Chapter 13

Corporations: Share Capital  
and the Balance Sheet

Questions

1. Corporation characteristics:

• A separate legal entity, formed under federal or provincial law

• Continuous life and transferability of ownership

• No mutual agency

• Limited liability of shareholders

• Separation of ownership and management

• Corporate earnings subject to a degree of double taxation

• Government regulation

• Corporations may incur costs unique to corporations.

2. The corporation itself pays income tax, and the shareholder pays personal tax on after-tax dividends received from the corporation. However, a portion of the corporate tax is allowed as a dividend tax credit to the shareholder to eliminate some of the double taxation.

3. The incorporators pay the fees and file the required documents with the incorporating jurisdiction, and approval of articles of incorporation is granted by the federal or a provincial government. The articles of incorporation include authorization for the corporation to issue a certain number of shares. The incorporators agree to a set of bylaws for governing the corporation. The corporation then issues its shares and receives assets. The shareholders elect the board of directors, which appoints the officers. At this point, the corporation begins operations.

4.

|  |  |  |
| --- | --- | --- |
| **Characteristic** | **Corporation** | **Partnership** |
| Legal Entity | • A business entity formed under federal or provincial law  • Is a distinct entity; assets and liabilities belong to the corporation | • Does not require federal or provincial approval to do business  • Is not distinct from partners who hold all assets and liabilities |
| Continue Life and Transferability of Ownership | • Sale or transfer of shares does not affect the continuity of the corporation | • Terminates when ownership changes |
| Mutual Agency | • Officers commit the corporation to contracts but not shareholders | • A partner can bind the partnership by signing a contract |
| Liability | • Shareholders have no personal obligation for corporate liabilities; directors may | • Partners are personally liable for all debts of the partnership |
| Ownership/ Management | • Corporations are owned by shareholders who elect a board of directors  • The board of directors appoints officers to manage the business | • Partners manage the partnership |
| Taxation | • Corporate earnings are subject to two different types of taxation: corporate income is taxed and after-tax dividends are taxable to the shareholders | • Partners are taxed on their share of partnership income |
| Additional Costs | • Corporations incur costs unique to corporations, such as the cost of directors’ insurance | • Partnerships do not incur these costs |

5. A common shareholder has the right to: (a) vote on matters that come before the shareholders, (b) receive a proportionate part of any dividends declared on that class of shares, (c) receive a proportionate share of corporate assets if the corporation liquidates, (d) sell the shares and (e) a preemptive right, the right to maintain one’s proportionate ownership in the corporation.

6. Preferred shares are automatically voting, unless stated otherwise; however, they are typically nonvoting. These rights may be withheld by the corporation only by agreement with the shareholders.

7. Issuance of shares increases the assets of the corporation, which receives assets in exchange for shares issued. Authorization merely gives the corporation permission to issue shares.

8. Issuance of 1,400 shares of $4.50 preferred shares for $110 would increase the contributed capital by $154,000 (1,400 × $110). The transaction would *not* increase retained earnings because a company does not earn a profit by selling its shares to its own shareholders. Recky Corp.’s annual cash dividend payments would increase by $6,300 (1,400 × $4.50).

9. July 6 Cash 3,475

Common shares\* 3,475

\*[(150 × $9) + (250 × $8.50)]

10. Issuance of 1,500 common shares for land and a building worth $125,000 increases contributed capital by $125,000.

11. Current liabilities: Dividends Payable

Shareholders’ equity: Preferred Shares, Common Shares, Retained Earnings.

12. Organization Cost is an intangible asset account. It is debited for its cost when acquired, and the cost is usually amortized as expense over a short period of time.

13. Three important dates for dividends are: (a) Declaration date: the board of directors announces the dividend; (b) Date of record: the corporation identifies the people who own the shares on this date so that they can receive the dividend; (c) Distribution date: the corporation pays the dividend.

14. (a) Cumulative preferred: $13,125 (2,500 × $1.75 × 3 years)

Common: $21,875 ($35,000 – $13,125)

(b) Noncumulative preferred: $4,375 (2,500 × $1.75)

Common: $30,625 ($35,000 – $4,375)

15. A preferred shareholder would rather own *cumulative* preferred shares because any preferred dividends undeclared by the corporation must be paid before paying dividends to the common shareholders. The corporation would rather issue *noncumulative* preferred shares in order to avoid having to pay dividends in arrears to preferred shareholders.

16. Cumulative preferred dividends in arrears are reported in the notes to the financial statements. Dividends become a liability only after the board of directors declares the dividends.

17. The *market value* of a share is the price at which a person could buy or sell a single share. The *book value* of a share is the total amount of shareholders’ equity (for common or preferred shares) in the company’s books divided by the number of shares (of that type) issued. Market value is far more important to investors than book value.

18. In a company with both preferred and common shares outstanding, the preferred shareholders have the first claim to shareholders’ equity. The book value of preferred shares is their liquidation value plus any cumulative preferred dividends in arrears if the preferred shares are cumulative. The remaining equity divided by the number of common shares gives the book value for each common share.

19. The *return on assets* measures a company’s success in using its assets to earn income for the stakeholders who are financing the business.

20. A healthy company’s return on shareholders’ equity should exceed its return on total assets because of the interest expense component of return on assets. Shareholders demand a higher rate of return than creditors. If return on total assets is higher than return on shareholders’ equity, the company may be over-leveraged.

Starters

*(5 min.)* S13-1

1. The *chairperson* of the board of directors is usually the most powerful person in a corporation.
2. The *shareholders* hold ultimate power in a corporation.
3. The *president* or *chief executive officer (CEO)* is in charge of day-to-day operations.
4. The *vice-president of accounting and finance* is in charge of accounting.

*(5 min.)* S13-2

**DIFFERENCE:**

A proprietorship’s balance sheet reports a single capital account, such as Joe Hopper, Capital. A corporation balance sheet reports shareholders’ equity by source. There are two sources: contributed capital and retained earnings.

**SIMILARITY:**

A proprietorship’s balance sheet and a corporation’s balance sheet both report assets and liabilities in the same way.

*(5 min.)* S13-3

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| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Jun. | 22 | Cash |  | 210,000 |  |
|  |  | Common Shares |  |  | 210,000 |
|  |  | Issued common shares (3,000 × $70) |  |  |  |
|  |  |  |  |  |  |
|  | 22 | Cash |  | 32,000 |  |
|  |  | Preferred Shares |  |  | 32,000 |
|  |  | Issued 1,500 preferred shares. |  |  |  |

*(5-10 min.)* S13-4

1. Total contributed capital increased $7,000 ($86,000 − $79,000). The increase was due to the sale of common shares in 2020, shown by the increase in the number of shares from 2019 to 2020 and by the increase in the dollar balance of the common shares from 2019 to 2020.

2. Thaler Corporation earned a profit in 2020 because the balance of retained earnings increased from 2019 to 2020 by $4,000 ($50,800 − $46,800).

*(5-10 min.)* S13-5

|  |  |
| --- | --- |
| Contributed capital |  |
| Preferred shares, $1.50 |  |
| Issued for cash (2,500 shares × $10) | $  25,000 |
|  |  |
| Common shares |  |
| Issued for cash (35,000 shares × $12.50) $437,500 |  |
| Issued for organization cost 7,500 |  |
| Issued for patent 45,000 | 490,000 |
| Total contributed capital | $515,000 |

*(5 min.)* S13–6

Shareholders’ equity

Common shares, 40,000 shares issued $29,500

Retained earnings 18,000

Total shareholders’ equity $47,500

*(5 min.)* S13-7

1. Common shares
2. Long-term debt
3. Common shares
4. Long-term debt

*(10 min.)* S13-8

|  |  |  |  |  |  |
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| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| 2019 | |  |  |  |  |
| Dec. | 10 | Retained Earnings |  | 45,000 |  |
|  |  | Dividends Payable — Preferred Shares |  |  | 15,000 |
|  |  | Dividends Payable — Common Shares |  |  | 30,000 |
|  |  | Declared a cash dividend.  (5,000 × $3.00) + (50,000 × $0.60) |  |  |  |
|  |  |  |  |  |  |
| 2020 | |  |  |  |  |
| Jan. | 8 | Dividends Payable — Preferred Shares |  | 15,000 |  |
|  |  | Dividends Payable — Common Shares |  | 30,000 |  |
|  |  | Cash |  |  | 45,000 |
|  |  | Paid the cash dividend. |  |  |  |

*(5-10 min.)* S13-9

1. The preferred shares are *cumulative* because they are specifically designated as cumulative in the name on the balance sheet.

2. Preferred gets $1,125 (45,000 × $0.025).

Common gets $15,875 ($17,000 – $1,125)

3. Preferred gets:

2018 dividend in arrears (45,000 × $0.025) $1,125

2019 dividend in arrears 1,125

2020 current-year dividend 1,125

Total $3,375

Common gets ($17,000 – $3,375) $13,625

*(5 min.)* S13-10

Preferred equity

Liquidation value (45,000 × $0.50) $ 22,500

Cumulative dividends (45,000 × $0.025 × 5) 5,625

Shareholders’ equity allocated to preferred $ 28,125

Book value per share = Shareholders’ equity – Preferred equity

Number of common shares outstanding

= $350,000 – 28,125

1,000,000

= $0.321875, which rounds to $0.32.

