Chapter 2 – Different Accounting Entities

Suggested Solutions

Discussion Questions

* 1. For accounting purposes it is assumed that the business is separate from the owner(s). The business may be in the form of a sole proprietorship, partnership, company or other operating structure. This assumption is essential to facilitate transaction recording and reporting in relation to the business or operating activities of that entity.

From the perspective of the law, most entity structures other than the company do not represent separate legal entities. That is, from the perspective of the law, there is no distinction between the business and the owners of the business. However, with the company entity structure, the business is granted the status of a ‘legal person’ and the rights and responsibilities that go with that status.

* 1. ‘Mutual agency’ essentially means that partners will be responsible jointly and separately for the actions of other partners in relation to the business operations.

2.3 The partnership is not directly taxed, as it is not a legal entity. It is the partners that are taxed on the basis of each individual partner’s share of the partnership profit or loss. Each individual partner is taxed in New Zealand using individual personal income tax rates.

2.4 A partnership effectively ceases whenever there is a change in the partners (i.e. a partner leaves or a new partner comes in). However, the business of the previous partnership may well continue and often the business name will also be retained, but the partnership (group of individual owners) will have changed.

2.5 The ‘company’ entity structure is given a legal existence in its own right which is quite distinct from the ownership and management interests. A company will continue to exist until such time as it is legally wound up as a result of financial difficulties, take-over by another company, or by the voluntary direction of the existing owners.

2.6 The potential advantages of the partnership structure over the sole proprietorship structure could include:

* Greater access to capital (more owners)
* Greater management flexibility (more owners)
* Possible economies of scale (shared overhead costs)
* Diversity of skills (expanded range of services)
* Possible taxation advantages (income splitting).

2.7 The basis for splitting up the profit or loss in a partnership is the responsibility of partners to decide. However, it would seem appropriate that such an arrangement take into account:

* The capital (resources) contribution of each partner (i.e. an interest equivalent return)
* The physical contribution of each partner to the partnership operations on an ongoing basis (i.e. a salary equivalent)
* The entrepreneurship (ideas) contribution of each partner (i.e. vision, risk-taking, contacts).

2.8 A listed company is an entity which is listed on the NZX and required to prepare financial statements in accordance with NZ GAAP and NZ IAS under the Financial Reporting Act 1993. An unlisted company is an entity that is not publically listed on the NZX and is not required to publicly file financial statements. The New Zealand Framework requires general purpose financial statements to be prepared for entities that:

* are publicly accountable (primarily entities which have debt or equity instruments (shares) being publicly traded on a stock exchange, and entities which are issuers (have issued debt or equity to the general public) or are registered banks, superannuation schemes or deposit-takers); or
* are large (for for-profit entities (see below), this means with either total assets in excess of $60 million or total revenue in excess of $30 million) and owned by large overseas companies; or
* have 10 or more shareholders, unless the shareholders opt out of compliance by means of a resolution.

2.9 Preference shares by definition must have some priority (or preference) over ordinary shares. This preference varies from company to company and will be detailed in the company’s legal documents and prospectus. However, preference shares normally provide a fixed dividend return. Other priorities or preferences might include:

* That dividends are cumulative (if not paid in one year will carry forward until future profits allow payment).
* That once a certain prescribed level of profit is achieved, these shares might participate in a further profit distribution.
* These shares may be redeemable in the sense that the company may purchase them back.
* These shares may be convertible into ordinary shares at a specified future date and price arrangement.
* In the event of liquidation, they may have preference over ordinary shares in the distribution of residual assets (after liabilities are paid out).
  1. (a) Non-redeemable means that the share cannot normally be repurchased from the shareholder by the company issuing the share.

(b) Participating means that the shareholder is not only entitled to the specified dividend related to that preference share, but they have the opportunity to share in further profits based on the conditions that attach to that share (e.g. if profit reaches a certain level then they will be paid an additional dividend).

(c) Cumulative means that dividends accrue from one year to the next. If they are not paid this year, they will be deferred and paid in a future year when profits are adequate to cover the dividends in arrears.

(d) Non-voting means that the shares do not normally entitle the shareholder to vote in relation to company matters.

(e) % refers to the dividend rate applicable to that preference share. It is an annual rate and is based on the issue price, or specified price of that share.

* 1. (a) The most common entity structures in use in New Zealand are:
* Sole traders
* Partnerships
* Companies.

(b) Illustrative reasons for the use of each form:

*Sole proprietorship:*

* Single owner
* Limited start-up capital requirements
* Small scale of operations
* Combined ownership and management
* Legal or professional restrictions (must operate as sole trader or partnership)
* Professional responsibility (in terms of unlimited liability)
* Minimal regulation
* Minimal external record-keeping requirements
* Taxation advantages
* Unrestricted ability to sell.

