UPV/EHU

OCW "Companies Accounting"

LECTURE MATERIAL: Topic I

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LEGAL FORMS A BUSINESS CAN ADOPT. CORPORATIONS. SHARE CAPITAL.

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TOPIC I

Purpose of the Topic:

- Define different types of forms a business can adopt.
- Identify the difference between Capital entities and Personal entities.
- Identify the advantages and disadvantages of Incorporations.
- Notice the importance of the Share Capital in Capital entities.
- Define different types of stocks and its characteristics.

1. LEGAL FORMS A BUSINESS CAN ADOPT.

When starting a business, the owner/s must select which is the best form of business ownership. There are different alternatives:

They can adopt an unincorporated form, a business where there is no difference between the owner`s and business` equity or incorporated forms, this is every form of business besides the proprietor`s equity.

1.1. Unincorporated businesses. Owners remain personally liable for liabilities incurred by the Company. They do not require any specific amount of Capital to guarantee creditors.

- **Sole Proprietorship:** enterprise owned and operated by an individual, not legally separate from its owner. It is the easiest form to set up a business.

  Advantages of this legal form:

  - It can be established instantly, easily and inexpensively.
  - No state paperwork is required for its creation
  - Profits or losses are reported on the owner's tax return.
  - Sole proprietors can freely mix business and personal assets.
  - They need few ongoing formalities.

  Disadvantages of this legal form:

  - The owner is subject to unlimited personal liability for the business debts, losses and liabilities. He can lose not only his investment in the business but also other personal assets as well.
  - Difficulties in obtaining capital, such as a bank loan.

- **Partnerships:** two or more persons engage in a business enterprise for profit.

  Are also unincorporated businesses, but separated entities from shareholders.

So they are a mixed form between sole proprietorship and corporations.

These forms of businesses are taxed individually over the individual return, not as corporations.

There is unlimited liability for the partners.

Partners are subject to mutual agency which means they can individually make decisions to run the business without having to get to an agreement.

Advantages of this legal form:

- It can establish instantly, easily and inexpensively.
- No state paperwork is required for its creation

Disadvantages of this legal form:

- Owners are subject to unlimited personal liability for business debts, losses and liabilities
- Individual partners bear responsibility for the actions of other partners
- Difficulties in obtaining capital, such as a bank loan.
- Poorly-organized partnerships and oral partnerships can lead to disputes among owners

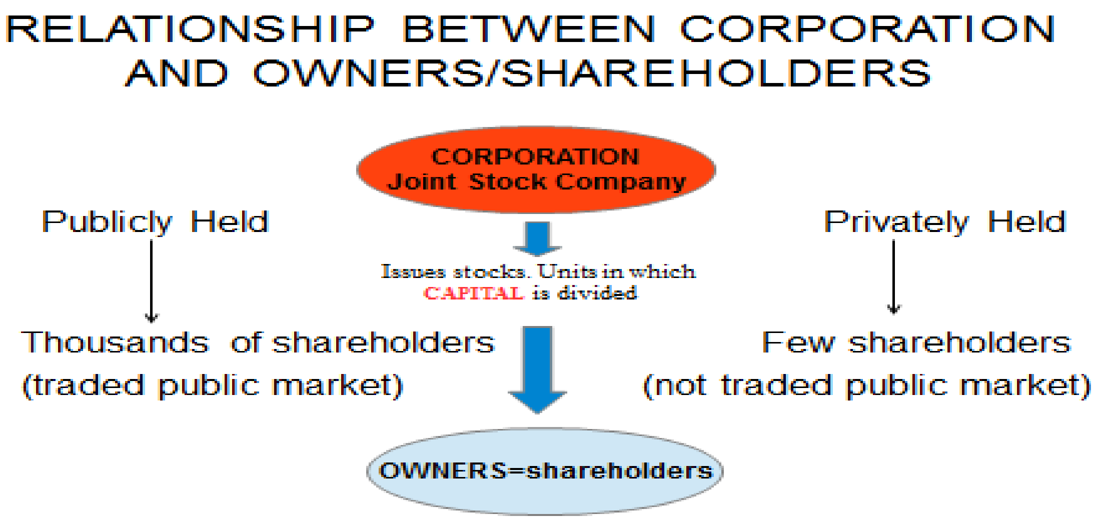
1.2. Incorporated businesses. Are separate legal entities, and this often provides a measure of legal and financial protection for the shareholders. Owners are not personally liable for the Company`s debts. Creditors can only make claims against the Company`s assets.

Corporations such as Limited Liability Companies and Joint stock Companies are the most common form of incorporation. As opposed to a sole proprietorship a corporation is a business that is recognized by law as a separate legal entity with its own powers, responsibilities, and liabilities. It runs business in its own name, with the same legal rights as a person.