*(5-10 min.)* S13-11

Book value per preferred share = Liquidation value + Dividends in arrears

Number of preferred shares outstanding

= ($55 × 11,000) + ($3 × 11,000 × 3 years)

11,000

= $605,000 + $99,000

11,000

= $704,000

11,000

= $64.00 per share

Book value per common share = Total shareholders’ equity – Preferred equity

Number of common shares outstanding

= $4,555,000 – $704,000

75,000

= $51.35 per share

*(5 min.)* S13-12

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Return on assets | = | Net income + Interest expense | = | $6,100 + $400 | |
| Average total assets | ($49,000 + $44,800) ÷ 2 | |
|  | | | = | $6,500 |
|  | | | $46,900 |
|  |  |  | = | 13.86% | |

*(5 min.)* S13-13

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  |  |  | |
| Return on common shareholders’ equity | = | Net income – Preferred dividends | = | $6,100 – $0 | |
| Average common shareholders’ equity | ($23,600 + $22,800) ÷ 2 | |
|  |  |  | = | $6,100 |
|  |  |  | $23,200 |
|  |  |  | = | 26.29% | |

Exercises

(5-10 min.) **E13-1**

*Note:* Student responses will vary because people have different reasons for the decisions they make.

Reasons for organizing as a corporation:

1. Ease of raising capital from other investors

2. Limited liability of shareholders for the business’s debts

3. Ease of transferring ownership if a shareholder wants to sell his or her interest in the business

Reasons for not organizing as a corporation:

1. Must pay corporate tax and personal tax on dividends

2. More government regulation of corporations

(5-10 min.) **E13-2**

MEMO TO: David Johnston and Lisa Jacobs

SUBJECT: Incorporation of Student Decor Ltd.

In order to incorporate Student Decor Ltd., you must obtain and complete the required documents from either the province in which you wish to incorporate or the federal Ministry of Industry. The completed documents must be submitted with the required fee. The documents are called articles of incorporation and include a request for authorization for the corporation to issue shares. When the appropriate jurisdiction authorizes the incorporation, Student Decor Ltd. will become a legal entity.

As soon as Student Decor Ltd. is incorporated you will draw up and agree to a set of bylaws by which Student Decor Ltd. will be governed. All those who purchase common shares in Student Decor Ltd. will be shareholders of the corporation. The shareholders will elect the board of directors of the corporation. The board of directors sets the policy for Student Decor Ltd. and appoints the officers of the corporation, including the president or chief executive officer in charge of managing day-to-day operations.

*Instructional Note:* Student responses may vary considerably.

(5-10 min.)**E13-3**

Req.1

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Jan. | 31 | Service Revenue |  | 356,400 |  |
|  |  | Interest Revenue |  | 5,800 |  |
|  |  | Income Summary |  |  | 362,200 |
|  |  | To close revenue accounts. |  |  |  |
|  |  |  |  |  |  |
|  | 31 | Income Summary |  | 255,000 |  |
|  |  | Amortization Expense |  |  | 1,800 |
|  |  | Interest Expense |  |  | 18,800 |
|  |  | Other Expenses |  |  | 35,400 |
|  |  | Salaries Expense |  |  | 199,000 |
|  |  | To close expense accounts. |  |  |  |
|  |  |  |  |  |  |
|  | 31 | Income Summary |  | 107,200 |  |
|  |  | Retained Earnings |  |  | 107,200 |
|  |  | To close net income to retained earnings. |  |  |  |

Req. 2

Retained Earnings = $78,400 + $107,200 = $185,600

(5-10 min.) **E13-4**

a. False—Unlike proprietorships or partnerships, where the proprietor or partner can bind the company to a contract, it is one of the distinguishing characteristics of corporations that a shareholder may not bind, or obligate, a corporation to a contract.

b. True

c. False—Preferred shareholders typically do not have voting rights.

d. True

e. False—Common shares in different classes can have different voting rights or no voting rights, based on the details specified in the articles of incorporation.

f. True

g. True

h. True

(10-15 min.) **E13-5**

Req. 1

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Jan. | 19 | Cash |  | 49,500 |  |
|  |  | Common Shares |  |  | 49,500 |
|  |  | (4,500 × $11.00) |  |  |  |
|  |  |  |  |  |  |
| Feb. | 3 | Cash |  | 15,000 |  |
|  |  | Class A Preferred Shares |  |  | 15,000 |
|  |  |  |  |  |  |
|  | 11 | Inventory |  | 20,000 |  |
|  |  | Vehicles |  | 17,000 |  |
|  |  | Common Shares |  |  | 37,000 |
|  |  |  |  |  |  |
| Mar. | 15 | Cash |  | 42,000 |  |
|  |  | Class B Preferred Shares |  |  | 42,000 |
|  |  | (3,000 × $14) |  |  |  |

Total common shares: Jan 19, 4,500 and Feb 11, 5,800 = 10,300

Req. 2

Total Contributed Capital:

Preferred: Class A (1,000 shares) $ 15,000

Class B (3,000 shares) 42,000

Common: 10,300 shares ($49,500 + $37,000) 86,500

Total contributed capital $143,500

(10 min.) **E13-6**

Case A—Issue shares and buy the assets in separate transactions.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Apr. | 18 | Cash |  | 1,460,000 |  |
|  |  | Common Shares |  |  | 1,460,000 |
|  |  | Issued shares. |  |  |  |
|  |  |  |  |  |  |
|  | 18 | Building |  | 900,000 |  |
|  |  | Equipment |  | 560,000 |  |
|  |  | Cash |  |  | 1,460,000 |
|  |  | Purchased property, plant, and equipment. |  |  |  |

Case B—Issue shares to acquire the assets.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Apr. | 18 | Building |  | 900,000 |  |
|  |  | Equipment |  | 560,000 |  |
|  |  | Common Shares |  |  | 1,460,000 |
|  |  | Issued shares to acquire building and equipment. |  |  |  |

The balances in all accounts are the same because, in both cases, the value of the assets received for the common shares issued is $1,460,000:

Building $900,000

Equipment 560,000

*(5-10 min.)* **E13-7**

A = $175,000 ÷ $5 = 35,000

B = 150,000 × $3 = $450,000

C = $175,000 + $450,000 = $625,000

D = $500,000 – 625,000 = –$125,000

(10-15 min.) **E13-8**

|  |  |
| --- | --- |
| **SKEET CORPORATION** | |
| Balance Sheet (partial) | |
| June 30, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $1.25, 100,000 shares authorized, 10,000 shares issued | $ 87,500 |
| Common shares, 500,000 shares authorized, 100,000 shares issued | 100,000 |
| Total contributed capital | 187,500 |
| Retained earnings | 97,000 |
| Total shareholders’ equity | $284,500 |

(15-20 min.) **E13-9**

Req. 1

|  |  |  |  |  |  |
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| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| **2019** | |  |  |  |  |
| Dec. | 4 | Cash |  | 140,000 |  |
|  |  | Common Shares |  |  | 140,000 |
|  |  | Issued 5,000 common shares. |  |  |  |
|  |  |  |  |  |  |
|  | 13 | Cash |  | 55,000 |  |
|  |  | Preferred Shares |  |  | 55,000 |
|  |  | Issued 500 preferred shares for cash. |  |  |  |
|  |  |  |  |  |  |
|  | 14 | Land |  | 120,000 |  |
|  |  | Common Shares |  |  | 120,000 |
|  |  | Issued 4,000 common shares for land. |  |  |  |
| **2020** | |  |  |  |  |
| Nov. | 30 | Income Summary |  | 120,000 |  |
|  |  | Retained Earnings |  |  | 120,000 |
|  |  | Closed net income to Retained Earnings. |  |  |  |

Req. 2

|  |  |
| --- | --- |
| **PLUM CORP.** | |
| Balance Sheet (partial) | |
| November 30, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $5.00, 100,000 shares authorized, 500 shares issued | $  55,000 |
| Common shares, 500,000 shares authorized, 9,000 shares issued | 260,000 |
| Total contributed capital | 315,000 |
| Retained earnings | 120,000 |
| Total shareholders’ equity | $435,000 |

(10-15 min.) **E13-10**

|  |  |  |
| --- | --- | --- |
| **OUTLET SERVICES INC.** | | |
| Balance Sheet | | |
| January 31, 2019 | | |
| **Assets** |  |  |
| Current assets |  |  |
| Cash | $494,000 |  |
| Accounts receivable, net | 318,000 |  |
| Inventory | 420,000 |  |
| Prepaid expenses | 3,600 |  |
| Total current assets |  | $1,235,600 |
| Property, plant, and equipment, net |  | 3,360,000 |
| Intangible assets |  |  |
| Trademark, net | 20,400 |  |
| Organization costs | 18,000 |  |
| Total intangible assets |  | 38,400 |
| Total assets |  | $4,634,000 |
|  |  |  |
| **Liabilities** |  |  |
| Current Liabilities |  |  |
| Accounts payable | $ 90,000 |  |
| Accrued liabilities | 50,400 |  |
| Total current liabilities |  | $ 140,400 |
| Long-term note payable |  | 600,000 |
| Total liabilities |  | $ 740,400 |
|  |  |  |
| **Shareholders’ Equity** |  |  |
| Contributed Capital |  |  |
| Preferred shares, $2.50, cumulative, 24,000 authorized and issued | $ 240,000 |  |
| Common shares, 500,000 authorized; 200,000 issued | 2,500,000 |  |
| Total contributed capital | 2,740,000 |  |
| Retained earnings | 1,153,600 |  |
| Total shareholders’ equity |  | 3,893,600 |
| Total liabilities and shareholders’ equity |  | $4,634,000 |

