THE USV ANNALS OF ECONOMICS AND PUBLIC ADMINISTRATION | VOLUME 16, ISSUE 2(24), 2016

ACCOUNTING, TAX AND FINANCIAL APPROACHES CONCERNING THE CONCEPT OF EQUITY

Associate Professor PhD **Mihaela TULVINSCHI**
"Ștefan cel Mare" University of Suceava, Romania
mihaelat@seap.usv.ro

Abstract:
Substantiating the concept of equity is an issue of interest to specialists in accounting, taxation and finance. The purpose of this article is to present three of the sensitive issues generated by the concept of equity. One aspect considered is the demarcation of financial liabilities from the equity instruments. The distinction between equity and debt instruments is necessary because it has consequences on financial reporting. A second part of the study focuses on the fiscal side, trying to find the answer to the question: Are there deferred taxes recognized in equity? Deferred tax liabilities will be presented at the end of the year in equity and not debt, because they are related to gains recorded directly in equity. The third part of the article discusses the financial importance of equity, focusing on subscription and attribution rights as financial instruments used when raising capital. By creating subscription rights it is desired to obtain immediate funds needed to finance the entity.

Key words: equity, the equity instruments, revaluation reserve, subscription and attribution rights.

JEL classification: M41, M19, G00

1. INTRODUCTION

The concept of equity demarcates the funding sources that the economic entity has no obligation to return at a specified due date. IASB conceptual framework defines equity as the residual interest in the entity's assets after deducting all of its liabilities. The interest in equity includes primary and secondary claims on capital. In a financial approach, equity or net assets represents the difference between total assets and total liabilities as they were assessed in the financial statements. In a practical approach, by equity we mean the wealth that would remain for the partners or shareholders at the time of liquidation of the company, after they had honored all its obligations. From an accounting perspective, equity includes contributions to capital, share premium, reserves, retained earnings and the result of the financial year.

Although the component last mentioned it is well known in the economic practice, we consider necessary a demarcation between the result of the exercise and the concept of global result. In the traditional economic practice, the financial year result is an indicator for measuring economic performance and an important component of equity. The profit for the year can be defined "in terms of positive difference between the income by selling goods made by an economic agent and their cost, considered as an expression of economic efficiency" (Popa, 2006,). Performance is "a great result obtained in management, economics, trade, etc. which features prints of competitiveness, efficiency and effectiveness of the organization and its procedural and structural components" (Verboncu, 2005). Part of the profit entity which remains available indefinitely, may be distributed in accounting terms, into reserves. In terms of managerial qualifications, reserves "gather images of the money set aside for a rainy day … Reserves, like any other fonts are used to finance business and locked in fixed assets and working capital." (Barrow, 2008)

The concept of global result has been defined by American standards in 1984 and applied in 1997. Currently, the IASB accountant conceptual framework took the concept of global result from the US rules. In this context, "the overall result is an extensive measure of the effects of transactions and other events of an entity, meaning all changes in equity, except those resulting from contributions or distributions to owners" (Jianu, 2007).

IASB proposes two models for the presentation of the overall result. The first model envisages the reflection of all transactions that take the form of gains or losses and that are recorded

directly to equity, without transiting through the profit and loss account. The second model offers more information on:

- capital transactions with owners and distributions to owners;
- the balance of retained earnings at the beginning of the financial year, the balance sheet date and the changes that have occurred during the financial year;
- the reconciliation between the accounting value of each class of share capital of each share premium and each reserve at the beginning and end of financial year.

Comparing the two models presenting the overall result, we notice that the first model is a statement of recognized gains and losses at the end of the financial year and the second model shows the statement of changes in equity. This last situation does not provide financial information about the entity's performance, reflecting only the variations of the equity components.

"The priorities and the payment requirements related to present claims the financial statements users to anticipate how future cash flows will be distributed among those who have claims on the entity." (Bunea, 2014) To better inform current and potential investors, the accounting conceptual framework introduces clarification on two important elements that form equity: claims on capital and equity instruments.

