CHAPTER 13
Equities

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

L.O. 13-1. Describe the characteristics of different types of share equity and identify the characteristics that are relevant for accounting purposes.

L.O. 13-2. Identify the different components of equity for accounting purposes that apply to a transaction and analyze the effect of the transaction on those equity components.

L.O. 13-3. Apply the accounting standards and procedures for transactions relating to contributed capital.

L.O. 13-4. Apply the accounting standards and procedures for transactions relating to the distribution of retained earnings.

L.O. 13-5. Prepare a statement of changes in equity.

CPA competencies addressed in this chapter:

1.1.2 Evaluates the appropriateness of the basis of financial accounting (Level B)

1.2.1 Develops or evaluates appropriate accounting policies and procedures (Level B)

1.2.2 Evaluates treatment for routine transactions (Level A)
i. Owners'/shareholders' equity

1.3.1 Prepares financial statements (Level A)

1.3.2 Prepares routine financial statement note disclosure (Level B)

1.4.1 Analyzes complex financial statement note disclosure (Level C)

Canadian Tire (Toronto Stock Exchange tickers CTC and CTC.A), the iconic retailer known for having Canada's unofficial second currency (Canadian Tire "money"), has grown from its first store in 1922 to almost 500 locations today. The company has two classes of shares: Common and Class A. In its 2013 annual report, the company reported the following information regarding its share capital:

($ millions)		2013	2012
Authorized			
3,423,366 100,000,000	Common Shares Class A Non-Voting Shares	$ 0.2	$ 0.2
Issued and outstanding 3,423,366 (2012—3,423,366) 76,560,851 (2012—77,720,401)	Common Shares Class A Non-Voting Shares	586.8	687.8
		$ 587.0	$ 688.0

Why do companies such as Canadian Tire have different classes of shares, and how do we account for them? What are the distinctions among "authorized," "issued," and "outstanding?" How do we account for differences between shares authorized and shares issued, or between the number issued and the number outstanding?

The company also disclosed that it issued and repurchased Class A shares. How do we account for such equity transactions?

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A. INTRODUCTION

Equity refers to the ownership interest in the assets of an entity after deducting its liabilities. In other words, equity is a residual amount that is determined by assets and liabilities through the balance sheet equation: equity = assets − liabilities. Indeed, if the balance sheet equation is to hold, equity must be a residual amount rather than defined independently, since the Conceptual Framework already defines assets and liabilities. The residual nature of equity, however, does not mean that we can be cavalier about it—it is still necessary to provide information useful to financial statement readers. The questions are, then, who uses information about equity, and what information about equity would be useful?

First, equity has legal **priority** below that of liabilities in general, meaning that available funds go toward paying off liabilities prior to paying equity claims should the enterprise be liquidated. As a result, debtors have little interest in the specifics of what happens with equity beyond the overall amount of equity to assess solvency of the enterprise. In contrast, equity holders are concerned about both liabilities and equity accounts. Thus, information about equity is primarily geared toward equity holders themselves.

priority The rank of a liability or an equity claim when a company liquidates, where higher priority confers preferential payout before other claimants.

Second, equity holders who do have residual claims on the enterprise are concerned about the size of their claims, and they need to be aware of changes to their share of profits. Consequently, accounting reports need to provide detailed information about the composition of equity and changes in equity that can result in the dilution

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of owners' stakes in the business. This information asymmetry between management and owners is particularly high, and the information need is particularly strong, when there are multiple types of equity and when there are many equity holders such as public companies.

Third, equity holders are interested in distinguishing (i) changes in equity due to direct contributions or withdrawals of capital from (ii) changes in equity derived from return on equity capital (i.e., income). This categorization is natural because it separates capital transactions with *owners* from the entity's income-generating transactions with *non-owners* such as customers, employees, and suppliers.[1] This chapter follows this categorization by first discussing contributed capital, followed by two equity accounts that accumulate income: retained earnings and accumulated other comprehensive income (AOCI). We then discuss the effect of various transactions on equity: stock issuances, stock splits, stock reacquisitions, dividend payments, and transfers to reserves.[2]

From this point forward in this chapter, we will focus on the incorporated form of business, so we will refer to shareholders rather than the more generic "equity holder." However, the material is equally applicable and therefore transferable to other forms of organizations such as proprietorships, partnerships, and trusts.

L.O. 13-1. Describe the characteristics of different types of share equity and identify the characteristics that are relevant for accounting purposes.

L.O. 13-2. Identify the different components of equity for accounting purposes that apply to a transaction and analyze the effects of the transaction on those equity components.

B. COMPONENTS OF EQUITY FOR ACCOUNTING PURPOSES

As noted in the introduction, accounting separates equity into three components: contributed capital, retained earnings, and AOCI. Within each of these three components are sub-components that differ from each other in a variety of ways.

1. Contributed capital

contributed capital The component of equity that reflects amounts received by the reporting entity from transactions with its owners, net of any repayments from capital.

Contributed capital refers to amounts received by the reporting entity from transactions with shareholders, net of any repayments from capital (rather than accumulated income). In a simple case where a company issues 10,000 shares for \$20 each, and later repurchases 1,000 of these shares at the same price, the contributed capital would equal 10,000 shares $\times$ \$20/share $-$ 1,000 shares $\times$ \$20/share $=$ \$180,000. (Section C will consider other cases when the share price changes from issuance to repurchase.)

Shares have a number of characteristics, including whether they have residual claims, par value, cumulative dividends, or voting rights, and whether they are authorized, issued, or outstanding. We discuss these characteristics below and any accounting implications involved.

a. Common shares (or ordinary shares)

common (ordinary) shares An equity interest that has the lowest priority and represents the residual ownership interest in the company.

In Canada, the shares that represent the ultimate residual interest in a company are usually called **common shares**. The equivalent term for common shares in IFRS is **ordinary shares**. These are the shares that have lowest priority, but claims to all residual assets after the entity satisfies all other debt or equity claims. These shares have the

1. In some cases, an owner can also engage in transactions with the reporting entity as someone other than an owner (e.g., a customer). For instance, many shareholders of large financial institutions such as Bank of Montreal or Royal Bank of Canada will also have deposits or loans with these banks. In such cases, we need to identify whether these individuals are acting as owners or non-owners.

2. Caution—the term "reserves" is used in two different contexts in this chapter. The first is as above, which refers to the appropriated portion of an entity's retained earnings. This terminology is used in this context in both Parts I and II of the *CPA Canada Handbook*—Accounting. The second, used later in the chapter, refers to an equity account to describe the balance sheet account used to accumulate the balance of other comprehensive income (OCI) and other items (e.g., contributed surplus). This terminology is used only in the context of Part I of the *CPA Canada Handbook*—Accounting.

most upside potential should the enterprise be successful, but also the most downside should the business fail. Because common shares represent the ownership interest, every corporation must have at least one class of common shares.

b. Preferred shares

While every corporation must have a class of common shares, some corporations also have additional classes of shares. Any share that does not represent the residual interest in the company is called a **preferred share**. For example, a company may have, in addition to a class of common shares, "Class A shares" and "Class B preferred shares." For accounting purposes, these other classes are all considered to be preferred shares to reflect their economic substance, whether the company literally labels them as "preferred" or not. Preferred shares, as the name suggests, have priority ahead of common shares.

preferred shares Any shares that are not common shares.

c. Shares with or without par value

The par value of a share is a legal term referring to the nominal value of a share, in contrast to the actual share price. The *Canada Business Corporations Act* (CBCA) does not permit companies to issue shares with par value.[3] However, provincial laws such as those in Ontario and British Columbia permit the use of par value for companies incorporated under those laws.[4] Shares issued with a stated par value are simply called **par value shares**.

par value shares Shares with a dollar value stated in the articles of incorporation; for preferred shares, the dividend rate may be stated as a percentage of the par value.

For preferred shares, par value is important for the determination of dividends. For example, a preferred share with par value of $20 per share could either specify a dividend rate of $1 per share or 5%; that 5% is expressed relative to the par value, so that $\$20/\text{share} \times 5\% = \$1/\text{share}$. This use of par value is similar to that for bonds discussed in Chapter 12. For common shares, par value has no particular economic significance because common shares do not have a pre-specified dividend rate. For this reason, most companies do not specify a par value for common shares. For both common and preferred shares, the par value has no bearing on the price at which shareholders buy or sell the shares. Actual prices can be higher or lower than par value.

For accounting purposes, when a company does issue shares with par value, we identify the amount from the par value separately from the amount received above par.[5] We denote the component of contributed capital other than par as **contributed surplus**. An example of transactions with shares with and without par value will follow in Section C.

contributed surplus The component of contributed capital other than par value.

d. Cumulative vs. non-cumulative dividends

Regardless of whether a share is a common or preferred share, dividends are always discretionary payments. A corporation need only pay dividends when it declares them to be payable. This discretion applies even if there is a stated dividend rate on the shares. As an added measure of protection, many preferred shares will require *cumulative dividends,* meaning that the company must pay for any past dividend payments that it missed (i.e., those scheduled but not declared) prior to paying any dividends on common shares. In other words, a company can defer but not avoid a cumulative dividend on preferred shares if it is to pay dividends on common shares. However, there is no interest to compensate for the time value of money lost on the deferral. Shares with non-cumulative dividends do not have any rights to missed dividend payments.

3. *Canada Business Corporations Act* (R.S.C. 1985, c. C-44) Section 24 Paragraph (1).

4. *Ontario Corporations Act* (RSO 1990, c. 38) Section 25 Paragraph 1 and *British Columbia Business Corporations Act* (SBC 2002, c. 57) Section 52 Paragraph 1.

5. We do not consider instances where issue price is below par because this rarely occurs in practice.

In either case, companies are loath to miss dividend payments even though dividends are discretionary. A dividend schedule is a commitment to disburse cash to shareholders on a regular basis, and breaking that undertaking is a strong signal that the company is in financial difficulty.

e. Voting rights

A corporation may assign voting rights in a variety of ways according to its articles of incorporation. The vast majority of large, publicly traded enterprises will have one vote per common share, so that decision rights match economic ownership (in terms of rights to future cash flows). A small minority of public companies deviate from this practice. However, private companies use shares with a variety of voting rights to suit their needs.

The opening vignette outlined the contributed capital for Canadian Tire, which has two classes of shares: 3,423,366 common shares and 76,560,851 Class A non-voting shares. It turns out that, while the voting rights differ between these two classes, they are both common shares and they are practically identical to each other economically. Specifically, Canadian Tire's 2013 financial statements indicate the following:

> In the event of the liquidation, dissolution, or winding-up of the Company, all of the property of the Company available for distribution to the holders of the Class A Non-Voting Shares and the Common Shares shall be paid or distributed equally, share for share, to the holders of the Class A Non-Voting Shares and to the holders of the Common Shares without preference or distinction or priority of one share over another.

The common shares, which have the voting rights, are closely held by the Billes family, who founded the company in 1922. Holding the two classes of shares is the family's way of maintaining voting control of the company while allowing them to secure additional capital from the stock market.

f. Number of shares authorized, issued, or outstanding

shares authorized The number of shares that are allowed to be issued by a company's articles of incorporation.

shares issued The number of shares issued by the corporation, whether held by outsiders or by the corporation itself.

shares outstanding Issued shares owned by investors.

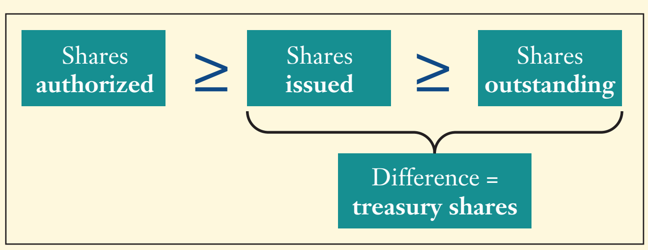
treasury shares Shares issued but held by the issuing corporation; treasury shares are not outstanding.

There are three figures that refer to the number of shares, two of which are important for accounting purposes. The number of **shares authorized** is the number of shares that the corporation is permitted to issue as specified in the articles of incorporation. This is a legal detail that has no practical significance. Indeed, many companies specify an unlimited number of authorized shares.

The two important figures are the number of shares issued and outstanding. **Shares issued** has the intuitive meaning—the number of shares issued by the corporation. However, some issued shares may not be outstanding. **Shares outstanding** are shares of the corporation owned by investors, including the company's officers and employees. Issued shares owned by the issuing corporation are called **treasury shares**. Treasury shares are issued but not outstanding.

Based on this discussion, the following relationships always hold:

Exhibit 13-1 Relationship among numbers of shares authorized, issued, and outstanding



CHECKPOINT **CP13-1**

Briefly describe the primary difference between common and preferred shares.

CHECKPOINT **CP13-2**

When is a corporation legally obligated to pay cash dividends?

CHECKPOINT **CP13-3**

Briefly describe the difference between cumulative and non-cumulative dividends.

CHECKPOINT **CP13-4**

Briefly describe the difference between issued and outstanding shares.

2. Retained earnings

Recall from introductory accounting that **retained earnings** reflect the cumulative net income (profit or loss) minus dividends paid. Some companies allocate a portion of retained earnings as reserves to identify amounts in equity that they do not intend to pay out as dividends. In some instances, the reserves are required by laws or regulations. **Appropriation** is the term for the process that allocates a portion of retained earnings to an appropriated reserve. For example, most universities have a portion of their net assets[6] set aside as reserves for the endowments that they have received from donors, when the donors specify that the university should spend only the income and not the capital from those donations. The use of an endowment reserve account ensures that the university does not spend the donated capital. Another common example is the appropriation of retained earnings for the purpose of repaying a long-term bond that requires the bond issuer to maintain a "sinking fund." Suppose a company issues a $50 million bond due in 10 years, and the bond indenture specifies that the company must set aside $5 million per year in a sinking fund so that the company will have funds to repay the bondholders at the end of 10 years. Assuming that the company complies with the contractual requirements, the journal entry would be as follows for each of the 10 years:

retained earnings A component of equity that reflects the cumulative net income (profit or loss) minus dividends paid.

appropriation The process that allocates a portion of retained earnings to a reserve.

Exhibit 13-2 Journal entries for the annual appropriation of retained earnings of $5 million for a sinking fund reserve

Dr. Retained earnings	5,000,000	
Cr. Sinking fund reserve (or appropriated retained earnings)		5,000,000
Dr. Restricted cash	5,000,000	
Cr. Cash		5,000,000

Notice that two journal entries are required. The first one appropriates the retained earnings, while the second one shows the actual cash being set aside.

3. Accumulated other comprehensive income (AOCI)

Under IFRS, accumulated other comprehensive income (AOCI) accumulates other comprehensive income (OCI) from all prior periods, similar to the manner in which realized profits and losses are accumulated in retained earnings. AOCI is then

6. "Net assets" for a not-for-profit organization has the same meaning as "equity" for a for-profit entity.

reported on the balance sheet as a component of equity. AOCI is not reported under ASPE, however, as this latter set of standards does not include provision for either OCI or AOCI.

It should be noted that IFRS uses the generic term "reserves" to refer to AOCI as well as other types of reserves (e.g., contributed surplus). While AOCI is not specifically defined in IFRS, it remains acceptable to use this terminology in financial statements.

Accounting for investments in financial assets was detailed in Chapter 7. As discussed there and in Chapters 3 and 10, OCI usually represents the unrealized change in the fair (market) value of select assets including FVOCI investments. For example, a $25,000 investment in bonds classified at fair value through OCI whose market value subsequently increases to $27,000 by balance sheet date results in an unrealized gain of $2,000 being reported in OCI. The $2,000 in OCI would then be closed out to AOCI at year-end as part of the closing entry process.

"Recycling" is an issue unique to OCI. Recall that items recorded through net income impact retained earnings in the same period. For example, ignoring related expenses and tax effects, recording revenue of $100 in 2018 results in an additional $100 of net income and therefore an extra $100 of retained earnings in 2018. The same does not apply to OCI as this is closed to a reserve account within equity (AOCI) where it is "parked" until a future date when it may be recognized through net income and retained earnings. **Recycling** refers to this process of initially recognizing amounts through OCI, accumulating that OCI in AOCI (reserves), and later removing those amounts from AOCI by recognizing them in net income and retained earnings.

recycling (of OCI) The process of recognizing amounts through OCI, accumulating that OCI in reserves, and later recognizing those amounts through net income and retained earnings.

