per annum. The amount was paid on June 30, 20X1. To discharge the purchase consideration, the company issued 20,000 equity shares of ₹ 10 each at a premium of ₹ 1 each and allotted 7% Debentures of the face value of ₹ 1,50,000 to the vendors at par.

Fellow Travellers Ltd gives you the following information for the year ended 31st December, 20X1 was as follows:

	₹
Purchases, including Inventory	*1,40,000*
Sales: 1st January to 31st May 20X1	*60,000*
1st June to 31st Dec., 20X1	*1,20,000*
Closing Inventory in hand	*25,000*

Expenses:	
Freight and carriage	*5,000*
Salaries and Wages	*10,000*
Debenture Interest	*5,250*
Depreciation	*1,000*
Interest on purchase Consideration (up to 30-6-20X1)	*9,000*
Selling commission	*9,000*
Directors' Fee	*600*
Preliminary expenses	*900*
Provision for taxes (entirely related with company)	*6,000*

Prepare statement apportioning the expenses and calculate profits/losses for the 'post' and 'pre-incorporation' periods and also show how these figures would appear in the Balance Sheet of the company.

Solution

Fellow Travellers Ltd.
Statement showing calculation of profit /losses for pre and post incorporation periods

		Ratio	***Pre-incorporation***	***Post-incorporation***
Gross profit allocated on the basis of sale		1:2	20,000	40,000
Less: Administrative Expenses allocated				
On time basis:				
(*i*) Salaries and wages	10,000			
(*ii*) Depreciation	1,000			
	11,000	5:7	4,583	6,417
Selling Commission on the basis of sales		1:2	3,000	6,000
Interest on Purchase				

Consideration (Actual)		5:1	7,500	1,500
Expenses applicable wholly to the Post-incorporation period:				
Debenture Interest (1,50,000 x 7% x 6/12)	5,250			
Director's Fee	600			5,850
Preliminary expenses				900
Provision for taxes				6,000
Net Profit			4,917	13,333

Time Ratio

Pre incorporation period = 1 January 20X1 to 31 May 20X1 = 5 months

Post incorporation period = 1 June 20X1 to 31 December 20X1 = 7 months

Time ratio = 5: 7

Sales Ratio

Sales in pre incorporation period (1 January 20X1 to 31 May 20X1) = ₹ 60,000

Sales in post incorporation period (1 June 20X1 to 31 December 20X1) = ₹ 1,20,000

Sales ratio = 1:2

Fellow Travellers Ltd.

Extract from the Balance Sheet as at 31st Dec., 20X1

	Particulars	***Notes***	***₹***
	Equity and Liabilities		
1	**Shareholders' funds**		
a	Share capital	1	2,00,000
b	Reserves and Surplus	2	38,250
2	**Non-current liabilities**		
a	Long-term borrowings	3	1,50,000
3	**Current liabilities**		
a	Short Term Provisions	4	6,000

Notes to accounts

		₹
1.	**Share Capital**	
	20,000 equity shares of ₹ 10 each fully paid	2,00,000
2.	**Reserves and Surplus**	
	Profit Prior to Incorporation	4,917
	Securities Premium Account	20,000
	Profit and loss Account	13,333
	Total	38,250
3.	**Long term borrowings**	
	Secured	
	7% Debentures	1,50,000
4.	**Short Term Provisions**	
	Provision for Taxes	6,000

Illustration 5

The partners of Maitri Agencies decided to convert the partnership into a private limited company called MA (P) Ltd. with effect from 1st January, 20X2. The consideration was agreed at ₹ 1,17,00,000 based on the firm's Balance Sheet as at 31st December, 20X1. However, due to some procedural difficulties, the company could be incorporated only on 1st April, 20X2. Meanwhile the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% per annum. The same books of account were continued by the company which closed its account for the first time on 31st March, 20X3 and gives the following information:

	₹
Sales	*2,34,00,000*
Cost of goods sold	*1,63,80,000*
Expenses:	
Salaries	*11,70,000*
Depreciation	*1,80,000*
Advertisement	*7,02,000*

Discounts	*11,70,000*
Managing Director's remuneration	*90,000*
Miscellaneous office expenses	*1,20,000*
Office-cum-show room rent	*7,20,000*
Interest	*9,51,000*

The company's only borrowing was a loan of ₹ 50,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements.

