

THEME: UNDERSTANDING EQUITY ACCOUNTS

By John W. Day, MBA

ACCOUNTING TERM: Equity

Equity is the difference between assets and liabilities as shown on a balance sheet. In other words, equity represents the portion of assets that are fully owned by the owners (stockholders, partners, or proprietor) of a business.

FEATURE ARTICLE: The Equity Account – It's Your Money.

When I prepare financial statements, I always review the general ledger (GL) account numbers that the client has coded on the check register. Whenever I see a balance sheet GL account number, I automatically double-check it. The reason I do this is that the balance sheet is the least understood part of the financial statements for most clients. This is especially true regarding the equity section. In a way, this is rather strange, since the equity section represents the owner's share of the business. I would want to keep a very close eye on my investment and, to do that effectively, I would need to know the nature of each equity account and how to interpret the changes in those accounts as they occur.

If I am a sole proprietor, it's not as crucial because everything in the equity section is mine. That's not to diminish the importance of knowing what the accounts mean, as there are other good reasons to track the increases and decreases that occur within them. However, if I am a partner in a partnership or a stockholder in a corporation, it is my responsibility to protect my investment interest from mistakes and/or deliberate misstatements. This can be a challenge and accounting knowledge is required.

It is in this light that I thought a review of the equity accounts for a sole proprietor, partnership, and corporation could prove useful. In order to do this, you need to understand how debits and credits work. If you need a reminder, you can click on this link http://www.reallifeaccounting.com/accounting_model.asp and print out a copy of the "Accounting Model" for a guide.

Sole Proprietor

The equity section title in a sole proprietorship is most commonly called "Owner's Equity". The accounts within this section are usually laid out in this fashion:

Owner's Equity
Current Year Capital Contributions
Owner's Draw
Net Profit or Loss

Look at the accounting model chart and find the equity section. An increase to the equity section requires a “credit” entry, while a decrease requires a “debit” entry. Following this “accounting logic”, it makes sense that a contribution of personal money to the business requires a debit entry to Cash and a credit entry to Current Year Capital Contributions. On the other hand, if cash is removed from the business for personal reasons, a debit entry to Owner’s Draw and a credit entry to Cash would be required.

Furthermore, if the business showed a profit, that would indicate an increase in equity (credit), or if it showed a loss, that would indicate a decrease (debit) in equity.

Since the Owner’s Equity account (a credit balance account) is an “accumulation account”, all the other accounts are closed out at the end of the year into the Owner’s Equity account. This makes perfect sense when you follow the journal entries required to close out the accounts. For Instance:

Net Profit or Loss is automatically closed into Owner’s Equity at the end of the year by your computer. If a journal entry were written, it would look like this if there was a profit:

DESCRIPTION	DEBIT	CREDIT
Net Profit	50,000	
Owner’s Equity		50,000

Or like this if there was a loss:

DESCRIPTION	DEBIT	CREDIT
Owner’s Equity	5,000	
Net Loss		5,000

Other journal entries required to close the books are:

DESCRIPTION	DEBIT	CREDIT
Owner’s Equity	20,000	
Owner’s Draw		20,000

DESCRIPTION	DEBIT	CREDIT
Capital Contribution	2,000	
Owner’s Equity		2,000

As you can see the function of the sole proprietor equity accounts is not complicated or difficult to understand.

Partnership

Depending on how many partners there are, partnership equity accounts usually are organized as follows under the title, "Partner's Equity":

Partner A, Capital Account
Partner B, Capital Account
Partner C, Capital Account
Accumulated Earnings Clearing
Net Profit or Loss

All the increases or decreases occur within the partner's capital accounts. In other words, the partner capital accounts *are* the equity accounts. If a partner makes a capital contribution, then his/her capital account is increased (credit). If the partner takes a distribution, then the capital account is decreased (debit). If the business has a profit or a loss at the end of the year, then that profit or loss is distributed among the partners at whatever ownership interest or other arrangement is appropriate.