Retained Earnings: 623,600 + 530,000 net income = 1,153,600

(10-15 min.) **E13-11**

Req. 1

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date**  **2020** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| May | 1 | Retained Earnings |  | 175,300 |  |
|  |  | Dividends Payable—Preferred |  |  | 150,000 |
|  |  | Dividends Payable—Common |  |  | 25,300 |
|  |  |  |  |  |  |
|  | 28 | Dividends Payable—Preferred |  | 150,000 |  |
|  |  | Dividends Payable—Common |  | 25,300 |  |
|  |  | Cash |  |  | 175,300 |
|  |  |  |  |  |  |
|  | 31 | Income Summary |  | 225,000 |  |
|  |  | Retained Earnings |  |  | 225,000 |

Preferred dividend = 75,000 × $2

Common dividend = 110,000 × $0.23

Req. 2

$52,100 + $225,000 – $175,300 = $101,800

(10-15 min.) **E13-12**

1. 1,000 shares × $5.00 = $5,000

2. Preferred gets $5,000

Common gets $15,000 ($20,000 – $5,000)

3. Preferred shares are noncumulative because they are not specifically designated as cumulative.

4. Preferred gets:

2020 current-year dividend = $5,000

Common gets $35,000 ($40,000 – $5,000)

(15-20 min) **E13-13**

Since total dividends are $0 for 2019, no one is paid in that year.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Brzynski Marketing Ltd.** | | | | | | | |
| Dividend Payment Schedule | | | | | | | |
|  |  | | | | **Preferred** | **Common** | **Total** |
| Total dividend | | | |  |  |  | $47,000 |
| Preferred dividends in arrears for 2019: (60,000 × $0.10) | | | |  | 6,000 |  |  |
| Total preferred dividends in arrears | |  | | |  |  | 6,000 |
| Remainder | | | |  |  |  | 41,000 |
| Dividends for 2020: | | | |  |  |  |  |
| Preferred | | | |  |  |  |  |
| Total preferred dividends for 2020 | | |  | | 6,000 |  | 6,000 |
| Remainder | | | |  |  |  | 35,000 |
| Common | | | |  |  | $35,000 | 35,000 |
| Remainder | | | |  |  |  | $         0 |
| Totals | | | |  | $12,000 | $35,000 | $47,000 |

(10-15 min.) **E13-14**

Book value per preferred share = Liquidation value + Dividends in arrears

Number of preferred shares outstanding

= $15,000 + $0

300

= $50.00

Book value per common share = Shareholders’ equity – Preferred equity

Number of common shares outstanding

= $302,500\*

25,000

= $12.10

\* ($15,000 + $187,500 + $115,000 – $15,000)

(10-15 min.) **E13-15**

Dividends in arrears = 300 shares × $7.00 × 4 = $8,400

Book value per preferred share = Liquidation value + Dividends in arrears

Number of preferred shares outstanding

= $15,000 + $8,400

300

= $78.00

Book value per common share = Shareholders’ equity – Preferred equity

Number of common shares outstanding

= $294,100\*

25,000

= $11.76

\* ($15,000 + $187,500 + $115,000 – $23,400)

(10-15 min.) **E13-16**

Req. 1

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Return on assets | = | Net income +  Interest expense | = | $3,250 + $5,200 | = | $8,450 |
| Average total assets | ($105,000 + $95,000)÷2 | $100,000 |
|  |  |  |  |  |  |  |
|  | = | 0.0845 × 100 = | 8.45% |  |  |  |
|  |  |  |  |  |  |  |
| Return on common shareholders’ equity | = | Net income –  Preferred dividends | = | $3,250 – (200 × 1.15) | = | $3,020 |
| Average common shareholders’ equity |  | ($46,700 + $43,000)÷2 | $44,850 |
|  |  |  |  |  |  |  |
|  | = | 0.067336 × 100 = | 6.73% |  |  |  |

Req. 2

These profitability measures suggest some weakness because Woldenga’s ROA exceeds the ROE by 1.7 percent meaning that the company is paying more for its borrowed funds than it is earning.

(10-15 min.) **E13-17**

Req. 1a

Return on total assets

($420,000 + $0)÷[($4,524,000 + $4,050,000)÷2] = 9.80%

Req. 1b

Return on common shareholders’ equity

[$420,000 – ($2.50 × 24,000)]÷[(($2,500,000 + $1,043,600) + ($2,500,000 + $623,600))÷2] =10.80

Req. 2

No investment will take place. The business has good returns, but not good enough.

**Serial Exercise**

(20-25 min.) **E13-18**

*Req. 1*

|  |  |  |  |
| --- | --- | --- | --- |
| **Date** | **Account Titles and Explanations** | **Debit** | **Credit** |
| Jan. 1 | Cash | 200,000 |  |
|  | Common Shares |  | 200,000 |
|  | Issued 50,000 common shares for cash. |  |  |
|  |  |  |  |
| 10 | Land | 70,000 |  |
|  | Preferred Shares |  | 70,000 |
|  | Issued 2,000 preferred shares for land. |  |  |
|  |  |  |  |
| Dec. 15 | Retained Earnings | 15,000 |  |
|  | Dividends Payable, Preferred Shares |  | 8,000 |
|  | Dividends Payable, Common Shares |  | 7,000 |
|  | Declared cash dividends. Preferred shares dividends are $8,000 (2,000 shares × $4 per share). Common shares dividends are $7,000 ($15,000 − $8,000). |  |  |
|  |  |  |  |
| 31 | Dividends Payable, Preferred Shares | 8,000 |  |
|  | Dividends Payable, Common Shares | 7,000 |  |
|  | Cash |  | 15,000 |
|  | Paid cash dividends. |  |  |
|  |  |  |  |

*Req. 2*

|  |  |
| --- | --- |
|  |  |
| Retained Earnings, January 1, 2022 | $ 0 |
| Net income for the year | 417,000 |
|  | 417,000 |
| Cash dividends declared | (15,000) |
| Retained Earnings, December 31, 2022 | $402,000 |
|  |  |

*Req. 3*

|  |  |
| --- | --- |
| **Outdoor Equipment Corporation** | |
| Balance Sheet (Partial) | |
| December 31, 2022 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $4.00, 500,000 authorized, 2,000 shares issued and outstanding | $ 70,000 |
| Common shares, 1,000,000 authorized, 50,000 shares issued and outstanding | 200,000 |
| Total contributed capital  Retained earnings | 270,000  402,000 |
| Total shareholders’ equity | $672,000 |

**Challenge Exercise**

(15-20 min.) **E13-19**

|  |  |
| --- | --- |
| Common shares, Dec. 31, 2019 | $   300,000 |
| Issuance of shares for cash (3,000 shares at $60) | 180,000 |
| Issuance of shares to purchase another company (15,000 shares at $70) | 1,050,000 |
| Common shares, Dec. 31, 2020 | $1,530,000 |
|  |  |
| Retained earnings, Dec. 31, 2019 | $1,538,000 |
| Net income | 1,430,000 |
| Cash dividends | (650,000) |
| Retained earnings, Dec. 31, 2020 | $2,318,000 |

Beyond the Numbers

(15-20 min.) **BN13-1**

1. Contributed capital and retained earnings are reported separately as they represent different sources of capital:

• Contributed capital represents investments in share capital by shareholders.

• Retained earnings is capital earned by profitable operations of the corporation that has not been paid out in dividends.

• Incorporating acts require corporations to report the sources of their capital.

2. Dirt Girl Landscaping faces the problem of determining the market value of the land it receives. The current market value of the land will determine the recorded value of the land and of the common shares issued. This assumes the shares of Dirt Girl Landscaping are not traded on a stock exchange. If they were traded on a stock exchange and a market price per share existed, then the value of the land could be determined by multiplying the number of shares given to Todt for the land by the market price per share. The value of the land should be the same in both situations—its current market value.

3. Investors buy common shares in the hope of earning higher returns on their investment than are available on an investment in preferred shares. For a healthy company, the rate of return on common shareholders’ equity is usually higher than the rate of return on preferred shares. Also the market value of common shares in such a company will increase more than its preferred shares’ price.

4. Yes, if book value exceeds market value. No, if market value exceeds book value. The shareholder will accept the offer that maximizes his or her wealth.

5. Convertible preferred shares may be exchanged by preferred shareholders, if they choose, for another specified class of shares in the corporation. An investor would exercise the conversion privilege if the market value of the shares received on conversion exceeded the market value of the preferred shares held after brokerage commissions and any other fees are paid.