*Partnership:*

* Access to additional capital
* Complementary skills and services
* Flexible management
* Economies of scale
* Limited scale of operations
* Legal or professional restrictions (must operate as sole trader or partnership)
* Professional responsibility (in terms of having unlimited liability)
* Tax-sharing advantages
* Moderate regulation
* Minimal external record-keeping requirements.

*Companies:* (limited by share capital)

* Access to significant capital (type and amount)
* Separation of ownership and management
* Continuity of operations
* Ready ability to sell off ownership (listed companies)
* Limited liability
* Possible taxation advantages (lower tax rate of 28% for 2012 onwards)
* Unlimited level of activity.
  1. Given the characteristics of partnerships, i.e.
* co-ownership of assets
* co-ownership of profits
* mutual agency
* shared management
* unlimited liability
* limited life,

it would be impractical to operate with a large number of separate owners.

2.13 Without a formal partnership agreement operating administrative difficulties will inevitably arise.

The resolution of such difficulties without an agreement may well be costly in terms of time, financial performance and, particularly, inter-partnership relationships.

The partnership agreement would normally include aspects such as:

* The partnership name
* The proposed activities of the partnership
* The partnership location
* Record-keeping arrangements
* The contributions of the partners
* The profit or loss sharing arrangements
* Management responsibilities
* Arrangements for partners’ withdrawal (retirement from the partnership)
* Arrangements for introducing new partners
* Dispute resolution provisions.

2.14 Whether ‘limited liability’ is an advantage or a disadvantage depends on the perspective of the stakeholder. We have noted that it is an advantage to the investor because his/her obligation is limited to the amount payable on the shares owned. The creditors have no further claim against the owners in the event of a company’s liquidation.

However, from the viewpoint of employees and unsecured creditors, the limited obligation (liability) of owners may be a disadvantage in getting back their entitlements in the event of a company’s liquidation.

2.15 Possible measures to reduce the supplier’s risk in relation to dealings with limited liability companies may include:

* Restricting transactions to cash sales
* Limiting the credit period or level of credit provided
* Obtaining personal guarantees from the company owners/managers
* Obtaining security over company assets
* Requiring certain debt covenants to be complied with, for example:
* Maximum level of debt
* Minimum interest cover
* Maximum owners’ distribution
* Required return on assets
* More frequent reporting
* Specified accounting-rule application.

2.16 (a) Possible benefits to the owner:

* Limited liability
* Unlimited life
* Possible taxation benefits (lower tax rate)
* Possible access to funds from additional owners
* Potentially the ability to transfer or sell part of the ownership interest without selling the entire business
* Possible separation of ownership and management.

(b) The major disadvantage to suppliers is that of the limited liability of the owners in relation to business debts.

* 1. (a) The management of a business may choose to convert from a sole proprietorship to a partnership to obtain the following benefits:
* Access to additional capital
* Economies of scale in the operations
* Management flexibility
* Diversification and access to additional skills
* Risk-sharing
* Tax-sharing.

(b) The management of a business may choose to convert from a partnership to a closely-held (unlisted) company to obtain the following benefits:

* Access to additional capital
* Economies of scale in the operations
* Separation of ownership and management (specialised management)
* Access to limited liability for the owners
* To ensure continuity of operations and existence
* To reduce the maximum taxation level (company tax is lower than the higher marginal rates of individual taxation)
* To facilitate ownership transfer.

(c) The management of a listed company may choose to convert to an unlisted company to obtain the following benefits:

* To reduce the level and cost of external regulation
* To reduce the scrutiny of external stakeholders and the pressure for short-term performance
* To restrict the ease of future ownership transfers
* To increase the future return to ongoing private shareholders.
  1. There are a number of advantages of having a partnership agreement that specifies the arrangement for allocating (dividing) profits between partners. These might include:
* The general benefits of forward planning by the partners
* Avoidance of unnecessary and disruptive future conflicts between partners
* To ensure an equitable distribution of the profit or loss based on the relative values of each partner’s contribution
* To avoid future costs in the resolution of conflict
* To avoid the potentially inequitable resolution provided under the Partnership Act 1908 that would simply split profits up equally without regard to the respective contributions of each partner in terms of capital, effort and entrepreneurship.

2.19 This distinction is important to protect the rights of both external lenders and other ownership interests. Inappropriate return of capital could reduce the level of asset security for debt holders or other categories of owners.

2.20 The New Zealand Exchange is more concerned with the equity of disclosure then with the accounting content. As such, it focuses on the frequency and timing of disclosures.

