**Equity of a company**

Equity is the owner’s portion of a business.

The equity of a company is made up of:

* Share capital
* Retained earnings,
* Other reserves

***Share capital*** is the total equity purchased by shareholders represented by shares issued to them.

***Reserves*** are profits set aside, or reserved (not made available for dividend), for use in the company. By reducing dividend payout, cash is available for reinvestment in the business. A reserve may be made for a specific purpose (e.g. asset replacement reserve) or general purposes (to build up its asset base).

**Retained earnings**

This is the cumulative profits (or losses) that the company makes. The balance in the retained earnings account is a reserve. (Undistributed profit)

The retained earnings account can be used to:

* + transfer amounts to reserve accounts, such as the General Reserve for expansion of the business
  + set aside profit for a specific purpose such as a an asset replacement reserve
  + pay out cash dividends or share dividends (bonus shares)
  + offset losses in future years

**General Reserve**

This is profits set aside to generally expand the asset structure of the business.

The general reserve can be used to:

* pay a cash dividend
* pay a bonus share dividend
* transfer back to retained profits

*Accounting Entries*

A transfer is made to the General Reserve

DR Retained Earnings

CR General Reserve

A transfer is made from General Reserve e.g. to make profit available for dividend.

DR General Reserve

CR Retained Earnings

**Asset Revaluation reserve**

This represents the gain made when a non-current asset has increased in value. It would be misleading to show land that has appreciated ten times, at its original cost, because this would go against the qualitative characteristic, *relevance.*

The asset revaluation reserve can be used to:

* transfer back to retained profits
* pay a cash dividend
* pay a share dividend or bonus share issue
* record a subsequent write-down of the same class of assets which had been revalued upwards previously.

A*ccounting Entries.*

DR Non-current asset

CR Asset revaluation reserve

*Examples*

Land shown in the Balance Sheet at a cost of $200,000 is to be revalued to $450,000 on 30 June 2010

|  |  |  |  |
| --- | --- | --- | --- |
| 2010 |  | DR | CR |
| Jun 30 | Land | 250,000 |  |
|  | Asset Revaluation Reserve |  | 250,000 |
|  | *(Land revalued)* |  |  |

**Bonus share issue (share dividend)**

Bonus shares are issued to existing shareholders with no payment required.

They will receive a number of extra shares in proportion to the existing shares held e.g. 1 for every 5 held.

**Shareholders benefit** in terms of increased shareholding and future dividends.

The market responds by reducing the market value of each share because there are more shares in circulation but with the same total market value. The lower share price makes shares more affordable to new investors.

*Example*

A company have $300,000 share capital with 200,000 shares

How much is the share price for each share?

$300,000/200,000 = $1.5 per share

The bonus issue is 1 for every 2 held.

How much is the number of share after bonus issue?

Existing no. of shares / No. of share held = No. of bonus issue share

200,000/2 = 100,000

Total number of share after bonus issue

= Existing no. of shares + No. of bonus issue share

Total no. share after bonus issue = 200,000 + 100,000 = 300,000

How much is the share price for each share after bonus issue?

Existing share capital / Total number of share after bonus issue

= $300,000 / 300,000 =$1 per share

**The company benefits** in terms of the positive news to the market about future prospects. It also allows companies to convert some reserves into shares.

As an alternative to paying out a cash dividend to its shareholders, a company can make a dividend distribution in the form of bonus shares out of a general reserve. Because of this bonus shares are sometimes called *share dividends.*

The advantage to a company of issuing bonus shares is that cash is retained in the company.

**No effect on total equity**

In terms of the accounting equation, an increase in the share capital is balanced by an **equal** decrease in the general reserve. There is, therefore, no change in the total amount of the equity.

*Accounting entry*

DR General Reserve (or other reserve)

CR Share Capital