OCI arising from investments in debt securities at fair value through OCI is recycled through net income and retained earnings, whereas OCI arising from investments in equity securities[7] is not. Rather, an entity may (but is not required to) reclassify the accumulated other comprehensive income directly to retained earnings. Essentially, the entity would process a journal entry debiting AOCI and crediting retained earnings thus bypassing the income statement.

Consider again the previous example of the $25,000 investment in bonds. When the value of the investment increased to $27,000, the $2,000 unrealized gain was reported in OCI, which was then closed out to AOCI. Assuming that the investment was subsequently sold for $28,000, the company would then record a gain of $3,000 through net income. $1,000 of the reported income pertains to the increase in the value of the investment subsequent to balance sheet date; the remainder represents recycling of the $2,000 residing in AOCI. "Recycling" is somewhat descriptive in that the $2,000 is recognized twice: first through OCI and a second time through net income.

It is important to note that AOCI needs to be distinguished by its source. For example, a company needs to distinguish AOCI arising from at fair value through OCI investments separately from amounts arising from revaluation.[8]

CHECKPOINT **CP13-5**

Where is accumulated other comprehensive income reported and what does it represent?

CHECKPOINT **CP13-6**

Briefly describe recycling as it pertains to other comprehensive income.

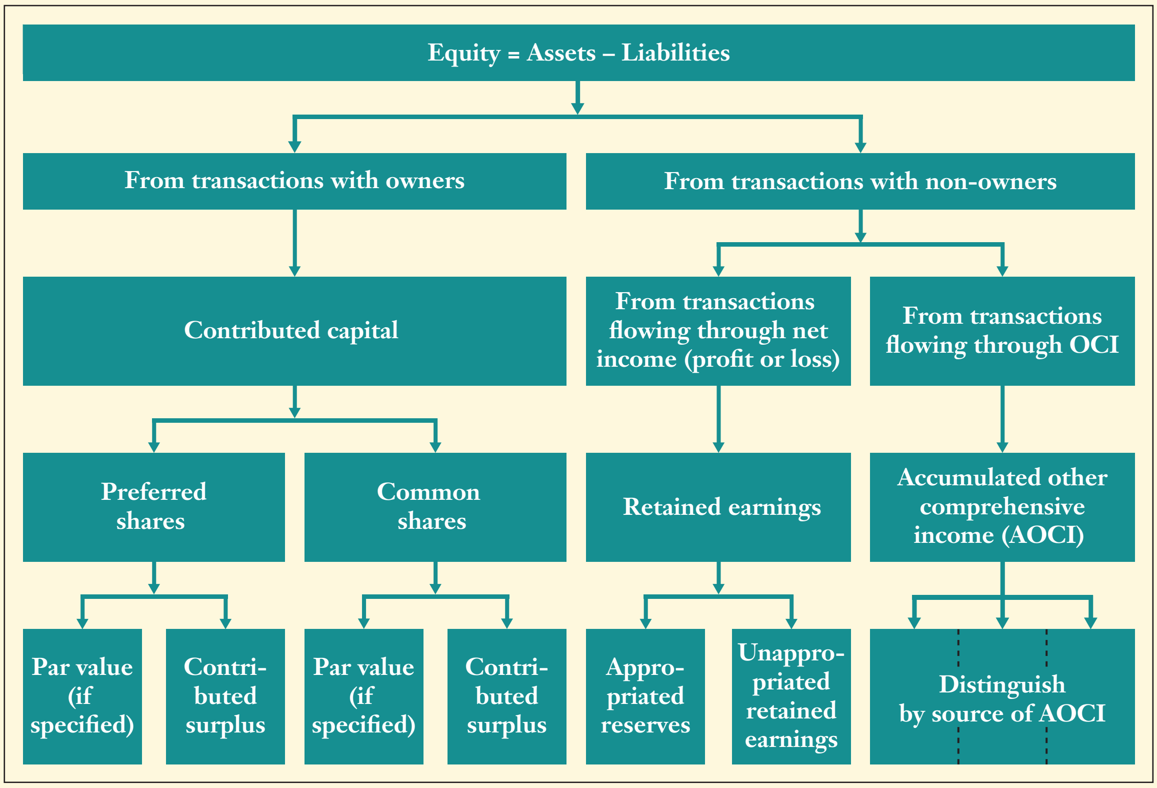
7. Recall from Chapter 7 that normally investments in equity securities are classified at fair value through profit or loss. The entity may, however, irrevocably elect to present subsequent changes in fair value through OCI.

8. In practice, AOCI needs to be even more specifically identified. For example, we would specify "AOCI from the revaluation of Land at 333 Yonge Street, Toronto, ON" due to the need to track the revaluation reserve according to the item (or group of items) being revalued.

4. Summary

The following diagram summarizes the accounting classification of the different components and sub-components of equity:

Exhibit 13-3 Equity and its components



The next two sections will examine the accounting for transactions relating to contributed capital and retained earnings.

C. EQUITY TRANSACTIONS RELATING TO CONTRIBUTED CAPITAL

L.O. 13-3. Apply the accounting standards and procedures for transactions relating to contributed capital.

This section discusses the accounting for transactions primarily affecting contributed capital, although in some transactions there will also be ancillary effects on retained earnings.

IFRS provides little guidance with respect to specific categories of equity to be used for transactions relating to contributed capital, as international standards are unable to deal with the wide variety of country-specific laws that affect business ownership. Indeed most standards simply use the encompassing term "equity." The three broad classifications within equity are share capital, retained earnings, and reserves. What modest direction there is in this respect is set out in IAS 1:

- Paragraph 54(r) requires that an entity provide information in the statement of financial position (balance sheet) pertaining to issued capital and reserves attributable to the parent.

- Paragraph 78(e) provides that, if warranted by the size, nature, and function of the amounts involved, equity capital and reserves should be disaggregated into various classes, such as paid-in capital, share premium, and reserves.
- Paragraph 79(b) mandates that a description of the nature and purpose of each reserve within equity be provided in the statement of financial position, the statement of changes in equity, or the notes to the financial statements.

1. Issuance of shares

a. Shares sold for cash

The accounting for the issuance of shares for cash is fairly straightforward. For example, suppose Naples Inc. and Parksville Company are both incorporated in 2018 and they both issue 10,000 common shares and receive $20 per share from investors. Naples' shares have no par value, while Parksville's have a par value of $1. The journal entry to record this share issuance is as follows:

Exhibit 13-4 Journal entries for the issuance of common shares with or without par value

Naples Inc.—with no par value			Parksville Company—with par value of $1/share		
Dr. Cash	200,000		Dr. Cash	200,000	
Cr. Common shares		200,000	Cr. Common shares—par value		10,000
			Cr. Contributed surplus		190,000

As noted previously, the par value in this case has no economic significance. Therefore, we should consider the effect of the above two journal entries to be the same. In other words, we should think of the amount from the par value ($10,000) and the contributed surplus ($190,000) for Parksville Company together as a single amount of $200,000 for contributed capital. This aspect will be important for understanding the reacquisition of shares discussed below.

b. Shares sold on a subscription basis

Occasionally, companies will sell shares to the public or employees on a subscription basis. While the terms of the sale will vary between issues, the commonality is that the subscriber makes a down payment toward the cost of purchasing the shares and agrees to pay the remainder at a later date. Accounting for the sale of shares on a subscription basis is not complicated, as illustrated in Exhibit 13-5. Golf Is Good Inc. sells 10,000 no-par value common shares for $8 each on a subscription basis. Terms of the sale require the purchaser to pay $3 per share when the contract is signed and the balance in three months' time.

The first step in the process is to establish a common shares subscribed account and record the initial receipt of cash. The balance is debited to a subscriptions receivables account.

Exhibit 13-5a Journal entry at date of contract signing

Dr. Cash (10,000 shares × $3/sh)	30,000	
Dr. Subscriptions receivable [10,000 shares × ($8/sh − $3/sh)]	50,000	
Cr. Common shares subscribed (10,000 shares × $8/sh)		80,000

When subsequent payments are received, cash is debited and subscriptions receivables credited.

Exhibit 13-5b Journal entry for subsequent payment

Dr. Cash (10,000 shares × \$5/sh)	50,000	
Cr. Subscriptions receivable		50,000

When the shares are paid for in full, the common shares subscribed account is closed and the shares are issued to the purchaser.

Exhibit 13-5c Journal entry to record the issuance of the shares

Dr. Common shares subscribed	80,000	
Cr. Common shares		80,000

A question that arises from accounting for shares sold on a subscription basis is how to report the subscriptions receivable on the balance sheet. Logically, it makes sense to report subscriptions receivable as a contra equity account so as to prevent manipulation of financial statements. The contra account treatment ensures that only the amount received (\$30,000 in the example just given) enters equity. The alternative of treating the \$50,000 subscriptions receivable as an asset and the full \$80,000 as equity can improve leverage ratios. This issue becomes more important with the size of the share subscription program and the time lag between subscription and payment.

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The contra equity treatment is the approach that the FASB has taken in the United States. ASPE, however, does allow some limited discretion in this respect, as Section 3251 provides the following guidance:

> ¶10 Share purchase loans receivable shall be presented as deductions from shareholders' equity unless there is substantial evidence that the borrower, not the enterprise, is at risk for any decline in the price of the shares and there is reasonable assurance that the enterprise will collect the full amount of the loan in cash.[9]

IFRS does not directly address the matter, leaving it as a matter of professional judgment.

Another issue that results from selling shares on subscription is how to account for defaulted contracts. Essentially, there are three potential outcomes: (i) refund the cash paid and cancel the contract, (ii) issue a lesser number of shares to the subscriber that reflects the amount paid, or (iii) keep the money paid as a penalty for the subscriber defaulting on the contract. The outcome will depend on any relevant legislation regarding share subscriptions and the provisions of the subscriptions contract. In the case of outcome (iii), the funds retained are recorded through contributed surplus; this is a capital transaction and does not flow through net income.

c. Bundled sales

On rare occasions, companies will sell a bundle or basket of securities that includes two or more equity instruments. The question is how the issuer should allocate the proceeds to the individual instruments. One approach is the relative fair value method, also called the proportional method, as described in Chapter 8 for bundled purchases of property, plant, and equipment. Recall that under this method, the sales price is allocated proportionally to the components based on the estimated fair value of each component. A second method is the residual value method, also called the incremental method. Briefly, the enterprise estimates the fair value of the components and then

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allocates amounts to these components in descending order according to the reliability of each component's fair value (i.e., most reliable first).

Exhibit 13-6 illustrates the application of the two methods. Sailing Boats Ltd. sold 1,000 packages of equity security consisting of one common share and one preferred share. Each package was sold for $100; total proceeds were $100,000. At time of sale, the market price of the common shares was $91 and the estimated fair value of the preferred shares was $10. In Scenario 1, the company uses the relative fair value method. In Scenario 2, the company uses the residual value method and considers the market price of the common shares to be measured more reliably than the estimated fair value of the preferred shares.

Exhibit 13-6a Scenario 1—Use the relative fair value method

The sum of the fair values is $101 ($91 + $10). Proportional allocation results in 91/101 of the sales price being allocated to the common shares and 10/101 being allocated to the preferred shares.

Dr. Cash (1,000 packages × $100/package)	100,000	
Cr. Common shares (91/101 × $100,000)		90,099
Cr. Preferred shares (10/101 × $100,000)		9,901

Exhibit 13-6b Scenario 2—Use the residual value method

The common shares can be more reliably measured at their market price of $90, so the common shares pick up the first increment of $90. The preferred shares pick up the residual value of $10 ($100 − $90).

Dr. Cash (1,000 packages × $100/package)	100,000	
Cr. Common shares ($90 × 1,000)		90,000
Cr. Preferred shares ($10 × 1,000)		10,000

Note that bundled sales are different from compound financial instruments, which will be discussed in Chapter 14. Bundled sales are for two or more equity instruments that are normally sold separately, but sold together in the particular instance. Compound financial instruments are those that are not normally sold separately as components but are rather sold jointly. The difference is analogous to a bundled sale of two cars versus the sale of a single car, which has many different components (frame, engine, tires, etc.).

d. Share issuance costs

Accounting for share issuance costs does not provide any special challenges. Expenses that are directly associated with issuing stock, including underwriting, accounting, and legal fees, are charged directly to equity as they represent a capital transaction. Entities may elect to deduct the issue costs from the related share capital account, reporting the net amount raised, or charge them directly to retained earnings.

2. Stock splits

stock split An increase in the number of shares issued without the issuing company receiving any consideration in return.

A **stock split** is an increase in the number of shares issued without the issuing company receiving any consideration in return. For instance, a company can double the number of shares issued by undergoing a two-for-one stock split. The economic positions for the company as well as every single shareholder remain the same. It is no different from having, say, either five $20 bills or ten $10 bills—the total value is still $100.

Because there are no changes in economic substance, no journal entry is required, other than a memo entry to note that the number of shares has changed.

Companies engage in stock splits typically to bring their share price to a desired range. Typical trading rules on exchanges require multiples (called "lots") of 100 shares, so a share price of $200 per share is often considered too high because trades would involve a minimum value of $20,000. A more modest price of $20 per share would lower the minimum trading value to $2,000, which can increase trading volume and improve liquidity in the market for the company's shares.

Companies can also engage in reverse stock splits to reduce the number of shares issued and increase the stock price correspondingly. Reverse stock splits are also called share consolidations.

CHECKPOINT **CP13-7**

Briefly describe the primary reason why companies declare a stock split.

3. Reacquisition of shares

Companies buy back their own shares for a number of reasons. First, share repurchases are a tax-efficient alternative to dividend payments to return cash to shareholders. The tax advantage arises from the fact that companies choosing to pay dividends must pay them equally to each share in a class, whereas in a share buyback, shareholders can choose whether (and when) to sell their shares back to the company. Investors' ability to choose when to sell allows for better tax planning.

Second, buying back shares alleviates information asymmetry by providing a credible positive signal to the market similar to the positive signal from the announcement of dividend increases. (See Chapter 1 for a discussion of signalling.) The signal is credible because it is costly for the company to expend cash to buy back its own shares. From the buyback, we infer that corporate executives believe their company's shares to be undervalued.

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Third, many companies offer stock compensation to executives and other employees. To make these shares available, the company can either issue new shares or buy back existing shares that had been previously issued. The latter is often administratively less cumbersome.

Finally, share buybacks decrease the number of shares outstanding, which lowers the denominator in the calculation of earnings per share (EPS). Depending on the cost of the shares at the time of repurchase and the amount of profits, it is possible to increase reported EPS. (See Chapter 15 for details of calculating EPS.)

There are other reasons for buying back shares, but the above discussion suffices to show that companies have many reasons for engaging in these transactions, and therefore we expect these transactions to be fairly common. As the opening vignette notes, Canadian Tire in 2013 did in fact repurchase some of its Class A non-voting shares.

The accounting for share repurchases can be complex and depends on whether the shares are cancelled after repurchase or held in treasury. We discuss these two situations separately below. Note that the following discussion is based on ASPE given the lack of specific guidance in IFRS.

a. Cancellation of reacquired shares

A business that is incorporated under the *Canada Business Corporations Act* is not permitted to hold its own shares.[10] Therefore, any repurchased shares must be retired. To

10. *Canada Business Corporations Act* (R.S.C. 1985, c. C-44) Section 30 Paragraph (1).

illustrate the accounting for share repurchases, we continue the example of Naples Inc. and Parksville Company from page xxx (Exhibit 13-4). Recall that each company issued 10,000 shares for $20 per share. Naples' shares have no par value, while Parksville's shares have a $1 par value.

Now suppose that each company repurchases 1,000 of its own shares at $18 each in 2019 and cancels them immediately. How would we account for this repurchase?

