K.T.S.P. Mandal's

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Rajgurunagar – 410505

Second Year B.Com

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As per the new Syllabus

Subject – Corporate Accounting

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Topic 2 – Profit Prior to Incorporation

<u>Meaning of Incorporation of a Company</u> –

The word 'Company' has a strict legal meaning according to the provisions of the Companies Act of 2013, a company refers to a company formed and registered under the Companies Act. In common law, a company is a "legal person" or a "legal entity" which is separate and capable of surviving beyond the lives of its members.

Incorporation of a company refers to the setting up of a company according to the provisions laid out in the Companies Act of 2013.

Incorporation of Company is the process involved in forming a corporate entity or a company. It is the legal entity that separates the company, its income, and assets from that of the owners. Incorporation of a company has several benefits to the investors or owners

<u>Process of Incorporation of a Company</u> –

1. Application for Approval of Name

The first step in getting a company incorporated is of obtaining the approval of name from Registrar of Companies. A company may adopt any name which is not prohibited under the Emblem and Names (prevention of improper use) act, 1950 and which is not identical with or does not clearly resemble the name of company already registered. At least three names can be given as choices to be checked for availability.

2. Preparation of Memorandum of Association –

The preparation of Memorandum of Association is the next step in the incorporation of a company. It is the constitution of the company, which describes its objects and scope and the relation with outside world. The memorandum is to be signed by at-least seven persons if it is a public limited company and at least two persons in case of a private limited company. The memorandum should also be properly stamped.

3. Preparation of Articles of Association:

Besides memorandum, the promoters will also prepare Articles of Association. It is a document which contains rules and regulations relating to the internal management of the company. A public limited company may not file its own Articles of Association; it may adopt model clauses prescribed in Table A, Schedule 1 of the Act. A private limited company is also required to submit its Articles duly signed by the signatories

4. Preparation of other documents:

The promoters are also expected to prepare the following documents at the time of incorporating the company:

(i) The consent of directors is acquired first and filed with the Registrar of Companies.

(ii) The promoters should execute a Power of Attorney in favor of one of them or an advocate who is to carry out the formalities required for registration.

(iii) Copies of preliminary agreements, memorandum and Articles of Association must also be prepared and filed at the time of registration.

(iv) The company is required to have a registered office and its information is filed with the Registrar within 30 days of its registration or from the date of commencement of business, whichever is earlier.

(v) Where the company names first directors in its Articles, their particulars are to be submitted with the Registrar within 30 days of its registration or appointment of such directors.

(vi) A statutory declaration that all legal requirements for registration have been complied with is also filed with the Registrar at the time of registration. The declaration must be signed by an advocate of Supreme Court or High Court, or an attorney or pleader of High Court or a practicing Chartered Accountant.

5. Payment of fees:

At the time of registration, prescribed registration fees and filing fee for each document filed for registration are to be paid at the Registrar's office. The fee to be paid varies with the amount of nominal Capital in case of companies with share capital or according to the number of members in case of companies without share capital.

6. Incorporation Certificate:

When all the required documents are filed with the Registrar along with the requisite fees, a scrutiny is made. When all documents are found in order, the Registrar will enter the name of the company in the Register of Companies and issues a Certificate of Incorporation. The date mentioned in the certificate is the date of incorporation of the company.

Difference between Incorporation & Commencement of business –

Commencement of business is just that, when a person or group of people starts to do business. Depending on who is asking the question (a taxing authority, a business licensing authority, a bank, a business partner, and so on) that could be among other things the date that people get started in earnest to pursue the business, the day of the first legitimate sale, the day the first customer considers a purchase, the date one incurs the first business expense, or the day everyone moves into an office.

Incorporation is a formal process by which a business enterprise obtains a charter from a supervising governmental authority, usually by filing some paperwork, paying a fee, and applying for the corporate charter. Depending on the place, and type of company, that could be an absolute requirement in order to do business, or just a special arrangement a business may have with the government to get various government benefits (in particular, liability protection), in exchange for paying a fee and agreeing to follow the government rules.

Accounting of Incomes and Expenses during Pre and Post-Incorporation –

- Computing Profit or Loss Prior to Incorporation –

When a running business is taken over from a date prior to its incorporation/commencement, the profit earned up to the date of incorporation/commencement (incorporation, in case of private company; and commencement, in case of public company) is known as ‘Pre-incorporation profit’.

The same is to be treated as capital profit since these are profits which have been earned before the company came into existence. In short, the profit earned after the date of purchase of business is called ‘Post-incorporation or Post-acquisition profit’ and the profit earned before the date of purchase of business is termed as ‘Pre-incorporation profit’.