2. THE DELIMITATION OF DEBT FROM EQUITY INSTRUMENTS

The distinction between equity and debt instruments is necessary because it has consequences on financial reporting. IASB general conceptual framework establishes the separation of elements that oblige the entity to outflows of liquidity or other resources that do not create such obligations. Distinction between equities elements is treated by IAS 32 "Financial instruments", IAS 39 "Financial instruments: recognition and measurement", IFRIC 2 "Members shares in operative entities and similar instruments" and IFRS 2 "Share-based payment".

The definitions of financial instruments are many and varied, which shows the great interest of specialists in finance and accounting towards them. The International Accounting Standard 39 "Financial instruments: recognition and measurement" believes that it can be called financial instrument any contract that generates simultaneously a financial asset for one entity and a financial liability or equity instrument for another economic entity. Some authors (Alexander et all, 2003) consider that from this definition emerges the idea that the financial instrument is a contract and not an asset or a financial liability. According to other authors (Huian, 2008), "within the recalled standard, term instrument, asset and financial liability are sometimes used with too much liberality, leaving room for unwanted confusion."

Equity instruments can create primary and secondary claims on equity. They do not generate debt. Ordinary shares, preferred shares and retained earnings are the main equity instruments that generate primary claims. In accounting, primary claims on capital are recognized as rights of shareholders to participate in the distributions of capital during the entity life or at the moment of liquidation. Secondary claims refer to a present right or obligation to receive or provide other equity interests. Equity instruments that create secondary claims on the equity are: forward contracts to buy, sell or issue its own shares and options to buy or sell own shares.

Shares represent the main equity instruments. In the specialized literature (Huian, 2008), shares are grouped according to the rights they confer to common shares and preferential shares. Common shares give voting and dividends rights, but puts the holders in a lower position than the privileged shareholders. Preferential shares are classified in (Dalton, 2000).

- cumulative preferential shares for which unpaid dividends are accumulated and must be paid before those related to ordinary shareholders;
- redeemable preferential shares that can be withdrawn by the issuer at its option;
- convertible preferential shares that can be exchanged into common shares at the option of the holder.

Summarizing the provisions of international standards listed above, we can say that a financial instrument is an equity instrument rather than a financial liability if the instrument does

not include any contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or liabilities with another entity. In addition, IAS 32 specifies that if a financial instrument will or may be settled in the issuer own equity instruments it is either an underived tool that does not include any contractual obligation or a derivative that will be settled only by the issuer by changing a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

According to IAS 32, the costs of issuing or acquiring items of capital nature called equity instruments, include: registration costs, commissions and fees paid to consultants and internal management costs.

The European Accountants Federation agrees with the provisions of the Conceptual General Framework regarding the separate presentation of equity and debt in the statement of the financial position.

3. DEFERRED TAX RECOGNIZED IN EQUITY

Tax implications in capital accounting are generated by the initial capital, its subsequent increases, the legal reserves accounting and the recognition of reserves from the equity category revaluation.

From a tax perspective, specialized literature (Mateş, 2009) presents three types of contributions:

- *simple inputs* made by partners or shareholders in exchange for social parts or shares, subject to social risks in the sense of losing all or part of the input;
- *inputs with a pecuniary interest* paid in return for the entrepreneurs reduction of risks is in reality a sale of shares and social parts;
- *mixed inputs*, some paid as simple inputs and others as inputs with a pecuniary interest.

The economic entity options to turn to one of the specified categories of inputs inevitably depend on tax. This can play an essential role by influencing the cost of each resource and by the incidence that a decision or another can have on the taxable income. The tax consequences of raising capital take the form of fees to be paid at the Trade Registry Office, notary, Official Gazette, etc. these reducing the unit treasury.

A special case is the increase of social capital from the net profit. Such a decision does not have as effect a distribution of additional equity therefore it is not considered a distribution of dividends and is not taxable.

Fiscal transparency "regarding the capital can be obtained by taxing income earned by companies through associates at a global income level" (Mateş, 2009). In these circumstances the entities gross benefits would return to shareholders and associates and will be taxed under the rules applied to individuals.