Here is a tip: Most small business accounting software programs are not sophisticated enough to distribute the year end net profit or loss to the individual partner's capital accounts according to a set formula. Therefore, when the computer automatically closes the net profit or loss into the account set up for that purpose (I like to name it Accumulated Earnings Clearing) then all someone has to do is write a general journal entry to remove the amount from the clearing account and distribute it properly to the partner capital accounts.

General partners who work in the business are paid a management fee called a "guaranteed payment". This fee is a legitimate business expense and therefore acts to lower the net profit of the business. This fee is similar to a salary paid to a working stockholder in a corporation, except, according to U.S. tax law, a fee paid to a working partner cannot be run through payroll. It is treated as a draw, subject to self-employment taxes. Both the general partner's guaranteed payment and share of the profits are taxable and subject to self-employment taxes.

Sometimes a business may not have enough cash to make a distribution to the partners even though the business realized a profit. Partners may have a rude awakening to discover that they still have to pay taxes on those profits regardless of whether they received any money.

Another scenario to be aware of if you are a non-working general partner or a limited partner is this one: You and your partner contributed an equal amount of cash for working capital. The reason for investing your money is because you expect to share in the profits. Your partner is a working partner and is entitled to receive a management fee for services rendered. You need to keep an eye on

the books because there may never be a profit to share in if your partner simply continues to increase his/her management fee. It can be a sticky situation because the working partner may feel he/she is never making enough money to justify all the work he/she has to do. It is best to define what the management fee is going to be in the partnership agreement beforehand.

Corporation (Primarily closely held corporations)

Closely held (private) corporation equity accounts are a little more complicated than a sole proprietorship or partnership. These are the typical accounts found in the corporation equity section under the title, "Stockholder's Equity":

- Retained Earnings
- Paid-in-Capital
- Dividends Paid
- Common and/or Preferred Stock
- Net Profit or Loss

Retained Earnings is similar to the Owner's Equity account in that the Net Profit or Loss is closed into that account at the end of each accounting year. Paid-in-Capital is the account used to record capital contributions made by stockholders. Keep in mind, as in the examples above, that increases to an equity account are credits. For example:

DESCRIPTION	DEBIT	CREDIT
Cash	5,000	
Paid-in-Capital		5,000

If dividends were paid the journal entry would look like this:

DESCRIPTION	DEBIT	CREDIT
Dividends Paid	10,000	
Cash		10,000

When common stock is sold or issued to raise money or acquire property:

DESCRIPTION	DEBIT	CREDIT
Cash	100,000	
Common Stock		100,000

When Net Profit is closed out for the year:

DESCRIPTION	DEBIT	CREDIT
Net Profit	20,000	
Retained Earnings		20,000

These accounts are also found on public corporations, however they may have additional equity accounts that are necessary to explain more complex activities.

You can see that the equity accounts in all three business entities function in a similar manner. From year to year, there should be continuity. This means there should be a logical explanation for any increases or decreases in the equity accounts. As an investor or owner, you have a right to know the reasons for any changes. If there has been a mistake, willful or otherwise, it is most likely going to show up in the equity section. Stay vigilant and protect your investment.

QUESTION: Can I Have Negative Equity?

Yes, you can have negative equity, but what that means is that you have no equity. If your draws and losses exceed your contributions and previous profits then a negative equity situation can happen. Remember the accounting equation:

$$\text{ASSETS} = \text{LIABILITIES} + \text{EQUITY}$$

Therefore, a negative equity situation might look like this:

$$(A) \$1,000 = (L) \$2,000 + (E) < \$1000 >$$

The result is that the liabilities of the business are higher than its assets. This is an indicator that the health of the business is at risk. In addition to this obvious state of affairs is the question of “**tax basis**”. Accounting and taxes are intimately intertwined and having a grasp of the meaning of tax basis is important. Without venturing too far into the realm of taxes, let’s look at the tax impact of “negative equity” for the three entities - partnership; sole proprietorship; and, corporation.

