

PRE-INCORPORATION CONTRACTS REVISITED

by

Richard Jooste

Associate Professor, School of Law, University of Cape Town

and

Carolina Koornhof

Senior Lecturer, Department of Accounting, University of the Witwatersrand

Acknowledgement:

The authors wish to express their appreciation for the assistance received from Professor M D F Steele of the Department of Accounting, University of the Witwatersrand and Professor G K Everingham of the Department of Accounting, University of Cape Town. The views expressed are not necessarily theirs, nor, of course, are they responsible for any defects in this article.

ABSTRACT

Some confusion still exists with Accountants as to the correct accounting treatment for pre-incorporation contracts. An attempt is made in this article to present a framework of the legal positions and accounting treatments of all practical situations encountered with pre-incorporation contracts.

Keywords

Pre-incorporation contracts
Capital and Revenue profits
Retrospectivity of contracts

PRE-INCORPORATION CONTRACTS REVISITED

INTRODUCTION

The accounting treatment of pre-incorporation contracts was a much debated topic in the late sixties and the early seventies. No final agreement was reached as to the correct treatment, and alternative accounting treatments abound. The solution that appears to be prevalent in practice is to ignore the recognition of the specific accounting implications of pre-incorporation contracts.

This situation appears to have evolved because authoritative writers on the legal issues in this area have failed to recognise the true nature of certain transactions. Misdirection has also resulted from the Courts misuse of terminology. It is apparent that a correct accounting treatment will be determined only after a clear understanding of the legal nature of pre-incorporation contracts is obtained. A recent article in the South African Law Journal, entitled "When do pre-incorporation contracts have retrospective effect?" (Jooste, 1989) has served to clarify many of the **legal** issues. It is, therefore, an opportune time to revisit the **accounting** treatment for pre-incorporation contracts.

The purpose of this article is to clarify the law concerning pre-incorporation contracts and to determine the most appropriate accounting treatment in relation to the various circumstances in which pre-incorporation contracts arise. For the purposes of this article a pre-incorporation contract is defined as a contract in terms of which a promoter on behalf of a company to

be formed enters into a contract which involves the acquisition of a business as a going concern from a date prior to the company's incorporation date.

The date on which the contract takes effect is of central importance because it determines the legal nature and distributability of the profits. That date will vary according to the circumstances in each particular case. The manner in which this article is structured is to describe the various situations that may pertain, and then, in relation to each, to set out both the legal position and the accounting treatment.

For the sake of brevity the company will be referred to as X (Pty) Ltd, the promoter of the company as A and the other contracting party as B.

RETROSPECTIVITY SPECIFIED IN THE CONTRACT

If the terms of the contract, either express or tacit, as evidenced from all surrounding circumstances, provide that the contract is to have retrospective effect, then the contract undoubtedly has such effect (Jooste, 1989, p.507). The capacity in which A, the promoter of the company, acted is not relevant in these circumstances. If, therefore, A negotiates a contract with B on 1 June 19x0 and the terms thereof are that X (Pty) Ltd is to acquire B's business as from that date, and if X (Pty) Ltd is incorporated on 1 August 19x0 and ratifies the contract on 15 August 19x0, X (Pty) then acquires the business as of 1 June 19x0.

What is the legal nature of the profits earned by X (Pty) Ltd from the business during the period prior to its incorporation? The profits accruing to the company between 1 June 19x0 and 1 August 19x0 are capital profits because they accrue to the company prior to the commencement of business and it is submitted that they are legally distributable as dividends unless the Articles provide otherwise and provided they meet the other legal requirements for the proper distribution of a dividend (Cilliers and Benade, 1987, p.278; Faul, Everingham, Redelinghuys and van Vuuren, 1985, p.93). The profits accruing subsequent to the date of incorporation (1 August 19x0) are revenue profits and are also legally distributable. It is submitted that this is the situation even if the date of issue of the certificate to commence business does not coincide with the date of incorporation; the company is in existence and, whether or not the certificate has been issued, the company is trading.

From an accounting perspective it is necessary to identify the profits or losses accruing to the company in terms of the contract and to investigate the

nature of these profits or losses. In the example the profits or losses accrue to the company from 1 June 19x0. The profits accruing to the date of incorporation are capital profits and the profits accruing subsequent to the date of incorporation are revenue profits. The same classification applies to losses.