The company was able to double the average monthly sales of the firm, from 1st April, 20X2 but the salaries tripled from that date. It had to occupy additional space from 1st July, 20X2 for which rent was ₹ 30,000 per month.

Prepare statement of apportioning cost and revenue between pre-incorporation and post-incorporation periods and calculation of profits/losses for such periods

Solution

MA (P) Ltd.

Statement showing calculation of profit/losses for pre and post incorporation periods

	Basis of allocation	***Pre-inc.***	***Post-inc.***
		₹	**₹**
Sales	Sales ratio	26,00,000	2,08,00,000
Less: Cost of goods sold	Sales ratio	18,20,000	1,45,60,000
Salaries	W.N.4	90,000	10,80,000
Depreciation	Time ratio	36,000	1,44,000
Advertisement	Sales ratio	78,000	6,24,000
Discounts	Sales ratio	1,30,000	10,40,000
M.D.'s remuneration	Post-inc	—	90,000
Misc. Office Expenses	Time ratio	24,000	96,000
Rent	W.N.5	90,000	6,30,000
Interest	Time ratio	3,51,000	6,00,000
Net Profit/(Loss)		(19,000)	19,36,000

Working Notes:

(1) Calculation of Sales ratio:

Let the average sales per month in pre-incorporation period be x. Then the average sales in post-incorporation period are 2x. Thus total sales are $(3 \times x) + (12 \times 2x)$ or 27x. Ratio of sales will be 3 x : 24x or 1:8.

Time ratio is 3 months: 12 months or 1:4

(2) Expenses apportioned on turnover ratio basis are cost of goods sold, advertisement, discounts.

(3) Expenses apportioned on time ratio basis are Depreciation, and misc. office expenses.

(4) Ratio for apportionment of Salaries:

If pre-incorporation monthly average is x, for 3 months 3x.

Average for balance 12 months 3x, for 12 months 36x.

Hence ratio for division, 1:12.

(5) Apportionment of Rent:

		₹
Total Rent		7,20,000
Additional rent for 9 months (From 1st July 20X2 to 31st March, 20X3)		(2,70,000)
Rent for old premises for 15 months at ₹ 30,000 p.m.		4,50,000
	Pre-inc.	Post-inc.
Old Premises	90,000	3,60,000
Additional rent	—	2,70,000
	90,000	6,30,000

(6) Apportionment of interest:

Total interest	9,51,000
Less: Interest for post incorporation (50,00,000 x 12%)	6,00,000
Interest apportioned to pre incorporation period	3,51,000

Illustration 6

ABC Ltd. took over a running business with effect from 1st April, 20X1. The company was incorporated on 1st August, 20X1. The following information for the year ended 31.3.20X2 is given:

	₹
Gross profit	3,20,000
Expenses:	
Salaries	48,000
Stationery	4,800
Travelling expenses	16,800
Advertisement	16,000
Miscellaneous trade expenses	37,800
Rent (office buildings)	26,400
Electricity charges	4,200
Director's fee	11,200
Bad debts	3,200
Commission to selling agents	16,000
Tax Audit fee	6,000
Debenture interest	3,000
Interest paid to vendor	4,200
Selling expenses	25,200
Depreciation on fixed assets	9,600
Net profit	87,600

Additional information:

(a) *Total sales for the year, which amounted to ₹ 19,20,000 arose evenly up to the date of 30.9.20X1. Thereafter they recorded an increase of two-third during the rest of the year.*

(b) *Rent of office building was paid @ ₹ 2,000 per month up to September, 20X1 and thereafter it was increased by ₹ 400 per month.*

(c) *Travelling expenses include ₹ 4,800 towards sales promotion.*

(d) Depreciation include ₹ 600 for assets acquired in the post incorporation period.

