

CHAPTER 13

Corporations: Share Capital and the Balance Sheet

Chapter Overview

This chapter introduces the student to the corporation, the dominant form of business organization in our country. The characteristics of the corporation are listed, and a brief description of how a corporation is organized follows. The term *share capital* is defined. The two components of shareholders' equity—contributed capital and retained earnings—are explained, followed by a discussion of dividends and shareholders' rights.

The next section of the chapter describes the different classes of shares (common and preferred) and their characteristics, followed by a brief description of no-par-value shares and stated value of shares. Included is a discussion of issuing common shares for cash, issuing shares for assets other than cash, and issuing preferred shares and convertible preferred shares. Ethical considerations related to shareholders' equity are presented. After a discussion of organization costs, the shareholders' equity section of a corporation's balance sheet is illustrated.

The chapter continues with accounting for dividends. Dividend dates, journal entries for cash dividends, and dividends on cumulative and noncumulative preferred shares are discussed. Convertible preferred shares are explained. The different values of shares—market value and book value of preferred and common shares—are defined and illustrated. Two profitability measures are presented: rate of return on total assets and rate of return on shareholders' equity. The chapter concludes with a discussion of the impact of IFRS on share capital.

Try It! questions appear at the end of each Learning Objective for students to test their understanding of the Learning Objective just completed. The answers appear at the end of the chapter and on MyLab Accounting.

Students should be directed to **MyLab** for extra practice. Also included on MyLab are Excel templates for Exercise 13-8, Problem 13-4A, Problem 13-6A, Problem 13-4B, and Problem 13-6B.

The **Assignment Grid** recommends “Pre-Test” problems in MyLab that can be assigned before a test or exam to ensure students understand the topics, as well as “Post-Test” problems that students can complete after a test or exam to check understanding before moving on.

Connecting Learning Objectives and Key Questions

	Learning Objective	Key Question
1	Identify the characteristics of a corporation	What is a corporation, and why is it an important form of business?
2	Record the issuance of shares, and prepare the shareholders' equity section of a corporation's balance sheet	How do we record and present share information?
3	Account for cash dividends	What are cash dividends, and how do we account for them?
4	Use different share values in decision making	What is the difference between book value and market value of shares?
5	Evaluate a company's ROA and ROE	What are the rate of return on total assets (ROA) and the rate of return on common shareholder's equity (ROE), and how do we calculate them?
6	Identify the impact of IFRS on share capital	How does IFRS apply to share capital?

Suggested Priority of Chapter Topics

Must cover

- Corporations
- Shareholders' equity
- Issuing shares
- Accounting for cash dividends
- Different values of shares
- Evaluating operations

Recommended

- Organization costs
- The impact of IFRS on share capital

Chapter Outline

Learning Objective 1: Identify the characteristics of a corporation

(What is a corporation, and why is it an important form of business?)

- A. The corporation is the dominant form of business organization in Canada.
- B. The **characteristics** of a corporation are listed below:
 - 1. **Separate legal entity**—a corporation is an entity formed under federal or provincial law and exists separately from its owners (shareholders).
 - 2. **Continuous life and transferability of ownership**—shareholders may transfer shares as they wish. Transfers do not affect the continuity of the corporation.
 - 3. **No mutual agency**—shareholders are not agents of the corporation and cannot commit the corporation to a contract. Partners *are* considered agents of the partnership.
 - 4. **Limited liability of shareholders**—shareholders can lose no more than their investment in the business. A partner has unlimited liability in a partnership.
 - 5. **Separation of ownership and management**—a shareholder's only control of the operations of a corporation is the right to elect the board of directors. The corporation is managed by corporate officers elected by the board of directors.
 - 6. **Corporate taxation**—corporations are separate taxable entities and pay several taxes not levied on partnerships and proprietorships. Corporate earnings are subject to a degree of **double taxation** in that corporate earnings are taxed to the corporation as well as to the shareholder when earnings are distributed as dividends. However, Canadian tax laws have attempted to minimize this double taxation.
 - 7. **Government regulation**—corporations are subject to more regulation by governmental agencies that ensure full disclosure to investors and creditors.
 - 8. **Unique costs for corporations**—the cost for director's insurance is unique to corporations.

Exhibit 13-1 summarizes the advantages and disadvantages of the corporate form of organization.

- C. To **organize** a corporation, the incorporators obtain **articles of incorporation** from the federal or provincial government.
 - 1. The **articles of incorporation** include the number of shares the corporation is authorized to issue.
 - 2. **Bylaws** (adopted by the incorporators) govern the acts of the corporation.
 - 3. The shareholders elect the **board of directors**, which sets policy and appoints the officers. The directors elect a **chairperson** and appoint the **president**, who is responsible for day-to-day operations. (Exhibit 13-2 shows the authority structure in a corporation.)