Ethical Issue

(10 min.) **EI13-1**

Req. 1

Wertz’s reporting a $50,000 franchise at $375,000 is *unethical*. The franchise cost $50,000, not $375,000. The three transactions are not independent. Wertz and the corporation are effectively the same entity. The third party serves no purpose other than as an accomplice to fraudulently increase the value of the franchise.

Req. 2

Potential buyers of the individual-language franchises can be harmed. Wertz’s balance sheet overstates his assets. If outsiders believe his balance sheet, they may be induced to pay Wertz more than the individual-language franchises are worth.

Lenders can also be harmed by loaning money to Wertz on more favourable terms than his financial position warrants.

The public is also defrauded if Wertz amortizes the cost of the franchise for income tax purposes. Basing amortization on $375,000 overstates tax deductions and understates the corporation’s income. As a result, the tax payments are lower than they should be.

Accounting plays the role of recording assets at their cost. This sequence of events was an attempt to arbitrarily increase the value at which the franchise was recorded.

Problems

Group A

(10-20 min.) **P13-1A**

DATE: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

TO: Mark Mathews and Karen Willamas

FROM: Student Name

SUBJECT: Advantages and disadvantages of the corporate form of business organization

The corporate form of business organization offers some advantages over the proprietorship and the partnership forms. An important advantage of an established corporation is the limited liability of shareholders for business debts. This enables a person to invest in a corporation without having to assume any personal obligation for the corporation’s liabilities. The most that an investor can lose from investing in a corporation is his or her investment in the business.

The separate legal existence of the corporation apart from its owners eases the transfer of ownership from one person to another. A shareholder buying into or selling out of a corporation has no effect on the operation of the corporation. A shareholder cannot commit the corporation to an obligation unless he or she is an officer of the business. These features enable a corporation to raise money from a large number of people. A partnership can raise owners’ equity only from the partners. Most corporations have more owners and can grow larger than a partnership.

Shareholders elect a board of directors that appoints corporate officers to manage the business. It is important that corporate officers manage the business for the benefit of the shareholders. In a partnership, the partners manage the business for their benefit only.

Corporations often have to pay fees to organize as a corporation. Corporations are also taxed on their business income but for an active business this rate is less than the one an individual would pay. It is also possible to smooth out large fluctuations in income by deferring salary payments to a subsequent year, which cannot be done by an individual. However, if the corporation pays dividends, the shareholders also pay income tax on the dividend income. Therefore, shareholders are subject to a form of double taxation.

Also, corporations are regulated more heavily than partnerships. Complying with various regulations can be expensive for a corporation. Corporations also may incur additional costs compared to partnerships, such as liability insurance for a corporation’s directors.

*Instructional Note:* Student responses will vary considerably.

(30-45 min.) **P13-2A**

Req. 1

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date**  **2020** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Aug. | 2 | Organization Costs |  | 22,000 |  |
|  |  | Cash |  |  | 22,000 |
|  |  | Paid fees and legal fees to incorporate. ($6,000 + $16,000) |  |  |  |
|  |  |  |  |  |  |
|  | 2 | Cash |  | 337,500 |  |
|  |  | Common Shares |  |  | 337,500 |
|  |  | Issued 45,000 common shares to the incorporators. |  |  |  |
|  |  |  |  |  |  |
| Dec. | 10 | Computer Equipment |  | 80,000 |  |
|  |  | Preferred Shares |  |  | 80,000 |
|  |  | Issued 1,000 preferred shares to acquire a computer system. |  |  |  |
|  |  |  |  |  |  |
|  | 16 | Cash |  | 120,000 |  |
|  |  | Common Shares |  |  | 120,000 |
|  |  | Issued 15,000 common shares for cash. |  |  |  |

Req. 2

|  |  |
| --- | --- |
| **E-Z SERVICES INC.** | |
| Balance Sheet (partial) | |
| December 31, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $2.50, 500,000 shares authorized, 1,000 shares issued | $   80,000 |
| Common shares, 2,000,000 shares authorized, 60,000 shares issued\* | 457,500\*\* |
| Total contributed capital | 537,500 |
| Retained earnings | 145,000 |
| Total shareholders’ equity | $ 682,500 |

\* 20,000 + 25,000 + 15,000 = 60,000

\*\* $150,000 + $187,500 + $120,000 = $457,500

(15-20 min.) **P13-3A**

Req. 1

$4.00 is the annual dividend rate on the preferred shares.

Annual dividend on 2,500 shares = $10,000 ($4.00 × 2,500 shares)

Req. 2

Average issue price of common shares during 2019 = $1.50 per share ($225,000 ÷ 150,000 shares)

Req. 3

First-year operations were not profitable, as shown by the Deficit in Retained Earnings. Riverbend Inc. lost $50,000 in the first year of operations.

Req. 4

|  |  |  |  |
| --- | --- | --- | --- |
| **General Journal** | | | |
| **Date** | **Account Titles and Explanations** | **Debit** | **Credit** |
| Feb. 15 | Cash\* | 30,000 |  |
|  | Preferred Shares |  | 30,000 |
|  |  |  |  |
| Apr. 2 | Cash\*\* | 8,750 |  |
|  | Common Shares |  | 8,750 |
|  |  |  |  |
| Jun. 1 | Building\*\*\* | 250,000 |  |
|  | Common Shares |  | 250,000 |
|  |  |  |  |
| Dec. 31 | Income Summary | 180,000 |  |
|  | Retained Earnings |  | 180,000 |

\* (1,500 × $20)

\*\* (5,000 × $1.75)

\*\*\* (100,000 × $2.50)

(continued) **P13-3A**

Req. 5

|  |  |
| --- | --- |
| **RIVERBEND INC.** | |
| Balance Sheet (partial) | |
| December 31, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $4.00, 200,000 shares authorized, 1,500 shares issued | $ 30,000 |
| Common shares, 1,000,000 shares authorized, 255,000 shares\* issued | 483,750\*\* |
| Total contributed capital | 513,750 |
| Retained earnings | 130,000\*\*\* |
| Total shareholders’ equity | $643,750 |

\* 150,000 + 5,000 + 100,000 = 255,000

\*\* $225,000 + $8,750 + $250,000 = $483,750

\*\*\* ($50,000) + $180,000 = $130,000

(20-30 min.) **P13-4A**

|  |  |
| --- | --- |
| **RUBY DISTRIBUTORS LTD.** | |
| Balance Sheet (partial) | |
| December 31, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Common shares, 150,000 shares authorized and issued | $450,000 |
| Total contributed capital | 450,000 |
| Retained earnings (deficit) | (10,000) |
| Total shareholders’ equity | $440,000 |

Calculations:

Common shares: 150,000 × $3 = $450,000

Retained earnings: –$75,000 – $30,000 + $35,000 + $60,000 = –$10,000

|  |  |
| --- | --- |
| **GEM WHOLESALERS INC.** | |
| Balance Sheet (partial) | |
| December 31, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $1.10, cumulative, 200,000 shares authorized, 2,000 shares issued | $  25,000 |
| Common shares, 1,000,000 shares authorized, 100,000 shares issued | 300,000 |
| Total contributed capital | 325,000 |
| Retained earnings | 120,600 |
| Total shareholders’ equity | $445,600 |

Calculations:

Preferred shares: 2,000 × $12.50 = $25,000

Common shares: Balance given as $300,000

Retained earnings: $75,000 + $50,000 – (2,000 × $1.10 × 2) = $120,600

(20-35 min.) **P13-5A**

Req. 1

Toluca Enterprises Inc. has $2.75 cumulative preferred shares and common shares outstanding.

Req. 2

The average issue price per preferred share is $4.00 ($400,000 ÷ 100,000 shares issued).

Req. 3

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
|  |  |  |  |  |  |
| Mar. | 1 | Cash |  | 400,000 |  |
|  |  | Preferred Shares |  |  | 400,000 |
|  |  |  |  |  |  |
| Mar. | 1 | Cash |  | 1,850,000 |  |
|  |  | Common Shares |  |  | 1,850,000 |

Req. 4

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
|  |  |  |  |  |  |
| Mar. | 31 | Retained Earnings |  | 400,000 |  |
|  |  | Dividends Payable—Preferred Shares |  |  | 275,000 |
|  |  | Dividends Payable—Common Shares |  |  | 125,000 |

100,000 shares × $2.75 = $275,000

(20-30 min.) **P13-6A**

Req. 1a (preferred shares are noncumulative)

|  |  |  |  |
| --- | --- | --- | --- |
| **Rainy Day Corporation** | | | |
| Total Dividends to Preferred and Common Shares for 2017, 2018, and 2019 | | | |
|  | **Preferred** | **Common** | **Total** |
| **2017** |  |  |  |
|  | 0 | 0 | $ 0 |
|  |  |  |  |
| **2018** |  |  |  |
| Preferred (50,000 × $0.50) | $25,000 |  |  |
| Remainder to common |  | $89,000 |  |
| Total |  |  | $114,000 |
|  |  |  |  |
| **2019** |  |  |  |
| Preferred (50,000 × $0.50) | $25,000 |  |  |
| Remainder to common |  | $235,000 |  |
| Total |  |  | $260,000 |