First, note that the amounts for contributed capital before the repurchase are as follows:

Exhibit 13-7 Contributed capital for Naples Inc. and Parksville Company before share repurchases

Naples Inc.—with no par value		Parksville Company—with par value of $1/share	
Common shares (10,000 shares)	$200,000	Common shares (10,000 shares)	$ 10,000
		Par value ($1/share)	
		Contributed surplus	190,000
		Total contributed capital	$200,000

Observe that both companies' accounts reflect the original share issue price of $20 per share ($200,000 ÷ 10,000 shares). Also observe that the repurchase price of $18 is below the issue price. In other circumstances, we would consider this to be a "gain" because the sale price exceeds the purchase cost by $2 per share. However, accounting standards do not allow this "gain" to flow through the income statement like other gains. Instead of a gain, we record the $2 per share difference as a credit to increase contributed surplus.

WHEN A GAIN IS NOT A GAIN

A commonly given reason for why accounting does not recognize gains on share repurchase transactions is that it involves a company buying its own shares from its shareholders rather than a transaction with an external party. However, this is not a satisfying explanation because the (former) shareholders who sold the shares on the other side of the transaction would have recorded losses had they purchased at the issue price of $20 a ashare and sold back to the company at $18 a share. Instead, there are two other explanations that are more compelling. First, a drop in a company's share price is hardly good news for shareholders, so recording a gain in this situation would be inconsistent with the underlying economics. Second, permitting the recognition of gains creates a moral hazard (see Chapter 1). Since management has superior information relative to shareholders, management could record gains by judiciously timing share issuances and repurchases to the detriment of shareholders if accounting standards permitted the recognition of such gains.

THRESHOLD CONCEPT INFORMATION ASYMMETRY

Exhibit 13-8 Journal entries for the repurchase and cancellation of 1,000 shares at $18/share

Naples Inc.—no par value shares			Parksville Company—par value of $1/share		
Dr. Common shares	20,000		Dr. Common shares—par value	1,000	
(1,000 sh × $20/sh)			Dr. Contributed surplus	19,000	
Cr. Cash (1,000 sh × $18/sh)		18,000	Cr. Cash		18,000
Cr. Contributed surplus—from repurchase of shares		2,000	Cr. Contributed surplus—from repurchase of shares		2,000

Notice that in both cases, a total of $20,000 is removed (i.e., debited) from contributed capital, amounting to $20 per share. In addition, it is important to note that the $2,000 credited to contributed surplus needs to be identified as arising from share repurchases and, for Parksville Company, separated from the contributed surplus that previously arose from share issuance. The $19,000 debit and $2,000 credit to contributed surplus have not been and *cannot be netted out* because they relate to two different types of contributed surplus. There is also a third type of contributed surplus that can be created by other transactions. We can summarize these three types of contributed surplus as follows and identify each type by a letter for ease of reference later.[11]

Exhibit 13-9 Types of contributed surplus

Type	Description
A	Created by the issuance of shares, being the amount in excess of par; this amount would have been recorded in common shares had there been no par value.
B	Created by repurchase and resale of previously issued shares.
C	Created by any transactions other than the above (e.g., issuance of stock options).

Distinguishing the different types of contributed surplus is especially important for instances when the cost of share repurchase is higher than the amount previously received. ASPE Section 3240 provides the following guidance (italics in original):

> ¶11 *When a company redeems its own shares, or cancels its own shares that it has acquired, and the cost of such shares is equal to or greater than their par, stated or assigned value, the cost shall be allocated as follows:*
>
> *(a) to share capital, in an amount equal to the par, stated or assigned value of the shares (see paragraph 3240.14 for computation of assigned value);*
>
> *(b) any excess, to contributed surplus to the extent that contributed surplus was created by a net excess of proceeds over cost on cancellation or resale of shares of the same class;*
>
> *(c) any excess, to contributed surplus in an amount equal to the pro rata share of the portion of contributed surplus that arose from transactions, other than those in (b) above, in the same class of shares; and*
>
> *(d) any excess, to retained earnings.*[12]

In this paragraph, the reference to "assigned value" in (a) refers to the amount generated from the issuance of shares. If the shares have no par value, that amount is the amount recorded to common stock. If the shares do have a par value, that amount is composed of two parts: the par value and Type A contributed surplus. The "pro rata" reference in (c) means in proportion to the number of shares involved, relative to the number of shares outstanding prior to the transactions. In essence, we withdraw Type C contributed surplus in the same manner as Type A:

Reduction in Type A contributed surplus
= Number of shares repurchased × Type A contributed surplus per share

Reduction in Type C contributed surplus
= Number of shares repurchased × Type C contributed surplus per share

In contrast, we withdraw as much Type B contributed surplus as necessary and available in the account.

11. The labelling of contributed surplus as Types A, B, and C matches the references used in ASPE 3240.11 shown below.

12. Reproduced with permission of the Chartered Professional Accountants of Canada.

To illustrate a repurchase that affects all types of contributed surplus, let's continue with the example of Naples and Parksville. Suppose each company issues some stock options in 2015, which creates Type C contributed surplus in the amount of \$27,000, which is \$3 per share (\$27,000 ÷ 9,000 shares outstanding). Subsequently, in 2016, Naples and Parksville each repurchase another 2,000 shares at \$30 a share. The journal entry to record the repurchase would be as follows:

Exhibit 13-10 Journal entries for the repurchase and cancellation of 2,000 shares at \$30/share

Naples Inc.—no par value shares			Parksville Company—par value of \$1/share		
Dr. Common shares (2,000 sh × \$20/sh)	40,000		Dr. Common shares—par value (2,000 sh × \$1/sh)	2,000	
			Dr. Contributed surplus—excess over par (Type A) (2,000 sh × \$19/sh)	38,000	
Dr. Contributed surplus—from repurchase of shares (Type B)*	2,000		Dr. Contributed surplus—from repurchase of shares (Type B)*	2,000	
Dr. Contributed surplus (Type C) (2,000 sh × \$3/sh)	6,000		Dr. Contributed surplus (Type C) (2,000 sh × \$3/sh)	6,000	
Dr. Retained earnings	12,000		Dr. Retained earnings	12,000	
Cr. Cash (2,000 sh × \$30/sh)		60,000	Cr. Cash		60,000

* From Exhibit 13-8, the previous repurchase and cancellation of 1,000 shares in 2019 created \$2,000 Cr. of Type B contributed surplus.

The \$60,000 cost of repurchase needs to be allocated first to common shares at \$20 a share, or \$40,000 total. We then allocate \$2,000 to Type B contributed surplus because this is the total amount available from the previous repurchase transaction in 2019. For Type C contributed surplus, while there is a total of \$27,000 available, we use only \$6,000 because this is the pro rata amount, being calculated as either:

$$2{,}000 \text{ shares repurchased} \times \$3/\text{share of Type C contributed surplus} = \$6{,}000$$

or

$$\frac{2{,}000 \text{ shares repurchased}}{9{,}000 \text{ shares outstanding}} \times \$27{,}000 \text{ of Type C contributed surplus} = \$6{,}000$$

The remainder of \$12,000 must be debited from retained earnings according to ASPE 3240.11.

These different treatments of contributed surplus can seem arbitrary and bewildering. We can explain the reason for the differences as follows. Type A contributed surplus arises from the issuance of shares, and only when the shares have par value. In substance, this is part of the share price received, so it makes sense that we only withdraw Type A contributed surplus in amounts equal to their recorded per-share amounts (e.g., \$19 per share for Parksville Company). In contrast, Type B contributed surplus arises from share repurchase and resale transactions that generate "gains" (that are not recorded as such). As a result, it is logical that "losses" (again, not recorded as such) should go to offset prior "gains" to the extent that there are such "gains" accumulated because they are similar transactions. Finally, Type C contributed surplus arises from transactions that are not share repurchases or resales. This type of contributed surplus is attributable to every share outstanding, and therefore we withdraw Type C contributed surplus at a rate equal to their recorded per-share amounts.

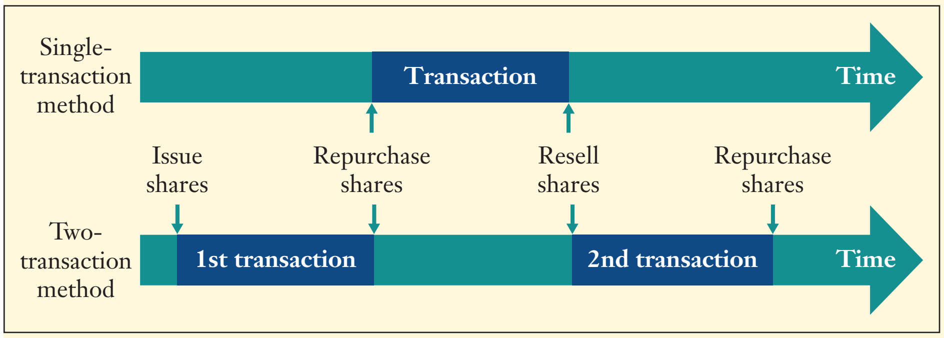
To summarize the accounting for share repurchases and cancellations, when the repurchase price (\$18) is less than the average share value (\$20), the "gain" is recorded in contributed surplus, increasing equity. When the repurchase price (\$30) is higher than the average common share value (\$20), the "loss" goes to reduce contributed surplus and retained earnings.

b. Holding reacquired shares in treasury

While a company incorporated under the *Canada Business Corporations Act* is generally not permitted to hold its own shares, companies incorporated in other jurisdictions may be allowed to do so. For example, the *British Columbia Business Corporations Act* allows companies to hold repurchased shares.[13] Shares in treasury are issued but not outstanding. Treasury shares have no voting rights and receive no dividends.

There are two methods that can be used to account for treasury shares: the single-transaction method and the two-transaction method. The single-transaction method treats the reacquisition of shares and the subsequent selling off of shares as two parts of the same transaction. The two-transaction method treats the two parts as components of two transactions: the repurchase is the close of a transaction that began with the initial issuance of the shares; and the subsequent resale is the beginning of the next sale-repurchase pair.

Exhibit 13-11 Two methods for treasury share transactions



Accounting standards indicate a preference for the single-transaction method over the two-transaction method, although both methods are acceptable (see ASPE 3240.06).

To illustrate the accounting for treasury stock transactions, suppose Smithers Company reacquired 3,000 no par shares at \$8 per share and subsequently sold 1,000 of these shares at \$12. Assume that the average price of shares outstanding is \$10 and there is no contributed surplus before this transaction. The journal entries would be as follows under each method:

Exhibit 13-12 Journal entries for the repurchase of 3,000 shares and later resale of 1,000 shares at \$12/share

Single-transaction method			**Two-transaction method**		
Repurchase 3,000 shares @ \$8/share					
Dr. Treasury stock	24,000		Dr. Common shares (3,000 sh × \$10/sh)	30,000	
Cr. Cash (3,000 sh × \$8/sh)		24,000	Cr. Cash		24,000
			Cr. Contributed surplus		6,000
Resell 1,000 shares @ \$12/share					
Dr. Cash (1,000 sh × \$12/sh)	12,000		Dr. Cash	12,000	
Cr. Treasury stock (1,000 sh × \$8/sh)		8,000	Cr. Common shares		12,000
Cr. Contributed surplus—from repurchase or resale of shares (Type B)		4,000			

13. *British Columbia Business Corporations Act* (SBC 2002, c. 57) Section 82 Paragraph 1.

As this example shows, the two methods have different effects on contributed surplus both in terms of amount and timing. In the single-transaction method, we increase contributed surplus when the repurchased shares are later resold (i.e., when the single transaction cycle is complete). In the two-transaction method, we increase contributed surplus at the time of repurchase.

For the single-transaction method, we have a separate treasury stock account. The amount recorded in treasury stock is a contra account in equity until these shares are sold off.

In instances when companies resell treasury shares for less than the repurchase cost (akin to a loss), the difference first comes out of Type B contributed surplus to the extent available and then out of retained earnings. We do not involve Type C contributed surplus because shares in treasury are issued but not outstanding, so none of the Type C contributed surplus can be attributed to these non-outstanding shares. ASPE Section 3240 indicates the following (italics in original):

> ¶16 *When a company resells shares that it has acquired, any excess of the proceeds over cost shall be credited to contributed surplus; any deficiency shall be charged to contributed surplus to the extent that a previous net excess from resale or cancellation of shares of the same class is included therein, otherwise to retained earnings.*[14]

To illustrate this accounting, suppose Smithers Company from above resells the other 2,000 shares that it previously repurchased. The resale price is only $5 a share. Prior to these transactions, the relevant balances in Smithers' accounts are as follows under the single-transaction method:

Exhibit 13-13 Smithers' account balances prior to the second treasury stock transaction

Treasury shares	16,000 Dr
Contributed surplus—from repurchase or resale of shares (Type B)	4,000 Cr

The journal entry for the resale would be as follows:

Exhibit 13-14 Journal entry to record Smithers' second resale of 2,000 shares of treasury stock @ $5/Share

Dr. Cash	10,000	
Dr. Contributed surplus—from repurchase or resale of shares (Type B)	4,000	
Dr. Retained earnings	2,000	
Cr. Treasury shares		16,000

In this repurchase and resale, the cost of $8 a share exceeds the sale price of $5 a share. The difference of $3 a share on 2,000 shares totals $6,000. We first allocate this amount to Type B contributed surplus to the extent that it is available ($4,000). The remainder of $2,000 goes to reduce retained earnings.

CHECKPOINT **CP13-8**

Briefly describe how the three different types of contributed surplus arise.

CHECKPOINT **CP13-9**

Which is the preferred method to account for treasury shares? Briefly describe the mechanics of this approach.

[14] Reproduced with permission of the Chartered Professional Accountants of Canada.

D. EQUITY TRANSACTIONS RELATING TO RETAINED EARNINGS

In this section, we discuss transactions that result in the distribution of retained earnings. We do not discuss accumulations of retained earnings, which have been dealt with in other chapters (such as Chapter 4, which dealt with recognition of revenues and expenses).

L.O. 13-4. Apply the accounting standards and procedures for transactions relating to the distribution of retained earnings.

Very few companies would pay all of their retained earnings as dividends, as there are cash flow implications, uncertainty as to the future performance of the business, contractual restrictions, and signalling effects. However, the amount of retained earnings does serve as a ceiling as to how much in dividends can be paid. On the other hand, it is commonly misunderstood that retained earnings represent funds available—that is not the case! Retained earnings may have been spent on equipment, for example, and not be available as cash. *Retained earnings is not cash.* To pay cash dividends, cash must be available.

THRESHOLD CONCEPT INFORMATION ASYMMETRY

1. Cash dividends

Cash dividends are by far the most common kind of dividends. These require attention to some relevant dates.

a. Declaration date

Dividends are discretionary payments, even for preferred shares that have cumulative provisions. Prior to declaration, a company has no obligation to pay, and therefore it records no liabilities for dividends. However, once the board of directors declares a dividend, the company then has an obligation to pay and should record a dividend payable.

b. Ex-dividend date and date of record

These two dates are closely related. The date of record is the date when the company compiles the list of shareholders to determine who should be paid how much in dividends. This date is specified at the time of dividend declaration. For shares that are publicly traded, the ex-dividend date will be several days before the record date. For the Toronto Stock Exchange, the ex-dividend date is currently two business days prior to the date of record. The ex-dividend date is the date on which a share trades without the right to receive a dividend that has been declared. Prior to ex-dividend, an investor who holds the share would be entitled to receive the previously declared dividend. For example, a dividend record date falling on a Monday would have an ex-dividend date on the previous Thursday (in a regular five-day work week). Investors who buy and hold the shares on Wednesday would be entitled to the dividends, whereas those who buy on Thursday would not receive the dividend.

c. Payment date

This is the date when the funds for the dividend are transferred to shareholders.

