Accounting Studies: For first year of English Section:

Forms of business organizations:

Corporations:

What is a corporation?

-A ***Corporation*** is a *legal entity*, having an existence separate and distinct from that of its owners. The owners of a corporation are called ***stockholders*** (or shareholders), and their ownership is evidenced by transferable shares of ***capital stock***.

- A corporation, as a ***separate legal entity***, may own property in its own name. The assets of a corporation belong to the corporation itself, not to the stockholders. As a **legal entity**, a corporation may enter into contracts, is ***responsible for its own debts***, and ***pays income taxes*** on its earnings.

-On a daily basis, corporations are run by ***salaried professional managers***, not by their stockholders. Ownership of stock does not *automatically* give the shareholder managerial authority.

Stockholders' Liability for Debts of a Corporation.

- Stockholders in a corporation have ***no personal liability*** for the debts of the business. In case of corporation failure, stockholders potential losses are ***limited*** to the amount of their equity in the business.

-***Limited personal liability*** is considered the *greatest advantage* of the corporate form of business organization, regarding investors in large companies and the owners of many small businesses.

- Creditors have claims against only the ***assets of the corporation***, not the personal assets of the corporation's owners. Limited shareholder liability, transferability of ownership, professional management, and continuity of existence make the corporation the best form of organization for pooling the resources of great many equity investors.

Owners' Equity in a Corporate Balance Sheet.

Generally, in every form of business organization, there are two basic ***sources*** of owners' equity, they are: ***1)*** investment by the owners, and ***2)*** earnings from profitable operations. In practice, corporations distinguish in their balance sheets between the amounts of equity arising from such sources.

Illustration:

Assume that on January 1, 2018, Masry Elwatny and several investors started Masry's Co. by investing L.E.100,000,000 cash. In exchange, the corporation issued to these investors 10,000 shares of its capital stock. On December 31, 2020 and over its three-year life, Masry's Co. has earned total net income of L.E.180,000,000, of which L.E.60,000,000 has been distributed to the stockholders as ***dividends.*** The stockholders' equity section of the company's 2020 balance sheet is shown as: (Review your material page 52).

The Issuance of Capital Stock.

-Upon establishing of a corporation, it collects cash or other assets of the prospective investors. When the corporation receives such cash or other assts from its owners, it issues shares of capital stock in exchange. Thus, the corporation records these investment transactions by crediting ***Capital Stock*** account and debiting such assets.

-For example, the entry made by Masry's Co. to record the issuance of 10,000 shares of capital stock in exchange of L.E.100,000,000 cash will be as presented in your material, page 55.

Retained Earnings and Dividends.

-R***etained earnings*** represents the owners' (shareholders) equity created through profitable operation of the business. Earning net income causes the balance in the *Retained Earnings* account to increase. But, many corporations follow a policy of ***appropriating to their stockholders (shareholders)*** some of the resources generated by profitable operations.

-These appropriations or distributions are termed ***dividends.*** Dividends ***reduce*** or decrease both total assets and stockholders' equity (exactly the same as do drawings in an unincorporated business). The reduction in stockholders' equity is reflected by decreasing the balance in the *Retained Earnings* account. Furthermore, retained earnings is reduced by any *net losses* incurred by the business.

<u>Illustration :</u>

-Assume that on December 1, 2020, the directors of Masry's Co. declare a regular quarterly dividend of a half pound per share on the 10,000 shares of outstanding capital stock. The board's resolution (decision) determined that the dividend will be paid on December 15 to stockholders of record on December 10.

-According to the given information, two entries are required: one on December 1 to record the ***declaration*** of the dividend, and the other on December 15 to record payment. Those could be made as shown in your available material, page 59.

Closing Entries and the Statement of Retained Earnings.

-The *Retained Earnings* account should reflect the effect of profits, losses, and dividends during a given accounting period. As mentioned previously, the amount of retained earnings is increased by earning net income; it is decreased by bearing net losses and by declaring dividends. In the accounting records, these changes are recorded by ***closing*** the balances in the *Income Summary* account and *Dividends* account into the *Retained Earnings* account.