As main tax implication in equity accounting, we intend to analyze the occurrence of deferred taxes when revaluation reserves are recognized.

We present the example of an economic entity which in April year N purchases a machine at the acquisition cost of 120 000 m.u. (monetary units). The machine is depreciated in 10 years. At the end of year N + 2, the business entity revaluates the machine at the fair value of 140 000 m.u.. Given that revaluation is not recognized for tax purposes, we will analyze the recognition of deferred taxes in equity.

The monthly amortization: 120 000/10/12 = 1 000 m.u.

At the end of year N + 2, the accumulated amortization is: 1000 x 32 = 32 000 m.u.

The amount remaining at 31.12.N + 2 120 000-32 000 = 88 000 m.u.

The revaluation methodology of the fixed asset by removing the accumulated amortization at the end of year N + 2 is presented in Table. 1.

Table no. 1. Revaluation on a net value basis

Explanation	Situation before revaluation	Situation after revaluation
Gross accounting value	120 000	140 000
Accumulated amortization	32 000	-
The net accounting value	88 000	140 000
Revaluation reserve	-	52 000

After performing the revaluation recognized in accounting, tax base is not adjusted because revaluation is not recognized for tax purposes. Therefore, the taxable amount is the amount remaining on 31.12.N + 2, of 88 000 m.u. . The fair value of the machine is higher than the tax base, which leads to a taxable temporary difference of 52 000 m.u. . The deferred tax liability is 16% x 52 000 = 8 320 m.u.. In the machine's 88 months of life remaining useful, the economic entity will obtain taxable benefits from the use of equipment of 140 000 m.u. , but will not be able to deduct legally tax except amortization expenses of 88 000 m.u. . Consequently, the economic entity will pay 8320 m.u. more tax than normal in accounting terms, if the transaction would not have tax consequences. Revaluation reserve will be recorded in the balance sheet in equity, without affecting the profit and loss account.

In accounting the following records shall be made:

- cancellation of the amortization recorded until revaluation:

Amortization of equipment and means of conveyance	=	Technological equipment (vehicles, machinery and work installation)	52 000	52 000

- recording the revaluation reserve and the deferred tax liability:

Technological equipment (vehicles, machinery and work installation)	=	%	52 000	
		Revaluation reserves		43 680
		Deferred income tax liabilities		8 320

According to IAS 12, deferred tax liabilities will be presented at the end of the year in equity and not debt, because they are related to gains recorded directly in equity. The situation of recognized gains and losses is presented in Table no. 2.

Table no. 2. The situation of recognized gains following the presentation of deferred tax in equity

Gains from revaluation of tangible assets	43 680
Deferred tax recognized in equity	8 320
Net income recognized directly in equity	52 000
Total gains recognized for the year N + 2	52 000

If the amount of 8320 m.u. reflecting tax asset would be recorded as an expense and would not affect items recognized in equity value, the data from the table above changes as:

Table no. 3. The situation of gains recognized after the registration of deferred tax expense

Gains from revaluation of tangible assets	52 000
Net income recognized in equity	52 000 – 8 320
Total gains and loss recognized for the year N + 2	43 680

Comparing international regulations (IAS 1, IAS 12, IAS 16) with Romanian accounting standards (OMPF 1802/2014, OMPF 4160/2015) we notice similarities and differences. A major difference is not recognizing deferred tax, in national rules. Under these circumstances, revaluation reserve in the example given will be 52 000 m.u. and will affect equity. In the chapter similarities, we will focus on accounting and tax treatment of the revaluation overplus. Both in the international regulations and in the national ones, the economic entity may transfer from the revaluation overplus to the retained earnings either at the time of the restraint removall either on the asset amortization. If this last option is chosen, the revaluation overplus transferred to retained earnings is the

difference between the revalued asset amortization and the asset's original cost amortization, the amount transferred coverring the associated deferred tax.