Teaching Tip

Consider large corporations located near your school. Discuss possible corporate structures for one of these entities. If time permits, assign an exercise whereby students prepare a corporate structure, including names of top executives of an actual corporation.

- D. A company **issues** share certificates (Exhibit 13-3) to owners for their investments. This investment is referred to as **share capital**. These shares are issued from the shares authorized in the articles of incorporation.
- E. The **shareholders' equity** of a corporation shows the two different sources of capital.
 - 1. **Contributed capital** represents all amounts paid in by owners (shareholders).
 - 2. **Retained earnings** is the capital provided by profits from operations and is not distributed to shareholders. Retained earnings are not a fund of cash.
 - a. A debit balance in retained earnings is called a **deficit**.
 - b. Distribution of profits to owners is called **dividends**. **Contributed capital** is the portion of shareholders' equity that cannot be used for dividends. Exhibit 13-4 focuses on the Shareholders' Equity section of a summarized balance sheet of Canadian Tire Corporation, Limited.
- F. **Shareholders' rights** are:
 - 1. To **sell** the shares.
 - 2. To **vote** at shareholders' meetings.
 - 3. To receive a **proportionate share of dividends** (if declared).
 - 4. To receive a **proportionate share of assets** of the corporation if it is wound up.
 - 5. To maintain a **proportionate ownership** in any new shares issued; this is called a **preemptive right**. However, this right is rarely exercised and usually withheld from shareholders.

Learning Objective 2: Record the issuance of shares and prepare the shareholders' equity section of a corporation's balance sheet

(How do we record and present share information?)

- A. Corporations may issue either preferred or common shares.
 - 1. **Common shares** are the most basic form of contributed capital. They carry all the rights discussed above unless specifically withheld. Some corporations may issue two classes of common shares—one voting and one nonvoting.

2. **Preferred shares** also carry shareholder rights, but are usually nonvoting. Preferred shareholders have priority over common shareholders in the payment of dividends and in the distribution of assets if the company is wound up. Different classes of preferred shares may also be issued.
 3. The *Canada Business Corporations Act* and most provincial incorporating acts require common and preferred shares to be **no-par-value** shares, which means they do not have a value assigned to them by the articles of incorporation. (Par-value shares were once allowed by some provinces, and are still common in the U.S.)
- B. A corporation **issues** shares when it needs capital. The shares issued are from the shares **authorized** in the articles of incorporation. A company need not issue all the shares authorized.
1. The corporation may sell the shares to an **underwriter** who agrees to sell the shares to its clients.
 2. The issuance of shares increases assets and shareholders' equity.
 3. Shares may be issued for cash or in exchange for assets other than cash. Exhibit 13-5 is a reproduction of a share issue announcement by DIRT Environmental Solutions Ltd.

Teaching Tip

Go to <http://business.financialpost.com/markets>, Google Finance, or Yahoo Finance. Select a company and show students how to find stock quotes online. You may wish to ask the students to bring a copy of the financial information section of a newspaper to class and have them look at a well-known company's shares.

4. When issuing common shares **for cash**, the Common Shares account is credited for the cash received.

Cash	XX	
Common Shares		XX

5. When issuing shares **for assets** other than cash, the asset should be recorded **at its current market value**. The common shares are then valued at this market value.

Asset	XX	
Common Shares		XX

6. Accounting for the issuance of **preferred shares for cash** is similar to accounting for common shares issued for cash.

Cash	XX	
Preferred Shares		XX

7. **Convertible preferred shares** are convertible at the option of shareholders for other classes of shares such as common shares. When convertible preferred shares are converted to common shares, the entry is:

Preferred Shares	XX	
Common Shares		XX

C. The **shareholders' equity' section** of the balance sheet follows this format (Exhibit 13-7):

Contributed capital:

Preferred shares, \$X, A shares authorized, B shares issued	\$XXX
Common shares, C shares authorized, D shares issued	XXX
Total contributed capital	XXX
Retained earnings	XXX
Total shareholders' equity	XXX

(Many companies combine several accounts.)

Teaching Tip

Point out the importance of the order and proper description of the accounts and amounts reported within the contributed capital section of the balance sheet. Refer students to Exhibit 13-7.