Note that it is the date of incorporation which changes the nature of the profits and not the date of ratification. This view is also confirmed by Faul, Everingham, Redelinghuys and van Vuuren (1985, p.93): ".....where a company is formed and takes over a going concern in terms of a pre-incorporation contract from a specified date before incorporation, the profit (or loss) between the date of acquisition and the *date of incorporation* must be determined as a separate figure because it represents capital profits or losses." (authors' emphasis).

The revenue profits of X (Pty) Ltd are disclosed in the Income Statement. The capital profits are, however, not disclosed in the Income Statement as they were earned prior to the formation of the company. The accounting treatment of these capital profits in the books of X (Pty) Ltd is affected directly by the manner in which the purchase price is paid.

If the purchase price is paid in cash, the capital profits (pre-incorporation profits) can be written off against the amount paid by B in excess of the payment for the identifiable assets of the business. This amount is generally reported as "goodwill". If, however, A and B agreed in the pre-incorporation contract on a specific amount to be paid for goodwill, it is more correct to report the pre-incorporation profits as a reserve. Whether a distributable or a non-distributable reserve is created, will be determined by the articles

of the company. If the articles do not prohibit distribution of capital profits, the profits are more often transferred to a distributable reserve. Where the articles prohibit the declaration of dividends from these profits, they are transferred to a non-distributable reserve.

It is submitted that when the purchase price is paid by issuing shares in X (Pty) Ltd, the pre-incorporation profits should be treated as a share premium. The alternative, however, to reduce the goodwill figure paid on acquiring the business of B, is acceptable, subject to the specific terms of the contract.

The prudence concept should be observed when pre-incorporation losses are identified. The pre-incorporation losses are written off in the Income Statement.

If in terms of the contract, X (Pty) Ltd acquired the business from a date earlier than the date on which the contract is negotiated (i.e. 1 June 19x0), for example 1 January 19x0, the profits accruing to the business prior to 1 June 19x0 will have been taken into account in determining the purchase price of the business and accordingly will not be legally distributable by X (Pty) Ltd because this would in effect constitute the distribution of a dividend out of capital (Cilliers and Benade, 1989, p.282).

The example illustrates that there is a difference between the capital profits acquired between 1 January 19x0 and 31 May 19x0 and the capital profits acquired between 1 June 19x0 and 1 August 19x0. The former profits are not distributable as a dividend and are called "pre-acquisition profits" while the latter are distributable as a dividend and are called "pre-incorporation profits". Cilliers and Benade (1970, p.63) note in this regard that there

is a regrettable tendency among authors on company accounting to equate, pre-acquisition profits with pre-incorporation profits without any attempt at an incisive analysis. Pre-acquisition profits should be transferred to a non-distributable reserve or be used to reduce goodwill if the amount paid for goodwill is not specified in the contract.

When the business is acquired from a date, for example, 1 July 19x0, which is later than the date of negotiation (1 June 19x0), it is submitted that the profits generated by the business between the two dates are also not legally distributable as a dividend because an estimate of such profits would have been taken into account in arriving at the purchase price of the business. A payment out of these profits would amount to a contravention of the rule that dividends may not be paid out of paid up share capital. The profits accruing from 1 June 19x0 to 1 July 19x0 should also be treated as pre-acquisition profits.

RETROSPECTIVITY NOT SPECIFIED IN THE CONTRACT

Although the majority of pre-incorporation contracts will specify either expressly or tacitly whether the contract has retrospective effect, and if so, the effective date, certain contracts may not address this aspect. In such an event, to determine whether the contract does have retrospective effect, it is necessary to ascertain the capacity in which A, the promoter, acted.

(a) **A ACTS AS AGENT**

A, acting as agent on behalf of the company to be formed, may negotiate a contract with B for the acquisition of B's business which will be binding on X (Pty) Ltd if it is ratified by the company after incorporation.

In terms of South African common law a company cannot ratify a contract entered into prior to its incorporation by a person who professed to act as its agent, as an agent cannot act on behalf of a non-existent principal (*McCulloch v Fernwood Estate Ltd* 1920, AD 204). This common law position has however been altered by section 35 of the Companies Act (Act 61 of 1973), which has removed the nullifying effect of the common law, provided the requirements laid down by the section are met.

The requirements are:

- the contract must be in writing,
- the contract was entered into by a person who professed to act as the agent or trustee of a company not yet formed,

- the memorandum of association must contain as one of its objectives the adoption or ratification of the contracts.