(e) Purchase consideration was discharged by the company on 30th September, 20X1 by issuing equity shares of ₹ 10 each.

Prepare Statement showing calculation of profits and allocation of expenses between pre and post incorporation periods.

Solution

Statement showing calculation of profits for pre and post incorporation periods for the year ended 31.3.20X2

Particulars	***Pre-incorporation period*** ₹	***Post- incorporation period*** ₹
Gross profit (1:3)	80,000	2,40,000
Less: Salaries (1:2)	16,000	32,000
Stationery (1:2)	1,600	3,200
Advertisement (1:3)	4,000	12,000
Travelling expenses (W.N.4)	4,000	8,000
Sales promotion expenses (W.N.4)	1,200	3,600
Misc. trade expenses (1:2)	12,600	25,200
Rent (office building) (W.N.3)	8,000	18,400
Electricity charges (1:2)	1,400	2,800
Director's fee (post-incorporation)	-	11,200
Bad debts (1:3)	800	2,400
Selling agents commission (1:3)	4,000	12,000
Tax audit fee (1:3)	1,500	4,500
Debenture interest (post-incorporation)	-	3,000
Interest paid to vendor (2:1) (W.N.5)	2,800	1,400
Selling expenses (1:3)	6,300	18,900
Depreciation on fixed assets (W.N.6)	3,000	6,600
Net profit (Bal.Fig.)	12,800	74,800

Working Notes:

1. Time Ratio

Pre incorporation period = 1st April, 20X1 to 31st July, 20X1

i.e. 4 months

Post incorporation period is 8 months

Time ratio is 1: 2.

2. Sales ratio

Let the monthly sales for first 6 months (i.e. from 1.4.20X1 to 30.09. 20X1) be x

Then, sales for 6 months = 6x

Monthly sales for next 6 months (i.e. from 1.10.X1 to 31.3.20X2) = $x + \frac{2}{3}x = \frac{5}{3}x$

Then, sales for next 6 months = $\frac{5}{3}x \text{ X } 6 = 10x$

Total sales for the year = 6x + 10x = 16x

Monthly sales in the pre incorporation period = ₹ 19,20,000/16 = ₹ 1,20,000

Total sales for pre-incorporation period = ₹ 1,20,000 x 4 = ₹ 4,80,000

Total sales for post incorporation period = ₹ 19,20,000 – ₹ 4,80,000 = ₹ 14,40,000

Sales Ratio = 4,80,000 : 14,40,000 = 1 : 3

3. Rent

		₹
Rent for pre-incorporation period (₹ 2,000 x 4)		8,000 (pre)
Rent for post incorporation period		
August,20X1 & September, 20X1 (₹ 2,000 x 2)	4,000	
October,20X1 to March,20X2 (₹ 2,400 x 6)	14,400	18,400 (post)

4. Travelling expenses and sales promotion expenses

	Pre ₹	Post ₹
Traveling expenses ₹ 12,000 (i.e. ₹ 16,800- ₹ 4,800) distributed in Time ratio (1:2)	4,000	8,000
Sales promotion expenses ₹ 4,800 distributed in Sales ratio (1:3)	1,200	3,600

5. Interest paid to vendor till 30th September, 20X1

	Pre ₹	Post ₹
Interest for pre-incorporation period $\left(\frac{₹\ 4,200}{6}\times 4\right)$	2,800	
Interest for post incorporation period i.e. for August, 20X1 & September, 20X1 = $\left(\frac{₹\ 4,200}{6}\times 2\right)$		1,400

6. Depreciation

	Pre ₹	Post ₹
Total depreciation 9,600		
Less: Depreciation exclusively for post incorporation period 600		600
Remaining (for pre and post incorporation period) 9,000		
Depreciation for pre-incorporation period $\left[9,000\times\frac{4}{12}\right]$*	3,000	
Depreciation for post incorporation period $\left[9,000\times\frac{8}{12}\right]$*	____	6,000
* Time ratio = 1 : 2	3,000	6,600

