**ACCOUNTING FOR EQUITY**

* Identify and explain the management issues related to contributed capital.
* Identify the components of stockholders’ equity.
* Identify the characteristics of preferred stock.
* Account for the issuance of stock for cash and other assets.

**The Corporate Form of Business**

The corporate form of business is well suited to today’s trends toward large organizations, international trade, and professional management. Although fewer in number than sole proprietorships and partnerships, corporations dominate the Kenyan economy, in part because of their ability to raise large amounts of capital. To form a corporation, most countries require persons (called incorporators) to sign an application and file it with the proper state official. This application contains the **articles of incorporation**. If approved by the state, these articles, which form the company charter, become a contract between the state and the incorporators.

The company is then authorized to do business as a corporation. The authority to manage a corporation is delegated by its stockholders to a board of directors and by the board of directors to the corporation’s officers, the managers (see Figure below). That is, the stockholders elect a board of directors, which sets corporate policies and chooses the corporation’s officers, who in turn carry out the corporate policies in their management of the business.

**Stockholders** A unit of ownership in a corporation is called a **share of stock.** The articles of incorporation state the maximum number of shares that a corporation is authorized to issue. The number of shares held by stockholders is the outstanding stock; this may be less than the number authorized in the articles of incorporation. To invest in a corporation, a stockholder transfers cash or other resources to the corporation. In return, the stockholder receives shares of stock representing a proportionate share of ownership in the corporation. Afterward, the stockholder may transfer the shares at will. Corporations may have more than one kind of stock.

**Board of Directors** As noted, a corporation’s board of directors decides on major business policies. Among the board’s specific duties are authorizing contracts, setting executive salaries, and arranging major loans with banks. The declaration of dividends is also an important function of the board of directors.

**Dividends** are distributions of resources, generally in the form of cash, to stockholders, and only the board of directors has the authority to declare them. Paying dividends is one way of rewarding stockholders for their investment when the corporation has been successful in earning a profit. (The other way is through a rise in the market value of the stock.) There is usually a delay of two or three weeks between the time the board declares a dividend and the date of the actual payment. The composition of the board of directors varies from company to company, but generally it includes several officers of the corporation, called *executive directors* and several outsiders. The outsiders are called *independent directors or non-executive directors* because they do not directly participate in managing the business.

**Corporation’s Officers** The corporate officers, appointed by the board of directors to carry out corporate polices and run day-to-day operations, consist of the operating officers—generally the president, or chief executive officer; vice presidents; chief financial officer; and chief operating officer. Besides being responsible for running the business, they have the duty of reporting the financial results of their administration to the board of directors and the stockholders. Though they must, at a minimum, make a comprehensive annual report, they generally report more often. The annual reports of large public corporations are available to the public.

**Advantages and Disadvantages of Incorporation**

Managers of a corporation must be familiar with the advantages and disadvantages of this form of business. Some of the advantages are as follows:

\_ ***Separate legal entity*:** As a separate legal entity, a corporation can buy and sell property, sue other parties, enter into contracts, hire and fire employees, and be taxed.

\_ ***Limited liability*:** Because a corporation is a legal entity, separate from its owners, its creditors can satisfy their claims only against the assets of the corporation, not against the personal property of the corporation’s owners. Because the owners are not responsible for the corporation’s debts, their liability is limited to the amount of their investment. In contrast, the personal property of sole proprietors and partners generally is available to creditors.

\_ ***Ease of capital generation*:** It is fairly easy for a corporation to raise capital because shares of ownership in the business are available to a great number of potential investors for a small amount of money. As a result, a single corporation can have many owners.

\_ ***Ease of transfer of ownership*:** A share of stock, a unit of ownership in a corporation,

is easily transferable. A stockholder can normally buy and sell shares without affecting the corporation’s activities or needing the approval of other owners.

\_ ***Lack of mutual agency*:** Mutual agency is not a characteristic of corporations. If a stockholder tries to enter into a contract for the corporation, the corporation is not bound by the contract. But in a partnership, because of mutual agency, all the partners can be bound by one partner’s actions.

\_ ***Continuous existence*:** Because a corporation is a separate legal entity, an owner’s death, incapacity, or withdrawal does not affect the life of the corporation. A corporation’s life is set by its charter and regulated by state laws.

