

CHAPTER 15

SHAREHOLDERS' EQUITY

CHAPTER TOPICS CROSS REFERENCED WITH *CICA HANDBOOK*, PART I (IFRS) AND PART II (ASPE)

Share Capital	IAS 1	Section 3240
Share Capital: Treasury Shares (Acquisition of Shares)	IAS 1	Section 3240
Share Capital: Redemption or Cancellation of Shares	IAS 1	Section 3240
Capital Transactions	n/a	Section 3610
Equity	IAS 1	Section 3251
Financial Instruments—disclosure	IFRS 7	Section 3856
Financial Instruments—presentation	IFRS 9	Section 3856
Financial Reorganization	n/a	Section 1625

LEARNING OBJECTIVES

1. Discuss the characteristics of the corporate form of organization, rights of shareholders, and different types of shares.
2. Explain how to account for the issuance, reacquisition, and retirement of shares, stock splits, and dividend distribution.
3. Understand the components of shareholders' equity and how they are presented.
4. Understand capital disclosure requirements.
5. Calculate and interpret key ratios relating to equity.
6. Identify the major differences in accounting between IFRS and ASPE, and what changes are expected in the near future.
7. Explain how to account for par value and treasury shares. (Appendix 15A).
8. Explain how to account for a financial reorganization. (Appendix 15B)

CHAPTER REVIEW

1. Chapter 15 focuses on the shareholders' equity section of the corporate form of business organization. Shareholders' equity represents the amount that was contributed by the shareholders and the portion that was earned and retained by the enterprise. There is a definite distinction between liabilities and equity that must be understood if one is to effectively grasp the accounting treatment for equity issues. This chapter addresses the accounting issues related primarily to capital contributed by owners of a business organization.
2. Given that the CBCA and most provincial incorporation acts allow only for shares without par value, the chapter concentrates on the accounting for such shares. Appendix 15A is provided to cover the basic aspects of accounting for par value shares that are permitted in some Canadian jurisdictions, the U.S., and many other countries.

The Nature of Shareholders' Equity

1. In a corporate form of business organization the shareholders are said to possess a residual interest in the business. This means that the shareholders (owners) bear the ultimate risks and rewards of ownership. If a business is profitable, the owners benefit through increased share prices and perhaps the receipt of dividends. If a business is not profitable, it is the owners who stand to lose their investment in the business. The shareholders' interest in a business enterprise is measured by the difference between assets and liabilities and is recorded in the **shareholders' equity section** of the statement of financial position. Shareholders' equity is not a claim to specific assets but a claim against a portion of the total assets.
2. The two primary sources from which shareholders' equity is derived are (a) contributions by shareholders (paid-in capital) and (b) income (earnings) retained by the corporation. When accountants refer to a corporation's capital, they mean **contributed capital** and **earned capital**, which make up the shareholders' equity section of the statement of financial position. Contributed capital is the amount advanced by shareholders to the corporation for use in the business (price originally paid for shares). Earned capital is the capital that develops if the business operates profitably (retained earnings and accumulated other comprehensive income).

The Corporate Form, Share Capital, and Profit Distribution

1. In Canada, a business organization may incorporate either federally or provincially by submitting the necessary documents to the appropriate governmental office.
 - a. **Federally incorporated companies** are created and operate under the provisions of the Canada Business Corporations Act (CBCA). To create and operate one, **articles of incorporation** are submitted to the Corporations Directorate of Industry Canada, who will issue a **certificate of incorporation** after ensuring that the incorporation documents are appropriately completed. Once the certificate of incorporation is issued, the corporation is recognized as a separate legal entity bound by the laws of the country and the provisions of the CBCA. The entity's owners have greater legal protection against lawsuits. An added advantage is that incorporation involves the issue of shares, which allows access to capital markets.

Corporations may be classified by the nature of ownership as follows: public sector corporations (government units such as municipalities, cities; government business enterprises such as Canada Post) and private sector corporations.

Private sector corporations include not-for-profit entities and for-profit companies. Only for-profit companies issue shares. The shares of private for-profit companies are held by a few shareholders and are not available for public purchase. The shares of public for-profit companies are available to the public and generally traded on a stock exchange. These public companies must follow IFRS, which is now incorporated into the *CICA Handbook*.