Req.1b (preferred shares are cumulative)

|  |  |  |  |
| --- | --- | --- | --- |
| **Rainy Day Corporation** | | | |
| Total Dividends to Preferred and Common Shares for 2017, 2018, and 2019 | | | |
|  | **Preferred** | **Common** | **Total** |
| **2017** |  |  |  |
|  | $  0 | $   0 | $  0 |
|  |  |  |  |
| **2018** |  |  |  |
| 2017 in arrears to preferred |  |  |  |
| ($50,000 × $0.50) | $25,000 |  |  |
| Current to preferred (50,000 × $0.50) | 25,000 |  |  |
| Remainder to common |  | $ 64,000 |  |
| Total | $50,000 | $ 64,000 | $114,000 |
|  |  |  |  |
| **2019** |  |  |  |
| Current to preferred (50,000 × $0.50) | $25,000 |  |  |
| Remainder to common |  | $235,000 |  |
| Total |  |  | $260,000 |

(continued) **P13-6A**

Req. 2

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| **2019** | |  |  |  |  |
| Dec. | 22 | Retained Earnings |  | 260,000 |  |
|  |  | Dividends Payable—Preferred Shares |  |  | 25,000 |
|  |  | Dividends Payable—Common Shares |  |  | 235,000 |
|  |  | To declare dividends on shares to be paid in January. |  |  |  |
|  |  |  |  |  |  |
| **2020** | |  |  |  |  |
| Jan. | 12 | Dividends Payable—Preferred Shares |  | 25,000 |  |
|  |  | Dividends Payable—Common Shares |  | 235,000 |  |
|  |  | Cash |  |  | 260,000 |
|  |  | To pay dividend declared December 22, 2019. |  |  |  |

(15-20 min.) **P13-7A**

Req. 1

The preferred shares are labelled as *cumulative*.

Req. 2

Total contributed capital is $728,000 ($200,000 + $528,000)

Req. 3

Total market value of the common shares: $1,232,000

44,000 shares × $28.00 per share = $1,232,000

Req. 4

|  |  |
| --- | --- |
| Liquidation value (10,000 × $24.00) | $240,000 |
| Cumulative dividend for two years (10,000 × $1.20 × 2) | 24,000 |
| Shareholders’ equity allocated to preferred | $264,000 |

Book value per preferred share = Liquidation value + Dividends in arrears

Number of preferred shares outstanding

= $240,000 + $24,000

10,000

= $26.40

Book value per common share = Shareholders’ equity – Preferred equity

Number of common shares outstanding

= $896,000 – $264,000

44,000

= $14.36

(40-50 min.) **P13-8A**

**Req. 1**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | | **Debit** | **Credit** |
| **2018** | |  | |  |  |  |
| Dec. | 1 | Retained Earnings | |  | 180,000 |  |
|  |  | Dividends Payable—Preferred Shares | |  |  | 112,500 |
|  |  | Dividends Payable—Common Shares, Class A | |  |  | 7,941\* |
|  |  | Dividends Payable—Common Shares, Class B | |  |  | 59,559\* |
|  |  | To record dividends declared on shares.  (30,000 × $1.25 × 3 years) | |  |  |  |
|  |  |  | |  |  |  |
|  | 31 | Income Summary | |  | 60,000 |  |
|  |  | Retained Earnings | |  |  | 60,000 |
|  |  | To close books and record net income for year. | |  |  |  |
|  |  |  | |  |  |  |
| **2019** | |  | |  |  |  |
| Jan. | 7 | Cash | |  | 235,000 |  |
|  |  | Preferred Shares | |  |  | 235,000 |
|  |  | Sale of preferred shares for cash.  (10,000 × $23.50) | |  |  |  |
|  |  |  | |  |  |  |
|  | 15 | Dividends Payable—Preferred Shares | |  | 112,500 |  |
|  |  | Dividends Payable—Common Shares, Class A | |  | 7,941 |  |
|  |  | Dividends Payable—Common Shares, Class B | |  | 59,559 |  |
|  |  | Cash | |  |  | 180,000 |
|  |  | Payment of dividends declared December 1 | |  |  |  |
|  |  |  | |  |  |  |
| Feb. | 14 | Cash | |  | 165,000 |  |
|  |  | Common Shares—Class B | |  |  | 165,000 |
|  |  | Sale of common shares for cash.  (15,000 × $11) | |  |  |  |

\* Class A common shares 20,000 (or 2/17 of total common shares)

Class B common shares 150,000 (or 15/17 of total common shares)

170,000

Class A = 2/17 × ($180,000 – $112,500) = $7,941

Class B = 15/17 × ($180,000 – $112,500) = $59,559

(continued) **P13-8A**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| **2019** | |  |  |  |  |
| Dec. | 2 | Retained Earnings |  | 120,000 |  |
|  |  | Dividends Payable—Preferred |  |  | 50,000 |
|  |  | Dividends Payable—Common Shares, Class A |  |  | 7,568\* |
|  |  | Dividends Payable—Common Shares, Class B |  |  | 62,432\* |
|  |  | To record dividends declared on shares.  (40,000 × $1.25) |  |  |  |
|  |  |  |  |  |  |
|  | 31 | Income Summary |  | 145,000 |  |
|  |  | Retained Earnings |  |  | 145,000 |
|  |  | To close books and record net income for year. |  |  |  |
|  |  |  |  |  |  |
| **2020** | |  |  |  |  |
| Jan. | 15 | Dividends Payable—Preferred |  | 50,000 |  |
|  |  | Dividends Payable—Common Shares, Class A |  | 7,568 |  |
|  |  | Dividends Payable—Common Shares, Class B |  | 62,432 |  |
|  |  | Cash |  |  | 120,000 |
|  |  | Payment of dividends declared December 2. |  |  |  |

\* Class A common shares 20,000 (or 2/18.5 of total shares)

Class B common shares (150,000 + 15,000) 165,000 (or 16.5/18.5 of total shares)

185,000

Class A = 2/18.5 × ($120,000 – $50,000) = $7,568

Class B = 16.5/18.5 × ($120,000 – $50,000) = $62,432

(continued) **P13-8A**

Req. 2

|  |  |  |
| --- | --- | --- |
| **CRICKET CORP.** | | |
| Balance Sheet (partial) | | |
| December 31, 2019 | | |
| **Liabilities** |  |  |
| Current liabilities |  |  |
| Dividend payable | $   120,000 |  |
| Total current liabilities |  | $   120,000 |
| Total liabilities |  | 120,000 |
| **Shareholders’ Equity** |  |  |
| Contributed capital |  |  |
| Preferred shares, $1.25 cumulative, liquidation price of $20.00, 100,000 shares authorized, 40,000 shares issued | $ 435,000 |  |
| Common shares: |  |  |
| Class A, 20,000 shares authorized and issued | 125,000 |  |
| Class B, unlimited number of shares authorized, 165,000 shares issued | 1,665,000 |  |
| Total contributed capital | 2,225,000 |  |
| Retained earnings\* | 205,000 |  |
| Total shareholders’ equity |  | 2,430,000 |
| Total liabilities and shareholders’ equity |  | $2,550,000 |

\*Retained earnings: $300,000 – $180,000 + $60,000 – $120,000 + $145,000 = $205,000

Req. 3

Book value per preferred share = Liquidation value + Dividends in arrears

Number of preferred shares outstanding

= ($20.00 × 40,000) + $0

40,000

= $20

Book value per common share = Shareholders’ equity – Preferred equity

Number of common shares outstanding

= $2,430,000 – (40,000 × $20.00)

185,000

= $8.81

Req. 4

$125,000÷20,000 = $6.25 per share

Req. 1 (40-50 min.) **P13-9A**

|  |  |  |
| --- | --- | --- |
| **ETSE MANUFACTURING LTD.** | | |
| Balance Sheet | | |
| December 31, 2020 | | |
| **Assets** |  |  |
| Current assets |  |  |
| Cash | $  35,000 |  |
| Accounts receivable, net | 100,000 |  |
| Inventory | 190,500 |  |
| Prepaid expenses | 15,500 |  |
| Total current assets |  | $341,000 |
|  |  |  |
| Property, plant, and equipment, net |  | 381,000 |
| Intangible assets |  |  |
| Patent, net |  | 37,000 |
| Total assets |  | $759,000 |
|  |  |  |
| **Liabilities** |  |  |
| Current liabilities |  |  |
| Accounts payable | $  36,000 |  |
| Dividends payable | 4,500 |  |
| Accrued liabilities | 23,000 |  |
| Total current liabilities |  | 63,500 |
| Long-term note payable |  | 100,500 |
| Total liabilities |  | 164,000 |
|  |  |  |
| **Shareholders’ Equity** |  |  |
| Contributed capital |  |  |
| Preferred shares, $0.15, 25,000 shares authorized, 6,000 shares issued | 30,000 |  |
| Common shares, 100,000 shares authorized, 33,000 shares issued | 165,000 |  |
| Total contributed capital | 195,000 |  |
| Retained earnings | 400,000\* |  |
| Total shareholders’ equity |  | 595,000 |
| Total liabilities and shareholders’ equity |  | $759,000 |

\*Retained earnings = Total assets – Total liabilities – Total contributed capital

= $759,000 – $164,000 – $195,000 = $400,000

Req. 2 (continued) **P13-9A**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Return on total assets | = | Net income + Interest expense | = | | $140,750 + $10,850 | = | | $151,600 |
| Average total assets | ($759,000 + $567,500)÷2 | $663,250 |
|  |  |  |  |  | | |  |  |
|  | = | 0.2286 or 22.86% |  |  | | |  |  |
|  |  |  |  |  | | |  |  |
| Return on common shareholders’ equity | = | Net income – Preferred dividends | = | | $140,750 – (6,000 × $0.15) | = | | $139,850 |
| Average common shareholders’ equity |  | | ($565,000\* + $520,000)÷2 | $542,500 |
|  |  |  |  |  | | |  |  |
|  | = | 0.2578 or 25.78% |  |  | | |  |  |

\* Total shareholders’ equity $595,000

Less: Preferred equity     30,000

Common shareholders’ equity $565,000

Req. 3

These rates of return suggest some strength. Return on common shareholders’ equity is higher than the return on assets.

