WELCOME

SUBJECT- CORPORATE ACCOUNTING PAPER- I

MODULE- III

PROFIT /LOSS PRIOR TO AND AFTER INCORPORATION

BY

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INTRODUCTION

Legally a company comes into existence only on receiving the certificate of incorporation from the company registrar. Sometimes a new company is formed to take over the existing business as a going concern. The newly formed company may take over the business of the vendor/ selling company as on the date prior to the date of its incorporation. Existing business to be taken over belong to the purchasing company from the date of agreement to the date of purchase of business. The profit earned or loss sustained by the existing business from the date of agreement to purchase to the date of receiving the certificate of incorporation belongs to the vendor/ selling company. Thus any profit or loss to which company is liable before its incorporation is termed as profit/loss prior to incorporation. The profit/loss prior to incorporation is of a capital nature. No company can earn profits prior to incorporation.

The profit earned from the date of takeover of business to the date of incorporation is termed as capital profit or pre- incorporation profit and it is transferred to Capital Reserve Account. If there is a loss during the pre-incorporation period it is debited to goodwill account because it is a capital loss.

The profit earned from the date of incorporation to the year end is termed as revenue profit. Thus it is treated as revenue reserve and it is available for dividend distribution.

Thus, Total profit earned during the year is required to divide into two periods i.e. Prior incorporation period and after incorporation period.

Prior Incorporation Period- From the date of takeover of business to the date of incorporation.

After Incorporation Period- From the date of incorporation to the date of year end.

Capital Profit- The profit earned from the date of takeover of business to the date of incorporation is termed as capital profit. In short Profit earned in prior incorporation period is capital profit. (Not available for dividend distribution)

Revenue Profit- The profit earned from the date of receiving the certificate of incorporation to the date of year end is termed as revenue profit. In short Profit earned in after incorporation period is revenue profit. (Available for dividend distribution)

For example:

A company Ltd. made agreement with one of the existing company B Ltd. to purchase its business with effect from the 1st April 2017 and it gets certificate of incorporation on 1st July 2017. In such case the profit earned by the existing company from 1st April 2017 to 30 June 2017 is Profit Prior to Incorporation (Capital Profit) and the profit earned from 1st July 2017 to 31 March 2018 is Profit after Incorporation (Revenue Profit).

A private limited company can commence business immediately after its incorporation but public limited company can commence business only after getting the certification of commencement of business. In case of public limited company once the certificate of commencement of business is given, the companies power to carry on the business relates back to the date of incorporation. Hence the date of incorporation should be taken into consideration as the relevant date for apportionment of profits between pre an post incorporation periods.

ACCOUNTING TREATMENT

A) Profit Prior to Incorporation

1) Profit prior to incorporation is of a capital nature and hence it cannot be credited to Profit and Loss Account.

2) This profit cannot be used for dividend payment.

3) It may be used to write off Goodwill taken over.

4) It may be used to write down the overvalued assets.

5) If interest is paid to the vendor for delay in payment of purchase consideration, then the amount of interest to the date of incorporation will be charged on such profit.

6) If any balance remained then it is transferred to capital reserve account which can be used to write off capital losses of the company i.e. Preliminary expenses, discount on issue of shares or debentures, goodwill etc. until it is fully utilized the balance of capital reserve account has to be shown in the liabilities side of the balance sheet under the heading Reserve and Surplus.

B) Loss Prior to Incorporation

Instead of profit if there is a loss in prior incorporation period then it is treated as follows

1) Loss prior to incorporation is a capital loss it is debited to Goodwill Account.

2) It may be debited to Loss prior to Incorporation account.

3) It may be written off against other capital profits of the company.

4) It may be debited against the profits after incorporation.

5) It may be debited to newly opened suspense account which may be written off out of capital profit made in the subsequent years by the company.

6) It may be debited to construction account if the business was taken over by the purchasing company during the construction period.

7) It may be treated as deferred revenue expenditure and written off out of the profits of the company over a period of years. Until such loss is completely written off it is shown on the asset side of the Balance Sheet.