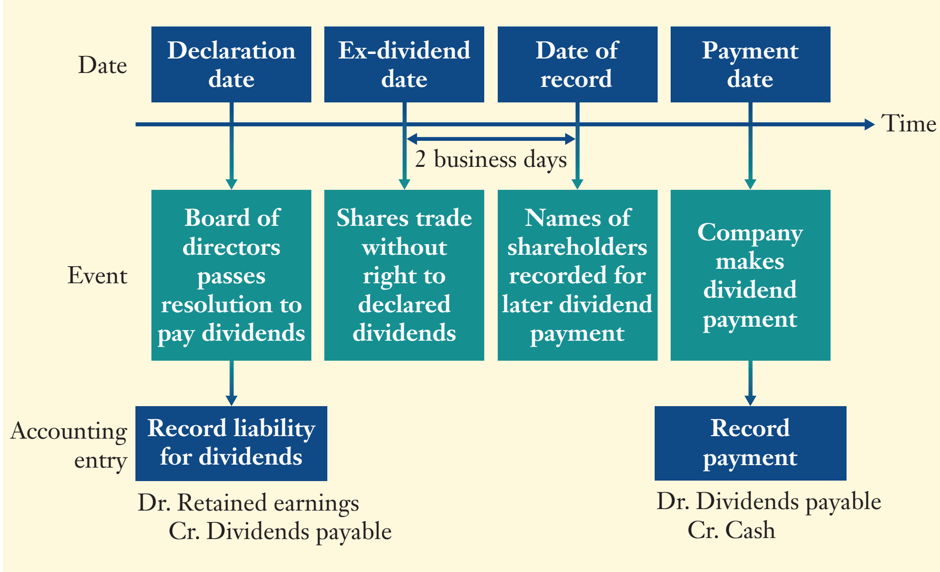
d. Summary

For accounting purposes, only the declaration date and payment date are relevant. The ex-dividend date is important to investors who need to know whether they should pay a price that includes the dividend or not. The date of record is a matter of administrative necessity to identify whom the company should pay.

2. Stock dividends

Companies can issue stock dividends instead of paying out a cash dividend. However, doing so simply increases the number of shares issued and there is no cash

Exhibit 13-15 Summary of relevant dates and accounting for cash dividends



outflow. Each shareholder owns the same fraction of the company as before the stock dividend. For example, suppose Trail Company has 800,000 no par shares outstanding and it declares a 5% stock dividend. Before the stock dividend, the shares traded at \$11.55. If you were a shareholder who owned 8,000 shares (1%) of Trail before the dividend, you would own 8,400 shares afterward, again 1% of 840,000 shares outstanding. Economically, stock dividends have the same effect as stock splits: both increase the number of shares without any change to the company's resources. The value of the company's shares before the stock dividend was \$9,240,000 (800,000 shares × \$11.55). We would expect no significant change in the company's value due to the dividend, so we would expect the ex-dividend stock price to be \$9,240,000 ÷ 840,000 shares = \$11.

As noted above in Section C, we make no journal entries for stock splits. However, we do record a journal entry for stock dividends. The difference in accounting treatment between stock splits and stock dividends is largely a result of legal and tax requirements. For tax purposes, stock dividends are treated as income to the shareholders just like cash dividends, but no tax consequences arise in stock splits. Stock dividends also result in an adjustment to the shares' tax basis (technically called paid up capital), which is relevant in the windup of a company.

Assuming that the stock price ex-dividend is \$11 as expected, we would record the following journal entry:

Exhibit 13-16 Journal entry to record a stock dividend of 40,000 shares at \$11/share for Trail Company

Dr. Retained earnings	440,000	
Cr. Common shares (40,000 shares × \$11/share)		440,000

This transfer from retained earnings to the contributed capital (common share) account explains why stock dividends are sometimes called "capitalization of retained earnings."

In general, the ex-dividend price of $11 is the appropriate price to use. To see why, consider a simpler but more extreme scenario where the stock dividend is 100%, so that the number of shares doubles. Suppose the market value of the shares outstanding is $100 and there is only one share pre-dividend. The share price should therefore be $100 per share before the stock dividend, and $50 per share afterward. This ex-dividend price equals the $50 of value transferred from the first share to the second share.[15]

For companies with shares that are not publicly traded, the stock dividend can be recorded using the book value per share. Since the result of a stock dividend is just a transfer of retained earnings into the contributed capital account without any cash changing hands, the company can choose whichever dividend rate will result in the desired amount of transfer.

3. Property dividends (dividends in kind)

Instead of cash, companies can also pay dividends using non-cash assets rather than cash. This method of distributing value to shareholders is uncommon because different investors will value the distributed property differently, and some may not appreciate it at all. For example, a cookie manufacturer could send its shareholders boxes of cookies, which could be a problem if a shareholder owned many shares. More practically, a property dividend could be used to transfer assets from a subsidiary to a parent company.

Property dividends are also used by a parent company to distribute shares of an associate or subsidiary to its shareholders. These types of transactions can be significant. The largest distribution of this kind in Canadian history was in May 2000 when Bell Canada Enterprises (BCE) spun off its 35% ownership in Nortel Networks Corp. in a transaction valued at $88 billion. At the time, the now defunct Nortel was the world's second largest telecom equipment supplier. More recently in 2006, BCE, in a transaction valued at $8.5 billion, spun off its shareholdings in Alliant Inc. into an income trust, distributing the trust units to its shareholders by way of a property dividend.

South of the border, Altria Group spun off 89% of Kraft Foods to its shareholders in 2007 in a transaction valued at US$47 billion. In 2008, Altria then distributed its majority holdings in Philip Morris International Inc. to its shareholders.

Since the assets being distributed are non-monetary, it is normally necessary to estimate the fair value of those assets for purposes of recording the value of the dividend. The difference between the book value and fair value is recorded in profit and loss (see IFRIC 17, Distribution of Non-cash Assets to Owners).

ASPE treatment differs from that in IFRS. ASPE 3831.15 specifies the use of book values, and hence no gains or losses, when an entity distributes to its owners shares of a subsidiary or investee accounted for by the equity method.

4. Dividend preference

When a company declares dividends it must consider dividend preference as discussed in Section B, subsection 1d earlier in this chapter. Recall that dividends in arrears on cumulative preferred shares together with the current dividend entitlement on cumulative and non-cumulative preferred shares must be paid before any monies can be

[15] For Trail Company, the 40,000 shares distributed will be part of the 840,000 shares outstanding after the dividend, or 40 / 840 = 1 / 21 = 4.762% of shares outstanding. The value of these 40,000 shares at the ex-dividend price of $11 is $440,000, which is equal to 1 / 21 of the market value of equity (1 / 21 × $9,240,000 = $440,000). In contrast, the pre-dividend price of $11.55 would result in a dividend value that is too high (40,000 shares × $11.55/share = $462,000).

distributed to common shareholders. The exhibits that follow illustrate the effect of various dividend preferences.

In 2019 Gail Robinson Inc. declared $1,000,000 in cash dividends. Its capital structure includes 200,000 common shares; 100,000 cumulative preferred shares "A" each entitled to an annual dividend of $1; and 50,000 non-cumulative preferred shares series "B" each entitled to an annual dividend of $3. The series A shares must receive their dividend entitlement for the year including any arrears before dividends can be declared on the series B shares.

- In Scenario 1, the prescribed dividends on both series of preferred shares were paid in 2018; there are no dividends in arrears.
- In Scenario 2, the prescribed dividends on both series of preferred shares were last paid in 2017.
- In Scenario 3, the prescribed dividends were paid on the series A preferred shares in 2018 but not on the series B preferred shares. There are no dividends in arrears on the series A preferred shares.

Exhibit 13-17a Example of dividend preference—Scenario 1

	Preferred A	Preferred B	Common	Total
Pfd A entitlement 2019—100,000 × $1	$100,000	$ 0	$ 0	$ 100,000
Pfd B entitlement 2019—50,000 × $3	0	150,000	0	150,000
Remainder	0	0	750,000	750,000
	$100,000	$150,000	$750,000	$1,000,000

In Scenario 1, there are no dividends in arrears, so only the current year's entitlement must be paid to the preferred shareholders. The balance of the dividends declared is distributed to the common shareholders.

Exhibit 13-17b Example of dividend preference—Scenario 2

	Preferred A	Preferred B	Common	Total
Pfd A entitlement 2019—100,000 × $1	$100,000	$ 0	$ 0	$ 100,000
Pfd A arrears 2018—100,000 × $1	100,000	0	0	100,000
Pfd B entitlement 2019—50,000 × $3	0	150,000	0	150,000
Remainder	0	0	650,000	650,000
	$200,000	$150,000	$650,000	$1,000,000

In Scenario 2, dividends were not paid on either class of preferred shares in 2018. The series A shares are cumulative, so both 2018 and 2019's entitlements must be paid before monies can be distributed to the common shareholders. The series B shares are non-cumulative in nature, however, so only the current year's entitlement needs to be paid.

Exhibit 13-17c Example of dividend preference—Scenario 3

	Preferred A	Preferred B	Common	Total
A entitlement 2019—100,000 × $1	$100,000	$ 0	$ 0	$ 100,000
B entitlement 2019—50,000 × $3	0	150,000	0	150,000
Remainder	0	0	750,000	750,000
	$100,000	$150,000	$750,000	$1,000,000

In Scenario 3, while dividends were not paid on the series B shares in 2018, there are no dividends in arrears as the series B shares are non-cumulative in nature. Therefore, only the current year's entitlement must be paid to the preferred shareholders.

E. STATEMENT OF CHANGES IN EQUITY

L.O. 13-5. Prepare a statement of changes in equity.

ASPE 1000, Financial Statement Concepts, establishes that profit-oriented enterprises normally prepare a statement of retained earnings, whereas IAS 1, Presentation of Financial Statements, stipulates that a complete set of financial statements includes a statement of changes in equity for the period. You should be familiar with the statement of retained earnings from your previous study of financial accounting, but may not be familiar with the statement of changes in equity. This latter statement also reconciles the change in retained earnings but is much more comprehensive than the statement of retained earnings. As discussed in Chapter 3, the statement of changes in equity provides information about the changes that took place during the period in all equity accounts. For ease of reference much of this material is reproduced below.

Presentation of the statement of changes in equity is governed by IAS 1, most notably paragraphs 10, 47, 79, and 106 to 110. This standard requires that companies present a statement of changes in equity that includes the following items:

- For each component of equity (e.g., contributed capital, unappropriated retained earnings, reserves, AOCI), a reconciliation of the opening and closing balances, separately disclosing changes resulting from profit or loss; OCI; and capital transactions
- The total comprehensive income for the period
- The effect of retrospective changes in accounting policies

The standard provides options with respect to certain disclosure; the following may be presented in either the statement of changes in equity or in the notes to the financial statements:

- For each component of equity, an analysis of OCI by item
- The change in an entity's equity between the beginning and end of the reporting period
- The amount of dividends declared, including dividends per share amounts

Lastly, the reporting entity should also disclose, either in the balance sheet, the statement of changes in equity, or in the notes to the financial statements:

- Equity disaggregated into its components (par value, contributed surplus, retained earnings, by class of shares, etc.)
- The number of shares authorized, issued, and outstanding for each class of shares; a reconciliation of shares outstanding at the beginning and end of the year; whether the shares have par value; and any rights, preferences, or restrictions on the shares
- A description of the nature and purpose for each reserve

One of the objectives of financial statements is to provide information on changes in financial position. The statement of changes in equity aims to achieve this objective by identifying the reasons for the change in total equity and its components from the beginning to the end of the period. Exhibit 13-18 shows an example of such a statement.

Exhibit 13-18 Statement of changes in equity for Illustrator Ltd.

Illustrator Ltd.
Statement of Changes in Equity
For the year ended December 31, 2019

In $000's	Share capital	Accumulated OCI on FVOCI securities*	Retained earnings	Total	2018 Total
Profit for the year	–	–	2,393	2,393	1,386
Other comprehensive income					
Net gains on available-for-sale securities	–	420	–	420	240
Total comprehensive income	–	420	2,393	2,813	1,626
Issuance of common shares	2,000	–	–	2,000	–
Dividends decl	–	–	(200)	(200)	(200)
Net change in equity	2,000	420	2,193	4,613	1,426
Balance at January 1	13,000	240	23,400	36,640	35,214
Balance at December 31	15,000	660	25,593	41,253	36,640

Classes of transactions:
1. Profit or loss
2. Other comprehensive income
3. Dividends
4. Capital transactions
5. Effect of changes in accounting policy and correction of errors

Components of equity

*OCI = other comprehensive income
FVOCI = at fair value through OCI investments

There are three components of equity shown in Exhibit 13-18 that we will consider:[16]

1. *Contributed capital*—the amount of funds provided by owners, net of any repayments to the owners or repurchases of ownership units (shares)
2. *Retained earnings*—the amount of cumulative profits (or losses) recognized through the statement of comprehensive income less dividends (and a few other adjustments as noted elsewhere in this chapter)
3. *Reserves*—amounts accumulated from events or transactions increasing equity that are not transactions with owners and which have not flowed through profit or loss; an example of a reserve is "accumulated other comprehensive income," or AOCI.

There are potentially up to five classes of transactions that explain the change in these three components:

1. *Profit or loss*—income and expenses as recognized on the statement of comprehensive income, other than (2) below
2. *Other comprehensive income* (OCI)
3. *Dividends*

[16] A fourth component is non-controlling interest, which is beyond the scope of this text.

4. *Capital transactions*—transactions with owners such as share issuances or repurchases
5. *Effect of changes in accounting policy and correction of errors*

Exhibit 13-19 summarizes the typical relationship between the five classes of transactions and the three components of equity, along with the two presentation options.

Exhibit 13-19 Content and alternative presentations of the statement of changes in equity

Class of transaction	Component of equity affected
1. Profit or loss (also called net income)	Retained earnings
2. Other comprehensive income	Accumulated other comprehensive income (a component of reserves)
Total comprehensive income (1 + 2)	
3. Dividends*	Retained earnings
4. Capital transactions (e.g., share issuance or repurchase)	Contributed capital and sometimes retained earnings
5. Effect of changes in accounting policy and correction of errors	Contributed capital or retained earnings

* Dividends may be disclosed outside the statement of changes in equity.

It is important to note that there can be several types of contributed capital, such as when a company has more than one class of shares. Also, each type of OCI needs to be tracked as a separate component of reserves. Because there are five different classes of transactions and multiple components of equity, it is usually most convenient to use a matrix-style presentation as illustrated in Exhibit 13-18.

F. PRESENTATION AND DISCLOSURE

As noted in the introduction, the information relating to equity is primarily to serve the needs of the shareholders (rather than creditors or other parties). Consequently, the presentation and disclosure rules are geared toward enabling shareholders to understand the different equity claims and categories, and changes in them. As discussed in Section E above, companies are required to prepare a statement of changes in equity to facilitate shareholder understanding of this area.

To illustrate the presentation of these items, Exhibit 13-20 reproduces the 2013 Statements of Changes in Equity for Canadian Tire Corporation, Limited.

