

CHAPTER 4

WANT TO START A BUSINESS? INJECT CAPITAL!

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20 BOOKS OF ACCOUNTS – A QUICK RECAP

In Chapter 3, we talked about the Books of Accounts which are normally used by a Business. The following Books are used for the purposes of Accounting for Capital:

- General Ledger.
- Cash & Bank Book.

In this Chapter, wherever Accounting entries are required to be shown, we will use these two Books of Accounts for illustration purposes.

21 WHAT IS CAPITAL?

Capital (also commonly called “equity”) is what Owners initially put in their Business at the time that a Business is started, and as and when further money or funds are required by a Business. Capital is also used in a broad context to include Owner’s Capital as well as Bank Financing; however, in accounting terminology, Capital is referred to as being Owners’ Capital.

Capital can be used for various purposes, which can include amongst other things:

- Buying land.
- Constructing the factory, warehouse, shop etc.
- Buying machinery, equipment.
- Buying raw material.
- Paying for expenses.

Once Capital is injected in a Business, it is normally considered to be “permanent” i.e. this represents the amount of resources, which Owners have put in their Business and will always remain there.

EXAMPLE # 4.1

Inject Capital

The two partners of "Hanif Autos Engineering" put in cash Capital of Rs. 250,000 each on 1/8/05 when they started the Workshop. This amount was put in the Business's Bank Account.

The Accounting entry to record cash capital injection will be as follow:

GENERAL LEDGER							
CAPITAL ACCOUNT – HANIF AHMAD							GL-1
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/8/05	GL-25	Bank Account	250,000

GENERAL LEDGER							
CAPITAL ACCOUNT – NABEEL MANSOOR							GL-2
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/8/05	GL-25	Bank Account	250,000

CASH & BANK BOOK							
BANK ACCOUNT Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/8/05	GL-1	Hanif's Capital Account	250,000				
	GL-2	Nabeel's Capital Account	250,000				

22 WHAT IS EQUITY?

In commonly used language, the words "Equity" and "Capital" are used to mean one and the same thing. However, in Accounting language, there is a difference between these two terms which is explained below.

When money is initially or, even subsequently, put in a Business, it is called "Capital". However, after completion of the first year or later years of operations, when accounts are made and it is determined that the Business has made some profit – at that stage, Capital plus profit earned is called "Equity".

Besides Capital and Profit earned, Equity can also include some other account heads including Revaluation Reserve and Share Premium Account.

23 HOW MUCH CAPITAL SHOULD BE INJECTED?

This is a very important question which every Owner needs to answer realistically whenever starting a new Business. No Business makes money from the day that it starts. Every Owner should make an honest assessment of:

- How much capital will be required to set up the Business?
- How much of it will be spent before the Business makes money?

Answers to these two questions will normally be obtained from a feasibility study which is prepared whenever a Business is being planned.

It is very desirable for every Owner that the amount of Capital in the Business is sufficient (as in above) so that the Owners can focus on Business's activities rather than having to worry about shortage of funds.

24 HOW FREQUENTLY SHOULD CAPITAL BE INJECTED?

Capital is normally injected at the time that a Business is started. Even if sufficient

Capital was injected, there may be situations in future which require additional Capital to be injected. No matter how much time and effort is spent in planning the Business, circumstances can change e.g.

- Increase in cost of machinery.
- Delay in construction of factory.
- Problems in production.

Such situations cost money which needs to be arranged for by Owners, failing which, Businesses can be in serious financial problems. Therefore, while it is preferred that all the Capital be injected in the initial stage, there may be times when additional Capital will be required at a later stage.

25 IS CAPITAL ALWAYS IN CASH?

A Business requires many different things to start and to continue its operations whether it is cash, machinery, furniture, land, building etc.

A Business can have cash injected as Capital by Owners which can be spent on purchasing such items, or the Owners can provide some or all of those items from their personal resources. There is no right answer. It depends on each situation – but Capital can be in the form of cash or non-cash.

When Capital is injected in a Business as non-cash, the only question that remains is to assign a value to such non-cash items which should be their fair market value; fair market value is the price at which a buyer and a seller are willing to enter into a transaction keeping in mind the age and condition of that item.

In simple words, it is the market price!

EXAMPLE # 4.2

Non-Cash Capital

Continuing from example # 4.1, Mr. Hanif also brought his existing tools and machinery worth Rs. 150,000 into the Business. Moreover, Workshop was set up in the backyard of Mr. Hanif's own house which was valued at Rs. 100,000.

GENERAL LEDGER							
CAPITAL ACCOUNT – HANIF AHMAD							GL-1
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/8/05	GL-53	Tools & Machinery Account	150,000
				1/8/05	GL-44	Workshop Shed Account	100,000

GENERAL LEDGER							
TOOLS & MACHINERY ACCOUNT							GL-53
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/8/05	GL-1	Hanif's Capital Account	150,000				

GENERAL LEDGER							
WORKSHOP SHED ACCOUNT							GL-44
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/8/05	GL-1	Hanif's Capital Account	100,000				

26 DECIDING ON A PROFIT SHARE

In a sole proprietorship, there is only one Owner. In a partnership and companies (companies will be covered in the next section) there are multiple Owners each of whom may make a contribution towards Capital.

In Business, the amount of Capital that each Owner contributes towards the total Capital determines that Owner's share in the profits of the Business. However, having said that, it is not correct to say that this is the only basis – there may be instances

where one Owner puts all the Capital and the other Owner brings technical, financial, marketing or production knowledge for which he is also given a profit share.

In any case, in most circumstances, profit share is determined through mutual agreement.

