

Sources of capital: owner's equity



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Owner's Equity as a Source of Capital Sources of capital come in two forms: debt and equity. Obtaining permanent capital through equity is the capital supplied by the entity's owners. It is the owner's share in the financing of all the assets. Richard Scott, United States accounting professor wrote, " one of the most deep-seated, and incontrovertible concepts embraced by accounting theory today is that of owner's equity. " Through analysis of the case, we found this to be true. There are different financing costs both a company and its investors face when considering equity financing.

It is strangely fascinating that often times, equity financing becomes more costly than debt financing. The analysis of opportunity for both sides of the transaction, financier and debtor, requires multiple formulas and calculations. Options for financing vary in pre-tax earnings and return on investment. For this reason, the options should be thoroughly analyzed to find the best yield for both parties, company and investor. Innovative Engineering Company was founded as a partnership, and within five years became a thriving business bringing with it both success and the need for new permanent capital.

The two partners, Gale and Yeaton, estimated the capital need at \$1. 2 million. Initially, the partners found interested investors, but none willing to risk their personal assets by participating in a partnership. Though incorporation is more costly and subject to numerous regulations, it provides limited liability to its investors and the ability to raise capital through bonds and stock. The partners planned to form a corporation to secure investors. Under incorporation, owner's equity becomes stockholder's equity.

The two types of equity are purchased equity, consisting of preferred stock, common stock, and paid in capital, and that of earned equity, also referred to as retained earnings. The latter represents profits earned by the company and retained in the business. Owner's equity is shown on the balance sheet and within the statement of owner's equity in a company's financial statements, and is most commonly influenced by income and dividends. Four proposals were developed to attempt to meet the needs of investors in the Innovative Engineering case and the two original partners struggled to maintain ownership control. Proposal A includes a \$1. million long-term loan, giving Arbor Capital Corporation 10% common stock. Proposal B includes \$200, 000 debt, \$900, 000 preferred stock, and \$100, 000 common stock. Proposal C includes \$600, 000 debt, \$600, 000 equity with 40% common stock. Proposal D includes \$300, 000 debt, \$900, 000 equity with 50% common stock. Calculating the implications of each proposal is necessary to seek further investors and find the best option for both sides of the transaction. Gale and Yeaton assumed an interest cost of debt at 8% and a dividend rate for preferred stock at 10%. They also assumed pessimistic, best guess, and optimistic variables.

For a further analysis of earnings, the pre-tax earnings and return on investment are calculated as follows: Pre-Tax = $100,000 / (1 - .34) = 151,515.15$

Proposal A: Debt = \$1, 100, 000 Common Stock = \$100, 000
Interest = \$88, 000 Dividend = \$21, 200 Pre-Tax Earnings = \$109, 200 (sum - common stock and debt)
Return on Investment = 9% (pre-tax earnings / \$1, 200, 000)

Proposal B: Debt = \$200, 000 Preferred Stock = \$900, 000
Common Stock = \$100, 000 Interest = \$16, 000 Preferred Dividend = \$90,

000 Common Dividend = \$10,000 Pre-Tax Earnings = -\$64,000 Return on Investment = -5% Proposal C: Debt = \$600,000 Common Stock = \$600,000

Interest = \$48,000 Common Dividend = \$240,000 Pre-Tax Earnings = \$288,000 Return on Investment = 24% Proposal D: Debt = \$300,000 Common Stock = \$900,000 Interest = \$24,000 Common Dividend = \$450,000 Pre-Tax Earnings = \$474,000 Return on Investment = 40% Again, proposal D shows the most promise for Arbor Capital Corporation, with larger pre-tax earnings and a greater return on investment. Innovative Engineering Company is in a good position and has options. They should not consider proposal B. Proposal A will give them greater control over the company but comes with large debt financing and is risky.

They should consider other investors and should look at options such as warrants. They should further research their options for a large loan. We have found debt financing can be cheaper than equity financing and should be considered. We are certain Innovative Engineering Company could find more attractive financing than proposal D. They should have more options, because their need is success driven versus a start-up company. From outside research we have found there is a natural definition of market efficiency relating capital stock and investment flow.

Obviously, equity financing should not be used if it becomes more expensive than debt financing. The company can create value by managing these sources of capital, finding an optimal balance of both.

Works Cited

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