Accounting (Basics) - Lecture 9

ACCOUNTING CONCERNING EQUITY OF ACCOUNTING UNIT. CHANGES IN EQUITY, CAPITAL FUNDS, PROFIT FUNDS, ACCUMULATED PROFIT OR OUTSTANDING LOSS FROM PREVIOUS YEARS AND LOSS/PROFIT FROM THIS ACCOUNTING PERIOD.

Content

- Accounting concerning equity of accounting unit
- Changes in equity, capital funds, profit funds
- Accumulated profit or outstanding loss from previous years and loss/profit from this accounting period.

Equity

- For all users of accounting information, it is vital to determine the amount of equity and long-term liabilities of the business.
- This information shows clearly what portion of assets is backed by its own resources (investments of founders and generated profit) and what portion is funded from long-term liabilities (mostly loans and allowances).

Equity

- This includes all resources available for the business for over one year.
- The amount of these resources affects the stability and long-term growth.
- As such businesses are regarded stable when they have long-term resources (own and foreign) covering the value of long-term assets (fixed assets) and/or of a portion of short-term assets (current assets).

Equity

- Equity is accounted in group of accounts **Capital accounts**, sub-divided into these groups:
  - Registered capital and capital funds
  - Reserve, indivisible fund and other funds created from profit and transferred business result
  - Business result
  - Allowances

Equity

- Typical of equity accounting is its dependence on the legal form of the entity.
- This is why its basic division and relationship between the legal form and accounting methods for separate equity components is mentioned first.
- From the above perspective, entities can be divided into **natural persons and legal persons**.

Equity

- **Natural persons** account equity mostly when entered as entrepreneurs in the business registry.
- **Legal persons** are divided into three groups in terms of equity accounting:
  - Business firms,
  - Associations,
  - State enterprises and other entities in which equity components are created

Business firms

- **Business firms** are legal persons established for business divided into four basic types:
- joint stock company
- limited liability company
- unlimited liability company
- limited partnership

Registered capital

- **Registered capital** means the collection of all monetary and non-monetary investments (that can be valued with money) by the partners into the business firm, by associates into the association or by the founder into the state enterprise.

Founding date

- **Founding date** = date of signing the articles of partnership, deed of foundation, etc.
- Setting up a business is related with a number of different tasks mostly of the legal nature and lots of organisation, within which assets and resources already start moving.
- To be more specific, registered capital is subscribed, parts of liabilities redeemed, monetary expenses needed for formulating agreements, verifying signatures, etc.

Formation date

- **Formation date** = date of entering the company in the business registry.
- Since the formation date, the entity is obliged to keep accounting.
- It is as of this date that the opening balance sheet is prepared.
- In this opening balance sheet the full amount of registered capital is accounted on account **Registered capital**.

Accounting of subscriptions and registered capital pay-back

- Registered capital is invested into the business in two phases:
  - **Subscription** where subscribers commit to invest certain capital into the entity. Straight upon subscription, the subscriber becomes the owner of the respective share in the company’s assets. For the entity a receivables from the subscriber arises who is responsible for the liabilities of the company in the amount of subscribed, unpaid capital.
  - **Pay-back** of subscribed capital represents the actual investment of monetary and non-monetary contributions into the company.

Accounting differences in registered capital

- Businesses may change the amount of registered capital during their lives.
- In capital companies, however, it must not drop below the minimum line set by the law.

Accounting differences in registered capital

- **Increase in registered capital** in a joint stock company may proceed in multiple ways always subject to the general board decision:
  - through subscription of new shares,
  - through a transformation of issued bonds into shares,
  - from other own resources – capital funds, retained earnings from previous years, current period earnings, etc.

Increase in registered capital

- Increases in registered capital on subscription are credit to account **Changes in registered capital** and debited from account **Receivables for subscriptions.**

Increase in registered capital

- In **limited liability companies** registered capital may be increased:
  - through further monetary and non-monetary investments by partners,
  - from other own resources – capital funds, retained earnings from previous years, current period earnings, etc.

Decrease in registered capital

- **Decisions on decreasing registered capital** are made by General Meetings of business firms, usually due to dealing with long-term losses of a business.

