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PROFIT OR LOSS PRIOR TO INCORPORATION

BASIC CONCEPTS

- 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.
- Generally there are two methods of computing Profit & Loss prior to Incorporation
  - One is to close of 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.
  - Other 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.
- A company taking over a running business may also agree to collect its debts as an agent for the vendor and may further undertake to pay the creditor on behalf of the vendors. In such a case, the debtors and creditors of the vendors will be included in the accounts for the company by debit or credit to separate total accounts in the General Ledger to distinguish them from the debtors and creditors of the business and contra entries will be made in corresponding Suspense Accounts. Also details of debtors and creditors balance will be kept in separate ledger.
- The vendor is treated as a creditor for the cash received by the purchasing company in respect of the debts due to the vendor, just as if he has himself collected cash from his debtors and remitted the proceeds to the purchasing company.
- The vendor is considered a debtor in respect of cash paid to his creditors by the purchasing company. The balance of the cash collected, less paid, will represent the amount due to or by the vendor, arising from debtors and creditors balances which have been taken over, subject to any collection expenses.
- The balance in the suspense accounts will be always equal to the amount of debtors and creditors taken over remaining unadjusted at any time.

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Question 1

X Ltd. was incorporated on 1.8.2009 to take over the running business of M/s Kumar Bros. with assets from 1.4.2009. The accounts of the company were closed on 31.3.2010.

The average monthly sales during the first four months of the year (2009-10) was twice the average monthly sales during each of the remaining eight months.

Calculate time ratio and sales ratio. ***(May,2010)***

Answer

Time ratio:

Pre-incorporation period (1.4.2009 to 1.8.2009) = 4 months

Post incorporation period (1.8.2009 to 31.3.2010) = 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

Question 2

ABC Ltd. took over a running business with effect from 1st April, 2009. The company was incorporated on 1st August, 2009. The following Profit and Loss Account has been prepared for the year ended 31.3.2010:

	Rs.		Rs.
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 Audit fee	6,000		

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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 Rs.19,20,000 arose evenly upto the date of 30.9.2009. Thereafter they spurted to record an increase of two-third during the rest of the year.

(b) Rent of office building was paid @ Rs.2,000 per month upto September, 2009 and thereafter it was increased by Rs.400 per month.

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

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

(e) Purchase consideration was discharged by the company on 30th September, 2009 by issuing equity shares of Rs.10 each.

Prepare the Profit and Loss Account in columnar form showing distinctly the allocation of expenses between pre and post incorporation periods. ***(May, 2010)***

Answer

Profit and Loss Account of ABC Ltd.

for the year ended 31.3.2010

Particulars	Pre-incorporation period Rs.	Post-incorporation period Rs.	Particulars	Pre-incorporation period Rs.	Post-incorporation period Rs.
To Salaries (1:2)	16,000	32,000	By Gross profit (1:3)	80,000	2,40,000
To Stationery (1:2)	1,600	3,200			
To Advertisement (1:3)	4,000	12,000			
To Travelling expenses (W.N.3)	4,000	8,000			
To Sales promotion expenses (W.N.3)	1,200	3,600			

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To Misc. trade expenses (1:2)	12,600	25,200			
To Rent (office building) (W.N.2)	8,000	18,400			
To Electricity charges (1:2)	1,400	2,800			
To Director's fee	-	11,200			
To Bad debts (1:3)	800	2,400			
To Selling agents commission (1:3)	4,000	12,000			
To Audit fee (1:2)	2,000	4,000			
To Debenture interest	-	3,000			
To Interest paid to vendor (2:1) (W.N.4)	2,800	1,400			
To Selling expenses (1:3)	6,300	18,900			
To Depreciation on fixed assets (W.N.5)	3,000	6,600			
To Capital reserve (Bal.Fig.)	12,300	-			
To Net profit (Bal.Fig.)	-	75,300			
	80,000	2,40,000		80,000	2,40,000

Working Notes:

Pre incorporation period = 1st April, 2009 to 31st July, 2009

i.e. 4 months

1. Sales ratio

Let the monthly sales for first 6 months (i.e. from 1.4.2009 to 30.09.09) be = x

Then, sales for 6 months = 6x

Monthly sales for next 6 months (i.e. from 1.10.09 to 31.3.2010) = $x + \frac{2}{3}x = \frac{5}{3}x$

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 = Rs.19,20,000/16 = Rs.1,20,000

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

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

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

= 1 : 3

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2. Rent

		Rs.
Rent for pre-incorporation period (Rs.2,000 x 4)		8,000 (pre)
Rent for post incorporation period		
August,2009 & September, 2009 (Rs.2,000 x 2)	4,000	
October,2009 to March,2010 (Rs.2,400 x 6)	14,400	18,400 (post)

3. Travelling expenses and sales promotion expenses

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

4. Interest paid to vendor till 30th September, 2009

	Pre *Rs.*	*Post* *Rs.*
Interest for pre-incorporation period $\left(\frac{\text{Rs.}4,200}{6}\times 4\right)$	2,800	
Interest for post incorporation period i.e. for		
August, 2009 & September, 2009 = $\left(\frac{\text{Rs.}4,200}{6}\times 2\right)$		1,400

5. Depreciation

		Pre *Rs.*	*Post* *Rs.*
Total depreciation	9,600		
Less: Depreciation exclusively for post incorporation period	600		600
	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
		3,000	6,600

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Question 3

Pre–incorporation expenses.

Answer

Pre–incorporation expenses denote expenses incurred by the promoters for the purposes of the company before its incorporation.

Broadly, these include expenses in connection with:

(a) preliminary analysis of the conceived idea,

(b) detailed investigation in terms of technical feasibility and commercial viability to establish the soundness of the proposition,

(c) preparation of 'project report' or 'feasibility report' and its verification through independent appraisal authority (before giving final approval to the proposition) and

(d) organisation of funds, property and managerial ability and assembling of other business elements.

These expenses should be properly capitalised and shown in the balance sheet under the heading "Miscellaneous Expenditure". There is no legal requirement to write–off these expenses to profit and loss account within any specified period of time nor is there any rigid accounting convention in regard to this matter. However, good corporate practice recognises the need to write off these expenses to profit and loss account within a period of 3 to 5 years.

Question 4

Rama Udyog Limited was incorporated on August 1, 2008. It had acquired a running business of Rama & Co. with effect from April 1, 2008. During the year 2008-09, the total sales were Rs.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:

(i) Depreciation Rs.1,08,000, (ii) Audit fees Rs.15,000, (iii) Directors' fees Rs.50,000, (iv) Preliminary expenses Rs.12,000, (v) Office expenses Rs.78,000, (vi) Selling expenses Rs.72,000 and (vii) Interest to vendors upto August 31, 2008 Rs.5,000.

Please ascertain pre-incorporation and post-incorporation profit for the year ended 31st March, 2009. ***(November, 2009)***

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Answer

Statement showing pre and post incorporation profit for the year ended 31st March, 2009

Particulars	*Total Amount* Rs.	*Basis of Allocation*	*Pre-incorporation* Rs,	*Post-Incorporation* Rs.
Gross Profit	5,40,000	2:7	1,20,000	4,20,000
Less: Depreciation	1,08,000	1:2	36,000	72,000
Audit Fees	15,000	1:2	5,000	10,000
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 (Rs.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 Re.1 then it should be 50 paise per month in the first half year. So sales for the first four months (i.e. from 1st April, 2008 to 31st July, 2008) will be 4 × .50 = Rs.2 and for the last eight months (i.e. from 1st August, 2008 to 31st March, 2009) will be (2 × .50 + 6 × 1) = Rs.7. Thus sales ratio is 2:7.

2. **Time ratio**

   1st April, 2008 to 31st July, 2008 : 1st August, 2008 to 31st March, 2009

   = 4 months : 8 months = 1:2

   Thus, time ratio is 1:2.

3. **Gross profit**

   Gross profit = Net profit + All expenses

   = Rs.2,00,000 + Rs.(1,08,000+15,000+50,000+12,000+78,000+72,000+5,000)

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

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