

Testbank

to accompany

Applying International Financial Reporting Standards 2e

By

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CHAPTER 2

Shareholders' equity: share capital and reserves

True/False

1. Currently the IFRS do not contain specific guidelines for non-profit organisations and non-governmental organisations concerning the accounting treatment and presentation of their financial statements.

The statement is True.

There is no definition of the term 'not-for-profit' in any International Financial Reporting Standards.

Section 2.2 'Types of companies'

2. Ordinary shares in a company carry a pre-emptive right.

The statement is True.

This means that shareholders have the right to participate in any new issues of shares at the same class.

Section 2.3 'Key features of the corporate structure'

3. Prior to the allotment of shares, the balance in the application account represents a liability of the company to the applicants.

The statement is True.

If the shares are not issued, the money must be returned to the shareholders.

Section 2.4 "Contributed equity: Issue of share capital"

4. Underwriting commission fees paid to underwriters are treated as expenses as they are not considered to be an integral part of the equity issue transaction.

The statement is False.

IFRS 3, paragraph 31 provides that such costs are to be accounted for as a reduction in the share capital being raised.

Section 2.4 "Contributed equity: Issue of share capital"

5. If a company forfeits shares and the company's constitution is silent in relation to reissue, the company is entitled to keep any balance in the account after reissue, payment of unpaid calls and interest and administrative costs.

The statement is True.

Such amounts are typically retained in a reserve account.

Section 2.4 "Contributed equity: Issue of share capital"

6. If a company makes a renounceable rights issue, the shareholders are not allowed to sell their rights, but must either accept or reject the offer to acquire additional shares in the company.

The statement is False.

The scenario described is that of a non-renounceable issue. Under the terms of a renounceable rights issue, shareholders may sell their rights to other investors to acquire the company's shares.

Section 2.5 "Contributed Equity: Subsequent movements in share capital"

7. Share options issued at no cost to the recipient are accounted for in the same way as rights issues.

The statement is True.

The accounting rules differ for share options depending on whether they are issued for consideration or no consideration.

Section 2.5 "Contributed Equity: Subsequent movements in share capital"

8. If a company uses its surplus cash reserves to buy-back its own shares the total equity of the company will increase by the equivalent amount of cash spent.

The statement is False.

If a company buys-back its own shares effectively the shares capital of the company is reduced.

Section 2.6 "Contributed Equity: Subsequent decreases in share capital"

9. A liability is recognised for dividends declared after the reporting date but prior to the issue of the financial statements.

The statement is False.

Such amounts are not recognised as a liability, but are disclosed in the notes to the financial statements in accordance with IAS 1.

Section 2.7 'Reserves'

10. Transactions with owners in their capacity as owners are required to be shown in the Statement of Changes in Equity.

The statement is True.

This is a requirement under paragraph 106(d)(iii) of IAS 1.

Section 2.8 'Disclosure'

Multiple Choice

1. For-profit companies may be

- I Unlimited
 - II Listed
 - III Limited by guarantee
 - IV No-liability
-
- A II and III only
 - B I, II and III only
 - C II, III and IV only
 - D I, II, III and IV

ANS: D

Section 2.2 'Types of companies'

2. Which of the following statements is incorrect?

- A Each share in a company carries a right to share in the assets on the liquidation of the company
- B Each share in a company carries a right to share proportionately in all new share issues of a company
- C A share represents an ownership right in a company
- D Each share in a company carries a right to vote for directors of the company

ANS: B

Section 2.3 'Key features of the corporate structure'

3. In respect to the issue of shares by a company, what is an IPO?

- A Investment in Preference and Ordinary shares;
- B Initial Public Offering of shares;
- C Investment Prospectus for an issue of Options;
- D Instruments Providing Options to ordinary shareholders.

ANS: B

Section 2.4 "Contributed equity: Issue of share capital"

4. When a public share issue is made, the offer comes from:
- A the company issuing the shares;
 - B the relevant oversight body once it has reviewed the prospectus documentation;
 - C the broker handing the share issue for the company;
 - D the applicant.

ANS: D

Section 2.4 "Contributed equity: Issue of share capital"

5. ABC Ltd was registered as a corporation on 1 July 20X9. On 4 July 20X9, ABC Ltd issued a prospectus offering 100 000 ordinary shares at an issue price of \$2.50 each, payable \$1.50 on application and \$1.00 on allotment.

Application closed on 1 August 20X9 with the company having received applications for 110,000 shares. The shares were allotted on 15 August 20X9, with the over-subscription amount being refunded to unsuccessful applicants. All allotment monies were received by 31 August 20X9. Following the allotment the balance in the Share Capital account would be:

- A \$100 000 Credit;
- B \$250 000 Credit;
- C \$100 000 Debit;
- D \$250 000 Debit.

