CHAPTER 5

PROFIT OR LOSS PRE AND POST INCORPORATION

LEARNING OUTCOMES

After studying this unit, you will be able to–

- Understand the meaning of pre-incorporation profit or loss;
- Account for pre-incorporation profit or loss;
- Learn methods 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.

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 is usually takes time from the date when it is agreed to be taken over it is normally not possible to follow any of the method aforementioned. The only alternative left, in the circumstances, 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.

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	Sales Ratio

outward, Selling and distribution expenses, Commission to selling agents/travelling agents, advertisement expenses, Bad debts, Brokerage, Sales Promotion]	
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

Calculation of time ratio and sales ratio

Example

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 weightage for each post-incorporation month is x, then

Weighted sales ratio = $4 \times 2x : 8 \times 1x = 8x : 8x$ or 1 : 1

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

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 Tangible Assets	*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 tangible assets	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 3

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.

The summarised Profit and Loss Account of the "Fellow Travellers Ltd." for the year ended 31st December, 20X1 was as follows:

	₹		₹
To Purchase, including Inventory	*1,40,000*	*By Sales:*	
To Freight and carriage	*5,000*	*1st January to 31st May 20X1*	*60,000*
To Gross Profit c/d	*60,000*	*1st June to 31st Dec., 20X1*	*1,20,000*
		By Inventory in hand	*25,000*
	2,05,000		*2,05,000*

To Salaries and Wages	*10,000*	*By Gross profit b/d*	*60,000*
To Debenture Interest	*5,250*		
To Depreciation	*1,000*		
To Interest on purchase Consideration (up to 30-6-20X1)	*9,000*		
To Selling commission	*9,000*		
To Directors' Fee	*600*		
To Preliminary expenses	*900*		
To Provision for taxes (entirely related with company)	*6,000*		
To Dividend paid on equity shares @ 5%	*5,000*		
To Balance c/d	*13,250*		
	60,000		*60,000*

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 (Time basis)		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
Balance c/d to Balance Sheet			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 on 31st Dec., 20X1

	Particulars	*Notes*	₹
	Equity and Liabilities		
1	**Shareholders' funds**		
a	Share capital	1	2,00,000
b	Reserves and Surplus	2	33,250
2	**Non-current liabilities**		
a	Long-term borrowings	3	1,50,000

3	**Current liabilities**		
a	Short term provisions	4	6,000
	Total		3,89,250

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	
	Less: Dividend on equity share	(5,000)	8,333
	Total		33,250
3.	**Long term borrowings**		
	Secured		
	7% Debentures		1,50,000
4.	**Other Current liabilities**		
	Provision for Taxes		6,000

Illustration 4

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 prepared the following summarised profit and loss account.

		₹
Sales		*2,34,00,000*
Less: Cost of goods sold	*1,63,80,000*	
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*	*2,14,83,000*
Profit		*19,17,000*

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 $3x : 24x$ 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

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 summarised Profit and Loss Account has been prepared for the year ended 31.3.20X2:

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

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
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
Capital reserve (Bal.Fig.)	12,800	-
Net profit (Bal.Fig.)	-	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 = $\frac{5}{3}x \times 6 = 10x$

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 summarised Profit and Loss Account as given by ABC Ltd. for the year ending 31.12.20X1 is as under:

Summarised Profit and Loss Account

		₹			₹
To	*Rent and Taxes*	*90,000*	*By*	*Gross Profit*	*10,64,000*
To	*Salaries including manager's salary of ₹ 85,000*	*3,31,000*	*By*	*Interest on Investments*	*36,000*
To	*Carriage Outwards*	*14,000*			
To	*Printing and Stationery*	*18,000*			
To	*Interest on Debentures*	*25,000*			
To	*Sales Commission*	*30,800*			
To	*Bad Debts (related to sales)*	*91,000*			
To	*Underwriting Commission*	*26,000*			
To	*Preliminary Expenses*	*28,000*			
To	*Audit Fees*	*45,000*			
To	*Loss on Sale of Investments*	*11,200*			
To	*Net Profit*	*3,90,000*			
		11,00,000			*11,00,000*

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 9/2*x* : 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.

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 summarised Profit and Loss Account for the year ended 31-3-20X3 is 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 extract of Profit and Loss Account for the year ended 31.03.20X2:

Particulars	Amount (₹)	Particulars	Amount (₹)
To Salaries	1,20,000	By Gross Profit	6,00,000
To Rent, Rates & Taxes	80,000		
To Commission on Sales	21,000		
To Depreciation	25,000		
To Director Fees	12,000		
To Advertisement	36,000		
To Net Profit for the Year	2,74,000		
	6,00,000		6,00,000

(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.

ANSWERS/ HINTS

MCQ

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

THEORETICAL QUESTIONS

1. 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			1,81,240
Pre-incorporation profit transfer to Capital Reserve			360	

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 directors	Post	6.00	-	6.00
remuneration	Post	2.00	-	2.00
Interest on Debentures		5.50	0.93	4.57
Rent (W.N.4)	1:6	1.50	0.21	1.29
Bad debts (1 + 0.5)	Post	2.00	-	2.00
Underwriting commission	Post	2.00	-	2.00
Audit fees	Pre	1.00	1.00	-
Loss on sale of Investment	1:3	4.00	1.00	3.00
Depreciation				
(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*	
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.