EXAMPLE # 4.3

Profit Share

Following on from Examples # 4.1 and 4.2, the profit share was decided to be agreed in proportion to Capital injected by each Partner:

Owner's Name	Capital Injected	Profit Share
Hanif Ahmad	Rs. 500,000	2/3 or 66.67%
Nabeel Mansoor	Rs. 250,000	1/3 or 33.33 %

27 BUSINESSES ARE SEPARATE FROM OWNERS

A Business, whether it is in the form of a Sole Proprietorship, a Partnership or a Company (collectively, all these three are called the "Legal Form" of a Business), is different from the Owners of that Business irrespective of the fact that it was the Owners who had initially put Capital in the Business.

What that means, from a practical view point, is that after a Business has been set up, both the Owner and the Business become independent legal entities and the Owners cease to have an automatic right to the property and assets of the Business except for in specified circumstances.

This is an important distinction which needs to be carefully appreciated: generally speaking, we have seen that Owners continue to handle, manage and operate the assets of a Business as their own which is not correct.

Taking the example of Capital injected in a Business by its Owners, the amount of Capital received by a Business, therefore, is a liability for the Business (normal account type is Credit) and is payable to the Owners. That is why, in Example # 4.1, Capital accounts of Mr. Hanif and Mr. Nabeel have credit balances.

28 CAPITAL FOR COMPANIES

In Chapter 3, we briefly explained that names of Businesses with words "Limited" or "Private Limited" are regulated by Companies Ordinance 1984 and are commonly called "Companies". As explained in the previous section, Companies (like other "legal forms" of Businesses) are separate legal entities and the Owners should treat, manage and operate Companies differently as compared to their other personal property.

In case of Companies, there are strict legal guidelines in Companies Ordinance 1984, which govern every aspect of a Company's operations. Capital is no different.

28.1 SHARE CAPITAL

In case of Companies, Capital is referred to as "Share Capital" and the Owners who put Capital in a Company are called "Shareholders".

Share Capital normally has two features:

- (i) Number of shares: the total number of shares issued by a Company.
- (ii) Par Value of shares: the value assigned to each share, also called Nominal value.

The following example will illustrate this:

- A Company is formed to run a Business for which the Capital is planned to be PKR 1,000,000/-. Share Capital for this Company can be:
 - 100,000 shares of PKR 10 par value each PKR 1,000,000, OR
 - 10,000 shares of PKR 100 par value each PKR 1,000,000, OR
 - 200,000 shares of PKR 5 par value each PKR 1,000,000.

And, many other combinations are similarly possible.

EXAMPLE # 4.4**Capital for Companies**

Hussain Khaddar & Looms (Pvt) Limited is a new company which was formed on 1/7/05. The following non-cash Capital was put in the Company: 2 kanals of land: Rs. 500,000; Building: Rs. 500,000; & Machinery etc.: Rs. 1,000,000. The two shareholders, Mr. & Mrs. Hussain Ahmed, also decided to put in Rs. 250,000 each as cash in the Company's Bank account. Shareholding will be equally split between the husband and wife. Total Capital of the company is, therefore, Rs. 2,500,000 made up of 250,000 shares @ Rs. 10 each.

- (i) Cash Capital injected in the Company

GENERAL LEDGER							
SHARE CAPITAL ACCOUNT							GL-1
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/7/05	GL-20	Bank Account	250,000
				1/7/05	GL-20	Bank Account	250,000

CASH & BANK BOOK							
BANK ACCOUNT				GL-20			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/7/05	GL-1	Hussain Ahmed Account	250,000				
	GL-1	Mrs. Hussain Ahmed Account	250,000				

(ii) Injection of non-cash Capital

GENERAL LEDGER							
LAND ACCOUNT				GL-17			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/7/05	GL-1	Share Capital Account	500,000

GENERAL LEDGER							
FACTORY BUILDING ACCOUNT				GL-19			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/7/05	GL-1	Share Capital Account	500,000

GENERAL LEDGER							
MACHINERY ACCOUNT							GL-25
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/7/05	GL-1	Share Capital Account	1,000,000

GENERAL LEDGER							
SHARE CAPITAL ACCOUNT							GL-1
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/7/05	GL-17	Land Account	500,000
				1/7/05	GL-19	Factory Building Account	500,000
				1/7/05	GL-25	Machinery Account	1,000,000

(III) Shareholding

Individuals who put Capital in a Company are called "Shareholders" and the number of shares that each Shareholder holds in a Company represents that individual's shareholding. It is an individual's shareholding in a Company which determines the profit share of each Shareholder.

28.2 FURTHER CAPITAL

Like any other legal form of Businesses, further Capital can also be injected in a Company at any time. Whenever additional Capital is injected in a Company, new shares are issued. There are provisions in law (Companies Ordinance 1984) that need to be followed before further Capital is injected and shares get issued.

28.3 OTHER PROVISIONS

There are a number of other provisions in Companies Ordinance 1984 which also need to be followed. All these provisions have not been discussed here. Please consult your

legal advisor or Chartered Accountant if you need to discuss anything specific in this regard.

CHAPTER HIGHLIGHTS

What have we covered?

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|---|---|
| 1. Owner's initial contribution to the Business is called Capital. | 5. The amount of Capital that each Partner contributes towards the total Capital required normally determines the profit share. |
| 2. Equity and Capital are normally used to mean the same. However, equity includes Capital plus profit earned. | 6. Business is separate from its Owners. |
| 3. Capital is normally injected at the time that a Business is started. However, additional Capital may also be injected at any time. | 7. Capital is referred to as Share Capital and the owner(s) who inject Capital in a Company are called Shareholders. |
| 4. Capital can be in the form of cash or can be non-cash. | 8. The number of shares held by an individual in a company represents that individual's shareholding which determines the profit share between partners in a Company. |