<u>Illustration :</u>

Assume that at December 31, 2019, Masry's Co. had retained earnings of ***L.E.80,000,000***. During 2020, the company earned net income of ***L.E.60,000,000*** and paid four quarterly dividends totaling ***L.E.20,000,000***. Who could the entries at December 31, 2020, to close the *Income Summary* and *Dividends* accounts be appeared? The answer is provided in your material, page 62.

-On the other hand, corporations prepare a ***Statement of Retained Earnings***, instead of a statement of owner's equity which is prepared by an unincorporated business. Statement of retained earnings summarizes the changes in the amount of retained earnings over the year. However, many corporations instead prepare a ***Statement of Stockholders' Equity***, which shows the changes in *all* stockholders' equity accounts over the year. A statement of retained earnings for Masry's Co. appears as follows:

MASRY'S CO.
Statement of Retained Earnings
For the Year Ended December 31, 2020

Retained earnings, Dec. 31, 2019………………………………… L.E.	80,000,000
Net income for the year………………………………………..	60,000,000
Subtotal………………………………………………………..	*140,000,000*
Less: Dividends…………………………………………………	20,000,000
Retained earnings, Dec. 31, 2020……………………………...L.E.	**120,000,000**

The most common differences among business organizations.

Characteristics of Forms of Business Organizations

Forms / Character	Sole Proprietorship	General Partnership	Corporation
1. Legal Status	Not a separate legal entity	Not a separate legal entity	Separate legal entity
2. Liability of owners for business debts	Personal liability for business debts	Personal liability for business debts	No personal liability for corporate debts
3. Accounting status	Separate entity	Separate entity	Separate entity
4. Tax status	Income taxable for owner	Income taxable for partnership	Files a corporate tax return and pays income taxes on its earnings
5. Persons with managerial authority	Owner	Every partner	Hired professional managers
6. Continuity of the business	Entity ceases with retirement or death of owner	New partnership is formed with a change in partners	Indefinite existence

Now, let us test our understanding of this subject, through answering the following questions:

TRUE OR FALSE:

For each of the following statements, circle the **T** or the **F** to indicate whether the statements is **True** or **False**.

1- **T** **F** The business assets in a corporation actually belong to the stockholders, not to the business.

2- **T** **F** Tax laws see net income of the corporation as an income of business entity.

3- **T F** Limited personal liability is considered the greatest disadvantage to corporate form of business organizations.

4- **T F** A sole proprietorship is a legal entity, having an existence separate and distinct from that of its owners.

5- **T F** The owners of a corporation are called shareholders, and their ownership is evidenced by transferable shares of capital stock.

6- **T F** Capital stock represents the amount which the owners originally invested in the business in exchange for shares of the company's stock.

7- **T F** Retained earnings represents the increase in stockholders' equity that has accumulated over the years as a result of invested capital stock.

MULTIPLE CHOICE:

Choose the best answer for each of the following questions and circle the identifying letter.

1. On June 1, the board of directors of Information Corporation declared a regular quarterly dividend of L.E.15 per share on the 20,000 shares of outstanding capital stock. The dividend is payable on June 20. What entry is necessary to record the declaration of the dividend on June 1?

- **A** Dividends Payable…... 300,000
  Cash………………. 300,000
- **B** Dividends……………. 300,000
  Cash……………….. 300,000
- **C** Dividends……………. 300,000
  Dividends Payable... 300,000
- D Dividends Payable….. 300,000
  Dividends………….. 300,000

2. On June 1, the board of directors of XYZ Corporation declared a regular quarterly dividend of L.E.15 per share on the 20,000 shares of outstanding capital stock. The dividend is payable on June 20. What entry is necessary to record payment of the dividend on June 20?

- **A** Dividends Payable…... 300,000
  Cash………………. 300,000
- **B** Dividends……………. 300,000
  Cash……………….. 300,000
- **C** Cash…….…………… 300,000
  Dividends Payable... 300,000
- D Dividends Payable….. 300,000
  Dividends………….. 300,000

3. XYZ, Inc. had retained earnings of L.E.1,500,000 at the beginning of the current year. During the year, the corporation incurred a net loss of L.E.200,000 and declared dividends in the amount of L.E.50,000. What is the balance of XYZ's retained earnings at the end of the year?

- **A** L.E.1,250,000.
- **B** L.E.1,300,000.
- **C** L.E.1,350,000.
- D L.E.1,650,000.

Best wishes Dr Ali Abdelkarim Rawy