For example, X Ltd. was incorporated on 1st April 2006, took over a running business, Y Ltd., from 1st January 2006 and it closed its accounts on 31st December 2006. Now, the company X Ltd. is entitled not only to the profit/loss made by Y Ltd. from 1st April to 31st December 2006 but also to the profit/loss made by Y Ltd. from 1st January 2006 to 31st March 2006.

Thus, any profit/loss made before the incorporation is known as “Profit (Loss) Prior to Incorporation” which is treated as a capital profit and the same cannot be distributed as business profit. Hence, it cannot be distributed by way of dividend.

The same is to be transferred to Capital Reserve or may be adjusted against Goodwill. “Loss prior to incorporation” is treated as a capital loss and, hence, the same is shown under the head “Miscellaneous Expenditure” in the assets side of the Balance Sheet.

Method of Computation of Profits/Loss Prior to Incorporation:

In order to ascertain the profit prior to incorporation a Profit and Loss Account is to be prepared at the date of incorporation. But in practice, the same set of books of accounts is maintained throughout the accounting year.

A Profit and Loss Account is prepared at the end of the year and thereafter the profits (or losses) between the two periods are allocated:

(i) From the date of purchase to the date of incorporation or pre-incorporation period;

(ii) From the date of incorporation to the closing of the accounting year or post-incorporation period.

Method of Accounting of Profit/Loss Prior to Incorporation:

Steps may be suggested for ascertaining profit or loss prior to incorporation:

Step I:

A Trading Account should be prepared at first for the whole period, i.e., between the date of purchase and the date of final accounts, in order to calculate the amount of gross profit.

Step II:

Calculate the following two ratios:

I) Sales Ratio –

Amount of sales should be calculated for the pre and post-incorporation periods

II) Time Ratio –

It is calculated after considering time period, i.e. one is required to calculate the period falling between the date of purchase and the date of incorporation and the period between the date of incorporation and the date of presenting final accounts.

Step III:

A statement should be prepared for calculating the amount of net profit before and after incorporation separately on the following principle:

(i) Gross Profit should be allocated for the two periods on the basis of sales ratio which will present the gross profit for the two separate periods, viz. pre-incorporation and post-incorporation.

(ii) Fixed Expenses or expenses incurred on the basis of time, viz., Rent, Salary, Depreciation, Interest, etc. should be allocated for the two periods on the basis of time ratio.

(iii) Variable Expenses or expenses connected with sales should be allocated for the two periods on the basis of sales ratio

iv) Certain expenses, viz., partners' salary, directors' salary, preliminary expenses, interest on debentures, etc. are not apportioned since they relate to a particular period. For example, partners' salary is to be charged against pre-acquisition profit whereas directors' remuneration, debenture interest, etc. are to be charged against post-acquisition profit.

List of Expenses: Allocated on the basis of Sales/Turnover:

(a) Gross Profit
(b) Selling Expenses
(c) Advertisement
(d) Carriage Outwards
(e) Godown Rent
(f) Discount Allowed
(g) Salesmen's Salaries
(h) Commission to Salesmen
(i) Promotion Expenses for Sales
(j) Distributions Expenses (Variable Portions)
(k) Free Samples given
(l) Expenses incurred for After-Sale Service, etc.
(m) Delivery Van Expenses.

List of Expenses: Allocated on the basis of Time:

(a) Office and Administration Expenses
(b) Salaries to Office Staff
(c) Rent, Rates and Taxes
(d) Depreciation on Fixed Assets
(e) Printing and Stationery
(f) Insurance
(g) Audit Fees
(h) Miscellaneous Expenses
(i) Distribution Expenses (Fixed Portion)
(j) Travelling Expenses (General)
(k) Interest of Debenture
(l) General Expenses
(m) Expenses Fixed in Nature.

Application/Accounting Treatment of Profit/Loss Prior to Incorporation:

(a) Pre-incorporation Profit:

Since "Profit prior to Incorporation" is a Capital Profit the same should be written off against:

(i) Preliminary Expenses Account

(ii) Formation Expenses Account

(iii) Liquidation Expenses Account

(iv) Write down the value of Fixed Assets, if any

(v) Goodwill Account

(vi) Balance, if any, transferred to Capital Reserve.

(b) Pre-incorporation Loss:

Since “Pre-incorporation Loss” is a Capital Loss the same is adjusted against

(i) Any Capital Profit

(ii) Debited to Goodwill Account

(iii) Writing-off Fictitious Assets

(iv) Capital Reserve.