Note that Canadian Tire has shown the opening and closing balances of each component of equity, and the transactions that explain the changes in these balances. In addition, it must also disclose the additional information detailed in Section E, including:

- Equity disaggregated into its components (par value, contributed surplus, retained earnings, by class of shares, etc.)
- The number of shares authorized, issued, and outstanding for each class of shares; a reconciliation of shares outstanding at the beginning and end of the year; whether the shares have par value; and any rights, preferences, or restrictions on the shares
- A description of the nature and purpose for each reserve
- The amount of dividends declared

Exhibit 13-20 Canadian Tire's 2013 statement of changes in equity

Canadian Tire Corporation, Limited Consolidated Statements of Changes in Equity

(C$ in millions)	Share capital	Contributed surplus	Cash flow hedges	Fair value changes in available-for-sale financial assets	Total accumulated other comprehensive income (loss)	Retained earnings	Equity attributable to owners of the Company	Equity attributable to non-controlling interests	Total equity
Balance at December 29, 2012	$ 688.0	$2.9	$ (2.0)	$ 0.3	$ (1.7)	$4,074.4	$4,763.6	$ –	$4,763.6
Restatement of Employee Benefits (Note 39)						0.7	0.7		0.7
Restated balance at December 29, 2012	688.0	2.9	(2.0)	0.3	(1.7)	4,075.1	4,764.3	–	4,764.3
Total comprehensive income									
Net income						561.2	561.2	3.2	564.4
Other comprehensive income (loss)									
Items that may be reclassified subsequently to net income:									
Cash flow hedges:									
Gains, net of tax of $30.0			83.1		83.1		83.1		83.1
Reclassification of gains to non-financial asset, net of tax of $12.2			(33.7)		(33.7)		(33.7)		(33.7)
Reclassification of losses to income, net of tax of $0.1			(0.4)		(0.4)		(0.4)		(0.4)
Available-for-sale financial assets:									
Gains, net of tax of $nil				0.1	0.1		0.1		0.1
Reclassification of gains to income, net of tax of $nil				–	–		–		–
Item that will not be reclassified subsequently to net income:									
Actuarial gains, net of tax of $3.6						10.0	10.0		10.0
Total other comprehensive (loss)	–	–	49.0	0.1	49.1	10.0	59.1	–	59.1
Total comprehensive income (loss)	–	–	49.0	0.1	49.1	571.2	620.3	3.2	623.5
Contributions by and distributions to owners of the Company									
Issue of Class A Non-Voting Shares (Note 28)	5.8				–		5.8		5.8
Repurchase of Class A Non-Voting Shares (Note 28)	(105.9)				–		(105.9)		(105.9)
Excess of issue price over repurchase price (Note 28)	(0.9)	0.9			–		–		–
Dividends					–	(119.6)	(119.6)		(119.6)
Contributed surplus arising on sale of property to CT REIT		2.4					2.4		2.4
Contributions by and distributions to non-controlling interests									
Issuance of Units (Note 17)								283.0	283.0
Distributions								(3.6)	(3.6)
Total contributions by and distributions to shareholders	(101.0)	3.3	–	–	–	(119.6)	(217.3)	279.4	62.1
Balance at December 28, 2013	$ 587.0	$6.2	$ 47.0	$ 0.4	$ 47.4	$4,526.7	$5,167.3	$282.6	$5,449.9
Balance at December 31, 2011	$ 710.5	$1.1	$ 9.4	$ 1.6	$ 11.0	$3,686.4	$4,409.0	$	–$4,409.0
Restatement of Employee Benefits (Note 39)						1.0	1.0		1.0

Exhibit 13-20 Continued

Restated balance at December 31, 2011	710.5	1.1	9.4	1.6	11.0	3,687.4	4,410.0		−4,410.0
Total comprehensive income									
Net income						498.9	498.9		498.9
Other comprehensive income (loss)									
Items that may be reclassified subsequently to net income:									
Cash flow hedges:									
Losses, net of tax of $7.8			(21.0)		(21.0)		(21.0)		(21.0)
Reclassification of losses to non-financial asset, net of tax of $3.5			9.7		9.7		9.7		9.7
Reclassification of gains to income, net of tax of $nil			(0.1)		(0.1)		(0.1)		(0.1)
Available-for-sale financial assets:									
Gains, net of tax of $0.2				0.3	0.3		0.3		0.3
Reclassification of gains to income, net of tax of $0.6				(1.6)	(1.6)		(1.6)		(1.6)
Items that will not be reclassified subsequently to net income:									
Actuarial losses, net of tax of $3.9						(9.5)	(9.5)		(9.5)
Total other comprehensive (loss)	–	–	(11.4)	(1.3)	(12.7)	(9.5)	(22.2)	–	(22.2)
Total comprehensive income (loss)	–	–	(11.4)	(1.3)	(12.7)	489.4	476.7	–	476.7
Contributions by and distributions to shareholders									
Issue of Class A Non-Voting Shares (Note 28)	12.4				-		12.4		12.4
Repurchase of Class A Non-Voting Shares (Note 28)	(33.1)				-		(33.1)		(33.1)
Excess of issue price over repurchase price (Note 28)	(1.8)	(1.8)			-		-		–
Dividends					-	(101.7)	(101.7)		(101.7)
Total contributions by and distributions to shareholders	(22.5)	1.8	–	–	–	(101.7)	(122.4)	–	(122.4)
Balance at December 29, 2012	$ 688.0	$2.9	$ (2.0)	$ 0.3	$ (1.7)	$4,075.1	$4,764.3	$ –	$4,764.3

The related notes form an integral part of these consolidated financial statements.

Refer to Appendix C for annual report of Canadian Tire Corporation, Limited for the year ended December 28, 2013. Note 28, Share capital and Note 29, Share-based payments, illustrate the company's disclosure pertaining to its equity.

G. COMPREHENSIVE ILLUSTRATION OF EQUITY TRANSACTIONS

This section provides a comprehensive example that illustrates most of the equity transactions discussed in this chapter. Suppose Flatrock Kitchen Decor Ltd. was incorporated on January 1, 2019. The incorporation documents authorized an unlimited number of common shares and 100,000 preferred shares. During the following fiscal year, the company engaged in the following transactions relating to its equity:

a. On January 1, the company issued 10,000 no par value common shares at $10 per share. On the same day, it issued 500 preferred shares for proceeds of $120 per share. These preferred shares have a par value of $100 per share and cumulative dividends of 8% per year.
b. On March 15, the company issued an additional 10,000 common shares at $20 per share.
c. On April 20, Flatrock repurchased and cancelled 2,000 common shares at a cost of $12 per share.
d. On September 1, the company issued stock options to its executives. These stock options entitle the executives to purchase up to 10,000 common shares at a price of $25 per share over the next five years. The board of directors intended the options to compensate for management's services for the eight months from January 1 to August 31, 2019. Compensation consultants have estimated the value of these options to be $18,000.

Exhibit 13-21 Analysis of Flatrock's equity transactions

	Common shares						Preferred shares					
	Common stock			Type B CS	Type C CS		Par value			Type A CS		Retained earnings
Trx	# sh	$	$/sh	$	$	$/sh	# sh	$	$/sh	$	$/sh	$
a.	10,000	$100,000	$10				500	$50,000	$100	$10,000	$20	
b.	10,000	200,000	20									
	20,000	$300,000	15									
c.	−2,000	− 30,000	15	6,000								
	18,000	$270,000	15	$6,000								
d.	–	–	–	–	18,000	$1						
	18,000	$270,000	15	$6,000	$18,000	1						
e.	−2,000	− 30,000	15	−6,000	− 2,000	1						−$ 2,000
	16,000	$240,000	15	$ –	$16,000	1						
f.	Net income											30,000
	Preferred dividends (8% × $50,000)											− 4,000
	Common dividends											−15,000
												$ 9,000

Repurchase at $12/share. Withdraw at average carrying value of $15/share. Difference ("gain") of $3/share goes to Type B contributed surplus.

$18,000 / 18,000 shares = $1/share.

Repurchase at $20/share. Withdraw at average carrying value of $15/share. Difference ("loss") of $5/share or $10,000 total first comes out of Type B CS as much as is available. $1 per share comes out of Type C CS. Remainder comes from retained earnings.

Note: CS = contributed surplus

e. On September 2, the company repurchased and cancelled 2,000 shares at $20 per share.
f. For the fiscal year ended December 31, 2019, the company had net income of $30,000 and zero OCI. The board of directors declared the 8% dividends payable to preferred shareholders and $15,000 of dividends for the common shareholders.

To analyze these transactions, it is often useful to use a spreadsheet. Similar to inventory accounting, it is necessary to keep track of both the dollar amounts and the number of units (shares). In addition, it is necessary to separate the equity components among common and preferred shares, any contributed surplus for each class of shares, as well as retained earnings. The following table shows such a spreadsheet for Flatrock's transactions in 2019:

The journal entries that accompany these transactions would be as follows:

Exhibit 13-22 Journal entries for Flatrock's equity transactions

a. Jan. 1	Dr. Cash	100,000	
	Cr. Common shares (10,000 sh × $10/sh)		100,000
	Dr. Cash (500 sh × $120/sh)	60,000	
	Cr. Preferred shares—par value (500 sh × $100/sh)		50,000
	Cr. Contributed surplus on preferred shares (Type A) (500 sh × $20/sh)		10,000
b. Mar. 15	Dr. Cash	200,000	
	Cr. Common shares (10,000 sh × $20/sh)		200,000
c. Apr. 20	Dr. Common shares (2,000 sh × $15/sh)	30,000	
	Cr. Cash (2,000 sh × $12/sh)		24,000
	Cr. Contributed surplus on common shares (Type B) (2,000 sh × $3/sh)		6,000
d. Sep. 1	Dr. Compensation expense (amount given)	18,000	
	Cr. Contributed surplus on common shares—from issuance of employee stock options (Type C)		18,000
e. Sep. 2	Dr. Common shares (2,000 sh × $15/sh)	30,000	
	Dr. Contributed surplus on common shares (Type B) (amount as needed)	6,000	
	Dr. Contributed surplus on common shares (Type C) (2,000 sh × $1/sh)	2,000	
	Dr. Retained earnings (remainder)	2,000	
	Cr. Cash (2,000 sh × $20/sh)		40,000
f. Dec. 31	Net income—not explicitly journalized; results from the net of revenues, expenses, gains, and losses		
	Dr. Retained earnings	19,000	
	Cr. Preferred dividends payable		4,000
	Cr. Common dividends payable		15,000

As this example shows, it is very important to maintain clear records of each class of shares and the different components associated with each class. It is not acceptable to intermingle different types of contributed surplus and amounts for different classes of shares.

H. SUBSTANTIVE DIFFERENCES BETWEEN RELEVANT IFRS AND ASPE

As indicated earlier in the chapter, IFRS does not provide specific recognition and measurement standards for items of equity. Therefore, preparers of financial reports for public enterprises need to consult guidance outside of IFRS.

In Canada, the most relevant guidance is contained in ASPE (Part II of the *CPA Canada Handbook*—Accounting).

ISSUE	IFRS	ASPE
Accounting for repurchase and resale of shares	No specific guidance.	ASPE prescribes the allocation of repurchase costs and proceeds from resale of shares.
Accounting for treasury shares	No specific guidance.	ASPE permits the use of the single-transaction or the two-transaction method, although the former is preferred.
Accumulated other comprehensive income (AOCI)	AOCI is a component of equity.	There is no concept of "other comprehensive income" in ASPE, and therefore no AOCI.
Dividends in kind	Distribution to the owners of shares of a subsidiary or investee is normally measured at fair value.	Distribution to the owners of shares of a subsidiary or investee is measured at book value unless the asset is impaired.
Presentation	A statement of changes in equity presents balances and transactions for all equity components.	A statement of retained earnings presents balances and transactions for retained earnings. Information relating to other equity components should be disclosed.

I. SUMMARY

L.O. 13-1. Describe the characteristics of different types of share equity and identify the characteristics that are relevant for accounting purposes.

- Shares can have a variety of characteristics involving par value, preference for dividends, the accumulation of dividends, and voting rights.
- For accounting purposes, par value affects how we record the proceeds received from the issuance of shares. Different classes of shares need to be separately recorded.

L.O. 13-2. Identify the different components of equity for accounting purposes that apply to a transaction and analyze the effect of the transaction on those equity components.

- We can divide equity into two broad components: contributed capital and accumulated income.
- Contributed capital consists of amounts received from the issuance of shares. In the case of par value shares, contributed capital has two components: par value and contributed surplus.
- Accumulated income consists of the accumulation of comprehensive income less dividends paid. The retained earnings portion derives from profit or loss, while amounts from other comprehensive income accumulate separately as accumulated other comprehensive income. Certain amounts of retained earnings may be set aside as reserves.

L.O. 13-3. Apply the accounting standards and procedures for transactions relating to contributed capital.

- Proceeds from the issuance of shares affect contributed capital and, in some instances, retained earnings.
- For accounting purposes, contributed surplus needs to be identified by source, which in this chapter we labelled as Types A, B, and C. Type A arises from the issuance of shares with par value, Type B from the repurchase and resale of shares, and Type C from all other transactions.

L.O. 13-4. Apply the accounting standards and procedures for transactions relating to the distribution of retained earnings.

- Dividends reduce retained earnings when they are declared.
- Stock dividends require a transfer from retained earnings to contributed capital, in contrast to stock splits, which require no journal entry. Generally, the ex-dividend price provides a fair measure of the value of the dividend.

L.O. 13-5. Prepare a statement of changes in equity.

- The statement of changes in equity provides information about the changes that took place during the period in all equity accounts.
- Preparation of the statement of changes in equity is governed by IAS 1.
- The opening and closing balance of each class of equity must be separately reconciled on the statement of changes in equity.
- The statement of changes in equity must include the total comprehensive income for the period.

J. ANSWERS TO CHECKPOINT QUESTIONS

CP13-1: The primary difference between common and preferred shares is that common shares represent the residual interest in the company while preferred shares do not.

CP13-2: A corporation is legally obligated to pay cash dividends when it declares them to be payable.

CP13-3: The difference between cumulative and non-cumulative dividends is that for cumulative dividends, the company must pay any past dividend payments it has missed (i.e., dividends scheduled but not declared) prior to paying any dividends to common shares. This differs from shares with non-cumulative dividends, which do not have any rights to missed dividend payments.

CP13-4: Issued shares are the net number of shares that the corporation has issued; outstanding shares are issued shares that are not held by the company as treasury shares. Outstanding shares + Treasury shares = Issued shares

CP13-5: Accumulated other comprehensive income (AOCI) is reported as a component of equity in the balance sheet. AOCI represents the accumulation of other comprehensive income (OCI) from previous periods.

CP13-6: Recycling of OCI refers to the process of recognizing amounts through OCI, accumulating that OCI in reserves, and later recognizing those amounts through net income and retained earnings.

CP13-7: The primary reason companies declare a stock split is to bring their stock price to a desired trading range.

CP13-8: The three types of contributed surplus are A, B, and C. Type A arises from issuing (selling) shares for more than their par value. Type B arises from the repurchase and resale of previously issued shares. Type C is created by transactions other than those that are Type A or B.

CP13-9: The preferred method of accounting for treasury shares is the single-transaction method. The mechanics of this method are that the cost of the repurchased shares are held in the treasury stock account—a contra equity account—until the shares are either resold or retired. The amount to be allocated to contributed surplus and/or retained earnings is not determined until the shares are removed from treasury.

K. GLOSSARY

appropriation: The process that allocates a portion of retained earnings to a reserve.

common shares: An equity interest that has the lowest priority and represents the residual ownership interest in the company.

contributed surplus: The component of contributed capital other than par value.

ordinary shares: See **common shares.**

par value shares: Shares with a dollar value stated in the articles of incorporation; for preferred shares, the dividend rate may be stated as a percentage of the par value.

preferred shares: Any shares that are not common shares.

priority: The rank of a liability or equity claim when a company liquidates, where higher priority confers preferential payout before other claimants of lower priority.

retained earnings: A component of equity that reflects the cumulative net income (profit or loss) minus dividends paid.

recycling (of OCI): The process of recognizing amounts through OCI, accumulating that OCI in reserves, and later recognizing those amounts through net income and retained earnings.

shares authorized: The number of shares that are allowed to be issued by a company's articles of incorporation.

shares issued: The number of shares issued by the corporation, whether held by outsiders or by the corporation itself.

shares outstanding: Issued shares held by investors.

stock split: An increase in the number of shares issued without the issuing company receiving any consideration in return.

treasury shares: Shares issued but held by the issuing corporation; treasury shares are not outstanding.

L. REFERENCES

Authoritative standards:

IFRS	ASPE Section
Framework for the Preparation and Presentation of Financial Statements	1000—Financial Statement Concepts
IAS 1—Presentation of Financial Statements	1400—General Standards of Financial Statement Presentation
IAS 32—Financial Instruments: Presentation	3240—Share Capital 3251—Equity 3260—Reserves
IFRIC 17—Distribution of Non-cash Assets to Owners	3831—Non-monetary Transfers

M. PROBLEMS

P13-1. Types of share equity and their characteristics (L.O. 13-1) (Easy – 5 minutes)

Identify whether the following statements are true or false.