\_ ***Centralized authority and responsibility*:** The board of directors represents the stockholders and delegates the responsibility and authority for the day to- day operation of the corporation to a single person, usually the president. Operating power is not divided among the many owners of the business. The president may delegate authority over certain segments of the business to others,

but he or she is held accountable to the board of directors. If the board is dissatisfied with the performance of the president, it can replace that person.

\_ ***Professional management*:** Large corporations have many owners, most of whom are unequipped to make timely decisions about business operations. So, management and ownership are usually separate. This allows a corporation to hire the best talent available to manage the business. The disadvantages of corporations include the following:

\_ ***Government regulation*:** Corporations must meet the requirements of state laws. As “creatures of the state,” they are subject to greater state control and regulation than are other forms of business. They must file many reports with the state in which they are chartered. Publicly held corporations must also file reports with the Securities and Exchange Commission and with the stock exchanges on which they are listed. Meeting these requirements is very costly.

\_ ***Taxation*:** A major disadvantage of the corporate form of business is **double taxation.** Because a corporation is a separate legal entity, its earnings are subjectto federal and state income taxes, which may be as much as 37.5 percent ofcorporate earnings. If any of the corporation’s after-tax earnings are paid outas dividends, the earnings are taxed again as income to the stockholders. Incontrast, the earnings of sole proprietorships and partnerships are taxed onlyonce, as personal income to the owners.

\_ ***Limited liability*:** Although limited liability is an advantage of incorporation, it can also be a disadvantage. Limited liability restricts the ability of a small corporation to borrow money. Because creditors can lay claim only to the assets of a corporation, they may limit their loans to the level secured by those assets or require stockholders to guarantee the loans personally.

\_ ***Separation of ownership and control*:** Just as limited liability can be a drawback of incorporation, so can the separation of ownership and control. Management sometimes makes decisions that are not good for the corporation as a whole. Poor communication can also make it hard for stockholders to exercise control over the corporation or even to recognize that management’s decisions are harmful.

**Equity Financing**

Equity consists of:

\_ ***Contributed capital***: the stockholders’ investments in the corporation.

\_ ***Retained earnings***: the earnings of the corporation since its inception, less any losses, dividends, or transfers to contributed capital. Retained earnings are reinvested in the business. They are not a pool of funds to be distributed to the stockholders; instead, they represent the stockholders’ claim to assets resulting from profitable operations.

\_ ***Treasury stock***: shares of its own stock that the corporation has bought back on the open market. The cost of these shares is treated not as an investment, but as a reduction in stockholders’ equity. By buying back the shares, the corporation reduces the ownership of the business.

A corporation can issue two types of stock:

\_ **Common stock** is the basic form of stock that a corporation issues; that is, if a corporation issues only one type of stock, it is common stock. Because shares of common stock carry voting rights, they generally provide their owners with the means of controlling the corporation. Common stock is also called **residual equity,** which means that if the corporation is liquidated, the claims of all creditors and usually those of preferred stockholders rank ahead of the claims of common stockholders.

\_ To attract investors whose goals differ from those of common stockholders, a corporation may also issue preferred stock. **Preferred stock** gives its owners preference over common stockholders, usually in terms of receiving dividends and in terms of claims to assets if the corporation is liquidated.

Equity financing is accomplished through the issuance of stock to investors in exchange for assets, usually cash. Once the stock has been issued to them, the stockholders can transfer their ownership at will. When they do, they must sign their **share certificates,** documents showing the number of shares that they own, and send them to the corporation’s secretary. In large corporations that are listed on the stock exchanges, stockholders’ records are hard to maintain. Such companies can have millions of shares of stock, thousands of which change ownership every day. Therefore, they often appoint independent registrars and transfer agents (usually banks and trust companies) to help perform the secretary’s duties. The outside agents are responsible for transferring the corporation’s stock, maintaining stockholders’ records, preparing a list of stockholders for stockholders’ meetings, and paying dividends. *Par value* and *legal capital* are important terms in equity financing:

\_ **Par value** is an arbitrary amount assigned to each share of stock. It must be recorded in the capital stock accounts, and it constitutes a corporation’s legal capital.

\_ **Legal capital** is the number of shares issued times the par value. It is the minimum amount that a corporation can report as contributed capital. Par value usually bears little if any relationship to the shares’ market value or book value.