*Preparing a fairly complex balance sheet will refine students’ understanding of the shareholders’ equity of a corporation. This will help students understand what they are buying (shareholders’ equity) when they purchase a company’s shares as an investment.*

*This problem also exposes students to two widely used measures of profitability—return on assets and return on common shareholders’ equity. Students, investors, and others can evaluate investments on the basis of their returns on assets and returns on equity. Higher return figures generally indicate better investments. Although these return measures are not the only indicators of profitability that investors use, they are helpful—along with other decision-making aids—in evaluating investments.*

Problems

Group B

(10-20 min.) **P13-1B**

DATE: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

TO: Jack Rudd and Pam Kines

FROM: Student Name

SUBJECT: Advantages and disadvantages of the corporate form of business organization

A corporation has a separate legal existence apart from its owners. This eases the transfer of ownership from one person to another with no effect on the operation of the corporation. A shareholder cannot commit the corporation to an obligation unless he or she acts in an official capacity for the business. The owners do not have personal liability for the debts and other actions of the business. In many corporations, ownership is separate from management as the board of directors appoints professionals to manage the business on a day-to-day basis. The continuous life and transferability of ownership make it easy for a corporation to raise money from a large number of people. A partnership, on the other hand, can raise owners’ equity only from the partners. The net result of these features is that most corporations have more owners and can grow larger than a partnership, the owners do not assume personal liability for debts of the corporation, and the business should be managed for the benefit of all the shareholders.

Corporations have disadvantages as compared to the partnership form of organization. Corporations often have to pay fees to organize. Corporations are also taxed on their business income but the rate for an active business is less than the one for an individual. If the corporation pays dividends, the shareholders also pay income tax on the dividend income. Therefore, shareholders may be subject to a degree of double taxation. Corporations are regulated more heavily than partnerships. Complying with various regulations can be expensive for a corporation. Corporations also may incur additional costs compared to partnerships, such as liability insurance for a corporation’s directors.

*Instructional Note:* Student responses will vary considerably.

(30-45 min.) **P13-2B**

Req. 1

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date**  **2020** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Jan. | 2 | Organization Costs |  | 8,500 |  |
|  |  | Cash |  |  | 8,500 |
|  |  | Paid costs and legal fees to incorporate. ($2,500 + $6,000) |  |  |  |
|  |  |  |  |  |  |
|  | 6 | Equipment |  | 175,000 |  |
|  |  | Common Shares |  |  | 175,000 |
|  |  | Issued 20,000 common shares for equipment. |  |  |  |
|  |  |  |  |  |  |
|  | 12 | Software |  | 19,500 |  |
|  |  | Preferred Shares |  |  | 19,500 |
|  |  | Issued 100 preferred shares to acquire software. |  |  |  |
|  |  |  |  |  |  |
| May | 22 | Cash |  | 35,000 |  |
|  |  | Common Shares |  |  | 35,000 |
|  |  | Issued 5,000 common shares for cash.  (5,000 × $7) |  |  |  |

Req. 2

|  |  |
| --- | --- |
| **GINGRICH SOLUTIONS LTD.** | |
| Balance Sheet (partial) | |
| December 31, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $2.00, 90,000 shares authorized, 100 shares issued | $ 19,500 |
| Common shares, 150,000 shares authorized, 25,000 shares issued\* | 210,000\*\* |
| Total contributed capital | 229,500 |
| Retained earnings | 40,000 |
| Total shareholders’ equity | $269,500 |

\* 20,000 + 5,000 = 25,000

\*\* $175,000 + $35,000 = $210,000

(15-20 min.) **P13-3B**

Req. 1

The annual dividend rate on the preferred shares is $0.20.

Annual dividend on 4,000 shares = $800 ($0.20 × 4,000 shares)

Req. 2

Issue price of common shares during 2019 = $8.75 per share ($87,500÷10,000 shares)

Req. 3

First-year operations were not profitable, as shown by the Deficit in Retained Earnings.

Req. 4

|  |  |  |  |
| --- | --- | --- | --- |
| **General Journal** | | | |
| **Date** | **Account Titles and Explanations** | **Debit** | **Credit** |
| Jan. 27 | Cash\* | 25,000 |  |
|  | Preferred Shares |  | 25,000 |
|  |  |  |  |
| Apr. 4 | Cash\*\* | 9,000 |  |
|  | Common Shares |  | 9,000 |
|  |  |  |  |
| Sep. 15 | Building | 235,000 |  |
|  | Common Shares |  | 235,000 |
|  |  |  |  |
| Dec. 31 | Income Summary | 62,500 |  |
|  | Retained Earnings |  | 62,500 |

\* (10,000 × $2.50)

\*\* (1,000 × $9)

(continued) **P13-3B**

Req. 5

|  |  |
| --- | --- |
| **SLOBODA CORPORATION** | |
| Balance Sheet (partial) | |
| December 31, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $0.20, 50,000 shares authorized, 10,000 shares issued | $  25,000 |
| Common shares, 100,000 shares authorized, 36,000\* shares issued | 331,500\*\* |
| Total contributed capital | 356,500 |
| Retained earnings | 42,500\*\*\* |
| Total shareholders’ equity | $399,000 |

Calculations:

\*10,000 + 1,000 + 25,000 = 36,000

\*\* $87,500 + $9,000 + $235,000 = $331,500

\*\*\* $62,500 - $20,000 = $42,500

(20-30 min.) **P13-4B**

|  |  |
| --- | --- |
| **KABADDI CORP.** | |
| Balance Sheet (partial) | |
| December 31, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Common shares, 100,000 authorized and issued | $1,000,000 |
| Total contributed capital | 1,000,000 |
| Retained earnings | 65,000 |
| Total shareholders’ equity | $1,065,000 |

Calculations:

Common shares: 100,000 × $10 = $1,000,000

Retained earnings: –$30,000 + $45,000 + $50,000 = $65,000

|  |  |
| --- | --- |
| **KERALA LTD.** | |
| Balance Sheet (partial) | |
| December 31, 2020 | |
| **Shareholders’ Equity** |  |
| Contributed capital |  |
| Preferred shares, $1.25, cumulative, 50,000 shares authorized, 4,000 shares issued | $  40,000 |
| Common shares, 500,000 shares authorized, 60,000 shares issued | 150,000 |
| Total contributed capital | 190,000 |
| Retained earnings | 77,500 |
| Total shareholders’ equity | $267,500 |

Calculations:

Preferred shares: 4,000 × $10 = $40,000

Common shares: Balance given as $150,000

Retained earnings: $55,000 + $62,500 – (4,000 shares × $1.25 × 2 years) – (60,000 shares × $0.50) = $77,500

(20-35 min.) **P13-5B**

Req. 1

Preferred shares

Common shares

Req. 2

The preferred shares are cumulative based on their balance-sheet description.

Req. 3

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Aug. | 31 | Cash |  | 32,500 |  |
|  |  | Preferred Shares |  |  | 32,500 |
|  |  |  |  |  |  |
| Aug. | 31 | Cash |  | 100,000 |  |
|  |  | Common Shares |  |  | 100,000 |

Req. 4

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date**  **2020** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Dec. | 31 | Retained Earnings |  | 15,000 |  |
|  |  | Dividends Payable—Preferred Shares |  |  | 5,000\* |
|  |  | Dividends Payable—Common Shares |  |  | 10,000 |
|  |  | To record the declaration of dividends on preferred shares for the current year and all arrears, and on common shares. |  |  |  |

\* 10,000 × $0.25 × 2 years = $5,000

(20-30 min.) **P13-6B**

Req. 1a (preferred shares are noncumulative)

|  |  |  |  |
| --- | --- | --- | --- |
| **Tijiu Broadcasting Inc.** | | | |
| Total Dividends to Preferred and Common Shares for 2018, 2019, and 2020 | | | |
|  | **Preferred** | **Common** | **Total** |
| **2018** |  |  |  |
| Preferred (15,000 × $2.50) | $37,500 |  |  |
| Remainder to common |  | $  7,500 |  |
| Total |  |  | $  45,000 |
|  |  |  |  |
| **2019** |  |  |  |
|  | $ 0 | $   0 | $ 0 |
|  |  |  |  |
| **2020** |  |  |  |
| Preferred (15,000 × $2.50) | $37,500 |  |  |
| Remainder to common |  | $82,500 |  |
| Total |  |  | $120,000 |