- D. Issuing shares for assets other than cash can pose an **ethical challenge** because the company may be tempted to **overstate** the asset value.
- E. **Organization costs**, such as legal fees for preparing documents, fees and taxes paid to the incorporation jurisdiction, and charges for selling company shares, are often incurred when a company incorporates. These costs are accumulated in an account, **Organization Costs**, and this account is treated as an intangible asset like patents or trademarks because it will benefit the organization for as long as it operates. Like other intangible assets, corporations can amortize this cost. Most corporations amortize the cost over a relatively short time period since it is often an immaterial cost. The Canada Revenue Agency allows corporations to expense a portion of organization costs against taxable income.

Learning Objective 3: Account for cash dividends

(What are cash dividends, and how do we account for them?)

- A. Corporations **declare dividends** from retained earnings and pay the dividends with cash.
- B. The relevant **dates for dividends**:
1. **Declaration date**—the date the board of directors announces its intention to pay the dividend and the dividend becomes a liability.

Retained Earnings	XX
Dividends Payable	XX

2. **Date of record**—the date, also announced by the board of directors, that determines who receives the dividend. No journal entry needed.
3. **Payment date**—the date the dividend is paid.

Dividends Payable	XX
Cash	XX

Exhibit 13-8 illustrates a “Notice of Dividends” for Good Company Inc.

- C. Preferred shareholders have a **dividend preference**; that is, the preferred shareholders receive their dividend *before* the common shareholders. This dividend is usually stated as a specific dollar amount.
- D. **Cumulative preferred shares** accumulate dividends each year until the dividends are paid.
 - 1. Dividends passed or not paid are called **dividends in arrears**. Dividends in arrears are not a liability.
 - 2. The corporation is not obligated to pay dividends on **noncumulative preferred shares**.

Teaching Tip

Review the journal entries associated with the date of declaration and the date of payment. Discuss the rules for allocating dividends to preferred and common shareholders for both cumulative and noncumulative preferred shares.

Exhibit 13-9 demonstrates how Guthrie Industries Inc. divided dividends between its preferred and common shareholders.

Learning Objective 4: Use different shares values in decision making
(What is the difference between book value and market value of shares?)

- A. The **market value (market price)** of shares is their current selling price.
- B. **Book value** is a measure of the amount of net assets or shareholders’ equity per share.

If a company has no preferred shares, then it uses formula 2 below to calculate book value. If a company has both preferred and common shares, the preferred shareholders’ equity must be calculated before the common shareholders’ equity can be calculated. Preferred shareholders’ equity (or equity allocated to preferred shareholders) is the top line in formula 1 below.

- 1. **Book value per preferred share** =
$$\frac{\text{Liquidation value} + \text{Dividends in arrears}}{\text{Number of preferred shares outstanding}}$$
- 2. **Book value per common share** =
$$\frac{\text{Total shareholders' equity} - \text{Equity allocated to preferred shareholders}}{\text{Number of common shares outstanding}}$$
- 3. Book value may be used to negotiate the purchase of a closely held business or when buying out a shareholder.
- 4. Exhibit 13-10 contrasts the book values and market values of three companies.

Teaching Tip

Discuss the different values that can be associated with shares. Emphasize that book value per share is not the same as market value.

Learning Objective 5: Evaluate a company's ROA and ROE

(What are the rate of return on total assets (ROA) and the rate of return on common shareholder's equity (ROE), and how do we calculate them??)

A. Investors and creditors evaluate management's ability to earn profits. Two key ratios are provided below:

$$1. \quad \text{Return on assets} = \frac{\text{Net income} + \text{Interest expense}}{\text{Average total assets}}$$

- a. This ratio measures how well a company uses its assets to earn income.
- b. Average total assets are computed by adding beginning and ending assets and dividing by 2.

$$2. \quad \text{Return on equity} = \frac{\text{Net income} - \text{Preferred dividends}}{\text{Average common shareholders' equity}}$$

- a. This ratio shows the relationship between net income and common shareholders' equity.
- b. Average common shareholders' equity is computed by adding beginning and ending common shareholders' equity (shareholders' equity minus preferred equity) and dividing by 2.

B. The higher the rates of return, the more successful the company. Return on equity should exceed the return on assets.

Teaching Tip

Have students choose a company with financial statements available on the Internet. Use the above formulas to calculate each of the returns. If more than one year of data are available, have students calculate returns for each year, and discuss whether the results indicate an improvement or decline in the return.

Objective 6: Identify the impact of IFRS on share capital
(How does IFRS apply to share capital?)

- A. The *principles* governing accounting for share capital are essentially the same under accounting standards for private enterprises (ASPE) and IFRS. See exhibit 13-11 for some minor differences.