CALCULATION OF VARIOUS RATIOS

1. Time Ratio-

For the calculation of time ratio date of incorporation is very important. Firstly you are required to decide pre incorporation and after incorporation period. From the date of takeover of business to the date of incorporation is the pre incorporation period and from the date of incorporation to the date of year end is the post incorporation period. On the basis of number of months of pre incorporation period and post incorporation period you can calculate the time ratio.

For example- A company Ltd. made agreement with one of the existing company B Ltd. to purchase its business with effect from the 1st April 2017 and it gets certificate of incorporation on 1st July 2017. In such case pre incorporation period is from1st April 2017 to 30 June 2017= 3 months and post incorporation period is from 1st July 2017 to 31 March 2018 = 9 months, So time ratio will be 3 : 9 = 1 : 3.

2. Sales Ratio:

When sales for two periods pre incorporation and post incorporation are not given directly in the problem then it is necessary to calculate sales ration on the basis of sales in various months.

For example company is incorporated on 1st July and the running business is taken over form 1st April, the sales from the 1 April to 31st March is 21,00,000 and the sales for each moth form April to June are half of the sales in subsequent months i.e. 1st July to 31st March. In such case we assume the sales of each months form 1st July to 31st March Rs. 2 then the sales form 1st April to 30th June must be Rs. 1. Therefore total sales from 1st April to 30th June amounted to Rs. 3 and from 1st July to 31st March, for 9 months amounted to Rs. 18. Hence the sales ratio for two periods pre incorporation and post incorporation is 3: 18 i.e. 1: 6. Hence the sales for two periods will be 3,00,000 and 18,00,000 respectively.

3. Special time ratio: (for interest on purchase price)

Special time ratio is calculated for interest on purchase price payable to vendors. Vendor can charge interest till the receipt of purchase consideration at a certain percentage. Interest to vendors shall be charged on the basis of time falling in the two periods but this time ratio is quite different from the usual time ratio because the date of payment of purchase price/consideration may be earlier than the closing of the accounting year. Interest payable up to the date of incorporation is charged to prior incorporation period and interest payable is respect of further period is charged to after incorporation period.

For example- A company Ltd. purchased the existing company B Ltd. with effect from the 1st April 2017 and it gets certificate of incorporation on 1st July 2017. Purchase consideration was paid by A Ltd on 1st October 2017. In such case interest from 1st April 2017 to 30th June 2017 i.e. 3 months charged to prior incorporation period and form 1st July 2017 to 1st October 2017 i.e. 4 months charged to after incorporation period.

BASIS OF ALLOCATION OF INCOME AND EXPENDITURE

Sr. No	Items	Basis of Allocation
1.	Gross Profit	Sales ratio
2.	Expenses of variable nature and Related to Sales- i.e. Selling expenses, Advertisement, Carriage outward, Godown Rent, Discount allowed, salesmens Salaries, commission on sales, Promotion expenses for sales, Distribution expenses (variable), Free samples given, expenses incurred for after sales services, delivery van expenses, Salesmens travelling expenses, Bad debts, travelling agents salaries and commission, Provision for bad debts (RDD) etc.	Sales ratio
3.	Expenses of fixed nature and Based on Time/Period- i.e. Salaries, Rent, Rates and Taxes, Insurance, Repairs, Depreciation, Office and Administration Expenses, depreciation on fixed assets, Printing and stationery, Miscellaneous expenses, Distribution expenses (fixed), Travelling Expenses (General),General expenses, Expenses of fixed nature etc.	Time ratio

Sr. No	Items	Basis of Allocation
4.	Expenses chargeable to Pre/Prior Incorporation period only i.e. Interest on capital, vendors salary, Bad debts related to Pre incorporation period, Interest on purchase consideration up to the date of incorporation etc.	Chargeable to Pre/Prior Incorporation period only
5.	Expenses chargeable to Post/After Incorporation period only i.e. Preliminary expenses, Directors fees, Interest on Debentures, Audit fees, Discount on issue of shares/debentures, Formation expenses, Underwriting Commission, Interest on purchase consideration after the date of incorporation etc.	Chargeable to Post/After Incorporation period only

THANK YOU