ANS: B

Section 2.4 "Contributed equity: Issue of share capital"

Use the following information to answer questions 6 to 8.

A company's capital consists of 50 000 ordinary shares issued at \$2 and paid to \$1 per share. On 1 September, a first call of 50c was made on the ordinary shares. By 30 September, the call money received amounted to \$22 500. No further payments were received, and on 31 October, the shares on which calls were outstanding were forfeited. On 15 November, the forfeited shares were reissued as paid to \$1.50 for a payment of \$1.00 per share. The appropriate cash amount from the reissue was received on 19 November. Costs of reissue amounted to \$2 000. The company's constitution provided for any surplus on resale, after satisfaction of unpaid calls, accrued interest and costs, to be returned to the shareholders whose shares were forfeited.

6. The entry to record the forfeiture of shares is:

A	Share capital	Dr	7 500	
	First Call – Ordinary shares	Cr		2 500
	Forfeited shares	Cr		5 000
B	Share capital	Dr	7 500	
	First call – Ordinary shares	Cr		5 000
	Forfeited shares	Cr		2 500
C	Share capital	Dr	5 000	
	Forfeited shares	Cr		5 000
D	Forfeited shares	Dr	2 500	
	Share capital	Cr		2 500

ANS: A

Section 2.4 “Contributed equity: Issue of share capital”

7. The entry to record the reissue of forfeited shares is:

A	Cash	Dr	5 000	
	Forfeited shares	Dr	2 500	
	Share capital – Ordinary	Cr		7 500
B	Cash	Dr	2 500	
	Forfeited shares	Dr	2 500	
	Share capital – Ordinary	Cr		5 000
C	Cash	Dr	5 000	
	Share capital – Ordinary	Cr		5 000
D	Share capital	Dr	7 500	
	Forfeited shares	Cr		7 500

ANS: A

Section 2.4 “Contributed equity: Issue of share capital”

8. The amount of the surplus payable to the shareholders whose shares were forfeited is:

- A \$5 000;
- B \$500;
- C \$2 500;
- D \$3 000.

ANS: B

Section 2.4 “Contributed equity: Issue of share capital”

9. If the balance in a forfeited shares account is refundable to the owners of those shares, then the forfeited shares account is classified as a component of:

- A income;
- B liabilities;
- C equity;
- D expense.

ANS: B

Section 2.4 “Contributed equity: Issue of share capital”

10. The appropriate account to record any excess proceeds received and retained (not refunded) by a company from an oversubscription to a share offer application, is the:
- A Share issue costs account;
 - B Forfeited Shares account;
 - C Share capital account;
 - D Calls in advance account.

ANS: D

Section 2.4 “Contributed equity: Issue of share capital”

11. Which of the following journal entries demonstrates the appropriate accounting treatment for share issue costs?
- A Dr Deferred asset: Cr Cash;
 - B Dr Cash: Cr Deferred asset;
 - C Dr Share capital: Cr: Cash;
 - D Dr Cash: Cr Share capital.

ANS: C

Section 2.4 “Contributed equity: Issue of share capital”

12. Without the prior approval of shareholders a company is restricted to private placements of shares, in any one year, of no more than:
- A 5% of existing capital;
 - B 10% of existing capital;
 - C 15% of existing capital;
 - D 20% of existing capital.

ANS: C

Section 2.5 “Contributed equity: Subsequent movements in share capital”

13. The bonus issue of shares has the following impact on the equity of a company;
- A total equity increases;
 - B total equity decreases;
 - C one equity account increases and another equity account decreases by an equal amount;
 - D only the amount of issued share capital changes.

ANS: C

Section 2.5 “Contributed equity: Subsequent movements in share capital”

14. A company issued share option is an instrument that gives the holder the right but not the obligation to:
- A buy a certain number of shares in the company by a specified date at a stated price;
 - B sell a certain number of shares in the company by a specified date at a stated price;
 - C receive a certain dividend declared by the company by a specified date;
 - D receive a bonus issue of shares in a proportion as notified by the company.