For the example above, the value of the revaluation reserve being transferred to retained earnings is calculated as follows:

- Monthly amortization at a fair value: 120 000/88 months = 1 363.63 m.u.
- Amortization calculated at a cost: 88 000/88 months = 1,000 m.u.
- Transfer value: 363,63 m.u.

Revaluation reserves	=	Retained earnings representing the overplus from revaluation reserves	363,63	363,63

We further intend to see whether the decision to switch from the revaluation model to the cost model generates asset undervaluation. We consider that the transition from one model to another is performed on 01.01. N + 4. This situation generates the following information:

- On 31.12.N-3 revaluation reserve recorded in the accounts of the entity is: 52 000 – 363,63 x 12 = 47 636,44 m.u.
- On 01.01.N + 4 the accounting value of the machine is equal to the fair value on 31.12.N + 2 minus the revaluation reserve recorded by the end of N + 3: 140 000 – 47 636,44 = 92 363,56 m.u.
- Amortization recorded in accounting between revaluation date (31.12.N-2) and the date of the switch from the revaluation method to the cost method is: 1 363,63 x 12 = 16 363,56 m.u.. This amount represents the amortization account balance because the amortization recorded until the time of revaluation has been canceled.
- The remaining value of the machine, on 01.01.N is: 92 363,44 – 16 363,56 = 76 000 m.u..
- The remaining amortization period at 01.01.N + 4 = 120 months - 44 months = 76 months.
- Monthly amortization for the period 01.01.N + 4 - 01.05.N + 10 is: 76 000 / 76 = 1 000 m.u. .

From calculations, it appears that the option of switching from the revaluation model to the cost model does not lead to a undervaluation of the asset. Applying the cost model assumes that, after initial recognition, an item of property will be valued at its cost less any accumulated amortization and any accumulated loss. I noticed that the revaluation model generates through the revaluation reserve, changes in equity and in terms of taxation, reaches recognition of deferred taxes in equity. We ask ourselves if the model influences the cost components of equity. The answer is yes if there is a difference between the carrying amount and analyzed fair value of property. This difference is recognized in accounting as assets depreciation expense, expense that changes the financial year result. Being a component of equity, we see an influence on equity by applying the cost model in subsequent measurement of property and equipment.

4. SUBSCRIPTION AND ATTRIBUTION RIGHT - SPECIFIC FINANCIAL ITEMS FOR CAPITAL INCREASE

To enhance the attractiveness of their shares the entities attaches equity instruments such as the right of subscription and right of attribution. Subscription rights affect the shares value, earnings per share and voting rights of the share holder. The share capital increase by issuing new shares involves determining the value of the nominal value and the mathematics – accounting value of the existing shares. The mathematical - accounting value is calculated as the ratio between the asset net value and the number of shares composing the capital. There are two reasons why the issue price is placed between the shares nominal value and the mathematics – accounting value. Firstly, the entity that issues shares shall receive at least the amount covering the property rights conferred to buyers. Secondly, the entity must create a motivational framework among buyers by offering a purchase price lower than the shares value.

If new shares will be purchased by third parties, it will create a disadvantage for the old shareholders. Their protection is ensured by holding preferential subscription rights (SR) that are attached to titles. Preferential subscription right is calculated „as the difference between the accounting-mathematical value of a share before and after the issuance of new shares.” (Grigore,

2016) In the specialized literature, it is considered that „the value calculated for a subscription right is a theoretical value, because in principle it is ranked as any title acknowledged on thr financial market quotation that leads us to a stock value." (Feleagă and Ionaşcu, 1998)

Old shareholders may exercise their right of subscription by buying new shares at a favorable price. They can choose to not participate in the issue of new shares and in the separate sale of shares attached to the old shares already owned.

The methodology by which the old shareholders are protected by holding subscription rights is shown in the following example:

It is considered a stock company which has registered a capital of 185 000 000 m.u. (consisting of 10 000 shares with a nominal value of 18 500 m.u. / share). The share is estimated at 19 000 m.u.. The share capital is increased by cash contribution for which are issued 5000 new shares with an issue valeue of 16 000 m.u. / share.