Illustration 7

ABC Ltd. was incorporated on 1.5.20X1 to take over the business of DEF and Co. from 1.1.20X1. The following information as given by ABC Ltd. for the year ending 31.12.20X1 is provided to you:

	₹
Gross Profit	10,64,000
Interest on Investments earned	36,000
Expenses:	
Rent and Taxes	90,000
Salaries including manager's salary of ₹ 85,000	3,31,000
Carriage Outwards	14,000
Printing and Stationery	18,000
Interest on Debentures	25,000
Sales Commission	30,800
Bad Debts (related to sales)	91,000
Underwriting Commission	26,000
Preliminary Expenses	28,000
Audit Fees	45,000
Loss on Sale of Investments	11,200
Net Profit	3,90,000

Prepare a Statement showing allocation of expenses and calculations of pre-incorporation and post-incorporation profits after considering the following information:

(i) *G.P. ratio was constant throughout the year.*

(ii) *Sales for January and October were 1½ times the average monthly sales while sales for December were twice the average monthly sales.*

(iii) *Bad Debts are shown after adjusting a recovery of ₹ 7,000 of Bad Debt for a sale made in July, 20X0.*

(iv) *Manager's salary was increased by ₹ 2,000 p.m. from 1.5.20X1.*

(v) *All investments were sold in April, 20X1.*

(vi) *The entire audit fees relates to the company.*

Solution

Pre-incorporation period is for four months, from 1st January, 20X1 to 30th April, 20X1. 8 months' period (from 1st May, 20X1 to 31st December, 20X1) is post-incorporation period.

Statement showing calculation of profit/losses for pre and post incorporation periods

		Pre-Inc ₹	Post inc ₹
Gross Profit		3,42,000	7,22,000
Interest on Investments		36,000	–
Bad debts Recovery		7,000	–
		3,85,000	7,22,000
Less::	Rent and Taxes	30,000	60,000
	Salaries		
	Manager's salary (85,000- refer note below)	23,000	62,000
	Other salaries (3,31,000 – 85,000)	82,000	1,64,000
	Printing and stationery	6,000	12,000
	Audit fees	-	45,000
	Carriage outwards	4,500	9,500
	Sales commission	9,900	20,900
	Bad Debts (91,000 + 7,000)	31,500	66,500
	Interest on Debentures	–	25,000
	Underwriting Commission	–	26,000
	Preliminary expenses	–	28,000
	Loss on sale of investments	11,200	–
Net Profit		1,86,900	2,03,100

Working Notes:

(i) Calculation of Sales ratio

Let average monthly sales be x.

Thus Sales from January to April are 4½ *x* (i.e., 1.5x + x + x + x) and sales from May to December are 9½ *x* (x + x + x + x + x + 1.5x + x + 2x).

Sales are in the ratio of 9/2x : 19/2*x* or 9 : 19.

Calculation of Time Ratio

Pre-incorporation period = 1.1.20X1 to 30.4.20X1 = 4 months

Post-incorporation period = 1.5.20X1 to 31.12.20X1 = 8 months

Time ratio = 1:2

(ii) Gross profit, carriage outwards, sales commission and bad debts written off (after adjustment for bad debt recovery) have been allocated in pre and post incorporation periods in the ratio of Sales i.e. 9 : 19.

(iii) Rent, salaries (subject to increase in manager's salary), printing and stationery are allocated on time basis.

(iv) Interest on debentures, underwriting commission and preliminary expenses are allocated in post incorporation period.

(v) Interest on investments, loss on sale of investments and bad debt recovery are allocated in pre-incorporation period.