Statement	T/F
a. Common (ordinary) shares have priority over preferred shares.	
b. A share with cumulative dividends must be a preferred share.	
c. Investors favour purchasing preferred shares.	
d. Common shares always have voting rights.	

P13-2. Types of share equity and their characteristics (L.O. 13-1) (Easy – 5 minutes)

Identify whether the following statements are true or false.

Statement	T/F
a. The number of shares issued > number outstanding > number authorized.	
b. A share with a fixed dividend rate (i.e., a preferred share) is more valuable than one without (i.e., a common share).	
c. All issued shares are eligible to vote for the board of directors.	
d. All outstanding shares are eligible to vote for the board of directors.	

P13-3. Types of share equity and their characteristics (L.O. 13-1) (Easy – 10 minutes)[17]

Canada and many other countries discourage and even prohibit the use of "par value" for common shares because it could be a misleading label.

Required:

Why is the term "par value" for *common* shares a misleading idea for many investors?

P13-4. Types of share equity and their characteristics (L.O. 13-1) (Easy – 10 minutes)

Having a cumulative dividend is a common feature of preferred shares.

Required:

a. What does it mean to have a cumulative dividend feature?
b. Why do preferred shares commonly have this feature?
c. Can common shares have a cumulative dividend feature? Explain briefly.

P13-5. Accounting standards for share equity (L.O. 13-1) (Medium – 15 minutes)

Preferred shares are defined as being a form of equity by the Canada Business Corporations Act (CBCA). Preferred shares generally have a specified dividend rate and in the event of bankruptcy or liquidation have priority over common shares. However, preferred shares do not have a residual interest in the entity.

17. Adapted from CGA-Canada FA3 examination, 2009.

Required:

a. Why is residual interest central to the value of common shares?
b. Identify qualities of preferred shares that make them similar to debt financing; identify qualities that make them similar to equity financing.
c. Discuss three reasons why management would want to use preferred shares as a source of financing.

P13-6. Accounting standards for share equity (L.O. 13-1) (Medium – 10 minutes)

A major objective of IFRS is to harmonize accounting rules and procedures around the world. Yet for the details and specifics of accounting for equity accounts (e.g., repurchase of the company's own shares), there are no international rules; rather, countries like Canada are defining the accounting standards for equity accounting and reporting.

Required:

a. Why are there no specific IFRS standards relating to equity accounts?
b. Is it a problem that there are not uniform standards for equity accounting and reporting?

P13-7. Share equity characteristics relevant for accounting (L.O. 13-1) (Medium – 10 minutes)

For accounting purposes, of the following characteristics, which distinguish a common share from a preferred share? Explain your answer briefly.

- The share has no par value.
- The share has voting rights.
- The share has a residual claim.
- The share does not have cumulative dividends.
- The share is issued and outstanding.

P13-8. Components of equity (L.O. 13-2) (Easy – 5 minutes)

Financial reporting distinguishes equity into two broad components: contributed capital and accumulated income; the latter is further separated into retained earnings and accumulated other comprehensive income (AOCI).

Required:

Briefly explain why equity needs to be separated into these categories.

P13-9. Components of equity (L.O. 13-2) (Easy – 5 minutes)[18]

Which of the following are accounts reported in the equity section of the balance sheet?

Account	Equity section	Asset or liability
Preferred shares		
Investment in Company A common shares		
Treasury shares		
Accumulated other comprehensive income		
Bonds payable		
Donated assets		
Appropriated reserves		
Provision for warranties		

P13-10. Components of equity (L.O. 13-2) (Easy – 5 minutes)

Which of the following are accounts reported in the contributed capital section of equity?

18. Adapted from CGA-Canada FA3 examination, June 2010.

Account	Contributed capital	Not contributed capital
Common shares		
Retained earnings		
Preferred shares		
Accumulated other comprehensive income		
Appropriated reserves		
Equity in associate		
Contributed surplus—common shares		
Treasury shares		

P13-11. Components of equity

(L.O. 13-2) (Easy – 5 minutes)

Which of the following transactions have the potential to directly affect the retained earnings portion of equity? Exclude indirect effects such as the transfer of income into retained earnings at the end of a year.

Account	Has potential to directly affect retained earnings	No direct effect on retained earnings
Declaration of a cash dividend		
Issuance of common shares		
Issuance of preferred shares		
Appropriation for a reserve		
Stock split		
Declaration of a stock dividend		
Omission of a cumulative dividend on preferred shares		

P13-12. Accounting for contributed capital

(L.O. 13-3) (Easy – 5 minutes)

When shares are repurchased at more than their original issue price, then held in treasury or cancelled, the journal entry potentially includes which of the following components?

Account	Transaction potentially affects this account in the manner indicated (Yes / No)
Debit to share capital	
Debit to contributed surplus	
Debit to treasury shares	
Debit to loss on share retirement	
Debit to retained earnings	
Debit to accumulated other comprehensive income (AOCI)	

P13-13. Accounting for contributed capital

(L.O. 13-3) (Easy – 5 minutes)[19]

When shares are repurchased and cancelled at more than their original issue price, the journal entry to record the retirement potentially includes which of the following components?

[19]. Adapted from CGA-Canada FA3 examination, June 2009.

Account	Transaction potentially affects this account in the manner indicated (Yes / No)
Debit to cash	
Debit to retained earnings	
Credit to share capital	
Debit to loss on share retirement	
Debit to contributed surplus	
Debit to treasury shares	

P13-14. Accounting for contributed capital

(L.O. 13-3) (Easy – 5 minutes)

When shares are repurchased and held in treasury, and the purchase is at more than the original issue price, the journal entry to record the repurchase potentially includes which of the following components under the single-transaction method?

Account	Transaction potentially affects this account in the manner indicated (Yes / No)
Debit to share capital	
Debit to contributed surplus	
Debit to retained earnings	
Debit to treasury shares	
Debit to accumulated other comprehensive income (AOCI)	
Credit to share capital	

P13-15. Accounting for shares sold on a subscription basis

(L.O. 13-3) (Easy – 15 minutes)

Wedding Boutique Corp. sells 20,000 no par common shares for $20 each to employees on a subscription basis. Terms of the sale require the employees to pay $12 on contract signing and the balance in one year's time. Wedding Boutique Corp. has a policy of refunding employees their initial payment if they subsequently default on the contract.

Required:

a. Prepare the journal entries required at time of contract signing.
b. Assume that all employees make the scheduled payments. Prepare the required journal entries.
c. Independent of part (b), assume that contracts representing the sale of 5,000 shares are defaulted upon. Prepare the required journal entries pertaining to the default.
d. Given the facts at hand, how would Wedding Boutique Corp. report the subscriptions receivable account on its balance sheet?

P13-16. Accounting for bundled sales and share issuance costs

(L.O. 13-3) (Easy – 10 minutes)

Walt's Antique Cars Inc. issued equity securities. The offering included 100,000 bundles of one no par common share and one no par preferred share. Each bundle sold for $50 Walt's has adopted a policy of charging share issuance costs to retained earnings.

Required:

a. Assume that the fair values of the common shares and preferred shares are $42 and $10, respectively. Prepare the journal entry for the issuance of the equity securities using the relative fair value (proportional) method.

b. Assume that the fair value of the common shares is $42 each but the value of the preferred shares is not known. Prepare the journal entry for the issuance of the equity securities.
c. How would your answer to part (a) change if Walt's incurred $20,000 of costs directly related to the issuance of the securities? Prepare the journal entry.

P13-17. Accounting for shares sold on a subscription basis

A·S·P·E

(L.O. 13-3) (Medium – 20 minutes)

In January 2015, Rita Inc. sells 50,000 no par common shares for $20 each to the investing public on a subscription basis. Terms of the sale require the investors to pay $11 on contract signing, $5 in July 2015, and the balance in December 2015. The subscription contract provides that Rita Inc. is not required to reimburse investors who default on their contract.

In July 2015, investors that subscribed to purchase 40,000 shares make the agreed-upon payment; the remainder default on the contract. In December 2015, investors that subscribed to purchase 35,000 shares make the agreed upon payment; the remainder default on the contract.

Required:

Prepare the journal entries required in January 2015, July 2015, and December 2015 assuming that Rita Inc. follows ASPE pertaining to accounting for equity transactions.

P13-18. Accounting for bundled sales and share issuance costs

(L.O. 13-3) (Medium – 20 minutes)

Shangri-La Inc. raised additional capital by selling equity to investors. The package of securities included one no par common share, one cumulative Class A preferred share, and one non-cumulative Class B preferred share. Shangri-La sold 200,000 packages for $100 each. It incurred $25,000 in costs directly related to the issuance of the securities. At the time of sale, the market value of the common and cumulative preferred shares was $60 and $35, respectively. The Class B preferred shares are a new class of shares so they did not have a market price. Shangri-La has a policy of charging share issuance costs to retained earnings.

Required:

a. Assume that the fair value of a Class B preferred share is $7. Prepare the journal entry for the issuance of the equity securities using the relative fair value (proportional) method.
b. Assume that the fair value of a Class B preferred share is $7. Using the relative fair value (proportional) method, prepare the journal entry for the issuance of the equity securities on the basis that Shangri-La had adopted a policy of allocating the share issuance costs to the related capital accounts.
c. Assume that the fair value of the Class B preferred share is not reliably measurable. Prepare the journal entry for the issuance of the equity securities.

P13-19. Accounting for contributed capital

(L.O. 13-3) (Medium – 20 minutes)

A·S·P·E

Utopia Is A Destination Inc. had the following shareholders' equity account balances on December 31, 2015:

Common stock, no par, 60,000 shares authorized, 40,000 issued	$ 800,000
Contributed surplus on repurchases and resales	20,000
Treasury stock, 3,000 shares	(90,000)
Retained earnings	400,000
Total shareholders' equity	$1,130,000

During 2016, the following transactions occurred:

i. March 1: Utopia resold 500 of the treasury shares at $40 per share.
ii. May 15: Utopia issues (sells) 5,000 common shares for $25 each.

iii. December 15: The board of directors declared cash dividends of $4 per share, payable on January 15, 2017.
iv. December 31: Net income for the year ended December 31, 2016, was $200,000.

Utopia uses the single-transaction method for treasury shares.

Required:

a. Assume that Utopia follows the guidance in ASPE pertaining to accounting for equity transactions. Record the journal entries for the transactions in 2016 and make all the necessary year-end entries relating to shareholders' equity accounts.
b. Prepare the presentation of the shareholders' equity section of Utopia's balance sheet as at December 31, 2016.

P13-20. Accounting for contributed capital (L.O. 13-3) (Medium – 10 minutes)

Accounting standards do not permit the recognition of capital transactions (those involving owners acting as owners) to flow through net income. Explain why accounting standards prohibit the recognition of gains or losses on capital transactions on the income statement.

P13-21. Accounting for contributed capital (L.O. 13-3) (Medium – 20 minutes)[20]

When a corporation engages in a capital transaction (those relating to its contributed capital), the journal entry may involve either a debit or a credit to contributed surplus. While not permitted by accounting standards, *if these debits or credits were to be recognized through income,* a debit would be called a "loss" and a credit would be called a "gain."

Consider the following sequence of transactions:

January 1, 2012: Company issues 10,000,000 no par common shares at $10 each.
January 1, 2018: Company reacquires 100,000 common shares in the open market at $8 each and cancels them immediately.

There were no other capital transactions and the company had not paid any dividends.

Required:

a. Prepare the journal entries for the two transactions.
b. Review the journal entry for January 1, 2018. How much was credited other than cash? Does this credit reflect good or bad management? As a shareholder, would you be happy or unhappy about this credit entry?
c. What would have been the journal entry for January 1, 2018, had the repurchase price been $30?
d. In the journal entry for part (c), explain why the debit goes to reduce retained earnings. How would a shareholder interpret the reduction in retained earnings?

A·S·P·E

P13-22. Accounting for contributed capital (L.O. 13-3) (Medium – 15 minutes)[21]

Cambridge Corp. has a single class of shares. As at its year ended December 31, 2015, the company had 2,500,000 shares issued and outstanding. On the stock exchange, these shares were trading at around $10 per share. In the company's accounts, these shares had a value of $30,000,000. The equity accounts also show $450,000 of contributed surplus from previous repurchases of shares.

On January 15, 2016, Cambridge repurchased and cancelled 100,000 shares at a cost of $10 per share. Later in the year, on August 20, the company repurchased and cancelled a further 300,000 shares at a cost of $15 per share.

Required:

Assume that Cambridge follows the guidance in ASPE pertaining to accounting for equity transactions. Record the journal entries for the two share transactions in 2016.

20. Adapted from CGA-Canada FA3 examination, December 2009.

21. Adapted from CGA-Canada FA3 examination, June 2010.

P13-23. Accounting for contributed capital (L.O. 13-3) (Medium – 15 minutes) A·S·P·E

Drayton Inc. was incorporated under provincial legislation with a December 31 year-end. The company has a single class of shares. As at December 31, 2014, it had 200,000 shares issued and outstanding. These shares had a book value of $5,000,000 on the balance sheet.

During 2015, Drayton repurchased 10% of the issued shares from one of the minority shareholders at a cost of $30 per share. The company held these in treasury and later found a buyer for half of these shares at $35. The other half were sold at $28 to another investor.

Required:

Assume that Drayton follows the guidance in ASPE pertaining to accounting for equity transactions. Record the share transactions using the single-transaction method for treasury shares, which is the preferred accounting method.

P13-24. Accounting for contributed capital (L.O. 13-3) (Medium – 15 minutes) A·S·P·E

Refer to the facts for Drayton Inc. presented in problem P13-23.

Required:

Assume that Drayton follows the guidance in ASPE pertaining to accounting for equity transactions. Record the share transactions using the alternative two-transaction method for treasury shares.

P13-25. Accounting for contributed capital (L.O. 13-3) (Medium – 15 minutes) A·S·P·E

Elgin Company had the following shareholders' equity account balances on December 31, 2019:

Common stock, no par, 40,000 shares authorized, 30,000 issued	$720,000
Contributed surplus on repurchases and resales	25,000
Treasury shares, 5,000 shares	(165,000)
Retained earnings	350,000
Total shareholders' equity	$930,000

During 2015, the following transactions occurred:

i. May 1: Elgin resold 800 of the treasury shares at $48 per share.
ii. December 30: The board of directors declared cash dividends of $2 per share payable on January 15, 2016.
iii. December 31: Net income for the year ended December 31, 2015, was $120,000.

Elgin uses the single-transaction method for treasury shares.

Required:

a. Assume that Elgin follows the guidance in ASPE pertaining to accounting for equity transactions. Record the journal entries for the transactions in 2015 and make all the necessary year-end entries relating to shareholders' equity accounts.
b. Prepare the presentation of the shareholders' equity section of Elgin's balance sheet as at December 31, 2015.

P13-26. Components of equity (L.O. 13-2, L.O. 13-3) (Medium – 15 minutes) A·S·P·E

Refer to the 2013 financial statements for Canadian Tire Corporation, Limited in Appendix C.

Required:

a. What was the amount of equity reported in Canadian Tire's financial statements as at December 28, 2013? What was this amount comprised of? Use the same categories that the company reports on its balance sheet.

b. The company had two categories of share capital. What were they and what was the closing balance of each?
c. What were the opening and closing balances of the company's contributed surplus? What two categories of items were responsible for the change during the year?
d. What were the opening and closing balances of the company's accumulated other comprehensive income (loss)? What were the two categories of AOCI reported in the Canadian Tire's financial statements?

