

EQUITY ANALYSIS

Equity (Net Worth) for different business entities

Equity accounts found on a balance sheet vary by the type of business entity that is represented. This reading will first discuss C corporations, which have some of the most commonly-known equity categories, then examine categories specific to the other major legal entities that businesses utilize.

C corporations

For C corporations, equity consists of forms of stock (common, preferred, treasury, and paid-in capital) and retained earnings. When considering stock accounts, a business banker identifies the principal shareholders, their percentages of ownership, and the terms of issuance (such as any individual buy-sell agreements). If an agreement exists by which the company may repurchase the stock of a shareholder, a business banker needs to understand the terms and conditions of the agreement and how it will be funded.

- **Common and preferred stock**—This balance sheet account represents the nominal value of all common and preferred stock issued by a company. Common stock represents ownership in a corporation and carries voting rights, whereas preferred stock usually does not have voting rights. Although holders of common stock have the right to elect directors and collect dividends, common stock claims are subordinate to preferred stock in liquidation. Further, preferred stockholders receive dividend payments before common stockholders. Privately held companies generally start with a limited amount of common stock
- **Paid-in capital (or surplus)**—When stock is sold in excess of its nominal or par value, the extra equity generated is paid-in capital. To illustrate, suppose a company has been authorized to issue 10,000 shares of stock at a par or face value of \$10 per share. It issues 5,000 shares, generating \$50,000 of equity, which is reported in the common stock account on the balance sheet. A few profitable years later, the company decides to issue the remaining shares, but because it has done so well and investors are willing to pay for future earnings, the company is able to sell its remaining 5,000 shares for \$20 per share. Of the \$100,000 in proceeds from the stock issuance, \$50,000 (par value) is added to the common stock account, while the other \$50,000 is recorded as paid-in capital. Stock issuance, whether at par value or higher, always increases owner equity
- **Treasury stock**—Sometimes a company may repurchase or buy back some of its outstanding shares of stock. To fund stock options, stock grants and mergers, publicly held companies often repurchase shares “into the treasury” (treasury stock). Public companies also use this technique if they believe their stocks are under-valued or priced too low by investors. As time passes, if a company continues to be profitable, it can sell the shares on the open market to raise capital. The projected return on the repurchased shares may exceed other options a company has for deploying excess cash

If the company is closely held, the firm may use this account to buyout individual owners, whether as part of succession planning or formal ownership transition, or as a way to buyout an owner that wants to exit voluntarily from the company. Common stock documents may mandate that sellers first offer the stock back to the company.

READING

Stock repurchased but not retired (in other words, locked up in a vault and held for the treasury) is treasury stock. Because it has been repurchased from shareholders, treasury stock represents a reduction in equity, just as an issuance of stock increases it. If treasury stock is retired later and thus no longer outstanding, the decline in equity is transferred to the common stock and paid-in capital accounts, as shown in the following illustration:

Debit	Credit
– Treasury stock account	+ Common stock and/or + Paid-in capital account

- Retained earnings—A firm's net profit after tax is either allocated to its owners, such as in dividends paid to stockholders, or kept in the business to build equity value and as a future source of financing. Profits left in a business are called retained earnings

Equity accounts for other entities

- Sole proprietorships—They have the following two unique equity accounts:
 - The **owner capital account** shows the combination of cash contributions, non-cash contributions, and retained earnings. Cash contributions are any funds used to start the business or provided by the owner over the years. Non-cash contributions include inventory or fixed assets converted to business use, recorded at fair market value
 - The **owner draw account** shows money and other assets the owner takes from the business to use personally. This is how the owner gets compensated, since a sole proprietor does not receive a paycheck with payroll and income taxes withheld. The owner writes a check, adding to the draw account, and reducing the equity of the business
- Partnerships—The **partners' capital account**, similar to a sole proprietorship, shows the combination of cash contributions and non-cash contributions of the partners, plus retained earnings. This account is also a combination of a running balance maintained for each partner, based on each partner's cash and non-cash contribution. Net income (or losses) of the partnership are allocated proportionately based on what is in the partnership agreement. The **partners' draw account** shows the combined money and other assets the partners have taken from the business to use personally. The amount of draws a partner is allowed to take can be different than his or her partnership interest (ownership percentage). So even though a business may have two equal partners, it does not mean they have to take the same draw amount. As with the partners' capital account, a running balance is maintained for each partner
- Limited Liability Companies (LLCs)—The LLCs have a **members' capital account** that functions in a similar fashion to partnerships. The account is effectively a combination of the individual capital accounts of each owner or member. LLC members can also make draws or distributions, but they can be on a basis that is different from their ownership interests

- S corporations —The equity section of the balance sheet for an S corporation is almost the same as the equity section for a regular or C corporation, because the S corporation designation is a tax rather than accounting issue. The one major difference is that an S corporation is limited to one class of stock, so there is a single **capital stock account**, instead of potentially separate common stock and preferred stock accounts. For accounting purposes, most S corporations maintain running capital account balances for each owner, but owner draws are required to be in proportion with their ownership interests