- b. **Provincially incorporated companies** would be subject to the requirements and provisions of the respective province's business corporations act.
2. Within a given class of shares, each share is exactly equal to every other share. A person's percent of ownership in a corporation is determined by the number of shares he or she possesses in relation to the total number of shares owned by all shareholders. In the absence of restrictive provisions, each share carries the right to participate proportionately in (a) **profits and losses**, (b) **management** (right to vote for directors), and (c) **corporate assets upon liquidation**.

In addition to these three rights, the CBCA allows a corporation to assign a **pre-emptive right** to any or all classes of shares through appropriate specification in the articles of incorporation.

3. The transfer of ownership between individuals in the corporate form of organization is accomplished by one individual selling or transferring his or her shares to another individual. The only requirement in terms of the corporation involved is that it be made aware of the name of the individual owning the shares.

A subsidiary ledger of shareholders is maintained by the corporation (or its registrar and transfer agent) for the purpose of dividend payments, issuance of stock rights, and voting proxies.

4. Common shares represent the **residual interest** in the company and bear the ultimate risks of loss and receive the benefits of success. Common shares are guaranteed neither dividends nor assets upon dissolution of the corporation. Thus, common shareholders are considered to hold a residual interest in the corporation. However, common shareholders generally control the management of the corporation and tend to profit most if the company is successful. In the event that a corporation has only one authorized issue of shares, that issue is by definition common shares, whether or not it is so designated in the charter.
5. The amount an individual pays for shares in a corporation represents the maximum amount that individual can lose in the event of corporate liquidation. This is known as the concept of **limited liability**. The property or service invested in the enterprise is the extent of a shareholder's possible loss.
6. Profits of a corporation distributed to shareholders are referred to as **dividends**. In general, dividends can only be paid if the company's capital will be maintained intact. Also, dividends must be formally approved by the board of directors and be in full agreement with share capital contracts.
7. When special classes of shares are created with certain preferential rights, they are usually called **preferred shares**. A common type of preference is a prior claim on earnings and priority claim on assets upon dissolution. Preferred shares can be cumulative, convertible, callable/redeemable, retractable, and/or participating.

- a. **Cumulative.** Dividends not paid in any year must be made up in a later year before paying any dividends to ordinary shareholders. Unpaid annual dividends on cumulative preference shares are referred to as **dividends in arrears** and are disclosed in a note to the financial statements.
- b. **Convertible.** Preference shareholders may, at their option, exchange their preference shares for ordinary shares on the basis of a predetermined ratio.
- c. **Callable/Redeemable.** At the option of the issuing corporation, preference shares can be redeemed at specified future dates and at stipulated prices.
- d. **Retractable.** The shares have a mandatory redemption period or a redemption feature that the issuer cannot control, such as the fact that the holders can put or sell their shares to the company.
- e. **Participating.** Holders of participating preference shares share with the ordinary shareholders in any profit distribution beyond a prescribed rate. This participation involves a pro rata distribution based on the total par value of the outstanding preference and ordinary shares.

Preferred shares are often issued instead of debt to keep the company's debt-to-equity ratio within a certain range. However, if the characteristics of the preferred shares are such that the instrument resembles debt more than equity, reclassification as debt may be required.

Accounting for the Issuance of Shares

1. Under the CBCA, shares must be without a nominal or par value. This means that all the proceeds from the issuance of the shares must be credited to the share capital account. Par value establishes the nominal value per share and is the minimum amount that must be paid in by each shareholder.
2. When **no-par shares** are issued, the share capital account is credited for an amount equal to the value of the consideration received.
3. When shares are sold on a **subscription basis**, the full price is not received initially. Normally, only a partial payment is made originally, and the shares are not issued and rights associated with them are not received until the issuing company receives the full subscription price. When an individual subscribes to a common share issue, the corporation debits **subscriptions receivable** and credits **common shares subscribed**.