ANS: A

Section 2.5 "Contributed equity: Subsequent movements in share capital"

15. Valdez Limited issued 10 000 share options to subscribe for ordinary shares. The exercise price on the options was \$3 per share. If all options were exercised on due date the following journal entry would be recorded:

A	Share capital - Ordinary	Dr	30 000	
	Cash	Cr		30 000
B	Share options – Ordinary	Dr	30 000	
	Share capital - Ordinary	Cr		30 000
C	Share options reserve	Dr	30 000	
	Cash	Cr		30 000
D	Cash	Dr	30 000	
	Share capital - Ordinary	Cr		30 000

ANS: D

Section 2.5 "Contributed equity: Subsequent movements in share capital"

16. Which of the following is not a reason that companies may undertake a share buy-back?
- A as a defence against a hostile takeover
 - B to manage the capital structure
 - C to increase the worth per share of the remaining shares
 - D as a way to efficiently manage surplus funds

ANS: A

Section 2.6 "Contributed equity: Subsequent decreases in share capital"

17. In relation to an asset revaluation surplus, an entity
- A is not able to use this surplus for the payment of future dividends
 - B is able to use this surplus for the payment of future dividends
 - C is not able to transfer this surplus to any other reserve account
 - D can transfer the surplus to current period profit or loss when the asset is disposed of

ANS: B

Section 2.7 'Reserves'

18. The balance in the retained earning account is affected by the transfer to that account of:

- I Issued share capital
 - II Dividends paid or provided for
 - III Transfers to or from other reserve accounts
 - IV Changes in accounting policies and errors
- A II and III only
 - B I, II and III only
 - C II, III and IV only
 - D I, II, III and IV

ANS: C

Section 2.7 'Reserves'

19. Dividends declared after the balance date but before the financial statements are authorised for issue:
- A meet the criteria for recognition as a liability
 - B satisfy the criteria for recognition as an expense
 - C are recognised in the Statement of Financial Position as they meet the definition of equity
 - D do not meet the IAS 37 criteria of a present obligation.

ANS: D

Section 2.7 'Reserves'

20. IAS 1 *Presentation of Financial Statements* requires the following items to appear on the face of the Statement of Changes in Equity
- I The net amount of cash from the issue of any securities during the period
 - II The cumulative effect of changes in accounting policy and the correction of errors
 - III Each item of income or expenses that are required to be recognised directly in equity
 - IV Profit or loss for the period.
- A I, II, III and IV
 - B II, III and IV only
 - C I, III and IV only
 - D II and IV only

ANS: B

Section 2.8 'Disclosure'

OTHER ASSESSMENT QUESTIONS

1. *Easy*

Identify 5 common differences between ordinary and preference shares.

Some of the common areas in which there are differences between ordinary and preference shares are as follows:

- > voting rights
- > right to participate in surplus assets and profits
- > right to receive cumulative or non-cumulative dividends
- > right to receive payment of capital or dividends before other shares
- > right to be redeemed at a certain time at the company's or the shareholder's option.

2. *Medium*

Summarise the steps involved in the issue of securities to the public.

When a company decides to issue securities to the public in order to raise funds it must proceed as follows.

- (1) It must prepare a disclosure document, referred to as a prospectus, that contains all the information as required under the relevant legislation, and must obtain the consent of the directors to the document.
- (2) It must then lodge the document with the relevant oversight body.
- (3) The securities are then offered to the public.
- (4) If necessary the prospectus must be amended.
- (5) The company must hold all application money in trust until the securities are issued or the money refunded.
- (6) Finally the company issues the securities if a minimum subscription has been achieved.

3. *Medium*

Outline 3 advantages to a company of a private placement. Also discuss a key disadvantage.

Three main advantages, as outlined by Bruce et al. (1991, pp 131-2) are:

1. Speed – placements can be effected in a matter of days
2. Price – New shares can be priced close to the market price
3. Direction – shares may be placed with friendly institutions.

The key disadvantage of a private placement is from the perspective of existing shareholders, in terms of a dilution of their ownership.

4. *Hard*

Explain why a company may hold excess money from an applicant for securities.

An investor may have applied for more shares than were allotted to that investor. In such case the company will be holding an excess of money received from the applicant. Also, an applicant for partly paid shares may pay the future calls in advance in the hope that the application will receive favourable treatment in the allotment process.

5. *Hard*

Discuss the effect that a bonus issue of shares may have on the share price of a company.

A bonus issue of shares is funded through a transfer from one equity account to another equity account and so does not increase or decrease total equity. However, the total number of shares on issue increases. Empirical research shows that share prices tend to increase as a result of a bonus issue. Explanations offered for this effect include that: it serves as an indicator of potential increases in dividends; the increase in shares on issue acts as a defence against a hostile takeover bid; it provides a tradeable non-cash return to shareholders.

6. *Easy*

Identify the key features of the company form of business organisational structure.

The key features of the company form of organisational structure include: limited liability of shareholders for the obligations of the company; increasing government regulation; and increasing disclosure of information and professional scrutiny of that information.

7. *Medium*

Explain what is meant by describing a country's financial systems as 'equity' based.

A financial system that is described as 'equity' based is characterised by a large number of companies that rely on a large number of private share investors for financing.

8. *Hard*

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