Assignment Grid (2nd column: * = Excel Template available; W = writing required)

Assignment		Topic(s)	Learning Objective (s)	Time in Minutes	Level of Difficulty	MyLab Pre-Test/ Post-Test
Starter 13-1	W	Authority structure in a corporation	1	5	Easy	
Starter 13-2	W	The balance sheets of a corporation and a proprietorship	1	5	Easy	
Starter 13-3		Issuing shares	2	5	Easy	
Starter 13-4	W	Issuing shares and analyzing retained earnings	2	5-10	Easy	
Starter 13-5		Contributed capital for a corporation	2	5-10	Easy	
Starter 13-6		Preparing the shareholders' equity section of a balance sheet	2	5	Medium	
Starter 13-7		Raising Capital	2	5	Medium	
Starter 13-8		Accounting for cash dividends	3	10	Medium	
Starter 13-9		Dividing cash dividends between preferred and common shares	3	5-10	Medium	
Starter 13-10		Book value per common share	4	5	Medium	
Starter 13-11		Calculating book value	4	5-10	Medium	
Starter 13-12		Computing return on assets	5	5	Medium	
Starter 13-13		Computing return on equity	5	5	Medium	
E13-1	W	Characteristics of a corporation	1	5-10	Easy	
E13-2	W	Organizing a corporation	1	5-10	Easy	
E13-3		Closing entries for a corporation	1	5-10	Easy	
E13-4	W	Types of shares	2	5-10	Easy	
E13-5		Issuing shares	2	10-15	Easy	
E13-6		Issuing shares to finance the purchase of assets	2	10	Easy	
E13-7		Calculating shareholders' equity data	3	5-10	Medium	
E13-8		Shareholders' equity section of a balance sheet	2	10-15	Medium	
E13-9		Issuing shares and preparing the shareholders' equity section of the balance sheet	2	15-20	Easy	
E13-10		Balance sheet presentation	2	10-15	Medium	
E13-11		Accounting for cash dividends	3	10-15	Easy	
E13-12		Dividing cash dividends between preferred and common shares	3	10-15	Easy	

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective (s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>	<i>MyLab Pre-Test/ Post-Test</i>
E13-13		Computing dividends on preferred and common shares	3	15-20	Medium	
E13-14		Book value per share of preferred and common shares	4	10-15	Easy	
E13-15		Book value per share of preferred and common shares; preferred dividends in arrears	3, 4	10-15	Medium	
E13-16		Evaluating profitability	5	10-15	Easy	
E13-17		Calculating ROA and ROE	5	10-15	Medium	Pre-Test
E13-18		Record the issuance of shares and preparation of shareholders' equity, account for cash dividends	2, 3	20-25	Medium	
E13-19		Accounting for shareholders' equity transactions	2, 3	15-20	Medium	
BN13-1	W	Characteristics of corporations' shareholders' equity	2, 4	15-20	Medium	
EI13-1	W	Ethical Issue	All	n/a		
P13-1A	W	Organizing a corporation	1	10-20	Easy	
P13-2A		Journalizing corporation transactions and preparing the shareholders' equity section of the balance sheet	2	30-45	Medium	Pre-Test
P13-3A		Issuing shares and preparing the shareholders' equity section of the balance sheet	2	15-20	Medium	Pre-Test
P13-4A	*	Shareholders' equity section of the balance sheet	2, 3	20-30	Medium	
P13-5A		Analyzing the shareholders' equity of a corporation	2, 3	20-35	Medium	
P13-6A	*	Computing dividends on preferred and common shares	3	20-30	Medium	
P13-7A		Analyzing the shareholders' equity of a corporation	3, 4	15-20	Medium	
P13-8A		Recording the issuance of shares; allocating cash dividends; calculating book value; preparing the liability and shareholders' equity sections of the balance sheet	2, 3, 4	40-50	Difficult	Pre-Test
P13-9A		Preparing a corporation balance sheet; measuring profitability	2, 5	40-50	Medium	
P13-1B	W	Organizing a corporation	1	10-20	Easy	
P13-2B		Journalizing corporation transactions and preparing the shareholders' equity section of the balance sheet	2	30-45	Medium	Post-Test
P13-3B		Issuing shares and preparing the shareholders' equity section of the balance sheet	2	15-20	Medium	Post-Test
P13-4B	*	Shareholders' equity section of the	2, 3	20-30	Medium	