2.21 In relation to the general disclosure requirements, the directors’ report will include:

* *a review of operations during the financial year and the results of those operations;*
* *details of any significant changes in the state of affairs during the year;*
* *details of any matter of circumstance that has arisen since the end of the year that has significantly affected, or which may significantly affect:*

1. *the operations in future financial years; or*
2. *the results of those operations in future financial years; or*
3. *the state of affairs in future financial years.*

2.22

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| ***Aspect*** | ***Bonus issue*** | ***Rights issue*** | ***Share buy-back*** |
| (a) Impact on equity | No effect on total equity, just the composition. | An increase in equity (share capital). | Reduced, as the company cancels the shares it buys back. |
| (b) Impact on total assets | No effect on total assets. | An increase in assets (cash contributed). | Reduced, as company funds are used to buy back shares. |
| (c) Benefits to the company | A greater number of shares on issue.  Possible defence against take-overs.  Positive market reaction. | Increased capital.  Ownership proportions unchanged.  Lower-cost capital raising arrangement. | Reduced long-term commitment to distribute profits to owners. |
| (d) Benefits to the shareholder | Own more shares.  The market tends to respond positively as bonus issues convey favourable inside information. | Retain the same ownership proportion.  Can normally sell rights if you do not want to acquire additional shares. | Creates additional market demand for shares (increased price).  For those retaining their shares, the potential return has increased (same profit, fewer shares). |

2.23 (a) The terms ‘true and fair’ are used in relation to the quality of financial statements and are made by the directors and auditors of those reporting entities. However, the terms have not been clearly defined, nor tested in court.

It is generally accepted that the terms are linked to the provision of all material financial information to the relevant stakeholders in relation to decisions about the allocation of scarce resources and the discharge of accountability (e.g. compliance with regulations).

Information is deemed material if its omission or misstatement would affect the decision in relation to resource allocation or accountability.

(b) The financial statements referred to are:

* The balance sheet
* The statement of comprehensive income
* The cash flow statement.

(c) Compliance with the accounting standards does not necessarily mean that the financial statements will be true and fair. However, the expectation would be that the accounting standards have been prepared on the assumption that compliance with the standards will lead to the provision of a true and fair view of the state of affairs of the entity, its financial performance for the period, and the liquidity position for the period.

Where directors are of the view that compliance with the accounting standards does not lead to the provision of financial statements presenting a true and fair view, they still must comply with the standards, but may provide additional information to present a true and fair view.

2.24 (a) The potential advantages of adopting international standards to replace national standard-setting would include:

* Greater consistency between the financial reporting of countries that adopt international accounting standards.
* Greater consistency will lead to improved comparability of the financial reports of business entities operating in different countries.
* Greater consistency and improved comparability should lead to more efficient capital flows and lower cost of capital for companies using internationally consistent accounting and reporting standards.
* With a single set of consistent accounting standards it will be easier for users to understand the content of reports.
* For multinational companies, the adoption of international accounting standards by the accounting regulators should result in more efficient and less costly reporting. They will not have to prepare different sets of reports based on different accounting regulations in different countries.
* Potentially more cost-effective accounting regulations and avoidance of inefficient duplication by independent national regulators.

(b) The potential limitations of New Zealand giving up setting its own individual standards are:

* International accounting standards, by their very nature, must gain acceptance by the member bodies. In the process of gaining this acceptance there will need to be compromise, and as a result the international standards may be inferior to the national standards. This may be reflected in them being more general in application, and less rigorous in terms of logical structure.
* The New Zealand economic, legal, political and cultural framework differs from that of other member countries of the international accounting standards body. The concept of ‘one size fits all’ may well be inappropriate to the imposition of accounting rules and regulations. There needs to be the opportunity for standards to vary in line with notable differences in the economic, legal, political and cultural variables.

2.25 (a) Corporate governance refers to the formal arrangements put in place by the entity to ensure that those responsible for managing the entity (directors and senior executives) maintain and protect the entity’s resources.

(b) Activities would include identifying:

* The role, composition and background of the board
* The role of the chairperson
* The role of the CEO and executive team
* The role of the non-executive and independent directors
* Details of executive compensation
* Details of internal controls
* The role of the internal audit
* Risk assessment and management procedures
* Corporate culture and ethical issues.

(c) Corporate governance has become significant in light of major corporate crashes (Enron, WorldCom, HIH Insurance, Feltex, Fortex, SCF, etc.) and the apparent unscrupulous behaviour of senior executives and directors in exploiting and opportunistically diverting the resources of the enterprise for their personal gain at the expense of the rights of and responsibilities to other stakeholders (e.g. shareholders, lenders, suppliers, employees).