Note

Let Pre-incorporation period manager's monthly salary be x

Total pre-incorporation period manager's monthly salary = 4x

Post-incorporation period manager's monthly salary = x + 2,000

Total pre-incorporation period manager's monthly salary = 8(x+2,000)

Total manager's salary (pre and post) = ₹ 85,000

Thus, 4x + 8(x+2,000) = 85,000

x = 5,750

Total pre-incorporation period manager's monthly salary = 4 x 5,750 = ₹ 23,000

Total pre-incorporation period manager's monthly salary = 8(5,750 + 2,000) = ₹ 62,000

SUMMARY

- Profit or loss of a business for the period prior to the date the company came into existence is referred to as Pre-Incorporation Profit or Loss.
- Such profit/ loss is disclosed separately from normal trading profits/losses of the business in the financial statements of the business entity.

TEST YOUR KNOWLEDGE

MCQ

1. Profit prior to incorporation is transferred to

   (a) General reserve.

   (b) Capital reserve.

   (c) Profit and loss account.

2. The profit earned by the company from the date of purchase to the date of incorporation is

   (a) Pre- incorporation profit.

   (b) Post- incorporation profit.

   (c) Notional profit.

3. Loss prior to incorporation is debited to which account?

   (a) Goodwill account

   (b) Loss prior to incorporation account

   (c) Either (a) or (b)

4. Profit prior to incorporation is

   (a) Available for distribution as dividend among the members of the company.

   (b) Not available for distribution as dividend among the members of the company.

   (c) Depends upon the Memorandum of Association.

5. Profit or loss prior to incorporation is of

   (a) Revenue nature.

   (b) Capital nature.

   (c) Nominal nature.

6. Which of the following expenditure is allocated on the basis of time?

   (a) Insurance.

(b) Bad debts.

(c) Discount allowed.

7. Which of the following is allocated on the basis of turnover?

(a) Salaries.

(b) Depreciation.

(c) Gross profit.

8. Preliminary expenses on the formation of the company are charged against

(a) Pre-incorporation profit.

(b) Post- incorporation profit.

(c) Not calculated because of bifurcation of profit into pre and post.

9. Which of the following expense is not allocated on time basis?

(a) Rent

(b) Salaries

(c) Discounts.

10. Pre incorporation profits cannot be used for

(a) Paying up partly paid up shares

(b) Issue of bonus shares

(c) Distribution of dividends

Theoretical Questions

1. Define Pre–incorporation profit/loss in brief.

Practical Questions

Question 1

Sneha Ltd. was incorporated on 1st July, 20X1 to acquire a running business of Atul Sons with effect from 1st April, 20X1. During the year 20X1-X2, the total sales were ₹ 24,00,000 of which ₹ 4,80,000 were for the first six months. The Gross profit of the company ₹ 3,90,800. The expenses debited to the Profit & Loss Account included:

(i) Director's fees ₹ 30,000

(ii) Bad debts ₹ 7,200

(iii) Advertising ₹ 24,000 (under a contract amounting to ₹ 2,000 per month)

(iv) Salaries and General Expenses ₹ 1,28,000

(v) Preliminary Expenses written off ₹ 10,000

(vi) Donation to a political party given by the company ₹ 10,000.

Prepare a statement showing pre-incorporation and post-incorporation profit for the year ended 31st March, 20X2.

Question 2

The partners Kamal and Vimal decided to convert their existing partnership business into a Private Limited Company called M/s. KV Trading Private Ltd. with effect from 1-7-20X2.

The same books of accounts were continued by the company which closed its account for first term on 31-3-20X3.

The information for the year ended 31-3-20X3 is given below:

	(₹) in lakhs	**(₹) in lakhs**
Turnover		240.00
Interest on investments		6.00
		246.00
Less: Cost of goods sold	102.00	
Advertisement	3.00	
Sales Commission	6.00	
Salary	18.00	
Managing director's remuneration	6.00	
Interest on Debentures	2.00	
Rent	5.50	
Bad Debts	1.00	
Underwriting Commission	2.00	
Audit fees	2.00	
Loss on sale of investment	1.00	
Depreciation	4.00	152.50
		93.50

The following additional information was provided:

(i) The average monthly sales doubled from 1-7-20X2. GP ratio was constant.

