III B. COM (V SEMESTER) – UNDER CBCS

PART III – MAJOR CORE -13

CORPORATE ACCOUNTING I

CLASS: III B.Com **SUBJECT CODE: SMCO51**

Unit –IV - Profit prior to Incorporation – Underwriting of Shares and Debentures

INTRODUCTION

Sometimes a company purchased a running business from a date prior to its incorporation. Profit earned on the business after acquisition but before incorporation is known as profit prior to incorporation. Such profit and is transferred to capital reserve a/c.

Example, A Ltd. Company purchased a running business of B Ltd on 1.1.2015 and incorporated the same on 1.4.2015. The account of the B Ltd is closed on 31.12.2015. Here profit earned by Ltd from 1.1.2015 to 1.4.2015 is profit prior to incorporation. Profit earned from 1.04.2015 to 31.12.2015 is profit after or post incorporation.

1. Profit before incorporation:

The profit earned by the company from the date of purchase of business to the date of incorporation is known as profit before incorporation. The profit earned before incorporation is deemed to be capital profit and transferred to capital reserve. According to the Companies Act, no company can earn profits before the grant of certificate of incorporation.

Certificate of incorporation is the birth certificate of a company. A company has to fulfil a lot of legal formalities to obtain the certificate of incorporation from the Registrar of Companies. So the profit earned by a company from the date of purchase of a business to the date of incorporation is known as profit before incorporation and will be debited to goodwill account.

2. Procedures of calculating the profit prior to incorporation:

The following are the procedures to be followed while calculating profit prior to incorporation.

I. Preparation of trading account for the whole period:

Prepare one trading account for the whole period from the date of purchase to the date of closing of accounts. The date of incorporation does not affect the calculation of gross profit.

II. Apportion of gross profit:

The gross profit so arrived should be apportioned between prior and post periods on the basis of sales in the two periods.

III. Calculation of time ratio and sales ratio:

- **Time ratio :**

  To calculate time ratio, date of purchase of business, date of incorporation and date of account closing of accounts are essential. The period between the date of purchase and date of incorporation denotes the period before incorporation. From the date of incorporation to the date of closing of accounts will be the period after incorporation.

Prior period : Post period

Date of purchase to date of Incorporation. : Date of incorporation to date of account closing.

- **Sales ratio :**

When total volume of sales and sales before incorporation period is given sales after incorporation will be calculated by deducting sales before incorporation from the total sales.

Prior period sales : Post period sales

Post period sales = Total sales - prior period sales

IV. Preparation of Profit loss account statement:

Prepare a statement for calculating the net profit before and after incorporation. This is done as follows

A. Divide gross profit in sales ratio:

Divide the whole gross profit calculated into prior and post period on the basis of sales ratio.

B. Divide on the basis of Time ratio:

All expenses which are of fixed in nature are allocated on the basis of time ratio. They are - salaries, rent, rated, taxes, insurance, depreciation, office expenses, printing and stationary, administrative expenses, postage, audit fees, repairs, general expenses.

C. Divide on the basis of sales ratio:

All types of expenses directly varying with turnover and expenses of variable in outwards, packaging, commission, advertisement, discount, bad debts, selling expenses, salesmen salary.

D. Allocation only for prior incorporation period:

Expenses exclusively for pre-incorporation period. E.g. interest payable to vendor on purchase price for pre-incorporation period, vendor's salary, loss or gain on the sale of investment before incorporation.

E. Allocation only for post incorporation period:

Expenses which are exclusively meant for post-acquisition period are to be allocated only to post acquisition period. They are preliminary expenses, director's fees, formation expenses, discount on issues of shares and debentures, underwriting commission, salary to managing director, interest on debentures, subscription to political parties, donation given by the company etc.

3. Divisible profits:

Profits available to shareholders for dividend are called divisible profits. In normal course, profits are distributed as dividends after meeting all expenses, losses, depreciation, fall in the value of current assets and transferring a reasonable amount to reserves. Section 205 of the companies Act lays down certain provisions for the ascertainment of divisible profits. They are:

1. Dividend out of the profit of the current year can be declared only after providing depreciation.
2. Dividend out of the profit of any previous financial year can be declared after providing for depreciation.
3. Dividend can be declared out of both profit of current year and profit of any previous financial year.
4. Dividend can be declared out of subsidy granted by central Government or State Government.