The costs of forming a corporation are called **start-up and organization costs**. These costs, which are incurred before a corporation begins operations,include state incorporation fees and attorneys’ fees for drawing up the articles ofincorporation. They also include the cost of printing stock certificates, accountants’fees for registering the firm’s initial stock, and other expenditures necessaryfor the formation of the corporation.

**Advantages of Equity Financing**

Financing a business by issuing common stock has several advantages:

\_ It is less risky than financing with debts because a company does not pay dividends on common stock unless the board of directors decides to pay them. In contrast, if a company does not pay interest on bonds, it can be forced into bankruptcy.

\_ When a company does not pay a cash dividend, it can plough the cash generated by profitable operations back into the company’s operations.

\_ A company can use the proceeds of a common stock issue to maintain or improve its debt to equity ratio.

**Disadvantages of Equity Financing** Issuing common stock also has certain disadvantages:

\_ Unlike interest on bonds, dividends paid on stock are not tax-deductible.

\_ When a corporation issues more stock, it dilutes its ownership. Thus, the current stockholders must yield some control to the new stockholders.

**Dividend Policies**

A corporation’s board of directors has sole authority to declare dividends, but senior managers, who usually serve as members of the board, influence dividend policies. Receiving dividends is one of two ways in which stockholders can earn a return on their investment in a corporation. The other way is to sell their shares for more than they paid for them. Although a corporation may have sufficient cash and retained earnings to pay a dividend, its board of directors may not declare one for several reasons. The corporation may need the cash for expansion; it may want to improve its overall financial position by liquidating debt; or it may be facing major uncertainties, such as a pending lawsuit or strike or a projected decline in the economy, which makes it prudent to preserve resources.

A corporation pays dividends quarterly, semi annually, annually, or at other times declared by its board of directors. Most states do not allow a corporation to declare a dividend that exceeds its retained earnings. When a corporation does declare a dividend that exceeds retained earnings, it is, in essence, returning to the stockholders part of their contributed capital. This is called a liquidating dividend. A corporation usually pays a **liquidating dividend** only when it is going out of business or reducing its operations. Having sufficient retained earnings in itself does not justify the declaration of a dividend. If a corporation does not have cash or other assets readily available for distribution, it might have to borrow money to pay the dividend—an action most boards of directors want to avoid.

**Dividend Dates** Three important dates are associated with dividends:

\_ The **declaration date** is the date on which the board of directors formally declares that the corporation is going to pay a dividend. Because the legal obligation to pay the dividend arises at this time, a liability for Dividends Payable is recorded and the Dividends account is debited on this date. In the accounting process, Retained Earnings will be reduced by the total dividends declared during the period. On declaration,

DR: Retained earnings.

CR: Dividend Payable with dividend declared.

\_ The **record date** is the date on which ownership of stock, and therefore the right to receive a dividend, is determined. Persons who own the stock on the record date will receive the dividend. No entry is made on this date. Between the record date and the date of payment, the stock is said to be **ex-dividend.** If the owner on the date of record sells the shares of stock before the date of payment, the right to the dividend remains with that person; it does not transfer with the shares to the second owner. No accounting entry is made on this date.

\_ The **payment date** is the date on which the dividend is paid to the stockholders of record. On this date, the Dividends Payable account is eliminated, and the Cash account is reduced. The entry,

DR: Dividend payable

CR: Cash/ Bank with dividend paid.

**PREFFERED STOCK**

Most preferred stock has one or more of the following characteristics.

***Preference as to dividends.***

Preferred stockholders ordinarily must receive a certain amount of dividends before common stockholders receive anything. The dividend is usually a stated percentage of par value. Example, Ksh. 10, 10% cumulative preference share will pay a dividend of 10% \* 10= Ksh. 1 per share per year.

Preferred stockholders have no guarantee of ever receiving dividends. A company must have earnings and its board of directors must declare dividends on preferred stock before any liability arises. The consequences of not granting an annual dividend on preferred stock vary according to whether the stock is noncumulative or cumulative:

\_ If the stock is **noncumulative preferred stock** and the board of directors fails to declare a dividend on it in any given year, the company is under no obligation to make up the missed dividend in future years.