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective (s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>	<i>MyLab Pre-Test/ Post-Test</i>
		balance sheet				
P13-5B		Analyzing the shareholders' equity of a corporation	2, 3	20-35	Medium	
P13-6B	*	Computing dividends on preferred and common shares	3	20-30	Medium	
P13-7B		Analyzing the shareholders' equity of a corporation	3, 4	15-20	Medium	
P13-8B		Recording the issuance of shares; allocating cash dividends; calculating book value; preparing the shareholders' equity section of the balance sheet	2, 3, 4	40-50	Medium	Post-Test
P13-9B		Preparing a corporation balance sheet; measuring profitability	2, 5	40-50	Medium	
P13-1C	W	The pros and cons of incorporation	1	15-25	Medium	
P13-2C	W	Deciding on an investment in shares; evaluating different types of shares	4, 5	20-30	Difficult	
DP13-1		Evaluating alternative ways of raising capital	2	30-45	Medium	
FSC13-1	W	Shareholders' equity	2	20-30	Medium	
FSC13-2	W	Shareholders' equity	2	15-20	Medium	

CHAPTER 13
TEN-MINUTE QUIZ

Circle the letter of the best response.

The shareholders' equity of Allen Corporation appears below:

Table 13-1	
Contributed capital:	
Preferred shares, \$6, 5,000 shares authorized, 500 shares issued	\$ 55,000
Common shares, 200,000 shares authorized, 30,000 shares issued	<u>900,000</u>
Total contributed capital	955,000
Retained earnings	<u>256,000</u>
Total shareholders' equity	<u>\$1,211,000</u>

- Refer to Table 13-1. The entry to record the issuance of 1,000 common shares for \$35 per share would be:

A.	Cash		1,000	
		Common Shares		1,000

B.	Cash		35,000	
		Common Shares		35,000

C.	Cash		40,000	
		Common Shares		40,000

D.	Cash		40,000	
		Preferred Shares		40,000
- Refer to Table 13-1. Allen Corporation issued 2,000 common shares in exchange for land valued at \$80,000. Which of the following statements is *false*?
 - Assets increase \$80,000.
 - Retained Earnings is not affected.
 - Shareholders' equity increases \$80,000.
 - Total contributed capital decreases \$80,000.
- Refer to Table 13-1. The average issue price of a preferred share is:
 - \$550
 - \$500
 - \$110
 - \$100
- Which of the following statements about dividends is *false*?
 - Dividends become a liability on the declaration date.
 - The payment of dividends reduces retained earnings.
 - Chronologically, the relevant dates for dividends occur in this order: date of record, declaration date, and payment date.
 - Dividends in arrears must be paid before other dividends.

5. Which of the following statements is *not* descriptive of common shares?
 - A. Dividends are listed as an expense on the income statement.
 - B. Issuing shares is less risky than borrowing.
 - C. Shareholders are considered owners, not creditors, of a corporation.
 - D. The payment of dividends is not mandatory.
6. Which of the following is *not* a characteristic of a corporation?
 - A. Transferability of ownership
 - B. Separate legal entity
 - C. No mutual agency
 - D. Unlimited liability of shareholders

The shareholders' equity of Borland Ltd. appears below.

Table 13-2		
	<u>20120</u>	<u>2017</u>
Contributed capital		
Preferred shares, \$6, 5,000 shares issued and outstanding	\$ 500,000	\$ 500,000
Common shares, 10,000 shares issued and outstanding	<u>500,000</u>	<u>400,000</u>
Total contributed capital	1,000,000	900,000
Retained earnings	<u>200,000</u>	<u>100,000</u>
Total shareholders' equity	<u><u>\$1,200,000</u></u>	<u><u>\$1,000,000</u></u>
Note: The preferred shares are non-cumulative, and no dividend was declared during 2020.		

7. Refer to Table 13-2. The book value of each common share in 2020 is:
 - A. \$100
 - B. \$70
 - C. \$69
 - D. \$50
8. Refer to Table 13-2. What is the rate of return on common shareholders' equity for 2020?
 - A. 11.67%
 - B. 11.86%
 - C. 16.67%
 - D. 6.36%
9. Refer to Table 13-2. Assume in 2020, Borland Ltd. declared and paid total cash dividends of \$40,000. How much dividends did common shareholders receive?
 - A. \$10,000
 - B. \$30,000
 - C. \$40,000
 - D. Cannot be determined based on the information provided.
10. Holders of preferred shares do not normally have
 - A. Preference as to dividends.
 - B. Full voting rights.
 - C. Preference as to assets on liquidation.
 - D. Ownership interest in the corporation.

Answer Key to Chapter 13 Quiz

1. B 2. D 3. C 4. C 5. A 6. D 7. B 8. A 9. A 10. B