

CHAPTER 15: SHAREHOLDERS' EQUITY

1. Understanding the Corporate Form, Share Capital, and Profit Distribution

Key Definitions and Concepts

The chapter contains analyses on single proprietorships, partnerships, and different types of corporations, including public sector corporations (e.g. governments). The focus of the chapter, though, is on stock-issuing private sector entities. Corporations are owned by their shareholders. Shares provide investors with proportional units of ownership in the corporation. There are several advantages that are gleaned from incorporation. The corporation, for instance, benefits from limited liability and it can readily fulfill its financing needs via the capital and financial markets. To this end, share-related activities are easily transacted; that is, both in terms of share issuances and share reacquisitions.

A corporation's *contributed capital* encompasses 2 components: (1) Capital stock or paid in capital (e.g., common shares and preferred shares); and (2) Surplus - the excess of net assets over the total paid-in, par or stated value of a corporation's shares. Surplus can be further subdivided into two 2 components: (1) Earned surplus (i.e., Retained Earnings); and (2) Contributed Surplus, which is the amount of money that a company earns from sources other than its profits. The text highlights several transactions that impact the corporation's contributed surplus, like the reacquisition of outstanding shares, forfeited share subscriptions, options and warrants that are exercised, and so forth. Illustration 15-9 provides a good summary of these transactions.

Accounting Standards, the Law, and Securities Commissions: Share Transactions

Accounting standards impact the constitution not only of the corporation's capital structure but also share issuances, stock splits, dividends, and so forth. As an example, application of ASPE and IFRS can see share repurchases altering the value of the corporation's contributed surplus depending on whether the corporation pays more or less to reacquire its shares relative to the average book value of these shares. The law also impacts the corporation's ability to execute particular equity-related transactions. For example, the Canada Business Corporations Act (CBCA) (1975) – which was born out of the Dickerson Report – regulates Canadian business corporations. The CBCA is a federal law¹ and it generally prohibits Canadian corporations, for instance, from issuing shares with a par value. This restriction can be contrasted with the bounds of Provincial Law and American Law. International, national and local securities commissions (e.g., OSC, SEC, and IOSCO) also adjudicate equity transactions. To illustrate this point, the U.S. SEC prohibits individuals/organizations from short-selling a stock when the intended purpose is to manipulate the price of the stock.

2. Recognition, Derecognition and Measurement

Issuance of Shares: Key Factors

Cash Consideration

The corporation ordinarily sells its shares to investors for cash. The corporation prepares this journal entry:

<i>Cash</i>	<i>xxx</i>	
<i>Common Shares (or Preferred Shares)</i>		<i>xxx</i>

Costs of Issuing Shares

Issuance costs – such as underwriting costs, accounting and legal fees, printing costs and taxes – are reported as a reduction of the amounts paid in. To put it another way, the value of common shares (or preferred shares) issued is reduced by these issuance costs. Bearing this in mind, the above entry is made, whereby both the amount of the cash received by the corporation and the value of the share issued by the corporation are reduced by the value of the issuance costs.

¹ Canadian business entities that incorporate at the federal-level are subject to the parameters of the CBCA, whilst entities incorporating at the provincial-level are subject to the terms of similar provincial legislation.

Simultaneous Issuance of Multiple Types of Shares

Different types of shares can be simultaneously issued. As an example, the corporation can concurrently issue common shares and preferred shares. There are 2 methods to account for shares issued with other securities: (1) the residual method; and (2) the relative fair-value method. On the exam you will be asked to apply a specific method or there will only be sufficient data to apply one of the two methods. Application of the residual method requires you to record the equity component that is easier to measure. Then cash is debited for the value of the proceeds collected by the corporation. Then the second equity component issued by the corporation is recognized for an amount equal to the difference between the cash proceeds collected by the corporation and the value of the first equity component. The corporation records this journal entry:

<i>Cash</i>	<i>xxx</i>	
<i>Common Shares</i>		<i>xxx</i>
<i>Preferred Shares</i>		<i>xxx</i>

Application of the relative fair value method gives rise to the above entry as well, although, the value of the common shares and the value of the preferred shares is different than the values recorded as per application of the residual method. Whenever the fair value method is applied to account for shares issued with other securities there must be data provided on the fair value of both the equity components. The relative value of each equity component is then used as the basis for prorating the value of the proceeds between the two equity components.