(ii) All investments were sold on 31-5-20X2.

(iii) Average monthly salary doubled from 1-10-20X2.

(iv) The company occupied additional space from 1-7-20X2 for which rent of ₹ 20,000 per month was incurred.

(v) Bad debts recovered amounting to ₹ 50,000 for a sale made in 20X0, has been deducted from bad debts mentioned above.

(vi) Audit fees pertains to the company.

Prepare a statement apportioning the expenses between pre and post incorporation periods and calculate the Profit/Loss for such periods.

Question 3

SALE Limited was incorporated on 01.08.20X1 to take-over the business of a partnership firm w.e.f. 01.04.20X1. The following is the related information for the year ended 31.03.20X2:

Particulars	Amount (₹)
Gross Profit (A)	6,00,000
Expenses: Salaries	1,20,000
Rent, Rates & Taxes	80,000
Commission on Sales	21,000
Depreciation	25,000
Interest on Debentures	32,000
Director Fees	12,000
Advertisement	36,000
(B)	3,26,000
Net Profit for the Year (A less B)	2,74,000

(i) SALE Limited initiated an advertising campaign which resulted increase in monthly average sales by 25% post incorporation.

(ii) The Gross profit ratio post incorporation increased to 30% from 25%.

You are required to apportion the profit for the year between pre-incorporation and post-incorporation, also explain how pre-incorporation profit is treated in the accounts.

Question 4

A partnership firm M/s. Nice Sons was carrying on business from 1st May, 20X1. The partners of the firm decided to convert the partnership firm into a private company called Zenith (P) Ltd. with effect from 1st September, 20X1. The annual accounts were drawn upto 31st March, 20X2. The related information from 1st May, 20X1 to 31st March, 20X2 is as follows:

Particulars	Amount (₹)	Amount (₹)
Turnover		55,20,000
Interest on Investment		60,000
Profit on sale of Investment		42,000
		56,22,000
Less:		
Cost of goods sold	34,50,000	
Printing & Stationery	77,000	
Manager's Salary	82,000	
Audit Fees	41,000	
Rent	1,33,000	
Bad Debts	33,000	
Underwriting Commission	56,000	
Depreciation	71,500	
Interest on Debentures	8,900	
Advertising campaign expenses	69,800	
Sundry office expenses	1,06,700	
Interest on borrowings	1,25,000	
		42,53,900
Net Profit		**13,68,100**

Additional Information Provided:

(1) The company's only borrowing was a loan of ₹ 15,00,000 at 9% p.a., to pay the purchase consideration due to the firm and for working capital requirements. The loan was taken on 1st September, 20X1.

(2) The company occupied additional space from 1st September, 20X1 for which rent of ₹ 8,000 per month was incurred.

(3) Audit fee pertains to the company.

(4) Bad debts recovered amounting to ₹ 36,000 for a sale made in June 20X1, has been deducted from bad debts mentioned above.

(5) All investments were sold in August 20X1.

(6) Zenith (P) Ltd. initiated an advertising campaign on 1st September, 20X1, which resulted increase in monthly average sales by 40%.

(7) The salary of Manager was increased by ₹ 3,000 p.m. from 1st July, 20X1

Prepare a statement showing pre-incorporation and post-incorporation profit for the year ended 31st March 20X2.

ANSWERS/ HINTS

MCQ

1.	(b),	2.	(a),	3.	(c),	4.	(b),	5.	(b),	6.	(a),
7.	(c),	8.	(b),	9.	(c),	10.	(c)				

Theoretical Questions

1. When a running business is taken over by the promoters of a company, as at a date prior to the date of incorporation of company, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre-incorporation profits or losses. For details, refer para 1 of the chapter.