Decrease in registered capital

- Capital may be decreased in joint stock companies in the following way:
  - through decrease in the nominal (face) value of shares (for stock certificates by replacement or by marking lower nominal (face) values on original shares, which often used to be the case)
  - through withdrawal of shares from circulation (based on a public draft contract of share acquisition with the aim of their withdrawal or based on a lottery)
  - refraining from issue of still unpaid shares

Capital Funds

- Capital funds are created from external resources, such as share premium, free-of-charge assets takeover, subsidies from the state budget and/or from similar resources, through asset re-valuation under legal regulations, received member shares in associations, etc.

Capital Funds

- For capital funds accounting, accounts in the following groups are set up:
  - Share premium
  - Valuation differences from re-valuation of assets and liabilities
  - Valuation differences from re-valuation on transformations

Capital Funds

- The **share premium** is the difference (surplus) between the issue price of shares and their nominal (face) value on the registered capital increase through the subscription of new shares.
- It also occurs in case of accounting non-monetary contributions of partners in a limited liability company – here it is the difference between the valuation of this contribution and the nominal (face) value of partner’s share.
- The share premium may be used for paying the loss from previous years and current accounting period and/or for increasing registered capital.

Capital funds

- **Other capital funds** are monetary and non-monetary contributions designed for boosting equity (not applying to registered capital and share premium).
- This account is used mostly for accounting received gifts and grants.

Capital funds

- These are specific examples of other capital funds:
  - gifts in the form of fixed assets, inventory, receivables and money,
  - member shares in housing cooperatives, state subsidies,
  - special funds created from funds from profit,
  - inventory differences (surpluses) for fixed non-depreciated assets.

Funds Created From Profit

- Funds created from profit are accounted on
  - Reserve funds
  - Indivisible funds
  - Statutory funds
  - Other funds

Funds Created From Profit

- The **reserve fund** might be created, as required by the law, **on an obligatory basis** from the net profit or without the requirement of the law.

Funds Created From Profit

- The creation and use of **statutory funds** is subject to the memorandum of partnership and/or articles.
- **Other funds** are created by entities based on the decision of the general meeting, board of directors and in the course of the accounting period by corporate management.
- Detailed analytical accounts must be kept with these funds, including the way they are used.

Business result of Entity

- Part of registered capital is the business result - making profit is, from the long-term perspective, the basic prerequisite for the existence of companies.
- The business result is tracked in the books in two items:
  - as the **business result of current accounting period**
  - as cumulated **business result from previous years**

Business result of a current accounting period

- The business result of a current accounting period is the net business result after income taxes.
- It is profit or loss from operations in the accounting period that has just ended.
- Its allocation is subject to an approval procedure of the company’s or association's general meeting to be held several months after the accounting period has closed.

Business result of a current accounting period

- When accounting starts in a new accounting period, this business result, as determined, is transferred from account **Opening balance sheet account** through correlative posting to the account **Business result**.

Business result of a current accounting period

- Accounting on this account then proceeds following the decisions of the General Meeting:
  - As **profit** is allocated (in equity companies), the first decision is made on the creation of the reserve fund, after that profit may be used for paying dividends to shareholders, bonus for the members of the Board of Directors and Supervisory Board, for creation of statutory funds and other funds and/or for an increase in registered capital.

Retained earnings from previous years

- Accounting on this account then proceeds following the decisions of the General Meeting:
  - Should a portion of profit remain undivided, it is transferred to account **Retained earnings from previous years**

Business result of a current accounting period

- If the company made a **loss**, the General Meeting may decide to pay this loss from the funds created, from transferred business result, on the duty of partners to pay the loss (emergence of a receivable from partners) and/or on covering the loss by reducing registered capital.
- If no decision has been made on the loss, the loss is also accounted on the account **Accumulated losses from previous years**.

Business result of a current accounting period

- Account **Business result** must be balanced as of the accounting period end, must not show any balance and hence does not appear in the balance sheet.
- If the entity made a loss over the previous year, it may pay the loss from the current period profit.
- If it made a loss in the current period and has retained earnings from previous years, it may use these earnings to cover such a loss.