First, what does “tax basis” mean? Basis means an equity position. In other words, it means the totality of your investment in a business enterprise. For instance:

Capital Contribution	+	\$ 5,000
Profit earned	+	2,000
Losses sustained	-	500
Draws or distributions	-	<u>1,000</u>
Total Equity position		\$ 5,500

Partnership

If you initially invested \$10,000 in a partnership, received another \$5,000 in your share of the partnership profits, but took a distribution of \$6,000, your ending equity position (tax basis) is \$9,000. Further, if the following year the partnership

incurred a large loss of which your share was \$10,000, then your tax basis in the partnership is a negative \$1,000 (\$9,000 less \$10,000 = <\$1,000>). That's all straightforward, but what are the tax consequences? You might think that you have a \$10,000 loss that will offset your spouse's salary income, but think again. U.S. tax law (and probably most other countries) only allows a \$9,000 loss because \$9,000 is the extent of your tax basis.

Examine this closely and you will see that this makes sense and is fair. The extra thousand dollar loss is not a "loss" to you because you didn't lose anything. You have to have something before you can lose it. You were able to report your loss of \$9,000, but if you want to take an additional loss of \$1,000 then you have to declare \$1,000 of additional income. Obviously, this loss and income offset (wash) each other.

Additionally, U.S. tax law allows a partner to include, as additional basis, his/her share of the partnership's liabilities. However, if those liabilities that have been used for basis are paid off, a taxable event may be triggered for the partner. In other words, the basis used for taking a loss on the partner's personal tax return no longer exists and so must be accounted for.

Sole Proprietorship

A sole proprietorship situation is a "horse of a different color" in that it doesn't matter if the balance sheet shows a negative equity position. If a sole proprietor sustains a loss, the full extent of that loss can be reported on the individual's personal tax return. The reason is that it is assumed that all funds paid out to create the loss come from the individual's personal resources. Therefore, a loss will always have tax basis for an individual sole proprietor.

Corporation (C & S)

A (C) corporation stockholder's tax basis is pretty simple. You buy stock for a certain price and that's your basis. If you pay in more money (capital) then your stock basis is higher. When it's time to sell the stock, the stock is valued to determine selling price. If the selling price of the stock is higher than what you paid for it, there is a gain on the sale. If the selling price is lower than your basis, then there is a loss on the sale.

An (S) corporation stockholder's tax basis is similar to a partner's tax basis, since both are what are called "pass-through" entities. Pass-through means that the entity itself does not pay taxes. It means that the profit or loss of the business are "passed-through" to the owner and reported on his or her personal tax return. One big difference between an (S) corporation stockholder and a partner is that the only liability that can be used as basis for the stockholder is money loaned to the corporation directly from the stockholder.

These are matters best discussed with your tax advisor, but it is important and useful to understand the relationship between equity and tax basis, especially when doing tax planning.

TIP: Keep Track Of Inside and Outside Basis

We just discussed “inside basis” which is the equity position of the owner that is kept track of on the balance sheet of the company. But, what is “outside basis”? Let me give you an example of “outside basis”. Perhaps you bought out an existing partner in a partnership. You didn’t buy into a partnership by giving the partnership money for a share of ownership, you gave the money to the partner. It is most likely that the price paid for the partnership interest was not the exact same amount the selling partner paid for his/her share. Your amount of partnership interest on the books (inside basis), absent a special election by the partnership, will be whatever his/her basis has been. However, your actual tax basis (outside basis) could be much higher, hence the importance of knowing what that amount is for your own tax reporting.

Make sure you keep track of both your inside and outside basis if you have both. If you don’t do it, make sure your tax preparer or accountant does.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at <http://www.reallifeaccounting.com> to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.