Practical Questions

Answer 1

Statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods

For the year ended 31st March, 20X2

Particulars	*Total Amount*	*Basis of Allocation*	*Pre-incorporation*	*Post-incorporation*
Gross Profit	3,90,800	Sales	39,080	3,51,720
Less: Directors' fee	30,000	Post	-	30,000

Bad debts	7,200	Sales	720	6,480
Advertising	24,000	Time	6,000	18,000
Salaries & general expenses	1,28,000	Time	32,000	96,000
Preliminary expenses	10,000	Post		10,000
Donation to Political Party	10,000	Post		10,000
Net Profit	1,81,600		360	1,81,240

Working Notes:

1. Sales ratio

Particulars	₹
Sales for period up to 30.06.20X1 (4,80,000 x 3/6)	2,40,000
Sales for period from 01.07.20X1 to 31.03.20X2 (24,00,000 – 2,40,000)	21,60,000

Thus, Sales Ratio = 1 : 9

2. Time ratio

1st April, 20X1 to 30 June, 20X1: 1st July, 20X1 to 31st March, 20X2

= 3 months: 9 months = 1: 3

Thus, Time Ratio is 1: 3

Answer 2

K V Trading Private Limited

Statement showing calculation of profit/loss for pre and post incorporation periods

₹ in lakhs

	Ratio	***Total***	***Pre Incorporation***	***Post Incorporation***
Sales	1:6	240.00	34.29	205.71
Interest on Investments	Pre	6.00	6.00	-
Bad debts recovered	Pre	0.50	0.50	-
(i)		246.50	40.79	205.71

Cost of goods sold	1:6	102.00	14.57	87.43
Advertisement	1:6	3.00	0.43	2.57
Sales commission	1:6	6.00	0.86	5.14
Salary (W.N.3)	1:5	18.00	3.00	15.00
Managing director's remuneration	Post	6.00	-	6.00
Interest on Debentures	Post	2.00	-	2.00
Rent (W.N.4)		5.50	0.93	4.57
Bad debts (1 + 0.5)	1:6	1.50	0.21	1.29
Underwriting commission	Post	2.00	-	2.00
Audit fees	Post	2.00	-	2.00
Loss on sale of Investment	Pre	1.00	1.00	-
Depreciation	1:3	4.00	1.00	3.00
(ii)		153.00	22.00	131.00
Net Profit [(i) – (ii)]		93.50	18.79	74.71

Working Notes:

1. **Calculation of Sales Ratio**

   Let the average sales per month be x

   Total sales from 01.04.20X2 to 30.06.20X2 will be 3x

   Average sales per month from 01.07.20X2 to 31.03.20X3 will be 2x

   Total sales from 01.07.20X2 to 31.03.20X3 will be 2x X 9 =18x

   Ratio of Sales will be 3x: 18x i.e. 3:18 or 1:6

2. **Calculation of time Ratio**

   3 Months: 9 Months i.e. 1:3

3. **Apportionment of Salary**

   Let the salary per month from 01.04.20X2to 30.09.20X2 is x

   Salary per month from 01.10.20X2 to 31.03.20X3 will be 2x

   Hence, pre incorporation salary (01.04.20X2 to 30.06.20X2) = 3x

Post incorporation salary from 01.07.20X2 to 31.03.20X3 = (3x + 12x) i.e.15x

Ratio for division 3x: 15x or 1: 5

4. **Apportionment of Rent** ***₹ Lakhs***

	₹ Lakhs
Total Rent	5.5
Less: additional rent from 1.7.20X2 to 31.3.20X3	1.8
Rent of old premises for 12 months	3.7

	Pre	**Post**
Apportionment in time ratio	0.925	2.775
Add: Rent for new space	-	1.80
Total	0.925	4.575

Answer 3

Statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods

Particulars	***Total Amount***	***Basis of Allocation***	***Pre-incorporation***	***Post-incorporation***
	₹		₹	₹
Gross Profit (W.N.2)	6,00,000	1:3	1,50,000	4,50,000
Less: Salaries	1,20,000	Time	40,000	80,000
Rent, rates and taxes	80,000	Time	26,667	53,333
Sales' commission	21,000	Sales (2:5)	6,000	15,000
Depreciation	25,000	Time	8,333	16,667
Interest on debentures	32,000	Post		32,000
Directors' fee	12,000	Post		12,000
Advertisement	36,000	post		36,000
Net profit	2,74,000		69,000	2,05,000