Req.1b (preferred shares are cumulative)

|  |  |  |  |
| --- | --- | --- | --- |
| **Tijiu Broadcasting Inc.** | | | |
| Total Dividends to Preferred and Common Shares for 2018, 2019, and 2020 | | | |
|  | **Preferred** | **Common** | **Total** |
| **2018** |  |  |  |
| Preferred (15,000 × $2.50) | $37,500 |  |  |
| Remainder to common |  | $  7,500 |  |
| Total |  |  | $  45,000 |
|  |  |  |  |
| **2019** |  |  |  |
|  | $ 0 | $   0 | $ 0 |
|  |  |  |  |
| **2020** |  |  |  |
| Arrears to preferred (15,000 x $2.50) | $37,500 |  |  |
| Current to preferred (15,000 × $2.50) | 37,500 |  |  |
| Remainder to common |  | $45,000 |  |
| Total | $75,000 | $45,000 | $120,000 |

(continued) **P13-6B**

Req. 2

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanation** | **Post. Ref.** | **Debit** | **Credit** |
| **2020** | |  |  |  |  |
| Dec. | 28 | Retained Earnings |  | 120,000 |  |
|  |  | Dividends Payable—Preferred Shares |  |  | 75,000 |
|  |  | Dividends Payable—Common Shares |  |  | 45,000 |
|  |  | To declare dividends on shares. |  |  |  |
|  |  |  |  |  |  |
| **2021** | |  |  |  |  |
| Jan. | 17 | Dividends Payable—Preferred Shares |  | 75,000 |  |
|  |  | Dividends Payable—Common Shares |  | 45,000 |  |
|  |  | Cash |  |  | 120,000 |
|  |  | To pay dividends declared on Dec. 28, 2020. |  |  |  |

(15-20 min.) **P13-7B**

Req. 1

The preferred shares are labelled as cumulative.

Req. 2

The common shareholders control the company because the preferred shares are nonvoting.

Req. 3

Total contributed capital is $690,000 ($350,000 + $340,000)

Req. 4

Total market value of the common shares: $270,000

90,000 shares × $3.00 per share = $270,000

Req. 5

|  |  |
| --- | --- |
| Liquidation value | $350,000 |
| Cumulative dividend for three years (16,000 × $1.40 × 3) | 67,200 |
| Shareholders’ equity allocated to preferred | $417,200 |

Book value per preferred share = Liquidation value + Dividends in arrears

Number of preferred shares outstanding

= $350,000 + $67,200

16,000

= $26.08

Book value per common share = Shareholders’ equity – Preferred equity

Number of common shares outstanding

= $810,000 – $417,200

90,000

= $4.36

(40-50 min.) **P13-8B**

Req. 1

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | | |
| **Date** | | | **Account Titles and Explanation** | **Post. Ref.** | **Debit** | **Credit** |
| **2018** | | |  |  |  |  |
| Dec. | | 1 | Retained Earnings |  | 170,000 |  |
|  | |  | Dividends Payable—Preferred Shares |  |  | 120,000 |
|  | |  | Dividends Payable—Common Shares, Class A |  |  | 8,333\* |
|  | |  | Dividends Payable—Common Shares, Class B |  |  | 41,667\* |
|  | |  | To record dividends declared on shares.  (40,000 × $0.75 × 4 years) |  |  |  |
|  | |  |  |  |  |  |
|  | | 31 | Income Summary |  | 80,000 |  |
|  | |  | Retained Earnings |  |  | 80,000 |
|  | |  | To close books and record net income for year. |  |  |  |
|  | |  |  |  |  |  |
| **2019** | | |  |  |  |  |
| Jan. | 7 | | Cash |  | 225,000 |  |
|  |  | | Preferred Shares |  |  | 225,000 |
|  |  | | Sale of preferred shares for cash.  (10,000 shares × $22.50) |  |  |  |
|  |  | |  |  |  |  |
|  | 14 | | Dividends Payable—Preferred Shares |  | 120,000 |  |
|  |  | | Dividends Payable—Common Shares, Class A |  | 8,333 |  |
|  |  | | Dividends Payable—Common Shares, Class B |  | 41,667 |  |
|  |  | | Cash |  |  | 170,000 |
|  | |  | Payment of dividends declared December 1, 2018. |  |  |  |
|  | |  |  |  |  |  |
| Feb. | | 14 | Cash |  | 75,000 |  |
|  | |  | Common Shares—Class B |  |  | 75,000 |
|  | |  | Sale of common shares for cash.  (15,000 shares × $5) |  |  |  |

\* Class A common shares 15,000 (or 1/6 of total shares)

Class B common shares 75,000 (or 5/6 of total shares)

90,000

Class A = 1/6 × ($170,000 – $120,000) = $8,333

Class B = 5/6 × ($170,000 – $120,000) = $41,667

(continued) **P13-8B**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanation** | **Post. Ref.** | **Debit** | **Credit** |
| **2019** | |  |  |  |  |
| Dec. | 2 | Retained Earnings |  | 75,000 |  |
|  |  | Dividends Payable—Preferred Shares |  |  | 37,500 |
|  |  | Dividends Payable—Common Shares, Class A |  |  | 5,357\* |
|  |  | Dividends Payable—Common Shares, Class B |  |  | 32,143\* |
|  |  | To record dividends declared on shares.  (50,000 × $0.75) |  |  |  |
|  |  |  |  |  |  |
|  | 31 | Income Summary |  | 63,000 |  |
|  |  | Retained Earnings |  |  | 63,000 |
|  |  | To close books and record net income for year. |  |  |  |
|  |  |  |  |  |  |
| **2020** | |  |  |  |  |
| Jan. | 13 | Dividends Payable—Preferred Shares |  | 37,500 |  |
|  |  | Dividends Payable—Common Shares, Class A |  | 5,357 |  |
|  |  | Dividends Payable—Common Shares, Class B |  | 32,143 |  |
|  |  | Cash |  |  | 75,000 |
|  |  | Payment of dividends declared December 2, 2019. |  |  |  |

\* Class A common shares 15,000 (or 1/7 of total shares)

Class B common shares (75,000 + 15,000)   90,000 (or 6/7 of total shares)

105,000

Class A = 1/7 × ($75,000 – $37,500) = $5,357

Class B = 6/7 × ($75,000 – $37,500) = $32,143

(continued) **P13-8B**

Req. 2

|  |  |  |
| --- | --- | --- |
| **BOHEMIA NURSERY LTD.** | | |
| Balance Sheet (partial) | | |
| December 31, 2019 | | |
| **Shareholders’ Equity** |  |  |
| Contributed capital |  |  |
| Preferred shares, $0.75, cumulative (no arrears), liquidation price of $25, 100,000 shares authorized, 50,000 shares issued | $1,025,000 |  |
| Common shares |  |  |
| Class A, 15,000 shares authorized and issued | 120,000 |  |
| Class B, unlimited number of shares authorized, 90,000 shares issued | 450,000 |  |
| Total contributed capital |  | $1,595,000 |
| Retained earnings\* |  | 198,000 |
| Total shareholders’ equity |  | $1,793,000 |

\*Retained earnings: $300,000 – $170,000 + $80,000 – $75,000 + $63,000 = $198,000

Req. 3

Book value per preferred share = Liquidation value + Dividends in arrears

Number of preferred shares outstanding

= ($25.00 × 50,000) + $0

50,000

= $25

Book value per common share = Shareholders’ equity – Preferred equity

Number of common shares outstanding

= $1,793,000 – (50,000 × $25.00)

105,000

= $5.17

Req. 4

$120,000÷15,000 = $8.00 per share

(40-50 min.) **P13-9B**

Req. 1

|  |  |  |
| --- | --- | --- |
| **EOC CORP.** | | |
| Balance Sheet | | |
| June 30, 2020 | | |
| **Assets** |  |  |
| Current assets |  |  |
| Cash | $  15,000 |  |
| Accounts receivable, net | 52,500 |  |
| Inventory | 93,500 |  |
| Prepaid expenses | 12,000 |  |
| Total current assets |  | $173,000 |
|  |  |  |
| Property, plant, and equipment, net |  | 300,000 |
| Intangible assets |  |  |
| Trademark, net |  | 19,000 |
| Total assets |  | $492,000 |
|  |  |  |
| **Liabilities** |  |  |
| Current liabilities |  |  |
| Accounts payable | $  36,000 |  |
| Dividends payable | 10,500 |  |
| Accrued liabilities | 30,000 |  |
| Total current liabilities |  | 76,500 |
| Long-term note payable |  | 48,500 |
| Total liabilities |  | 125,000 |
|  |  |  |
| **Shareholders’ Equity** |  |  |
| Contributed capital |  |  |
| Preferred shares, $0.20, 10,000 shares authorized and issued | 29,500 |  |
| Common shares, 500,000 shares authorized, 272,000 shares issued | 300,000 |  |
| Total contributed capital | 329,500 |  |
| Retained earnings | 37,500\* |  |
| Total shareholders’ equity |  | 367,000 |
| Total liabilities and shareholders’ equity |  | $492,000 |

\*Retained earnings = Total assets – Total liabilities – Total contributed capital

= $492,000 – $125,000 – $329,500 = $37,500

Req. 2 (continued) **P13-9B**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Return on total assets | = | Net income + Interest expense | = | | | $25,000 + $7,200 | = | $32,200 | | | | | |
| Average total assets | ($492,000 + $410,000÷2) | $451,000 | | | | | |
|  |  |  |  |  | | | | | |  |  | |
|  | = | 0.071 × 100 | = | 7.1% | | | | | |  |  | |
|  |  |  |  |  | | | | | |  |  | |
| Return on common shareholders’ equity | = | Net income – Preferred dividends | = | | $25,000 – (10,000 × $0.20) | | | | = | $23,000 | |
| Average common shareholders’ equity |  | | ($337,500\* + $200,000)÷2 | | | | $268,750 | |
|  |  |  |  |  | | | | | |  |  | |
|  | = | 0.086 × 100 | = | 8.6% | | | | | |  |  | |

\* Total shareholders’ equity $367,000

Less: Preferred equity     29,500

Common shareholders’ equity $337,500

Req. 3

These rates of return suggest weakness. Return on common shareholders’ equity is only 1.5 percent higher than return on assets. An 8.6 percent return on common shareholders’ equity is good considering bank savings rates are currently below 2 percent; a 12 percent return is considered excellent in most industries.