2. CORPORATIONS

Both **Limited Liability Companies** and **Joint stock Companies** are subject to the “Corporation Enterprises Act”[1]

[1] For the study of this and the next topics we will follow the “*Corporate Enterprises Act*” 1/2010, 10 July (In Spain *“Ley de Sociedades de Capital”)* . It rules limited liability companies, joint stock companies and limited partnerships. Our topics are focused in the **Joint Stock Companies,** because, although the majority of the companies are founded as limited liability companies, we consider the chosen form as the most complete one, because it can offer a variety of situations to work with.



2.1. Responsibility

- The acts of the owners /stockholders do not bind the corporation, unless they are agents and work for the company.
- The acts of the company do not bind the owners. Their only responsibility is for their investment.

2.2. Shared decision making and rights

- Important business decisions must be approved by a vote of the stockholders.
- The earnings of the company are divided among the shareholders/stockholders, after the Board of Directors has decided the amount and timing of dividend distribution.
- Stockholders share corporation`s earnings through dividends. This is the amount distributed by the Company after considering what the Law establishes (Legal Reserves, Goodwill Reserves,..), as well as what the Company wants to retain to finance future investments (Voluntary Reserves, Statutory Reserves).

2.3. Stocks Held

Joint Stock Companies can be **Publicly Held.** This means stocks are traded in Public Market (Security Exchange) .They are subject to the organism that rules this market, the

Security Exchange Commission.[2] They can attract a great public, thousands of shareholders.

Or they can be **Privately Held,** when stocks are not traded in Public Markets.

2.4. Advantages of this legal form

- The owners are subject to limited personal liability for business debts, losses and liabilities. They won`t lose more than the amount invested in that Corporation.
- Profits or losses are reported on the corporation`s tax return, not on the stockholder`s, which can be an advantage when the stockholder`s tax rate is high.
- Ownership can be easily transferred, moreover if the Corporation is Publicly Traded. (through a stockbroker) Privately Held Corporations transfer their ownership by signing a transfer statement.
- The continuance of the Company is not affected by the disappearance of a shareholder.
  When stocks are transferred among stockholders, the Corporation will only be notified in order to change the name of the new owner in the records. No accounting entry is recorded, only when the Corporation issues its stocks sells or repurchases them.
- The limited liability and the ease of trading with stocks make it easy for potential investors to investing in corporations, giving the chance to these companies to raise the amounts of capital needed to finance and grow.

2.5. Disadvantages of this legal form

- Starting and running a corporation has much more legal complexity than starting or running a sole proprietorship which can sometimes be started with nothing more than a tax identification number.
- "Double taxation" on the dividends it pays:
  - *Corporation's* income tax return.
  - *Stockholders' personal income tax returns, when receiving dividends.*

In accounting terms, when speaking about a Corporation, we consider the **Stockholder`s Equity.** It is a section in the Balance Sheet more detailed than the sole proprietor`s. Contributions from investors must be separated from amounts earned by running the business.

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3. SHARE CAPITAL.

Basic concept in the Stockholder`s Equity, included in the section BASIC FINANCING of the Balance Sheet.

[2] In Spain the CNMV (*Comisión Nacional del Mercado de Valores*)

External Financial Resources:
- **(100) Share Capital**
- (110) Share Premium/Additional paid-in-capital
- (13) Grants, Donations

Internal Financial Resources:
- Enrichment Resources (Reserves...)
- Maintenance Resources (Depreciation, Impairment)

3.1. Concept

The Share Capital in a Joint Stock Company is the money outlaid by the shareholders (Minimum 25% Par value established by Law) added to the contributions not yet outlaid (compromise to pay: Maximum 75% Par Value)(art.79) by the shareholders.

The relationship between the Corporation and the stockholders starts when issuing CAPITAL.

It is materialized in Stocks or Shares, paper evidence of ownership in a Corporation

ISSUED CAPITAL = **NUMBER OF SHARES** X (PAR VALUE/SHARE)
- Shares: Fractional parts in the issuing Capital
- Par Value/Face Value: Initial Value of stock
- Share Capital: Assigned in the Bylaws of Company.

According to the BASIC EQUATION in Accounting:

ASSETS =LIABILITY + OWNER`S EQUITY
(**CAPITAL**+RESERVES+P/L PERIOD...)
GENERATED RUNNING THE BUSINESS

Ex : A Company is formed with 1,000€ Capital by issuing 100 shares; 10€/share Par Value
ASSETS=LIABILITIES+**E**
1,000 (CASH)= +1,000(CAPITAL)
- **Journalize the entry in accounting**

3.2. Legal principles

The aim of all these principles described below is to protect creditors and prevent an entity distributing assets to its shareholders before payables are paid in full. Most of the articles of the Spanish Enterprises Act are focused on this purpose.