4. More than one class of shares is sometimes issued for a single payment or a lump sum amount. Such a transaction requires allocation of the proceeds between the classes of securities involved. The two methods of allocation used are (a) the **relative fair value method** and (b) the **residual value method**. The relative fair value method is used when the fair value of each class of security is readily determinable. If no fair value is determinable for any of the classes of shares, the allocation may have to be arbitrary.
5. **Shares issued for consideration other than cash** should be recorded using the fair value of the consideration received. If that fair value cannot be measured reliably, the fair value of the shares issued should be used. In cases where the fair market value of both items is not clearly determinable, an appropriate valuation technique should be used. Depending on available data, the valuation may be based on market transactions involving comparable assets or the use of discounted cash flows. Generally, the board of directors has the power to set the value of non-cash transactions. If the board of directors abuses this power watered shares or secret reserves can result.
6. Where an entity advances money to its employees or officers for the purpose of purchasing shares of company stock, it is common practice to deduct the remaining loan balances from the share capital reported within shareholders' equity.
7. The costs associated with issuing share capital should be deducted from the amounts paid in. **Share issue costs** are therefore debited to Share Capital as they are capital transactions as opposed to operating transactions. Management salaries and other indirect costs should be expensed as they are incurred.
8. The CBCA and various provincial acts permit a corporation to **redeem its shares**, provided such an action would not render the company insolvent. The CBCA then requires that **such shares be cancelled** and restored to the status of authorized but unissued shares if appropriate.

9. When **shares are repurchased, or reacquired and retired**, shareholders' equity accounts are adjusted as follows:
- a. If the cost of the reacquired shares is equal to or greater than their par, stated, or assigned value, the allocation is as follows:
 - To share capital in an amount equal to the par, stated, or assigned value of the shares;
 - Any excess to contributed surplus to the extent that contributed surplus was previously created by the cancellation or resale of shares of the same class;
 - Any excess to contributed surplus in an amount equal to the pro rata share of contributed surplus that arose from transactions in the same class of shares;
 - Any excess to retained earnings.
 - b. If the cost of the reacquired shares is less than the par, stated, or assigned value, the cost would be allocated as follows:
 - To share capital in an amount equal to par, stated, or assigned value of the shares;
 - The difference to contributed surplus.

Formality of Profit Distribution: Dividend Policy

1. The applicable laws of incorporation normally provide information concerning *legal restrictions* related to the payment of dividends. The CBCA prohibits the declaration or payment of dividends if such an action would render the corporation insolvent. At any rate, corporations rarely pay dividends in an amount equal to the legal limit. This is due, in part, to the fact that assets represented by undistributed earnings are invested in a variety of operating assets and are, therefore, used to finance future operations of the business.
2. While the unencumbered credit balance in retained earnings is normally considered to provide the basis for dividend distributions, very few companies pay dividends in amounts equal to this legally available amount. The major reasons may include (a) agreements with creditors, (b) the need to finance growth and expansion, (c) the need to provide for continuous dividends in good or bad years, and (d) the need to build a cushion. If funds are unavailable for the payment of dividends, the extent of the credit balance in retained earnings is of little significance. Thus, management must ask two questions before declaring a dividend: Is it **legally permissible**? and, Is the paying out of company assets **economically sound**?

- Dividends may be paid in cash (most common means), shares, or some other asset. Dividends, other than a stock dividend, reduce the shareholders' equity in a corporation through an immediate or promised distribution of assets. **Stock dividends** merely transfer a portion of the retained earnings account to capital accounts in shareholders' equity; no assets are distributed.

Cash Dividend

- The accounting for a **cash dividend** requires information concerning three dates: (a) **date of declaration**, (b) **date of record**, and (c) **date of payment**. A liability is established by a charge to retained earnings on the declaration date for the amount of the dividend declared. No accounting entry is required on the date of record. The liability is liquidated on the payment date through a distribution of cash. The following journal entries would be made by a corporation that declared a \$50,000 cash dividend on March 10, payable on April 6 to shareholders of record on March 25.

Declaration date – March 10

Retained Earnings	50,000	
Dividends Payable		50,000

Record date – March 25

No entry

Payment date – April 6

Dividends Payable	50,000	
Cash		50,000

Dividends in Kind (Property Dividends)

1. Property dividends (or **dividends in kind**) represent distributions of corporate assets other than cash. A property dividend may be viewed as a non-reciprocal transfer of non-monetary assets between an enterprise and its owners (see *Handbook*, Part II (ASPE) Section 3831). **Such transfers should be recorded at the fair value of the assets transferred.** Fair value is measured by the amount that would be realized in an outright sale near the time of distribution. When a property dividend is declared, fair value should be recognized in the accounts with the appropriate gain or loss recorded. The fair value then serves as the basis used in accounting for the property dividend. For example, if a corporation held shares of another company that it intended to distribute to its shareholders as a property dividend, it would first be required to make sure the carrying amount reflected current market value. If on the date the dividend was declared the difference between the cost and fair value of the shares to be distributed was \$75,000, the following additional entry would be made.