If in the example, A acting as agent for the company to be formed (X (Pty) Ltd), enters into the contract with B, and the contract does not specify the date of the acquisition of the business, then X (Pty) Ltd will acquire the business only from the date of ratification, i.e. 15 August 19x0 (Peak Lode Gold Mining Company v Union Government, 1932, TPD 48).

As far as the accounting treatment is concerned, as only profits earned after 15 August 19x0 (post ratification profits) accrue to the company, only such revenue will be included in the Income Statement of X (Pty) Ltd.

Strong criticism has been levelled at the Peak Lode decision which departs from the common law maxim that every ratification has retrospective effect and is equivalent to a prior mandate (Jooste, 1989, p. 508). However, despite the discomfort one may have with the Peak Lode case, it appears that the case does reflect the present state of the law. If the Appellate Division is ever afforded the opportunity, it will in all probability overrule the Peak Lode decision (Jooste, 1989, p. 510). Until such time, however, only post ratification profits should be included in the Income Statement.

(b) **A ACTS AS NUNTIUS**

B may appoint A as his nuntius or messenger in order to convey to X (Pty) Ltd, once it is formed, an offer to sell his business to X (Pty) Ltd. In such a case A is not acting as an agent but merely as a conduit which transmits the declaration of B's will to X (Pty) Ltd. A plays no independent part, does not negotiate or take decisions, but merely provides the means of communication.

In the absence of any express or tacit term specifying the date of the acquisition of the business, X (Pty) Ltd will acquire the business together with its profits, from the date of its acceptance of B's offer (which can only be after the date of incorporation). This flows from the basic principle of contract that prima facie the obligations contained in a contract date from the time those obligations are accepted and it is only if there is an express or tacit term to the contrary that this prima facie position is affected (Jooste, 1989, p.510). Any profits accruing to the business from the date of acceptance of the offer are legally distributable by X (Pty) Ltd.

From an accounting point of view only profits or losses incurred from the date of acceptance of the offer should therefore be included in the records of X (Pty) Ltd. As these profits or losses are of a revenue nature, they should be disclosed in the Income Statement.

Note that in this instance the date of acceptance should not be referred to as the date of ratification. Ratification is a concept restricted to the institution of agency.

(c) **A ACTS AS STIPULANS**

A may act, not as an agent, but as a stipulans under a stipulatio alteri; that is, he enters into a contract as a principal with B for the benefit of X (Pty) Ltd. What is envisaged here is an agreement whereby B (the promittens) binds himself towards A (the stipulans) to offer his business to X (Pty) Ltd, A and B contracting in their own names as principals. In the context of pre-incorporation contracts the stipulans (A) is usually referred to as a "trustee". It is not necessary in this instance to comply with the requirements of section 35 of the Companies Act (Jooste, 1989, p.510).

The stipulans (A) does not represent X (Pty) Ltd and accordingly there is no ratification by X (Pty) Ltd. X (Pty) Ltd either accepts or rejects the right (which is in the nature of an option to acquire B's business) stipulated in its favour. (Joubert, 1976, para 103). By accepting the right, X (Pty) Ltd does not ratify or even adopt the contract between A and B. That contract remains a contract between the stipulans (A) and the promittens (B), in terms of which the right to acquire the business is offered to X (Pty) Ltd and X (Pty) Ltd simply accepts or rejects that right (Joubert, 1976, para 103). If X (Pty) Ltd accepts the right, a contract in the nature of an option is created between X (Pty) Ltd and B and, if the company exercises the option, a further contract (a contract of purchase and sale) comes into being between B and X (Pty) Ltd. (Joubert, 1976, para 103)

As stated above, the basic principles of contract dictate that, prima facie, the rights and obligations under a contract come into existence and take effect from the date of acceptance of the contractual offer. This prima facie position may be deviated from only if express or tacit terms in the contract so determine. If the right held out to X (Pty) Ltd is an option to purchase B's business as a going concern, then in the absence of any express or tacit clause to the contrary and provided X (Pty) Ltd accepts the right and exercises the option, the contract of purchase and sale between X (Pty) Ltd and B will take effect on the date X (Pty) Ltd exercises the option. The business together with its profits will accordingly be acquired by X (Pty) Ltd as from that date and not retrospectively from an earlier date (Jooste, 1989, p.511).

