Solutions to Self-study material

Matching: 1. c, 2. a, 3. g, 4. b, 5. h, 6. i, 7. k, 8. o, 9. m
Multiple choice: 1. a, 2. e, 3. e, 4. c, 5. e, 6. d, 7. c, 8. a, 9. b, 10. b

Chapter 7

Solutions to What does it mean?

1. It means that ordinary shares have been issued to the shareholders in exchange for their investment of capital into the company. The capital has not been earned (it is not from profits); it has been paid in by the owners.
2. It means that no arbitrary value has been assigned to each ordinary share. The amount shown on the financial statements is a reflection of the issue price.
3. It means that the company has issued some shares that have many characteristics similar to those of bonds. Relative to ordinary shares, preference shares have a first claim to dividends and (usually) to assets in the event of liquidation.
4. It means that the company has retained earnings from its operations and cash that the directors want to distribute to the shareholders.

Discussion and solutions for So what do you think?

1. Owners are interested in the *returns* on and the *growth* of their equity investment in the entity. For companies, the owners are shareholders and returns to shareholders are in the form of dividends. Legally, dividends can only be appropriated from *profits* (ie from after tax net profit). The capital maintenance concept underlies this principle in accounting. Growth means increasing the revenue-generating capacity to increase future profits and dividends. Normally, not all profits are returned as dividends to the shareholders; some parts of profits are retained in the entity for growth.
2. The entity *accounts* for its revenues and expenses, and *reports* the profit (or loss) each financial period. It also keeps a Retained Earnings account, which records the accumulated (undistributed) profits and dividend distributions. The Retained Earnings account is an owners' equity account and its balance increases the total of owners' equity in the entity. Thus owners' equity is usually comprised of capital, current financial year profit and Retained Earnings. However, sometimes Reserves are created, and form part of owners' equity too.
3. There are two stages to the accounting process: recording and reporting. The recording process starts from transaction analysis through to the closing process (where all revenue and expense accounts are closed and the profit/loss for the accounting period is calculated). The reporting process is where the *information* on the result of its operations; changes in owners' equity and the financial position are presented to users in financial statements. The financial statements are the Income Statement, Owners' Equity Statement, Statement of Cash Flows and Balance Sheet, respectively. Shareholders usually only have access to the financial statements, which are referred to as General Purpose Financial Reports, because the information provided is to be general enough to satisfy the information needs of a broad range of users.
4. Traditionally, expenses are viewed as outflows of resources in the revenue-earning process (underlying this view is the matching concept). However, dividends are outflows of resources back to owners and these outflows are not related to earning revenues. SAC 4 has adopted a broader view for expenses, in that they are all net outflow of resources other than those returning to the owners because they are owners (dividends). That's why dividends are not deducted from revenues but are appropriated from retained earnings.