A·S·P·E

P13-27. Accounting for contributed capital (L.O. 13-3) (Difficult – 30 minutes)

Liway's Cleaning Emporium Corp. had the following shareholders' equity account balances on December 31, 2015:

Preferred shares A, $100, 4% cumulative, 10,000 authorized, 2,000 issued and outstanding	$ 200,000
Preferred shares B, $100, 5% non-cumulative, 10,000 authorized, 1,000 issued and outstanding	100,000
Common shares, no par, 50,000 authorized, 40,000 issued	4,000,000
Contributed surplus on repurchases and resales	100,000
Treasury shares—common, 2,000 shares	(200,000)
Retained earnings	1,400,000
Accumulated other comprehensive income	300,000
Total shareholders' equity	$5,900,000

During 2016, the following transactions occurred:

i. February 1: Liway's resold the 2,000 treasury shares at $90 per share.
ii. May 20: Liway's bought back 500 common shares for $95 each and retired them.
iii. December 1: The board of directors declared cash dividends of $600,000 payable on January 2, 2017. (There were no dividends in arrears.)
iv. December 31: Other comprehensive income for the year ended December 31, 2016, was $50,000.
v. December 31: Net income for the year ended December 31, 2016, was $1,000,000.

Liway's uses the single-transaction method for treasury shares and follows the guidance in ASPE pertaining to the issuance and redemption of share capital.

Required:

a. Record the journal entries for the transactions in 2016 and make all the necessary year-end entries relating to shareholders' equity accounts.
b. Prepare the presentation of the shareholders' equity section of Liway's' balance sheet as at December 31, 2016.
c. How much is the dividend per share paid to the common shareholders?

P13-28. Dividends preference (L.O. 13-4) (Easy – 10 minutes)

Stanger's Secure Storage Inc.'s capital structure includes the following equity instruments:

- No par value common shares, 1,000,000 shares issued and outstanding
- Class A, $100 par value, 4% cumulative preferred shares, 100,000 shares issued and outstanding
- Class B, $100 par value, 6% non-cumulative preferred shares, 50,000 shares issued and outstanding

The dividends on the Class B shares are subordinated to the Class A shares; dividends must be up to date on the Class A shares before dividends can be declared on Class B shares. In 2015, Stanger's declared $1,300,000 in dividends.

- Scenario 1—there are no dividends in arrears.
- Scenario 2—dividends were neither declared nor paid in 2014.
- Scenario 3—dividends were neither declared nor paid in 2013 or 2014.

Required:

Determine how much of the dividend must be distributed to each class of shares for each of the three scenarios.

P13-29. Accounting for retained earnings (L.O. 13-4) (Easy – 5 minutes)[22]

Mark Corporation declared and distributed a 5% stock dividend. Mark had 400,000 common shares outstanding and 1,000,000 common shares authorized before the stock dividend. The board of directors determined the appropriate market value per share as $7.

Required:

How much should be recorded for the stock dividend? Record the journal entry (if any) for the shares distributed.

P13-30. Accounting for retained earnings (L.O. 13-4) (Easy – 10 minutes)

Acton Company has two classes of shares that were both issued on January 1, 2013:

- Class A, $100 par value, 5% preferred shares, 100,000 shares issued and outstanding
- Class B, no par value common shares issued at $50 per share, 1,000,000 shares issued and outstanding

Due to challenging start-up problems in 2013 and 2014, there were no dividends paid; in 2015, dividends of $6,000,000 were paid. For 2016, dividends paid totalled $17,000,000, and for 2017 total dividends paid were $15,000,000.

Required:

How much was the amount of dividends paid to preferred and common shares in 2013 to 2017? First assume that the preferred shares are non-cumulative, then assume that they are cumulative. Use the following table for your answer.

(in $000's)	2013	2014	2015	2016	2017
Total dividends	0	0	$6,000	$17,000	$15,000
Non-cumulative preferred dividends					
Common dividends					
Total dividends	0	0	$6,000	$17,000	$15,000
Cumulative preferred dividends					
Common dividends					

P13-31. Accounting for retained earnings (L.O. 13-4) (Medium – 10 minutes)

Belmont Corporation has a December 31 year-end. On December 15, 2014, the board of directors declared a cash dividend of $0.50 per common share, payable on January 30, 2015. The date of record for this dividend is January 14, and the ex-dividend date is January 12, 2015. Additional information relating to the shares follows:

	No. of common shares at end of day	
Date	Issued	Outstanding
December 15, 2014	4,000,000	4,000,000
January 11, 2015	4,000,000	3,800,000
January 14, 2015	4,000,000	3,600,000
January 30, 2015	3,600,000	3,600,000

[22] Adapted from CGA-Canada FA3 examination, 2010.

Required:

a. Determine the dollar amount of dividends to be paid as a result of the dividend declaration on December 15, 2014.
b. Record all the journal entries related to this dividend in 2014 and 2015.

P13-32. Accounting for retained earnings (L.O. 13-4) (Medium – 20 minutes)

Cardiff Corporation is a public company traded on a major exchange. Cardiff's common shares are currently trading at $20 per share. The board of directors is debating whether to issue a 25% stock dividend or a five-for-four stock split (i.e., a shareholder who holds four shares would receive a fifth share). The board is wondering how shareholders' equity would be affected, and whether the value of the typical shareholder's investment will change.

Details of Cardiff's equity section of the balance sheet is as follows:

Common shares, no par, 10,000,000 shares issued and outstanding	$ 56,500,000
Retained earnings	170,000,000
Total shareholders' equity	$226,500,000

Required:

a. At what price would you expect the shares to trade after either transaction? Explain with calculations.
b. Show what the equity section of the balance sheet for Cardiff would look like after the stock dividend. Do the same for the stock split alternative.
c. Assume that an investor has 4,000 common shares before the stock dividend or stock split. What would be the value of the investor's holdings before and after the stock dividend or stock split?
d. What is your recommendation to the board of directors?

P13-33. Dividends in kind (L.O. 13-4) (Medium – 15 minutes)

Jamie Bleay Inc. (JBI) has an at fair value through profit or loss investment in which it owns 200,000 common shares of Richard Ramey Ltd. (RRL). JBI distributes its shareholding in RRL by way of a property dividend. Other information follows:

- The current book value of the RRL shares is $580,000.
- The market value of the RRL shares is $600,000.
- JBI's capital structure includes 50,000 issued and 40,000 outstanding common shares.
- The dividend is declared on December 15, 2015, and distributed on December 18, 2015.

Required:

a. Prepare the required journal entries to record the declaration and payment of the dividend in kind assuming that JBI prepares its financial statements in accordance with IFRS.
b. What is the fair market value of the RRL shares that each JBI common shareholder receives?

A·S·P·E

P13-34 Dividends in kind (L.O. 13-4) (Medium - 10 minutes)

Peter Quitzau Inc. (PQI) owns 200,000 common shares of Margaret Thornton Ltd. (MTL), a private company. PQI distributes its shareholding in MTL to PQI's shareholders by way of property dividend. Other information follows:

- PQI exercises significant influence over MTL. It accounts for its investment using the equity method.
- At dividend declaration date, the cost of the MTL investment was $400,000; the book value $500,000; and the estimated market value $600,000.
- The dividend was declared on December 15, 2018, and is distributed on December 18, 2018.

Required:

Prepare the required journal entries to record the declaration and payment of the dividend in kind, assuming that PQI prepares its financial statements in accordance with ASPE.

P13-35. Accounting for contributed capital and retained earnings

(L.O. 13-3, L.O. 13-4) (Medium – 20 minutes)

A·S·P·E

As of January 1, 2015, the equity section of GFF Educational Inc.'s balance sheet contained the following:

Preferred stock, $4 non-cumulative dividend, 2,000,000 shares authorized, 10,000 issued and outstanding	$1,000,000
Common stock, unlimited shares authorized, 1,000,000 issued and outstanding	4,000,000
Contributed surplus—from repurchase and cancellation of common shares	450,000
Contributed surplus— from repurchase and cancellation of preferred shares	10,000
Retained earnings	3,540,000
Total shareholders' equity	$9,000,000

- On March 1, 2015, GFF repurchased and cancelled 1,000 preferred shares at $120 per share.
- On June 30, 2015, GFF spent $500,000 to repurchase 100,000 common shares. These shares were cancelled immediately.
- On November 15, 2015, GFF issued a 15% stock dividend on common shares. GFF's stock traded at $8 per share after the dividend.
- On December 15, 2015, GFF declared the annual cash dividends on the preferred shares, payable on January 2, 2016.

Required:

Assume that GFF follows the guidance in ASPE pertaining to accounting for equity transactions. Record the journal entries for the above transactions occurring in 2015.

P13-36. Accounting for contributed capital and retained earnings

(L.O. 13-3, L.O. 13-4) (Medium – 30 minutes)

A·S·P·E

As of January 1, 2016, the equity section of Gail and Samson Inc.'s balance sheet contained the following:

Class A preferred stock, $3 cumulative dividend, 500,000 shares authorized, 2,000 issued and outstanding	$ 200,000
Class B preferred stock, $5 non-cumulative dividend, 200,000 shares authorized, 5,000 issued and outstanding	500,000
Common stock, unlimited shares authorized, 20,000 issued and outstanding	1,300,000
Contributed surplus—from repurchase and cancellation of common shares	100,000
Contributed surplus—from repurchase and cancellation of Class A preferred shares	25,000
Contributed surplus—from repurchase and cancellation of Class B preferred shares	20,000
Retained earnings	1,890,000
Total shareholders' equity	$4,035,000

- Dividends were last paid in 2013. There were no arrears at that time.
- On February 1, 2016, Gail sold 1,000 common shares for $65,000 cash.
- On March 1, 2016, Gail issued a 5% stock dividend on common shares. Gail's stock traded at $65 per share after the dividend.
- On April 1, 2016, Gail declared $50,000 in cash dividends, payable on April 15, 2016.
- On April 15, 2016, Gail paid the dividends declared on April 1.

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- On May 1, 2016, Gail repurchased and cancelled 1,000 Class B preferred shares at $110 per share.
- On June 1, 2016, Gail spent $75,000 to repurchase 1,000 common shares. These shares were cancelled immediately.
- On July 1, 2016, Gail declared and distributed a two-for-one stock split on the common shares.

Required:

a. Assume that Gail and Samson Inc. follow the guidance in ASPE pertaining to accounting for equity transactions. Record the journal entries for the above transactions occurring in 2016.
b. Briefly describe the procedure for recording the two-for-one stock split.
c. How much was the dividend per share amount paid to the common shareholder?

A·S·P·E

P13-37. Accounting for contributed capital and retained earnings

(L.O. 13-3, L.O. 13-4) (Medium – 30 minutes)

As of January 1, 2017, the equity section of Smokey The Cat Corp.'s balance sheet contained the following:

Class A preferred stock, $1 cumulative dividend, 100,000 shares authorized, 1,000 issued and outstanding	$ 10,000
Class B preferred stock, $2 cumulative dividend, 100,000 shares authorized, 2,000 issued and outstanding	40,000
Common stock, unlimited shares authorized, 10,000 issued and outstanding	200,000
(Contributed surplus—from repurchase and cancellation of common shares	5,000
Contributed surplus—from repurchase and cancellation of Class A preferred shares	5,000
Contributed surplus—from repurchase and cancellation of Class B preferred shares	5,000
Retained earnings	135,000
Total shareholders' equity	$400,000

- Smokey uses the single-transaction method to account for treasury shares.
- Dividends were last paid in 2013. There were no arrears at that time.
- On February 1, 2017, Smokey repurchased 1,000 common shares for $25,000 cash and held them as treasury shares.
- On March 1, 2017, Smokey issued a 10% stock dividend on common shares. Smokey's stock traded at $22 per share after the dividend.
- On April 1, 2017, Smokey repurchased and cancelled 1,000 Class B preferred shares at $23 per share.
- On June 1, 2017, Smokey declared and distributed a two-for-one stock split on the common shares.
- On July 1, 2017, Smokey declared $25,000 in cash dividends, payable on August 1, 2017.
- On August 1, 2017, Smokey paid the dividends declared on July 1.
- On September 1, 2017, Smokey resold the common shares in treasury for $28 each.

Required:

a. Assume that Smokey follows the guidance in ASPE pertaining to accounting for equity transactions. Record the journal entries for the above transactions occurring in 2017.
b. How much was the dividend per share amount paid to the common shareholder?
c. Ignoring income for the year, what is the total capitalization of the company on August 2, 2017?

P13-38. Accounting for contributed capital and retained earnings (L.O. 13-3, L.O. 13-4) (Medium – 20 minutes)

A·S·P·E

As of January 1, 2019, the equity section of BC Marine Co.'s balance sheet contained the following:

Common shares, 10,000,000 authorized, 2,000,000 issued and outstanding	$5,000,000
Contributed surplus—from repurchase and cancellation of common shares	150,000
Contributed surplus—expired options on common shares	200,000
Preferred shares, $2 cumulative dividend, 5,000,000 authorized, 50,000 issued and outstanding	1,050,000
Retained earnings	2,400,000
Total shareholders' equity	$8,800,000

- On May 1, 2019, the company spent $500,000 to repurchase 100,000 common shares. These shares were cancelled immediately.
- On July 15, 2019, the company repurchased and cancelled 1,000 preferred shares at $20 per share.
- On November 1, 2019, the company declared and paid the annual cash dividends on the preferred shares. On the same day, the company issued a 10% stock dividend on common shares. BC Marine's stock traded at $6 per share after the dividend.

Required:

Assume that BC Marine follows the guidance in ASPE pertaining to accounting for equity transactions. Record the journal entries for the above transactions occurring in 2019.

P13-39. Dividends in kind (L.O. 13-4) (Difficult – 30 minutes)

A·S·P·E

Ron Tidball Corp. (RTC) owns 100,000 shares in Scott Austin Ltd. (SAL). RTC distributes its shareholding in SAL by way of a property dividend. Other information follows:

- The current book value of the SAL shares is $450,000.
- The market value of the SAL shares is $500,000.
- The dividend is declared on June 15, 2015, and distributed on June 30, 2015.
- Scenario 1—SAL has 10,000,000 shares outstanding; the investment is designated as at fair value through profit or loss (IFRS) and is quoted in an active market (ASPE).
- Scenario 2—SAL has 50,000 shares outstanding. RTC has significant influence over SAL and accounts for the investment using the equity method.
- Scenario 3—SAL has 15,000 shares outstanding. RTC controls SAL.

Required:

a. For each of the scenarios, prepare the required journal entries to record the declaration and payment of the dividend in kind. Assume that RTC prepares its financial statements in accordance with IFRS.
b. For each of the scenarios, prepare the required journal entries to record the declaration and payment of the dividend in kind. Assume that RTC prepares its financial statements in accordance with ASPE.

P13-40. Dividends preference and distribution (L.O. 13-4) (Difficult – 30 minutes)

A·S·P·E

Della's Garden Delight Corp.'s capital structure includes the following equity instruments:

- No par value common shares, 2,000,000 shares issued and outstanding
- Class A, non-cumulative preferred shares each entitled to an annual dividend of $5, 80,000 shares issued and outstanding
- Class B, cumulative preferred shares each entitled to an annual dividend of $4, 40,000 shares issued and outstanding

The dividends on the Class A and B shares are *pari passu* (equally ranked) with respect to current dividend entitlements. (Dividends declared are applied firstly to arrears, if any. If the remaining dividend is insufficient to pay the current year's entitlement on the A and B shares, then that amount is distributed on a pro rata basis.) On December 31, 2015, Della's declared $744,000 in dividends, payable on January 15, 2016.

- Scenario 1—there are no dividends in arrears
- Scenario 2—dividends were neither declared nor paid in 2014
- Scenario 3—a total of $280,000 in dividends were declared and paid in 2013; dividends were neither declared nor paid in 2014

Required:

a. Determine how much of the dividend must be distributed to each class of shares for each of the three scenarios.
b. Are there any dividends in arrears after the declaration and payment of the dividend in Scenario 3? If so, how much?
c. Prepare the required journal entries for the declaration and payment of the dividends for the first scenario.