The theoretical value of a subscription right is calculated based on the data from Table no. 4.

Table no. 4. Situation of old and new shares distributed free of charge

Shares	Number of shares	Value per unit	Total value
Old	10 000	19 000	190 000 000
New	5 000	16 000	80 000 000
Total	15 000	18 000	270 000 000

1 SR (subscription rights) = loss in value = 19 000 – 18 000 = 1 000

The 1 000 lei loss is compensated by holding a subscription right for each share. Each shareholder will receive new shares based on the preferential subscription rights number and on the report parity (old number of shares / news number of shares). Parity ratio is 10 000/5000.

Next we analyze the situation of an old shareholder who has 21 old shares. With the increased of the capital the value of these shares is:

21 shares x 18 000 m.u.+ 21 SR x 1 000 m.u.

The old shareholder holds 21 SR which allows him on a parity report basis the subscription of 10 new shares, for which he will pay 10 shares x 16 000 = 160 000 m.u..

The old shareholder remains with a SR because it has an odd number of old shares and the parity ratio is 2/1. He has two options: either to sell this SR or to buy a SR from another shareholder, completing the number of subscription rights necessary for the acquisition of a new share.

If we analyze the situation of a new shareholder, he will have to buy two subscription rights to subscribe a new share. He will pay for a new action 16 000 u.m. + 2 x 1 000 u.m..

Old shareholders that will not subscribe to preferential capital growth can cede the right to subscribe attached to each old action and so compensates for the damage caused by the growth of capital.

The increase of capital by incorporating the reserves has as main motivation the need to strengthen the company's capital in order to create a favorable psychological effect to shareholders whose trust in their own investment increases. This decision implies for the economic entity to issue new shares to be distributed freely to the old shareholders who use their attribution rights (AR) and to new shareholders, if the latter buys attribution rights at the parity required. As the subscription rights, the attribution rights are negotiable values which protect the old shareholders.

To present the methodology for determining the attribution right and to highlight its role we considered the same company as in the previous example. Social capital of 185 000 000 m.u. consists of 10 000 shares with a nominal value of 18 500 m.u. / share. Share is valued at 19 000 m.u.. The company decides to issue 2000 new free shares to incorporate an optional reserve in capital.

The theoretical value of a subscription right is calculated based on the data from Table no. 5.

Table no. 5. Situation of old and new shares distributed free of charge

Shares	Number of shares	Value per unit	Total value
Old	10 000	19 000	190 000 000
New	2 000		
Total	12 000		270 000 000

The mathematical – accounting value after the capital increase is 190 000 000/12 000 = 15 833.33 m.u. / share.

1 AR (attribution right) = loss of value = 19 000 -15 833,33 = 3 166,67 m.u.

If an old shareholder holds 32 old shares, after the capital increase, it will hold: 32 shares x 15 833,33 + 32 AR x 3 166,67

The 32 attribution rights prevent him from obtaining, free of charge, 6 new shares because the attribution parity is a new action for five old shares. The old shareholder recoveres 30 attribution rights. The 2 attribution rights untapped directly may be sold or he may choose to purchase 3 additional attribution rights made available by other shareholders, thereby completing the number of attribution rights required to obtain a new share. For this new action, he will pay 3AR, meaning 3 x 3 166,67 m.u..

A new shareholder may acquire a new share if he buys five attribution rights: 5 x 3 166,67 because the attribution parity is 5/1.

As with preferential subscription rights, the value determined for an attribution right is a theoretical value. Basically, the attribution right is a title quoted on the financial market, being sold or bought at a stock value. In these circumstances, the old shareholders can sell their subscription rights on the financial market. They will make this decision based on a comparison between the stock value attribution right and the benefits (dividends, pluses of value) that would bring ownership of the new shares.

A simultaneous increase of capital is theoretically possible and would require the simultaneous issuance of new shares paid cash and of new shares distributed free of charge as a result of the incorporation of the share capital reserves. We believe that, in practical terms, such a decision is made with difficulty because it is impossible to determine rationally the advantages and disadvantages of the old shareholders.