Investment in Securities	75,000	
Gain on Appreciation of Securities		75,000

Stock Dividends

1. A **stock dividend** occurs when the board of directors declares that a dividend will be paid to shareholders in the form of the company's own shares (of the same or different class). Accounting for a stock dividend results in a capitalization of retained earnings (a reduction in retained earnings and a corresponding increase in the appropriate share capital account). As such, total shareholders' equity remains unchanged when a stock dividend is distributed. Also, all shareholders retain their same proportionate share of ownership in the corporation.
2. The *CICA Handbook* makes no recommendations regarding the amount of retained earnings that should be capitalized when a stock dividend is declared. The CBCA states "the declared amount of the dividend stated as an amount of money shall be added to the stated capital account maintained or to be maintained for the shares of the class or series issued in payment of the dividend" (Section 41 [2]). The CBCA does not allow shares to be issued until they are fully paid for in an amount not less than the fair equivalent of money that the corporation would have received if the shares had been issued for cash; therefore, the fair market value must be used for companies incorporated under the CBCA. Throughout the text, the amount to be capitalized is the fair value of the shares issued.

3. When a stock dividend is declared, retained earnings is debited for the fair value (assumed deemed amount) of the shares to be distributed. The credit is to **common stock dividend distributable**, which would be shown in the shareholders' equity as an addition to share capital. When the stock dividend is "paid," the appropriate share capital account is credited, and the common stock dividend distributable account is debited.

Liquidating Dividends

1. Liquidating dividends represent a return of the shareholders' investment rather than a distribution of profits. In a more general sense, any dividend not based on profits must be a reduction of corporate capital, and to that extent, it is a liquidating dividend.

Preferred Share Preferences to Dividends

1. The amount of dividends available for distribution to common shareholders is dependent upon the terms of the preferred shares. The amount can vary, depending upon whether the preferred shares are cumulative and/or participating and whether preferred dividends are in arrears. The text material includes numerical examples of these features in various combinations showing their impact on dividend distributions when both common and preferred shares are involved.

Stock Split

1. A **stock split** results in an increase (or decrease if a reverse split) in the number of shares outstanding. No accounting entry is required for a stock split, as the total dollar amount of all shareholders' equity accounts remains unchanged. A stock split is usually intended to improve the marketability of the shares by reducing the market price of the stock being split. In general, the difference between a stock split and a stock dividend is based upon the size of the distribution. **If the number of shares issued in a share dividend exceeds 20 or 25% of the shares outstanding, it should not be called a share dividend but instead a "share split" or "a split-up effected in the form of a dividend", and only the par value of the shares issued is transferred from retained earnings.**

2. A stock split is distinguished from a stock dividend because a stock split results in an increase in the number of shares outstanding with no change in the share capital or the retained earnings amount.
3. On the other hand, the stock dividend may result in an increase in both the number of shares outstanding and the share capital while reducing the retained earnings. A stock split may be used to increase the share's marketability. If the stock dividend is large, it has the same effect on the market as a stock split.
4. A stock dividend of less than 20-25% of the number of shares previously outstanding (small stock dividend) is generally accounted for at the fair value of the shares. A stock dividend of more than 20-25% of the number of shares previously outstanding (large stock dividend) is generally accounted for at par, stated value (original cost) of the shares or fair value.

Contributed Surplus

1. Contributed surplus results from a wide variety of transactions. The basic transactions that result in increases and decreases in contributed surplus are described below:

Transactions that may affect contributed surplus

- a. Par value shares issue, retirement (Appendix 15A)
 - b. Treasury share transactions (Appendix 15A)
 - c. Liquidating dividends
 - d. Financial reorganizations (Appendix 15B)
 - e. Stock options and warrants (Chapter 16)
 - f. Issue of convertible debt (Chapter 16)
 - g. Forfeited share subscriptions
 - h. Donated assets by shareholder
 - i. Redemption or conversion of shares
2. **Accumulated Other Comprehensive Income.** Accumulated other comprehensive income results because of treatment of revenues, expenses, gains, and losses that result from non-shareholder transactions, which are not included in the calculation of net income.