A·S·P·E

P13-41. Accounting for contributed capital and retained earnings

(L.O. 13-3, L.O. 13-4) (Difficult – 20 minutes)

The following is an extract from the balance sheet of Devlin Ltd. as at December 31, 2014:

Shareholders' equity	
Preferred shares, $1 per share non-cumulative dividend, redeemable at $12 per share, 500,000 authorized, 50,000 issued and outstanding	$ 500,000
Contributed surplus—preferred shares, from share repurchases and resales	150,000
Common shares, 10,000,000 authorized, 1,000,000 issued and outstanding	2,637,489
Retained earnings	12,649,187
Total shareholders' equity	$15,936,676

The company did not declare dividends on preferred shares in 2014. Transactions in 2015 include the following:

i. March 15: Devlin purchased 10,000 preferred shares on the stock exchange for $11.50 per share and held these in treasury.
ii. March 28: The company redeemed 15,000 preferred shares directly from shareholders.
iii. July 1: The market price of common shares shot up to $45 per share, so Devlin decided to split the common shares four to one.
iv. August 1: Devlin cancelled 8,000 preferred shares that were held in treasury.
v. December 31: The company declared dividends of $0.10 per common share.

Required:

Assume that Devlin follows the guidance in ASPE pertaining to accounting for equity transactions. Prepare the journal entries to record the above transactions. The company uses the single-transaction method to account for treasury shares.

A·S·P·E

P13-42. Accounting for contributed capital and retained earnings

(L.O. 13-3, L.O. 13-4) (Difficult – 30 minutes)

Fenwick Ltd. began operations in 2016. Its fiscal year-end is December 31. Components of the condensed balance sheet as at December 31, 2018, are as follows:

Current liabilities	$ 400,000
Bonds payable—7%, mature 2022	8,000,000
Total liabilities	$8,400,000

Common shares—500,000 authorized, 300,000 issued and outstanding	$6,000,000
Contributed surplus—common shares, from share repurchases and resales	400,000
Retained earnings (deficit)	(200,000)
Total shareholders' equity	$6,200,000

During 2019, Fenwick had the following activities:

i. January 1: Issued 40,000 preferred shares with cumulative dividends of $1.25 per share. Proceeds were $480,000, or $12 per share.
ii. July 1: Repurchased and cancelled 50,000 common shares at a cost of $18 per share.
iii. Net income for the year was $1,700,000.

During 2020, the company had the following activities:

i. July 1: Repurchased and cancelled 60,000 common shares at a cost of $30 each.
ii. December 31: Fenwick declared dividends totalling $400,000.
iii. Net income for the year was $800,000.

Required:

a. Assume that Fenwick follows the guidance in ASPE pertaining to accounting for equity transactions. Prepare the journal entries required for 2019.
b. Prepare the equity section of the balance sheet as at December 31, 2019, including any notes that would be required.
c. Prepare the journal entries required for 2020.
d. Prepare the equity section of the balance sheet as at December 31, 2020, including any notes that would be required.

P13-43. Accounting for contributed capital and retained earnings

(L.O. 13-3, L.O. 13-4) (Difficult –30 minutes)

A·S·P·E

Hamilton Holdings had the following balances in shareholders' equity as at December 31, 2014:

Preferred shares, $1 cumulative dividend, 1,000,000 authorized, 700,000 issued and outstanding	$17,500,000
Common shares, no par, unlimited number authorized, 1,200,000 issued	9,600,000
Contributed surplus—common shares, from share repurchases and resales	120,000
Treasury shares, 320,000 common shares	(1,920,000)
Retained earnings	23,450,000
Total shareholders' equity	$48,750,000

In addition, the financial statement notes on this date indicated that two years of preferred share dividends were in arrears, totalling $1,400,000.

The following transactions occurred during 2015:

i. January 31: Hamilton resold half of the shares held in treasury for proceeds of $7.50 each.
ii. March 30: The company repurchased and immediately cancelled 200,000 common shares at a cost of $1,620,000.
iii. June 1: The company repurchased and retired 175,000 preferred shares at a price of $30 each. Note that repurchased shares lose any rights to dividends.
iv. July 13: The company issued 250,000 common shares in exchange for some heavy machinery. The market price of the shares was $9 on this day.
v. August 1: The remaining shares held in treasury were cancelled. The share price was $9.50.
vi. September 30: The board of directors declared and issued a 10% stock dividend on common shares. The shares were trading at $11 per share on this day. On the ex-dividend date of October 31, the share price was $10. To issue this stock dividend, the board also declared dividends on preferred shares for the current year and the two years in arrears.

Required:

Assume that Hamilton follows the guidance in ASPE pertaining to accounting for equity transactions. Prepare the journal entries to reflect Hamilton's equity transactions in 2015. It may be helpful to use a tabular schedule similar to Exhibit 13-21 to track the number of shares and dollar amounts.

P13-44. Statement of changes in equity (L.O. 13-5) (Medium – 15 minutes)

Below are details relating to balances for the equity accounts of Barrie Company and changes to those balances (note that AOCI is accumulated other comprehensive income).

Balances or changes	Amount ($000's)
Common shares, Jan. 1, 2014	$20,000
Unappropriated retained earnings, Jan. 1, 2014	11,000
Appropriated retained earnings for sinking fund reserve, Jan. 1, 2014	2,000
AOCI from revaluations, Jan. 1, 2014	1,000
Net income for 2014	3,000
Retained earnings appropriated for sinking fund reserve during 2014	1,300
AOCI from revaluations in 2014	500
Dividends declared during 2014	1,000
Net income for 2015	4,000
Retained earnings appropriated for sinking fund reserve during 2015	400
AOCI from revaluations in 2015	(200)
Dividends declared during 2015	1,200

Required:

Prepare a statement of changes in equity for the years ended December 31, 2014 and 2015. The following format will be helpful for preparing this statement for each of the two years.

	Common shares	Retained earnings	Appropriated retained earnings	AOCI	Total
Changes during year 20XX:					
Balance Jan. 1, 20XX					
Balance Dec. 31, 20XX					

P13-45. Statement of changes in equity (L.O. 13-5) (Medium – 15 minutes)

Below are details relating to balances for the equity accounts of PICSR Company and changes to those balances (note that AOCI is accumulated other comprehensive income).

Balances or changes	Amount ($000's)
Common shares, Jan. 1, 2015	$50,000
Unappropriated retained earnings, Jan. 1, 2015	15,000
Appropriated retained earnings for sinking fund reserve, Jan. 1, 2015	4,000
AOCI from revaluations, Jan. 1, 2015	(2,000)
Net income for 2015	4,000
Retained earnings appropriated for sinking fund reserve during 2015	2,500
AOCI from revaluations in 2015	1,000
Dividends declared during 2015	3,000
Net income for 2016	6,000
Retained earnings appropriated for sinking fund reserve during 2016	600
AOCI from revaluations in 2016	500
Dividends declared during 2016	1,500

Required:

Prepare a statement of changes in equity for the years ended December 31, 2015 and 2016. The following format will be helpful for preparing this statement for each of the two years.

	Common shares	Retained earnings	Appropriated retained earnings	AOCI	Total
Changes during year 20XX:					
Balance Jan. 1, 20XX					
Balance Dec. 31, 20XX					

P13-46. Statement of changes in equity (L.O. 13-5) (Difficult – 30 minutes)

Below are details relating to balances for the equity accounts of Mark's Photography Company and changes to those balances (note that AOCI is accumulated other comprehensive income).

Balances or changes	Amount ($000's)
Preferred shares, Jan. 1, 2016	$100,000
Common shares, Jan. 1, 2016	200,000
Contributed surplus, Jan. 1, 2016	5,000
Retained earnings, Jan. 1, 2016	150,000
AOCI from revaluations, Jan. 1, 2016	10,000
AOCI from foreign currency translation adjustment (FCTA), Jan. 1, 2016	12,000
Net income for 2016	10,000
AOCI from revaluations in 2016	3,000
AOCI from foreign currency translation adjustments (FCTA) in 2016	(2,000)
Dividends declared on preferred shares during 2016	2,000
Dividends declared on common shares during 2016	3,000
Common shares issued during 2016	10,000
Net income for 2017	(4,000)
AOCI from revaluations in 2017	(1,000)
AOCI from foreign currency translation adjustments (FCTA) in 2017	2,000
Dividends declared on preferred shares during 2017	1,800
Dividends declared on common shares during 2017	2,000
Preferred shares redeemed during 2017	5,000
Increase in contributed surplus from redemption of preferred shares 2017	500

Required:

Prepare a statement of changes in equity for the years ended December 31, 2016 and 2017. The following format will be helpful for preparing this statement for each of the two years.

	Common shares	Preferred shares	Contributed surplus	Total capital	Retained earnings	AOCI from revaluations	AOCI from FCTA	Total AOCI	Total
Changes during year 20XX:									
Balance Jan. 1, 20XX									
Balance Dec. 31, 20XX									

N. MINI-CASES

CASE 1
Peterborough Printers
(30 minutes)

Peterborough Printers specializes in high-volume reproduction of advertising leaflets, such as those distributed by direct mail or inserted in newspapers. Located in Scarborough and founded by Peter Pang over 40 years ago, the company has been publicly traded for the past 20 years. Through its history, the company has successfully attracted and retained a solid and stable base of business clients largely as a result of Peter's savvy salesmanship.

Peterborough has two classes of shares, common and preferred. The common shares are listed on the Toronto Stock Exchange, and Peter still holds 20% of these shares. The preferred shares are privately held by five individuals and pay cumulative dividends.

You are the CFO of Peterborough Printers. You recently met with Peter to discuss financial matters. The following is an excerpt from that conversation:

PETER: This recession is a lot deeper and lasting a lot longer than I and many others had anticipated. Our sales are way down and I'm becoming more and more worried.

YOU: There's no doubt about it. We'll need to be on our toes to come out of this in one piece.

PETER: On top of the recession, there has been a gradual but noticeable drop in our printing volume over the past decade.

YOU: I think it has a lot to do with companies relying less on print media and switching to online advertising.

PETER: That's probably right. I' am working on adjusting our production capabilities in light of this long-term trend.

YOU: That's good to hear.

PETER: So, the reason we're meeting today is to see what we might do on the financial side of things to help us cope with the current economic pressures. In hindsight, we have been very fortunate, having built up a substantial cushion of cash and short-term investments during the good years. We are still in good shape now, but I expect another one or two lean years will take us to the breaking point.

As you know, Peterborough has been able to consistently maintain and increase dividends to our common shareholders over the past 20 years. Under the circumstances, we need to seriously think about whether we can continue with this policy. I wonder if there is anything we can do to maintain our financial health while not disappointing our shareholders. I've heard that some companies pay stock dividends. I'm not exactly sure how they work, but I've been told that paying these dividends doesn't cost us any cash.

YOU: What are your thoughts on the dividends on the preferred shares?

PETER: I'm not as concerned about maintaining those dividends. As it is, the dividends are cumulative, so these shareholders will get their money sooner or later, even if we have to miss paying them this year or next year.

YOU: Well, let me think about these dividend issues and get back to you tomorrow.

Required:

Draft a short report discussing the dividend policy alternatives and your recommendations.

CASE 2
Thamesford Tubs
(45 minutes)

A relaxing bath represents a busy day's more enjoyable moments for many people. For over a hundred years, Thamesford Tubs has been fulfilling this need, manufacturing bathtubs of all shapes and sizes and in all quality ranges. The company enjoyed -decades of success along with North America's burgeoning population, which created great demand for new homes and new bathtubs. At the company's peak, production reached 500,000 tubs a year.

In more recent years, however, demand for the company's products has decreased significantly due to a confluence of many factors. Consumer tastes have evolved toward a preference for showers over baths for several reasons: people have become more aware of the lower water consumption of showers compared to baths; increasing numbers of people live in condominiums/apartments in which space is at a premium compared to -detached homes; fewer consumers value distinctive and high-quality tubs; and there was a bursting of the housing bubble that dramatically lowered the rate of new home construction. Due to the significant drop in sales, Thamesford has experienced three consecutive years of losses, and management expects a net loss of around $2 million this year before business recovers to profitability.

It is mid-September, almost three-quarters of the way to Thamesford's fiscal year-end of December 31. The company has a $20 million bank loan coming due next March 30. Given recent years' operating results, the company's financial resources have been stretched, and there is little available to repay this loan in seven months' time.

In addition to this $20 million loan, Thamesford has another long-term loan outstanding for $16 million, which is due in five years, bearing interest at 8%. This loan requires Thamesford to maintain a current ratio of at least 1.0 and a debt-to-equity ratio less than 3:1 at each fiscal year-end. Violating these covenants would make the loan immediately due and payable. As of the previous fiscal year-end, the company was in compliance with these covenants. Other liabilities, which consist primarily of accounts payable, stood at $14 million, so liabilities totalled $50 million. These figures resulted in a current ratio of 1.5 and a debt-to-equity ratio of 2.5:1.

Top management is considering the options available to the company. The bank that lent the $20 million due next March is willing to refinance the loan for another three years, but at a considerably higher interest rate of 15% plus a pledge of the company manufacturing facilities as collateral. Alternatively, the company could issue preferred shares with a cumulative dividend rate of 12%. The investment firm proposing this option also suggested that the dividend rate could be lowered to 10% if Thamesford added a provision to give the preferred shareholders the right to retract the shares at the issuance price (i.e., the company must redeem the shares if a shareholder demanded it). A third alternative is to issue common shares, although Thamesford's share price is understandably depressed under the circumstances.

Required:

Play the role of Thamesford's chief financial officer and analyze the three financing alternatives. Provide a recommendation to your CEO and board of directors.

CASE 3

Equities

(30 minutes)

Out2B Corporation is a public company that manufactures high quality camping and outdoor equipment. Out2B has been able to maintain its leadership position within the industry for many years due to its innovative products and aggressive marketing strategy

You are John Quinn, the CFO of Out2B. It is now January 17, 2018 and you are in the process of closing the books for 2017. On January 24 there will be a meeting of the board of directors to discuss and to decide on the annual dividend. The dividend then will be announced the following day, and will be paid two weeks later. As the CFO, you will be presenting your recommendations for the annual dividend. It is a common practice to send the directors a short memo prior to the meeting with the recommendations you will be delivering during the meeting.

In preparation for your meeting, the employees of the accounting department have compiled the expected annual balance sheet and annual income statements, which are presented below:

Balance Sheet			
Current assets		**Current liabilities**	
Cash	$ 4,000,000	Accounts payable	$ 2,000,000
Accounts receivable	5,000,000	Provisions	3,000,000
Inventory	2,000,000	Short-term loan	2,000,000
Others	3,700,000	Others	2,000,000
Total current assets	14,700,000	Total current liabilities	9,000,000
Investments (market value)	7,000,000	Bonds Payable	16,000,000
Non-current assets		**Shareholders' equity**	
PP&E	10,500,000	Common stock	1,000,000
Intangible assets	3,500,000	Contributed surplus	4,900,000
Other assets	3,000,000	Retained earnings	7,800,000
Total non-current assets	17,000,000	Total shareholders' equity	13,700,000
Total assets	$38,700,000	Total liabilities and equity	$38,700,000

Income Statement	
Sales	$44,000,000
Cost of goods sold	29,400,000
Gross profit	14,600,000
Sales, general, and administration costs	6,000,000
Operating income before interest	8,600,000
Interest expenses	1,000,000
Income before tax	7,600,000
Income tax (30%)	2,300,000
Income after tax	$ 5,300,000

As part of your preparation, you have also collected some other relevant information:

- Last year, net income was $4.4 million and the firm distributed $3.3 million in cash dividends.
- The firm has two loan agreements (reported under "bonds payable") that require the firm to maintain at least $2.5 million in retained earnings and to maintain a debt-to-total assets ratio no higher than 0.7:1.
- There was no change in the number of outstanding shares during the year.
- Out2B has distributed dividends for many years, and as the profit increased over the years, dividends were increased as well.

Since you were appointed CFO only six months ago, this is your first significant interaction with the board of directors, and you want to impress them by providing them with solid recommendations.

Required:

a) What is the maximum amount that can be currently distributed as cash dividend?
b) What are important issues that may influence your decision? How are those issues going to affect your recommendations?
c) Given your answers in (a) and (b), write a short memo to the board of directors with your recommendations.
d) Prepare any journal entries that are related to your recommendations.