

Owner's Equity

Name

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Instructor Name

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Stockholders' Equity has two sources of capital, which include paid-in capital and earned capital. Paid-in capital must be kept alienated from the earned capital to avoid misinterpretation of each of the source. This in turn will facilitate a clear distinction with the operational capital acquired from profit making operation. Most investors are majorly concerned with the earned capital compared to the paid in capital. The reason behind this preference is the facts that earned capital represent the earning potential of a firm. Another major aspect is the dilution earning, which is more detailed, unlike the basic per share earnings.

Importance of Separating Paid-in-Capital from Earned Capital

Paid-in capital is the capital raised from the sale of capital stock in the stock markets in the form of shares. On the other hand, earned capital is the funds that a company or firm can acquire in the form of profit accrued by the sale of goods and services. Both capitals are very significant to the growth and expansion of the firm's operations. However, investors find it necessary to separate the two source of capital because for several reasons.

Kimmel, Donald, Jerry, and Weygandt (2010, p. 577) observe that one reason for separating the two sources of capital is that both are distinct funding sources and that paid-in capital signifies the funds to be used in the enhancement of earned capital. On the other hand, earned capital symbolises the funds accrued from the profitable operation in the firm. Therefore, combining the two sources would lead to confusion. That is, the paid in capital accelerates and boosts the earned capital. Combining the two source of capital will lead to a misinterpretation and misrepresentation of the earning of the firm. Mixing the two will also cause complexity in calculations with regard to profits margins. The two sources of capital must be separated so that the shareholders and investors information can be clearly distinguished from one another.

The two capitals must be distinguished for easy and guaranteed form of protection to companies offering capital in excess. This also provides a form protection to both creditors and investors in case of liquidation or insolvency. The reason behind it is that the two values of capital depict the strength of the firm financially. Investors must be aware of the manipulation of earning and computations. If the two source of capital are combined, it will be very difficult to convince them on the method to use on the computation of earnings.

Paid-in-Capital or Earned Capital

The majority of investors in most cases are concerned with the firm's earned capital other than the paid-in capital. The reason behind this is that earned capital is a representation of the potential earnings that a firm can generate in its day-to-day operations. Therefore, investors want to venture into a business that yield dividend according to their expectations. On the other hand, paid-in capital is the capital raised from the subscription of the shareholders through the sale of capital shares. This represents the capital invested by the shareholders and does not in any way represent the profitability of the firm. Despite the importance of the two forms of capital, paid-in capital is more significant than earned capital. Paid-in capital represents the amount the investors have raised above the par values of the firm's stock. The par value is very important in calculating the stability of the firms in terms of financial status (Kimmel, Donald, Jerry, & Weygandt, 2010, p. 577).

According to investors' opinions, firms would rather earn money via operations other than selling capital stock. This is because the firm reporting their financial status using earned capital reveals their financial value to the stakeholders. In contrast, the firm that report using its paid-in capital in excess of the already earned capital does not necessarily imply that the firm is experiencing good investment opportunities. Brigham and Houston (2009, p. 197) noted that earned capital also can be well thought-out as single and the most significant variable used