Presentation and Disclosure

1. Required disclosure, usually through notes to the financial statements, covers information on the terms and rights attached to each equity instrument, and changes in share capital over the fiscal year. The following would normally be disclosed:
 - a. Authorized number of shares
 - b. Existence of unique rights (e.g., dividend preferences)
 - c. Number of shares issued and amounts received
 - d. Whether par value or no par value
 - e. Amount of dividends in arrears for cumulative preferred shares
 - f. Details of changes during the year (presented in the statement of changes in equity under IFRS)
 - g. Restrictions on retained earnings

Under IFRS, companies must also disclose information about their objectives, policies, and processes for managing capital.

Analysis of Shareholders' Equity

1. A number of ratios are used to evaluate a company's profitability and long-term solvency. Common ratios used are:
 - a. **Rate of return on common shareholders' equity:** This ratio measures profitability from the common shareholders' perspective. This ratio shows how many dollars of net income were earned from each dollar invested by the investors. It is calculated as: $\text{net income} - \text{preferred dividends} / \text{average common shareholders' equity}$.
 - b. **Payout ratio:** This is the ratio of cash dividends to net income. This is an important ratio to some investors who are looking for good yield on the shares. It is calculated as: $\text{cash dividends} / \text{net income} - \text{preferred dividends}$.
 - c. **Price earnings ratio:** The analyst, in discussing the investment possibility of a given enterprise, mostly uses this ratio. It is calculated as follows: $\text{market price per share} / \text{earnings per share}$.
 - d. **Book value per share:** The book value per share is the amount each share would receive if the company were liquidated on the basis of amounts reported on the statement of financial position. This is calculated as follows: $\text{common shareholders' equity} / \text{number of outstanding shares}$.

IFRS/ASPE Comparison

1. Text Illustration 15-12 summarizes the major differences in accounting for equity between IFRS and ASPE. The IASB and FASB are working on several projects, including the financial statement presentation project and the project on liabilities

and equity. At the time of writing, the liabilities/equity project had been put on hold.

Par Value and Treasury Shares (Appendix 15A)

1. **Par value** is an amount stated as such on each share certificate. This establishes the nominal value per share and is the minimum amount that must be paid by each shareholder if the share is to be fully paid when issued. Shares issued for more than par value are said to be issued at a **premium**. Conversely, shares issued for less than par value are said to be issued at a **discount**. When the corporation issues shares at a discount, the holders are contingently liable to corporate creditors for the amount of the discount. This contingency is realized only in the event of a liquidation where creditors' claims remain unsatisfied. Canadian jurisdictions, which permit par value shares generally, do not permit the issuing of shares below par.
2. When **par value shares** are issued, the share capital (common or preferred) account is credited for an amount equal to par value times the number of shares issued. Any amount received in excess of par value is credited to contributed surplus.
3. **Treasury shares** are a corporation's own shares that (a) were outstanding, (b) have been reacquired by the corporation, and (c) are not retired. Treasury shares are not an asset and should be shown in the statement of financial position as a reduction in shareholders' equity, following the single-transaction method.
4. The CBCA does not sanction the holding of a company's own shares as treasury shares; however it is allowed in the United States and in certain provincial jurisdictions in Canada.
5. In Canada, the *CICA Handbook* recommends that the **single-transaction method** be used to account for treasury shares. Under this method, the reacquired shares' cost are held in a **treasury shares** account and reported as a deduction from the total of the components of shareholders' equity in the statement of financial position. When the shares are reissued, the treasury shares account is credited for the acquisition cost. If treasury shares are reissued for **more** than their acquisition cost, the excess is credited to a contributed surplus account. If the treasury shares are reissued for **less** than acquisition cost, the difference should be debited to any contributed capital from previous treasury share, or repurchase share transactions. If the balance in this account(s) is insufficient, the remaining difference is charged to retained earnings.