\_ If the stock is **cumulative preferred stock**, the dividend amount per share accumulates from year to year, and the company must pay the whole amount before it pays any dividends on common stock. Dividends not paid in the year they are due are called **dividends in arrears**, and for cumulative shares must also be paid in future.

***Preference as to assets if a corporation is liquidated.***

Preferred stockholders often have preference in terms of their claims to a corporation’s assets if the corporation is liquidated. If a corporation does go out of business, these preferred stockholders have a right to receive the par value of their stock or a larger stated liquidation value per share before the common stockholders receive any share of the corporation’s assets. This preference can also extend to any dividends in arrears owed to the preferred stockholders.

***Convertibility and a callable option.***

Like all preferred stockholders, owners of **convertible preferred stock** are more likely than common stockholders to receive regular dividends. In addition, they can exchange their shares of preferred stock for shares of common stock at a ratio stated in the company’s preferred stock contract. If the market value of the company’s common stock increases, the conversion feature is attractive to stockholders because it allows them to share in the increase by converting their stock to common stock.

Most preferred stock is **callable preferred stock**—that is, the issuing corporation can redeem or retire it at a price stated in the preferred stock contract. An owner of nonconvertible preferred stock must surrender it to the issuing corporation when asked to do so. If the preferred stock is convertible, the stockholder can either surrender the stock to the corporation or convert it to common stock when the corporation calls the stock. The *call price*, or redemption price, is usually higher than the stock’s par value. For example, preferred stock that has a Ksh. 100 par value might be callable at Ksh. 103 per share.

Dividends paid on preferred stock are usually a fixed percentage of the par value. Such stock is **non- participating preferred stock**. However some preferred stock may be paid additional dividends in excess of the stated percentage. Such stock is called the **participating preferred stock**.

A corporation may offer several different classes of preferred stock, each with distinctive characteristics to attract different investors.

**Accounting for Changes in Capital Structure**

1. **Issue of ordinary and preference shares**

This topic explores issues such as the authorised, issued and called-up share capital together with some of the ways in which an organisation might change their proportions. It reviews such aspects of capital as the bookkeeping entries to deal with the application and allotment of share issues. It also discusses the effects on the balance sheet of changes in capital structure.

* [Authorised, issued and called up share capital](http://www.bized.co.uk/learn/accounting/financial/sources/sharecap.htm).
* Bookkeeping for share issues. Shares can be issued in a number of ways, the most important aspect from our point of view being how and when shareholders pay for the shares they buy:
  + Shares can be issued and paid for in full on application, either
    - [at par](http://www.bized.co.uk/learn/accounting/financial/sources/par.htm), or [at a premium](http://www.bized.co.uk/learn/accounting/financial/sources/premium.htm).
  + Share issues might be [under or oversubscribed](http://www.bized.co.uk/learn/accounting/financial/sources/subscribe.htm).
  + Shares are not all issued for cash. Some issues, for example, [bonus issues](http://www.bized.co.uk/learn/accounting/financial/sources/bonus.htm) arise as a result of a capital restructuring of the company, sometimes called a rights issue.
  + Shares can be issued and paid for by instalments.
    - 1. ISSUE OF SHARES IN CASH AND AT PAR.

When shares are issued in cash and at par, the accounting entry is as follows.

Bank Account......................................................xx

Ordinary Share capital Account .....................................xx

(Being issuance of ............ ordinary/ preference shares at par.)

* + - 1. ISSUE OF SHARES IN CASH AT A PREMIUM.

If a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares must be transferred to an account called “the share premium account”.

Where, on issuing shares, a company has transferred a sum to the share premium account, it may use that sum to write off—

(a) The expenses of the issue of those shares;

(b) Any commission paid on the issue of those shares.

(c) Preliminary expenses used in setting up the company.

(d) The company may use the share premium account to pay up new shares to be allotted to members as fully paid bonus shares.

The accounting entry is as follows:

Bank Account......................................................xx

Ordinary Share capital Account .....................................xx

Share premium account ...............................................xx

(Being issuance of ........ordinary/ preference shares at Ksh. ........ per share)

**Illustration**

A company issued 10,000 ordinary shareholders (Ksh 10 par) to its members. The shares were issued at Ksh. 20 per share. The accounting entries will be as follows:

* + - 1. ISSUE OF SHARES IN CASH AT A DISCOUNT.