*Preparing a fairly complex balance sheet will refine students’ understanding of the shareholders’ equity of a corporation. This will help students understand what they are buying (shareholders’ equity) when they purchase a company’s shares as an investment.*

*This problem also exposes students to two widely used measures of profitability—return on assets and return on common shareholders’ equity. Students, investors, and others can evaluate investments on the basis of their returns on assets and returns on equity. Higher return figures generally indicate better investments. Although these return measures are not the only indicators of profitability that investors use, they are helpful—along with other decision-making aids—in evaluating investments.*

Challenge Problems

**P13-1C**

The student should look critically at incorporation from Bryan McNair’s perspective.

Separate legal entity This characteristic is not really an advantage to Bryan based on the information given. He does not appear to be interested in taking on co-owners.

Continuous life This may be an advantage later but does not appear to be an advantage at this time.

No mutual agency This characteristic does not appear to be advantageous unless Bryan sells shares to other people. The question states that the plan is for Bryan to hold all the shares.

Limited liability Limited liability would protect Bryan’s business assets from creditors other than the bank. It would also protect any of Bryan’s personal assets that do not form part of the bank’s security.

Separation of Bryan will be the shareholder and the manager, so this characteristic ownership and is not an issue.

management

Corporate taxation The students are not likely to be aware of the fact that corporate taxes and taxes on dividends may result in Bryan being taxed at a lower rate if he incorporates. The students are likely to suggest that Bryan’s taxes will be the same or higher if he incorporates.

Personal taxation Students are likely unaware that by incorporating, if Bryan were to eventually sell his shares in the company, the first $500,000 of capital gains would be tax free.

Government regulation This characteristic would be a drawback as it is likely that Bryan would have to spend more time preparing and filing forms.

Corporation costs As the sole shareholder, Bryan would also be the sole director, and as a director, he could be sued by outsiders doing business with his company. To protect himself, he would have to pay for director’s liability insurance, an additional cost of incorporating.

Conclusion The student may decide either way—the evidence suggests incorporation may not be advantageous to Bryan at this point.

**P13-2C**

Common The shares pay the lowest rate of return at 6 percent ($2.40÷$40.00) but have the potential for paying a higher (or lower) rate of return in the future. Any missed dividends are missed forever. In addition, the market price of the shares has the potential to increase.

Cumulative preferred The rate of return is 7 percent ($3.50÷$50.00) and the dividend is cumulative. This is an advantage since shareholders will receive a yearly dividend; a year might be missed but must be made up before the common shareholders receive a dividend. The share price will not be likely to change much up or down.

Convertible preferred The rate of return is 6.75 percent ($5.30÷$78.50) and is fixed; the dividend is not cumulative. The shares are convertible into common at the rate of 1 preferred for 2 common. The present prices would give the shareholder a cost per common share after conversion of $39.25 ($78.50÷2), which is below the current market price of $40.00.

Noncumulative preferred The rate of return is 6.2 percent ($1.55÷$25.00). The present dividend at 6.2 percent is just slightly higher than the rate on common of 6 percent. The share price is not likely to move much up or down.

Decision The student may select any one of the shares, other than the noncumulative preferred, given the cumulative preferred have a higher rate of return, and the cumulative feature has value. The common may appreciate in value; the cumulative preferred may be preferable if ERI’s income fluctuates so that a dividend may be omitted in any one year; the convertible preferred may be advantageous since it pays a higher dividend than the common and the shareholder can take advantage of an increase in the price of common shares by exercising the conversion feature.

Decision Problem

(30-45 min.) **DP13-1**

Req. 1

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **General Journal** | | | | | |
| **Date** | | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Jul. | 2 | Software |  | 100,000 |  |
|  |  | Common Shares |  |  | 100,000 |
|  |  | To incorporate the business and issue 100,000 common shares to the incorporators for their software. |  |  |  |

Req. 2

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **General Journal** | | | | |
| **Date** | **Account Titles and Explanations** | **Post. Ref.** | **Debit** | **Credit** |
| Jul. 3 | Cash |  | 100,000 |  |
|  | Preferred Shares |  |  | 100,000 |
|  | Plan 1: To issue 1,000 preferred shares to outside investors. |  |  |  |
|  |  |  |  |  |
| 3 | Cash |  | 72,000 |  |
|  | Common Shares |  |  | 72,000 |
|  | Plan 1: To issue 60,000 common shares to outside investors. |  |  |  |
|  |  |  |  |  |
| Jul. 3 | Cash |  | 150,000 |  |
|  | Preferred Shares |  |  | 150,000 |
|  | Plan 2: To issue 1,200 preferred shares to outside investors. |  |  |  |

(continued) **DP13-1**

Req. 3

**Plan 1:**

|  |  |
| --- | --- |
| **Shareholders’ Equity** | |
| Contributed capital |  |
| Preferred shares, $7.50, cumulative, 10,000 shares authorized, 1,000 shares issued | $100,000 |
| Common shares, 1,000,000 shares authorized, 160,000 shares issued | 172,000 |
| Total contributed capital | 272,000 |
| Retained earnings ($184,000 – $34,800) | 149,200 |
| Total shareholders’ equity | $421,200 |

**Plan 2:**

|  |  |
| --- | --- |
| **Shareholders’ Equity** | |
| Contributed capital |  |
| Preferred shares, $8.50, nonvoting, noncumulative, 10,000 shares authorized, 1,200 shares issued | $150,000 |
| Common shares, 1,000,000 shares authorized, 100,000 shares issued | 100,000 |
| Total contributed capital | 250,000 |
| Retained earnings ($184,000 – $34,800) | 149,200 |
| Total shareholders’ equity | $399,200 |

Req. 4

Plan 2 appears to fit the plan of Carlyle and Friesen better than Plan 1. Recall that their primary goal is to raise as much capital as possible without giving up control of the business. Under Plan 1, the preferred shares have voting rights if the dividends are more than two years in arrears. If they fall into arrears then the outside shareholders would have 110,000 votes (60,000 common votes and 50,000 preferred votes). If they can be sure that they will be able to make profits so that they can pay dividends of $7,500 each year, then this plan will fit their requirements. However, if they fail to pay the dividends, then Carlyle and Friesen will lose control because they will only have 100,000 votes.

Under Plan 2, the preferred shares do not have a vote even if the dividends are in arrears. Consequently, Carlyle and Friesen would have complete control since they alone have voting shares.

The reason that Carlyle and Friesen are switching to a corporation is to raise capital. What they will have to decide is whether they need the additional $22,000 so badly that they are prepared to take the risk that they cannot pay dividends. If $150,000 is sufficient for their needs, then they would be better off to take the certainty of Plan 2.

Financial Statement Cases

(20-25 min.) **FSC13-1**

1. The balance sheet states that share capital has a value of $215,971,000. No further breakdown is provided on the balance sheet, but the reader is referred to Note 15. In this note, more detail is provided.

Authorized shares:

* Unlimited Class A preferred shares with no par value (voting, convertible)
* An unlimited number of common shares (voting)

Shares issued and outstanding:

* 26,351,484 common shares at April 1, 2017

1. In note 15 the number of common shares shows as having increased from 25,797,351 on April 2, 2016 – a difference of 554,133 shares.

*(20-25 min.)* **FSC13-2**

1. Note 28 Common Share capital—in the financial statements indicates that TELUS Corporation has the following authorized share capital as at December 31, 2016:

First Preferred Shares—1 billion

Second Preferred Shares—1 billion

Common Shares—2 billion

1. Four million common shares were purchased for cancellation.
2. Book value = Total shareholders equity ÷ Total outstanding shares

= $7,936,000,000 ÷ 590,000,000

= $12.86

Total shares and total common equity are shown on the Consolidated Statements of Changes in Owners’ Equity.

The book value is based on historical cost as reported on the balance sheet. The market price varies from it because it reflects the hopes and fears of investors regarding the future value of the company and its profitability.

1. Basic EPS and Diluted EPS were both $2.06.

Earnings per share information is included in the Consolidated Statements of Income and Other Comprehensive Income.