Suppose, for illustrative purposes, that 15 August 19x0 is accepted as the date on which the option is exercised. Then the profits or losses of the acquired business will accrue to X (Pty) Ltd from this date. Such profits are of a revenue nature, are legally distributable and will be reported in the Income Statement of X (Pty) Ltd. The purchase price under these circumstances should reflect the fact that profits or losses to the date of the exercising of the option accrue to B.

As the date on which the option is to be exercised is not known when the contract between A and B is concluded, a time limit for the exercising of the option by X (Pty) Ltd will probably be included in the contract. In the absence of such a time limit the company would have a reasonable time within which to exercise the option. What is "reasonable" would depend on the particular circumstances.

Ratification only takes place when the promoter acts in the capacity of an agent and accordingly it would be incorrect to use the term "date of ratification" in circumstances where he acts as stipulans.

(d) **A ACTS AS PRINCIPAL, BUT NOT STIPULANS**

A acting as a principal, but not as a stipulans, may enter into a contract with B for the acquisition of B's business and may cede his rights in terms of the contract to X (Pty) Ltd when X (Pty) Ltd comes into existence. If A incurs obligations in terms of the contract with B, these may be taken over by X (Pty) Ltd, in which case a "delegation" takes place. The delegation requires the consent of B.

In the absence of express or tacit terms to the contrary, A acquires the rights and incurs the obligations in terms of his contract with B from the date he enters into the contract with B. X (Pty) Ltd acquires those rights and obligations by cession and delegation and accordingly they take effect from the date on which they were acquired by A and not the date of cession or delegation.

If, for example, A enters into a contract with B on 1 June 19x0 to acquire B's business as a going concern, then, in the absence of express or tacit terms to the contrary, A's right to the business and its profits in terms of the contract takes effect from that date. While A cedes the rights to X (Pty) Ltd on 1 August 19x0, the contract nevertheless takes effect from 1 June 19x0.

The legal nature of profits and losses of the business and the distributability of the profits is determined on the basis of the principles explained earlier. The date of incorporation, the requirements of the Articles regarding the distribution of capital profits and the rule against the distribution of capital are the determinants of the accounting treatment for profits. The prudence concept, which requires the immediate recognition of losses in the Income Statement applies, irrespective of whether the losses are of a revenue or capital nature.

SUMMARY

The purpose of this article is to clarify the legal position of pre-incorporation contracts and to discuss the most appropriate accounting treatments in the given circumstances. We believe that this article may serve as a theoretical and reference framework within which all practical situations concerning pre-incorporation contracts may be classified.

It was noted in the article that the terms of the contract regarding the retrospectivity of the contract, is the overruling factor. Only where a contract does not address retrospectivity, is the capacity in which the promoter acted of concern (see box for summary). From an accounting perspective the importance of correctly identifying the nature of the profits and losses prior to deciding on an appropriate treatment, was stressed. Although profits and losses are classified as either capital and revenue, it was emphasized further that capital profits may either be legally distributable as a dividend or not and that a correct subclassification is important to ensure that an appropriate accounting treatment is adopted.

Acquisition date not specified either expressly or tacitly in the contract	
<u>Capacity of promoter</u>	<u>Date of acquisition of business</u>
Agent	date of ratification by company
Nuntius	date of acceptance by company of seller's offer
Stipulans	date of exercise of option by company
Principal (not Stipulans)	date of acquisition by promoter

REFERENCES

Bell's South African Legal Dictionary, 1951, 548.

Cilliers, H.S. and Benade, M.L. *Does adoption or ratification of Pre-Incorporation contracts operative retroactively?* The South African Chartered Accountant, February 1970, pp. 61-64.

Cilliers, H.S. and Benade, M.L., Corporate Law, 1987, Butterworths.

Companies Act No 61 of 1973.

Faul, M.A., Everingham, G.K., Redelinghuys, H.F. and Van Vuuren, L.M. *Financial Accounting*, 1985, Second Edition, Butterworths.

Jooste, R., *When do Pre-Incorporation Contracts have retrospective effect?* The South African Law Journal, August 1989, Volume 106, Part III, pp. 507-516.

Joubert, W.A. (ed), The Law of South Africa, (1976) SV Agency and Representation (by J.C. De Wet) para 133 (LAWSA).

McCulloch v Fernwood Estate Limited, 1920, AD 204.

Peak Lode Gold Mining Company Limited v Union Government, 1932, TPD 48.

CK-PIC/ART/U1