5. CONCLUSIONS

From an accounting perspective, substantiation of the concept of equity depends on the definition of the concepts asset and liability. The argument for this is that claims on equity refers to the residual interest in the entity's assets after deducting its liabilities. In addition, the conceptual framework acknowledges the existence of the equity instruments that generate primary and secondary claims on equity. The main difference between financial liabilities and equity instruments aim the existence or, on the contrary, the lack of a contractual obligation to deliver cash or another financial asset to an entity.

Deferred taxes recognized in equity arise when performing an accounting revaluation of tangible assets without the right to a correspondence in tax reassessment. The difference between the accounting value of the revaluated asset and its tax base is a taxable temporary difference that will give rise to a deferred tax liability.

In terms of finance, the contribution to the equity is an essential financing amount of the entity. To enhance the attractiveness of shares, the entity attaches to it various options such as subscription rights and attribution rights. By creating subscription rights it is desired to obtain immediate funds needed to finance the entity.

The delimitation of the financial liabilities from equity instruments remains a topic for further research and a subject of discussion between international accounting organizations.

REFERENCES

1. Alexander, D., Britton, A, Jorissen, A., (2003), *International Financial Reporting and Analysis*, Thomson Learning, London
2. Barrow, C., (2008), *Management financiar pentru miniafaceri*, ediţia a 6 –a, Rentrop and Straton, 2008, traducere Scheuşan, I., Bucureşti
3. Bunea, Ş, (2014), *Preocupări la nivel internaţional privind revizuirea conceptelor fundamentale ale contabilităţii şi raportării financiare. Conceptul de capitaluri proprii şi distincţia acestuia de conceptul de datorie*, Revista Contabilitatea, Expertiza şi Auditul Afacerilor nr.6/2014, Editura CECCAR, Bucureşti
4. Dalton, J., (2000), *Piaţa acţiunilor*, Editura Hrema, Bucureşti
5. Feleagă, N., Ionaşcu, I., (1998), *Tratat de contabilitate financiară*, vol. II, Editura Economică, Bucureşti
6. Grigore, C., (2016), *Constituirea şi majorarea capitalului social*, Revista Contabilitatea, Expertiza şi Auditul Afacerilor nr.4/2016, Editura CECCAR, Bucureşti
7. Huian M. C., (2008), *Instrumente financiare: tratamente şi opţiuni contabile*, Editura CECCAR, Bucureşti
8. Jianu, I. (2007), *Evaluarea, prezentarea şi analiza performanţei întrprinderii*, Editura CECCAR, Bucureşti, 2007, p. 276
9. Mateş, D., (2009), *Contabilitatea evenimentelor şi tranzacţiilor între standarde, directive şi reglementări fiscale*, Editura Mirton, Timişoara
10. Popa, A. F., (2006), *Relativ şi distorsiune în determinarea rezultatului contabil*, articol publicat în volumul Congresului al XVI-lea al profesiei contabile din România „Profesia contabilă şi Globalizarea", Editura CECCAR, Bucureşti
11. Verboncu,I., Zalman,M., (2005), *Management şi performanţă*, Ed. Universitară, Bucureşti
12. *Ghid practic de aplicare a Reglementărilor Contabile privind Situaţiile financiare anuale individuale şi Situaţiile financiare consolidate* aprobate prin Ordinul Ministrului Finanţelor Publice nr. 1802/2014 publicat în Monitorul Oficial nr. 963/30.12.2014, Editura CECCAR, Bucureşti, 2015
13. Ordinul Ministrului Finanţelor Publice 4160/2015 privind modificarea şi completarea unor reglementări contabile, publicat în Monitorul Oficial nr. 21/12.01.2016
14. *Standarde Internaţionale de Raportare Financiară – IFRS*, (2015), Fundaţia IFRS, ediţia a 7-a revizuită, Editura CECCAR, Bucureşti