Exchanging Shares for Goods and/or Services

IFRS 2 (“Share Based Payment”) stipulates that the value of the equity issued is commensurate with the value of the goods and/or services received as consideration unless the value of the consideration cannot be reliably determined. The following journal entry is recorded by the corporation, for instance, when it receives machinery in exchange for its common shares:

<i>Machinery</i>	<i>xxx</i>	
<i>Common Shares</i>		<i>xxx</i>

Share Subscriptions

One way investors (or employees) can purchase shares from the corporation is by acquiring share subscriptions. The corporation can sell a particular number of share subscriptions to investors. The subscriptions specify the purchase price of each share. The investor makes a down-payment towards the eventual purchase price of the shares. The corporation records this journal entry when the share subscriptions are sold:

<i>Cash</i>	<i>xxx</i>	
<i>Share Subscriptions Receivable</i>	<i>xxx</i>	
<i>Common (or Preferred) Shares Subscribed</i>		<i>xxx</i>

Investors subsequently pay the remaining amount to acquire the shares (i.e., difference between the down-payment and the contractually specified purchase price of the shares). Assuming all subscribers pay the subscriptions in full, the corporation records these journal entries to recognize the proceeds received and the issuance of the shares:

<i>Cash</i>	<i>xxx</i>	
<i>Share Subscriptions Receivable</i>		<i>xxx</i>
<i>Common (or Preferred) Shares Subscribed</i>	<i>xxx</i>	
<i>Common (or Preferred) Shares</i>		<i>xxx</i>

Sometimes a certain number of subscriptions are forfeited. That is, a certain number of subscribers make an initial down-payment but then they fail to pay the rest of the money needed to acquire the shares from the corporation. The subscription contract specifies how the corporation handles forfeitures. The corporation can either refund the subscribers’ initial down-payment or it can retain the down-payment, thereby, returning no cash to the

subscribers. When the subscription contract specifies the corporation refunds the down-payment to subscribers, then, the corporation prepares this journal entry:

<i>Common (or Preferred) Shares Subscribed</i>	<i>xxx</i>	
<i>Cash</i>		<i>xxx</i>
<i>Share Subscriptions Receivable</i>		<i>xxx</i>

Conversely, in the event that the subscription contract specifies the corporation does not refund the down-payments to subscribers, then, the corporation enters this journal entry:

<i>Common (or Preferred) Shares Subscribed</i>	<i>xxx</i>	
<i>Contributed Surplus</i>		<i>xxx</i>
<i>Share Subscriptions Receivable</i>		<i>xxx</i>

Reacquisition and Retirement of Shares

Corporations repurchase their own shares, which are trading on the market. They do this for a variety of reasons, like to enhance earnings per share. Alternatively, a corporation can repurchase a portion of its shares when its shares are undervalued. Or the corporation may reacquire some of its shares to increase demand for its shares.²

To account for the reacquisition of a certain class of shares (e.g., common shares), the corporation must first determine the average price (i.e., book value) of that class of shares, whereby the average price per share = the total book value of that class of shares/the total number of said shares issued by the corporation. Then the corporation compares the price at which it reacquires these shares (i.e., acquisition cost) versus the average book value of the related class of shares.

If the acquisition price > the average book value, then, this journal entry is made:

<i>Common Shares</i>	<i>xxx</i>	
<i>Contributed Surplus</i>	<i>xxx</i>	
<i>Contributed Surplus</i>	<i>xxx</i>	
<i>Retained Earnings</i>	<i>xxx</i>	
<i>Cash</i>		<i>xxx</i>

Refer to page 949 and P15-6 (in-class) for details on how to calculate the amounts allocated to each of the above line items.

If the acquisition price < the average book value, then, this journal entry is made:

<i>Common Shares</i>	<i>xxx</i>	
<i>Contributed Surplus</i>	<i>xxx</i>	
<i>Cash</i>		<i>xxx</i>

Refer to page 949 and P15-6 (in-class) for details on how to calculate the amounts allocated to each of the above line items.

3. Dividends

Dividends are profit distributions made by the corporation to its shareholders.³ But corporations face limits when they disburse dividends. The CBCA, for instance, does not permit Canadian corporations to pay shareholders a dividend that would cause the value of the corporation's assets to drop below prescribed levels of share capital and/or liabilities. It also prohibits corporations from paying dividends that would force them into insolvency. Corporations must also be mindful of particular debt-to-equity ratios because they want to avoid making dividend payments that would cause them to breach particular debt covenants. Corporations also want to ensure that they retain a sufficient proportion of their earnings to facilitate future dividend payments.

² Refer to page 948 of the textbook for additional factors influencing the corporation's decision to repurchase its shares.

³ Note: Dividends are not paid on treasury stock.

Dividends: Key Dates

There are some key dates to bear in mind in relation to cash dividends:

Declaration Date: The board of directors votes on the declaration of dividends and if the resolution is approved, the dividend is officially declared on this date. The corporation prepares this journal entry on the declaration date:

<i>Dividends</i>	<i>xxx</i>	
<i>Dividends Payable</i>		<i>xxx</i>

Date of Record: An updated list of shareholders is produced on the date of record. The list is drafted by the corporation to identify its current shareholders. No journal entry is recorded on the date of record.