Working Notes:

1. Sales ratio

Let the monthly sales for first 4 months (i.e. from 1.4.20X1 to 31.7.20X1) be = x

Then, sales for 4 months = 4x

Monthly sales for next 8 months (i.e. from 1.8.X1 to 31.3.20X2) = x + 25% of x= 1.25x

Then, sales for next 6 months = 1.25x X 8 = 10x

Total sales for the year = 4x + 10x = 14x

Sales Ratio = 4 x :10x i.e. 2:5

2. Gross profit ratio

From 1.4.20X1 to 31.7.20X1 gross profit is 25% of sales

Then, 25% of 4x= 1x

gross profit for next 8 months (i.e. from 1.8.X1 to 31.3.20X2) is 30%

Then, 30% of 10x = 3x

Therefore gross profit ratio will be 1:3

3. Time ratio

1st April, 20X1 to 31st July, 20X1 : 1st August, 20X1 to 31st March, 20X2

= 4 months: 8 months = 1:2

Thus, time ratio is 1:2.

Answer 4

Statement showing the calculation of Profits for the pre-incorporation and post-incorporation periods ₹

	Ratio	*Total*	*Pre Incorporation*	*Post Incorporation*
Sales	1:2.45	55,20,000	16,00,000	39,20,000
Interest on Investments	Pre	60,000	60,000	-

Bad debts recovered	Pre	36,000	36,000	-
Profit on sale of investment	Pre	42,000	42,000	-
(i)		56,58,000	17,38,000	39,20,000
Cost of goods sold	1:2.45	34,50,000	10,00,000	24,50,000
Advertisement	Post	69,800	-	69,800
Sundry office expenses	4:7	1,06,700	38,800	67,900
Printing & Stationary	4:7	77,000	28,000	49,000
Manager Salary	W.N.3	82,000	26,000	56,000
Interest on Debentures	Post	8,900	-	8,900
Rent	W.N.4	1,33,000	28,000	1,05,000
Bad debts	1:2.45	69,000	20,000	49,000
Underwriting	Post	56,000	-	56,000
commission	Post	41,000	-	41,000
Audit fees	4:7	71,500	26,000	45,500
Depreciation		1,25,000	46,250	78,750
Interest on Borrowing	W.N. 5			
(ii)		42,89,900	12,13,050	30,76,850
Net Profit [(i) – (ii)]		13,68,100	5,24,950	8,43,150

Working Notes:

1. Calculation of Sales Ratio

Let the average sales per month be x

Total sales from 01.05.20X1 to 31.08.20X1 will be 4x

Average sales per month from 01.09.20X1 to 31.03.20X2 will be 1.4x

Total sales from 01.09.20X1 to 31.03.20X2 will be 1.4x X 7 =9.8x

Ratio of Sales will be 4x: 9.8x =1:2.45

2. Calculation of time Ratio

4 Months: 7 Months i.e. 4:7

3. Manager Salary ₹

Total salary	82,000
Less: Increased salary	27,000
	55,000
Monthly Salary =55,000/11	5,000
Salary from May to August	5,000 + 5,000 + 8,000 + 8,000 = 26,000
Salary from Sep to March	8,000 x 7= 56,000

4. Apportionment of Rent

	₹	
Total Rent	1,33,000	
Less: Additional rent from 1.9.20X1 to 31.3.20X2	56,000	
Rent of old premises for 11 months	77,000	
	Pre	**Post**
Apportionment in time ratio (4:7)	28,000	49,000
Add: Rent for new space	______	56,000
Total	28,000	1,05,000

5. Interest on borrowing

Company's Borrowing Interest = ₹ 15,00,000 x 9% x 7/12= ₹ 78,750

Interest for Pre-incorporation period = ₹ 1,25,000 – 78,750 = ₹ 46,250