TOPIC - 3

(CHAPTER 5 OF ICAI)

PROFIT OR LOSS PRE AND POST INCORPORATION

INTRODUCATION

1. Profit and loss of a such business for the period prior to the date the company incorporated is referred to as Pre-incorporation Profit and Losses.
2. Such Profit & Losses, though belonging to the company or payable by it, are of capital nature.
3. It is necessary to disclose them separately from trading profits or losses.

Treatment of Pre-Incorporation Profit/Loss?

S.No.	Pre-incorporation Profits	Pre-incorporation Losses
1	It is transferred to Capital Reserve Account (i.e. capitalized).	It is treated as a part of business acquisition cost (i.e. Goodwill) Or Shown as Negative Balance in Reserves under BS.
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 Profits • addition to Goodwill on acquisition • writing off capital profits

- In short, Pre-incorporation Profits/Losses are not included in Free Reserves therefore it cannot be distributed as Dividend to shareholders.
- Sometimes, Vendor (i.e. Seller) demands Interest on Late discharge of Purchase consideration, then such interest shall be calculated from the date of transfer of business to the date of actual payment of PC. This interest will be expense for the company (Pre period till the date of incorporation and Post period after date of incorporation).

How to calculate Profit/Loss Pre and Post Incorporation?

- All the Incomes and Expenses of the business apportioned on a reasonable basis in to Pre incorporation period and Post incorporation period.
- Such reasonable basis may be Time Ratio, Sales Ratio, or any other method suitable to the nature of Income and Expense.

Following basis of apportionment can generally be used for the various incomes and expenses:

Items of Incomes and Expenses	Basis of Apportionment between pre and Post incorporation period
Gross Profit or Gross Loss	First preference- Sales Ratio- On the basis of turnover in there spective periods Or Second preference On the basis of cost of goods sold in the respective periods in the absence of any information regarding turnover Or Third preference Time Ratio- On the basis of time in the respective periods in the absence of any information regarding turnover and cost of goods sold
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 & 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 pos-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: For the period from the date of acquisition of business to date of incorporation. From the date of incorporation	 Charge to Pre-incorporation period Charge to Post-incorporation period

DO NOT FORGET THIS:-

Time Ratio	Sales Ratio	Pre Incorporation Exp.	Post Incorporation Exp.
Salary exp.	Sales	Interest on Vendors capital	Company Audit fees
Rent exp.	COGS		Directors' Remuneration
Rents/Taxes	GP		Preliminary Exp.
Office Exp.	Commission on Sales		Interest on Debentures
Depreciation	Bad-debts		Underwriting exp.
Interest on Loans	Selling exp.		
Stationary Exp.	Sales promotion		
Electricity Exp.	Tax Audit Fees		
General Exp.	Discount Allowed		
	Advertisement Exp.		

*Time Ratio means Pre period months and Post period months

Class 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 (1.4.20X1to1.8.20X1) = 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 *2x : 8 *1x = 8x : 8x or 1 : 1

CLASS WORK QUESTION

Question 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, Rs. 2,00,000 was worked out after charging the following expenses:*

- *Depreciation - 1,23,000,*
- *Directors' fees - 50,000,*
- *Preliminary expenses-12,000,*
- *Office expenses -78,000,*
- *Selling expenses -72,000*
- *Interest to vendors up to August 31, 20 X1 - 5,000.*

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

Question 2 ***(ICAI MODULE)***

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		23,40,0000
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	
Total Expenses		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.

Question 3 ***(ICAI MODULE)***

ABC Ltd. took over a running business with effect from 1st April, 20X1. The company was incorporated on 1st August, 20X1. The following summarized Profit and Loss Account has been prepared for the year ended 31.3.20X2:

Salaries	48,000	Gross Profit	3,20,000
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		
	3,20,000		3,20,000

Additional information:

- *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.*
- *Rent of office building was paid @ ₹ 2,000 per month up to September, 20X1 and thereafter it was increased by ₹ 400 per month.*
- *Travelling expenses include ₹ 4,800 towards sales promotion.*
- *Depreciation include ₹ 600 for assets acquired in the post incorporation period.*
- *Purchase consideration was discharged by the company on 30th September, 20X1 by issuing equity shares of ₹ 10each.*

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

Question 4 ***(ICAI MODULE)***

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 asunder:

Summarized Profit and Loss Account

Particulars	Amount	Particulars	Amount
Rent and Taxes	90,000	Gross Profit	10,64,000
Salaries including manager's salary of 85,000	3,31,000	Interest on Investments	36,000
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		
	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:

- G.P. ratio was constant throughout the year.
- Sales for January and October were 1½ times the average monthly sales while sales for December were twice the average monthly sales.
- Bad Debts are shown after adjusting a recovery of ₹ 7,000 of Bad Debt for a sale made in July, 20X0.
- Manager's salary was increased by ₹ 2,000 p.m. from 1.5.20X1.
- All investments were sold in April, 20X1.
- The entire audit fees relates to the company.

Question 5 **(ICAI MODULE)**

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:

Particulars	Amount	Particulars	Amount
Purchase, including Inventory	1,40,000	Sales:	
Freight and carriage	5,000	1st January to 31st May 20X1	60,000
Gross Profit c/d	60,000	1st June to 31st Dec., 20X1	1,20,000
		Inventory in hand	25,000
	2,05,000		2,05,000
Salaries and Wages	10,000	Gross profit b/d	60,000
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		
Dividend paid on equity shares @ 5%	5,000		
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.

Question 6 ***(ICAI MODULE)***

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:

Particulars	(₹) 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:

- *The average monthly sales doubled from 1-7-20X2. G P ratio was constant.*
- *All investments were sold on31-5-20X2.*
- *Average monthly salary doubled from1-10-20X2.*
- *The company occupied additional space from 1-7-20X2 for which rent of ₹20,000 per month was incurred.*
- *Bad debts recovered amounting to ₹ 50,000 for a sale made in 20X0, has been deducted from bad debts mentioned above.*
- *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 7 ***(ICAI MODULE)***

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 to talled ₹ 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:

Particulars	(₹ in lakhs)
Salaries	69
Rent, Rates and Insurance	24
Sundry Office Expenses	66
Travelers' 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.

Question 8 ***(ICAI MODULE)***

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 ₹ 24,00,000of 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:

- *Director's fees ₹30,000*
- *Bad debts ₹7,200*
- *Advertising ₹ 24,000 (under a contract amounting to ₹ 2,000 per month)*
- *Salaries and General Expenses ₹1,28,000*
- *Preliminary Expenses written off ₹10,000*
- *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 9 *(PM)*

A firm M/s. Alag, which was carrying on business from 1st July, 2013 gets itself incorporated as a company on 1st November, 2013. The first accounts are drawn upto 31st March 2014. The gross profit for the period is ₹ 56,000. The general expenses are ₹ 14,220; Director's fee ₹ 12,000 p.a.; Incorporation expenses ₹ 1,500. Rent upto 31st December was ₹ 1,200 p.a. after which it is increased to ₹ 3,000 p.a. Salary of the manager, who upon incorporation of the company was made a director, is ₹ 6,000 p.a. His remuneration thereafter is included in the above figure of fee to the directors.

Give Statement showing pre and post incorporation profit. The net sales are ₹ 8,20,000, the monthly average of which for the first four months is one-half of that of the remaining period. The company earned a uniform profit. Interest and tax may be ignored.

Student Notes:-