When the issue price of share is less than the face value, shares are said to have been issued at discount. The Companies Act has laid down certain conditions subject to which a company can issue its shares at a discount. These conditions are as follows:

(i) At least one year must have elapsed from the date of commencement of business;

(ii) Such shares are of the same class as had already been issued;

(iii) The company has sanctioned such issue by passing a resolution in its General meeting and

Iv.the approval of the court is obtained.

Bank account .....................................................................xx

Share discount account .......................................................xx

Ordinary Share capital Account .......................................xx

* + - 1. ISSUE OF SHARES IN INSTALLMENTS.

|  |  |
| --- | --- |
| **(1) On receipt of application money** |  |
|  |  |
| Bank Account |  |
| To Share Application A/c |  |
| (Being the application money on....shares..@ KES..per share) |  |
|  |  |
| **(2) On allotment of shares** |  |
|  |  |
| (a) First of all application money on allotted shares is transferred to shares capital account by passing the following entry. |  |
| Share Application Account |  |
| To Share Capital A/C |  |
| (Being the application money transferred to Share Capital Account) |  |
|  |  |
| (b) Those applicants who could not be allotted any share, their application money will be returned. For the following entry will be passed. |  |
|  |  |
| Share Application Account |  |
| To Bank Account |  |
| (Being the application money of shares returned) |  |

|  |  |
| --- | --- |
| **(3) On the allotment of share, the allotment money becomes due to the company. For this, the company will pass the following entry** |  |
|  |  |
| Share Allotment Account |  |
| To Share Capital Account |  |
| Being the Share allotment money due on ....share @ KES...per share as per resolution dated...) |  |
|  |  |
| **(4) On receipt of allotment money, the entry is** |  |
|  |  |
| Bank A/c |  |
| To Share Allotment A/c |  |
| (Being the receipt of allotment money) |  |
|  |  |
| **(5) On making the first call due from shareholders the entry is** |  |
|  |  |
| Share First Call Account |  |
| To Share Capital Account |  |
| (Being the first call money due on... shares @ KES...per shares as per resolution of the Directors dated.....) |  |
| **(6) On receipt of the first call money, the entry is** | |  |
|  | |  |
| Bank Account | |  |
| To Share First Call Account | |  |
| (Being share first call money...shares @ KES....per share received) | |  |

**Note:** Similar entries will be passed for second call, third and final call, if any.

Any amount received from or paid to any shareholder is not to be credited or debited to shareholder account but collectively it will be either debited or credited to share application account, share allotment account or share call amount.

As and when any amount is received or become due, it will be entered either in share application and allotment account or share call account.

**Illustration 1**

Fashion Fabrics Ltd. issued 100,000 shares of Ksh. 10 each on 1st April, 2006.

The amount payable on these shares was as under:

Ksh 2 per share on application.

Ksh 3 per share on allotment.

Ksh 5 per share on call.

Make journal entries and prepare relevant accounts in the books of company.

**Journal entries**

1. Bank A/c Dr 200000

To Share Application A/c 200000

(Application money received @ Ksh. 2 per share)

2. Share Application A/c Dr 200000

To Share Capital A/c 200000

(Share application money for

100000 shares transferred to share capital A/c)

3. Share Allotment A/c Dr 300000

To Share Capital A/c… 300000

(Allotment money made due on

100000 shares @ Ksh 3/- per share)

4. Bank A/c Dr 300000

To Share Allotment A/c. 300000

(Allotment money received

on 100000 shares @Ksh. 3 per share.)

5. Share First & Final call A/c. Dr 500000

To Share Capital A/c 500000

(Call money on 1,00,000

shares @ Ksh 5 per share made due)

6. Bank A/c Dr 500000

To Share First & Final call A/c. 500000

(Call money received on 1,00,000 shares @ Ksh. 5 per share)

**Note :** Although shares may be equity shares or preference shares but if the term shares is used it means ordinary shares)

**Solve the following:**

ABC company LTD issued 3,000 shares of Ksh 100 par value. The shares were issued as follows:

On application Ksh. 20 per share.

On allotment Ksh. 30 per share.

On first call Ksh. 40 per share.

On second and last call Ksh. 20 per share (including share premium).

Post the transactions in a journal and show an extract of the relevant ledger accounts.