4. The differences between capital reserve and reserve capital

1. When a reserve is created out of capital profits, it is known as capital reserve. But reserve capital is the portion of capital that cannot be called up except at the time of winding up of the company.
2. Capital reserve will appear in the balance sheet liabilities side under the heading Reserve and Surplus. Reserve capital will not appear in the balance sheet.
3. Capital reserve may be utilised to be declared as dividend to shareholders under certain conditions .Reserve capital may be utilised at the time of winding up of a company.
4. Capital reserve is the form of accumulated profits of the company. Reserve capital is a contingent liability.

5. **Apportion of various expenses and incomes between pre and post incorporation periods:**

Apportion of various expenses and income is one of the major portions under profit prior to incorporation. The details of various expenses and incomes are classified under in the following ways.

Apportion of expenses

Basis of allocation	**Nature**	**Examples**
1.Time ratio	Fixed nature expenses	Salaries, rent, rates, taxes, insurance, depreciation, office expense, printing and stationary, administrative expense, postage, audit fees, repairs, general expenses.
2.Sales ratio	Variable in nature & sales related expenses	Gross profit or loss, carriage outwards, packaging, commission, discount, bad debt, advertisement, selling expenses, salesman's salary.
3.Only prior period	Related to prior	Interest payable to vendor, vendor's salary, loss or gain on the sale of investment before incorporation.
4.Only post period	Related to post	Preliminary expenses, director's fees, formation expenses, discount on issue of shares and debentures, under writing commission, salary to managing director, interest on debentures, subscription to political parties.
5.Weighted time ratio	When not in uniform position	No. of employees differs, difference in accommodation.
6.Weighted sales ratio	When sales were not uniform	If sales were not uniform weight age should be given.
7.Purchase ratio	Purchase basis	Carriage inward.

Allocation of income

1. Sales ratio: Discount received, commission received should be allocated on the basis of sales ratio.
2. Time ratio: Interest received should be allocated on the basis of time ratio.

UNDERWRITING OF SHARES AND DEBENTURES

I) When benefit of firm underwriting is given to underwriters

Particulars	Underwriters		
	X	**Y**	**Z**
Gross Liability	xxx	xxx	xxx
Less: Firm Underwriting	xxx	xxx	xxx
	xxx	xxx	xxx
Less: Marked applications	xxx	xxx	xxx
	xxx	xxx	xxx
Less: Unmarked applications (in the ratio of gross liability)	xxx	xxx	xxx
	xxx	xxx	xxx
Surplus adjustment (in the ratio of gross liability)			
Net Liability	xxx	xxx	xxx
Add: Firm Underwriting	xxx	xxx	xxx
Total Liability	xxx	xxx	xxx

II) When benefit of firm underwriting is not given to underwriters

Particulars	Underwriters		
	X	**Y**	**Z**
Gross Liability	xxx	xxx	xxx
Less: Marked applications	xxx	xxx	xxx
	xxx	xxx	xxx
Less: Unmarked and firm underwriting (in the ratio of gross liability)	xxx	xxx	xxx
	xxx	xxx	xxx
Surplus adjustment (in the ratio of gross liability)			
Net Liability	xxx	xxx	xxx
Add: Firm Underwriting	xxx	xxx	xxx
Total Liability	xxx	xxx	xxx

III) Partial underwriting

	X	Y	Z	Company
Gross liability	xxx	xxx	xxx	xxx
Less: Unmarked	---	---	---	xxx
	xxx	xxx	xxx	xxx

IV) Underwriting commission – 2.5% (if not given in the problem)

V) Journal Entries

i) For shares subscribed by the public

a) At Par

Bank a/c Dr.
To Share Capital a/c

b) At Premium

Bank a/c Dr.
To Share Capital a/c
To Securities Premium a/c

c) At Discount

Bank a/c Dr.
Discount on issue of shares a/c Dr.
To Share Capital a/c

ii) For underwriters liability

Underwriter's a/c Dr.	Underwriter's a/c	Underwriter's a/c
To Share Capital a/c	To Sh. Cap	Dis a/c
	To Sec Pre	To Sh. Cap

iii) For underwriting commission

Underwriting commission a/c Dr.
To Underwriter's a/c

iv) Amount receivable from underwriters

Bank a/c Dr.
To Underwriters a/c

v) Amount payable to underwriters

Underwriters a/c Dr.
To Bank a/c

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