

# Chapter 14

## Corporations: Organization and Share Capital Transactions

### New Accounting Terms

- ✓ Corporation
- ✓ Shareholders
- ✓ Organization costs
- ✓ Organization docs
- ✓ Share capital
- ✓ Common shares
- ✓ Preferred shares
- ✓ Authorized shares
- ✓ Issued shares
- ✓ Reacquired shares
- ✓ Dividends
- ✓ Cumulative dividend
- ✓ Dividends in arrears
- ✓ Shareholders' equity
- ✓ Retained earnings
- ✓ ROE
- ✓ BV per share

### Corporations

- ✓ A corporation is a legal entity created by law that is separate and distinct from its owners/shareholders
- ✓ About 90% of all businesses are corporations
- ✓ A corporation's purpose may be to earn a **profit**, or it may be organized as **non-profit**.



### Corporations

- ✓ 2 forms of profit making corporations:
  - § Public corporation – About 8% are public
  - § Private corporation – About 92% are private
- ✓ Costs incurred in forming a corporation are called **organization costs**.



### Organization Costs

- ✓ Organization costs include legal fees, incorporation fees, initial accounting fees, underwriter fees, & marketing fees.
- ✓ Organization costs is an asset as it provides a legal structure to the business but it is normally **expensed** in the year it is incurred.

DR Incorporation Costs  
CR Cash



### Organization Documents

Documents:

1. Articles of incorporation
2. Info on directors & executives
3. Business Plan
4. Business Licence

## Corporations – Advantages

- ✓ Separate legal existence
- ✓ Limited liability of shareholders
- ✓ Continuous life
- ✓ Corporate management - professional managers
- ✓ Transferable ownership rights
- ✓ Ability to acquire capital
- ✓ Reduced income taxes (for private corporations)



## Corporations – Disadvantages

- ✓ Corporation management - ownership separated from management
- ✓ Increased expenses
- ✓ Complexity of government regulations
- ✓ Potentially higher income taxes (for public corporations)



## Authorized vs Issued Shares

- ✓ To raise capital, the corporation sells shares
- ✓ If only one class of shares - common shares
- ✓ Ownership rights specified in articles of incorporation
- ✓ **Authorized shares** – maximum amount of shares a corporation is allowed to sell as authorized by articles of incorporation
- ✓ **Issued shares** – number of shares sold
- ✓ How many shares should be authorized for sale?
- ✓ How should the shares be issued?
- ✓ At what price should the shares be issued?
- ✓ What value should be assigned to the shares?



## Issuing shares for cash

Shares are most commonly issued for cash. When no-par value common shares are issued, the entire cash from the issue becomes legal capital for the company.

Accounting Titles and Explanation	Debit	Credit
Cash	1,000	
Common Shares		1,000
To record issue of 1,000 shares		



## S/E with C/S only

- ✓ Shareholders' equity (owner's equity)
- ✓ The S/E section of a corporation's B/S consists of:
  - § Contributed capital or Share capital
    - Amount from shares – common & preferred
    - Additional contributed capital (only when par value shares are issued) – **not relevant for us**
  - § Retained earnings

Shareholders' equity	
Contributed capital / Share capital	
Common shares, 100,000 no par value shares authorized, 50,000 issued	\$800,000
Retained earnings	130,000
Total shareholders' equity	<u>\$930,000</u>

## Issuing shares for services OR non-cash assets

- ✓ Shares may be issued for services, such as compensation to lawyers/consultants, or for non-cash assets such as land or building.
- ✓ Cost is either the FMV of the \$\$ given up or the \$\$ received, whichever is more clearly determinable.

### Issuing shares for services OR non-cash assets

Accounting Titles and Explanation	Debit	Credit
Fees to Lawyers	2,000	
Common Shares		2,000
To record issue of 1,000 shares		

Accounting Titles and Explanation	Debit	Credit
Land	10,000	
Common Shares		10,000
To record issue of 1,000 shares		

### Reacquired Shares

- ✓ **Reacquired shares** are a corporation's own shares that have been issued, fully paid for, and then reacquired by the corporation.
- ✓ Reacquired shares are generally **retired** and **cancelled**.
- ✓ Rarely, these shares are not retired, but are held as **treasury shares** for later reissue.

### Reacquired Shares

- ✓ Why would a company choose to reacquire its shares?
  - § Reduce quantity or raise share price
  - § Increase EPS
  - § If authorized share limit reached, may need additional shares for employee bonuses or purchase of other companies

### Preferred Shares

**Preferred shares** have priority over common shares with regards to:

1. **Dividends &**
2. **Assets in the event of liquidation**

Preferred shareholders usually do not have voting rights

Preferred shares are shown first in the share capital section of S/E



### Issuance of Preferred Shares

When preferred shares are issued:

Accounting Titles and Explanation	Debit	Credit
Cash	1,000	
Preferred Shares		1,000
To record issue of 10 preferred shares		

### S/E Presentation with P/S & C/S

ZABOSCHUK INC. Partial Balance Sheet	
Shareholders' equity	
Share capital	
\$9 preferred shares, no-par value, cumulative, 10,000 shares authorized, 6,000 shares issued	\$ 770,000
Common shares, no-par value, unlimited shares authorized, 400,000 shares issued	2,000,000
Total share capital	<u>2,770,000</u>
Retained earnings	<u>860,000</u>
Total shareholders' equity	3,630,000

## Preferred Shares Preferences

- ✓ Liquidation preference
- ✓ Cumulative dividends (those in arrears)
- ✓ Convertible to common shares
- ✓ Redeemable/callable (company option)
- ✓ Retractable (shareholder option)



## P/S Preference – Cumulative Dividends

- ✓ **Cumulative dividend:** P/Shareholders must be paid both current & any outstanding prior year dividends before C/shareholders receive any dividends.
- ✓ Preferred dividends not declared in a given period are called “**dividends in arrears**”.
- ✓ \$\$ amount of dividends in arrears should be disclosed in the notes.

## Order of Payment in A Liquidation

1. Accounting fees
2. Government for taxes
3. Bank loans
4. Other creditors
5. Preferred shareholders
6. Common shareholders
7. Anyone else



## Return On Equity [ROE]

- ✓ **ROE (or ROI)** is considered to be the most important measure of a company's profitability and efficiency.
- ✓ Evaluates how many \$\$ were earned for each \$ invested by the owners.

$$\text{Net Income} \div \text{Average Shareholders Equity} = \text{ROE}$$

## Book Value Per Share

- ✓ **Book value per share** represents the equity a common shareholder has in the equity of the corporation from owning one share.
- ✓ The formula for calculating BV per share when a corporation has only one class of shares is:

$$\text{Total S/E for C/S} \div \text{Number of Common Shares} = \text{BV per Share}$$

## Calculation of BV with P/S

When a company has both preferred and common shares, the calculation of book value is more complex.

### Steps Required:

1. Calculate the preferred S/E  
Number of P/S X BV of P/S
2. Determine the common S/E  
total S/E - preferred S/E

### Calculation of BV with P/S

3. Determine BV per share of common shares

Common S/E  
Number of C/S

Example:

$$(\$200 - \$50) / 15 = \$10 \text{ per common share}$$

### Book Value VS. Market Value

- ✓ Book value per share does not equal market value.
- ✓ Book value is based on historical costs.
- ✓ Market value reflects the judgement of shareholders and future investors about the company's potential for earnings & dividends.
- ✓ Market value may be > book value, but it does not necessarily mean that the shares are overpriced.