Payment Date: The corporation pays dividends to its shareholders on the payment date. The corporation prepares this journal entry on the payment date:

<i>Dividends Payable</i>	<i>xxx</i>	
<i>Cash (or another form of consideration)</i>		<i>xxx</i>

Cash Dividends, Dividends in Kind, and Stock Dividends

Dividends are generally paid in cash, though, companies disburse other assets to shareholders like property. The value of the property should be re-measured at its fair value before it is disbursed. "Dividends that are payable in corporation assets other than cash are called property dividends or dividends in kind... These dividends should generally be measured at the fair value of the asset that is given up..."⁴ The corporation should recognize a gain/loss upon re-measurement. The corporation records this journal entry (provided the value of the asset has increased relative to its original carrying value):

<i>Asset/Investment</i>	<i>xxx</i>	
<i>Gain</i>		<i>xxx</i>

Then the corporation prepares this journal entry on the declaration date:

<i>Retained Earnings</i>	<i>xxx</i>	
<i>Property Dividends Payable</i>		<i>xxx</i>

Finally the corporation prepares this journal entry on the distribution date:

<i>Property Dividends Payable</i>	<i>xxx</i>	
<i>Asset/Investment</i>		<i>xxx</i>

Corporations can also issue stock dividends.⁵ Stock dividends are for the most part measured in terms of the fair value of the associated stock. The CBCA requires the fair value of stock dividends to be added to the corporation's Share Capital. Interestingly, though, ASPE does not provide specific guidance on how to make this fair value measurement. The corporation prepares this journal entry on the declaration date:

<i>Retained Earnings</i>	<i>xxx</i>	
<i>Common Stock Dividend Distributable</i>		<i>xxx</i>

Then the corporation prepares this journal entry on the distribution date:

<i>Common Stock Dividend Distributable</i>	<i>xxx</i>	
<i>Common Shares</i>		<i>xxx</i>

⁴ Retrieved from page 951 of the text. Review the exception to this rule.

⁵ Certain classes of shares allow shareholders to choose to receive either a stock dividend or a cash dividend.

One reason why a company issues a stock dividend to its shareholders is to capitalize earnings, being as a stock dividend does not see the corporation relinquish a portion of its earnings. The book value of the corporation's equity does not change when a stock dividend is distributed to shareholders. Further shareholders' proportionate ownership in the corporation remains unchanged. The composition of shareholders' equity, though, is altered, given that a portion of retained earnings is transferred to share capital. One consequence of this alteration is, *ceteris paribus*, the corporation's EPS decreases.

One note here: The Canada Revenue Agency does not make a distinction between stock dividends and cash dividends for tax purposes.

Allocating Dividends: Common Shares vs. Preferred Shares

The corporation is obliged to pay dividends to preferred shareholders before it pays dividends to common shareholders. Moreover the corporation must pay all dividends in arrears on cumulative preferred shares before dividends are disbursed to other share classes. Ordinarily the corporation pays the requisite dividend to its preferred shareholders and any residual amount of the declared dividend is then paid to its common shareholders. However participating preferred shareholders receive a part of any excess portion of the declared dividend that is available after common shareholders receive an appropriate share of the declared dividend. Generally common shareholders receive a dividend that generates the same yield as the one earned by the preferred shareholders in a regular year, whereby there is no dividends in arrears. Once common shareholders receive a dividend that enables them to generate such a yield, then any remaining portion of the declared dividend is allocated between the corporation's preferred shareholders and its common shareholders in terms of two share classes' relative ownership interest. This situation is true when preferred shareholders are fully participative. Sometimes, however, preferred shareholders are only partially participative, which means that they will only receive a certain amount of the excess dividend. You are strongly encouraged to carefully review the illustration provided on pages 953 and 954 of the text entitled "Dividend Preferences." The illustration provides clear guidance on how the corporation allocates a dividend between the two share classes. Also refer to E15-6 (in-class).

Stock Splits

Stock splits increase the corporation's number of outstanding shares, and the corporation records no journal entry to recognize a stock split. Stock splits do not impact retained earnings in the way stock dividends do. (Recall: a stock dividend sees a portion of the corporation's retained earnings transferred to share capital.) One implication of a stock split is that, *ceteris paribus*, the split reduces the corporation's share price. As you will note from reading the textbook, the American Institute of Certified Public Accountants (AICPA) treats very large stock dividends (i.e. 20-25% increase in the corporation's number of shares) as though they are stock splits. Canadian practitioners, though, must exercise professional judgement to differentiate between very large stock splits and stock dividends for the reason that neither ASPE nor the IFRS-framework provide explicit guidance on how to make this distinction.