3.2.1 Establishment: the following items must be determined in the Bylaw of the Company.

- Paid and unpaid parts of the share amount`s value. Future payment for the stock can be made all at one time or following a financial plan.
- Number of shares
- Par value and types of shares

3.2.2. Completeness and outlay

- The Share Capital must be totally subscribed.
- Each Share must be outlaid in a 25% of its Par Value and 100% of the Share Premium (excess over the Par Value Issued).

3.2.3. Stability

- Share Capital amount can only be modified under approval of the owners. Increases and decreases of Capital are subject to

3.2.4. Reality

- There must be a real investment that supports the Share Capital, such as cash or non-monetary contributions.
- Spanish Law does not permit to issue under Par value shares. On the other hand it is permitted to issue shares above par value (with a Share Premium).
- A Legal Reserve should be set up. A 10% of the benefit of the period is destined every year till the company reaches a Legal Reserve of a 20% of the Share Capital.
- In order to pay dividends to shareholders, the Equity should be at least the same amount as Share Capital. Otherwise, losses should be settled.
- It is not permitted to distribute Benefits if there is any amount invested in "Research" or "Development" unless covered by unrestricted reserves.

4. SHARES

4.1. Concept

- Are written evidence of share in a Corporation.
- Fractional parts in the issuing Capital
- Its property gives the buyer the consideration of owner of the Company

- They are transferable units

4.2. Shareholder`s obligations and rights

The only obligation for the shareholder is to pay the issued value when asked for.

Rights: there are two types of stocks according to the rights they carry:

- **Common Stocks:** its owner holds the normal rights a stock provides:
    - Right to vote:
        - For the members of the Board of Directors
        - Other questions required for the running of the company.
    - Right to participate in the earnings of the company through dividends.
    - Right to maintain the same ownership percentage in the Company by using the pre-emptive right when increasing capital
    - Right to receive information on the managing of the Corporation.
    - Right to participate in the distribution of the assets when ceasing operations (liquidation) and the risk of losing their investment when funds are insufficient.
- **Preferred Stocks**.: its owner holds specific benefits different to common shares:
    - They normally carry a right to receive dividends before common stocks, expressed as a percentage of the par value. If the preferred stocks are "cumulative", this fixed rate can be accumulated for next periods if there is not enough profit to guarantee the distribution.
    - Right to participate before common stocks ´owner`s in the distribution of the assets when ceasing operations (liquidation).

4.3. Value of shares

- **Par Value or Face Value:** this is the value stated in the stock certificate to determine the Share Capital contributed.

- **Issuing Value:** is the price the Company sets when issuing the stocks:
    - **Par value**: the company is selling the shares at a par value (100%)
    - **Above par value**: the company is selling the shares above par value > 100% of par value, creating the **(110) Share premium or Additional Paid-in Capital.**

Ex: A Joint Stock Company is formed with a Share Capital divided into 5,000 shares, 100 €/share Par Value and issued in a 120%.

- ***Which is the Equity of the company?***
- ***Minimum outlaid according to the "Corporate Enterprises Act"?***

- **Book`s Value or Carrying Value[3]:** it is determine according to the Stockholder`s Equity, obtained from the Balance Sheet of the Corporation at a particular date:

**Book`s Value or Carrying Value =** Stockholder `s Equity/Total Shares

Ex: Six year after its foundation, "X" Inc. presents the following items in its Equity:
(100) Share Capital ……………………………………………6,000,000
(100,000 sh, PV = 60 €)
(112) Legal Reserve 1,000,000
(118) Contributions from shareholders………………………200,000
(129) P/L period………………………………………………………80,000
(130) Capital grants…………………………………………………10,000

- ***Book`s Value of its shares***

- **Market Value[4]:** it is determine through the interaction between buyers and sellers in organized markets. It is based on the prospects of the Company and the offer and demand of its stocks in the stocks exchange market. This value is fluctuating moment by moment due to the fact that it discounts predictions on the future of the Corporation.

There can be a great difference between the Book´s Value and the Market Value. Book`s value is determine by following the GAAP (general accepted accounting principles: cost price, prudence, accrual..) which can differ from the real value of the equity items at a particular moment. Assets are usually *not* reported on the balance sheet at their market value, so the equity does not always indicate the real value of the company.

[3] *Privately Held Corporations use the Book`s Value or Carrying Value as a reference*
[4] *Publicly Held Corporations use this value as a reference.*