CHAPTER 13
CORPORATIONS: ORGANIZATION, STOCK TRANSACTIONS, AND DIVIDENDS

DISCUSSION QUESTIONS

1. No. Common stock with a higher par is not necessarily a better investment than common stock with a lower par because par is an amount assigned to the shares.

2. The broker is not correct. Corporations are not legally liable to pay dividends until the dividends are declared. If the company that issued the preferred stock has operating losses, it could omit dividends first on its common stock and later on its preferred stock.

3. The company may not have had enough cash on hand to pay a dividend on the common stock, or resources may be needed for plant expansion, replacement of facilities, payment of liabilities, etc.

4. **a.** There is no change.
b. Total equity is the same.

5. **a.** Current liability
b. Stockholders' equity

6. The primary purpose of a stock split is to bring about a reduction in the market price per share and thus to encourage more investors to buy the company's shares.

7. **a.** It has no effect on revenue or expense.
b. It reduces stockholders' equity by $3,000,000.

8. **a.** It has no effect on revenue.
b. It increases stockholders' equity by $3,750,000.

9. The three classifications of restrictions on retained earnings are legal, contractual, and discretionary. Restrictions are normally reported in the notes to the financial statements.

10. Such prior period adjustments should be reported as an adjustment to the beginning balance of retained earnings.

PRACTICE EXERCISES

PE 13-1A

	Year 1	Year 2	Year 3
Amount distributed	$70,000	$200,000	$320,000
Preferred dividend (40,000 shares)	70,000	170,000*	120,000
Common dividend (100,000 shares)	$ 0	$ 30,000	$200,000

* Year 1 dividends in arrears of $50,000 ($120,000 – $70,000) plus Year 2 dividends of $120,000.

Dividends per share:			
Preferred stock	$1.75	$4.25	$3.00
Common stock	None	$0.30	$2.00

PE 13-1B

	Year 1	Year 2	Year 3
Amount distributed	$21,600	$4,000	$100,800
Preferred dividend (16,000 shares)	6,400	4,000	8,800*
Common dividend (80,000 shares)	$15,200	$ 0	$ 92,000

* Year 2 dividends in arrears of $2,400 ($6,400 – $4,000) plus Year 2 dividends of $6,400.

Dividends per share:			
Preferred stock	$0.40	$0.25	$0.55
Common stock	$0.19	None	$1.15

PE 13-2A

May	23	Cash (80,000 shares × $12)	960,000	
		Common Stock (80,000 shares × $3)		240,000
		Paid-In Capital in Excess of Stated Value—		
		Common Stock [80,000 shares × ($12 – $3)]		720,000

July	6	Cash	900,000	
		Preferred Stock (18,000 shares × $50)		900,000

Sept.	15	Cash (50,000 shares × $15)	750,000	
		Common Stock (50,000 shares × $3)		150,000
		Paid-In Capital in Excess of Par—		
		Common Stock [50,000 shares × ($15 – $3)]		600,000

PE 13-2B

Jan.	22	Cash	720,000	
		Common Stock (180,000 shares × $4)		720,000
Feb.	14	Cash	2,420,000	
		Preferred Stock (44,000 shares × $55)		2,420,000
Aug.	30	Cash (9,000 shares × $60)	540,000	
		Preferred Stock (9,000 shares × $55)		495,000
		Paid-In Capital in Excess of Par—		
		Preferred Stock [9,000 shares × ($60 – $55)]		45,000

PE 13-3A

Feb.	28	Cash Dividends	350,000	
		Cash Dividends Payable		350,000
Apr.	1	No entry required.		
May	15	Cash Dividends Payable	350,000	
		Cash		350,000

PE 13-3B

Feb.	1	Cash Dividends	480,000	
		Cash Dividends Payable		480,000
Mar.	18	No entry required.		
May	1	Cash Dividends Payable	480,000	
		Cash		480,000

PE 13-4A

Sept.	2	Stock Dividends (1,500,000 shares × 3% × $36)	1,620,000	
		Stock Dividends Distributable		
		(45,000 shares × $5)		225,000
		Paid-In Capital in Excess of Par—		
		Common Stock [$45,000 shares × ($36 – $5)]		1,395,000
Oct.	3	No entry required.		
Nov.	30	Stock Dividends Distributable	225,000	
		Common Stock		225,000

PE 13-4B

June	8	Stock Dividends (820,000 shares × 5% × $63)	2,583,000	
		Stock Dividends Distributable		
		(41,000 shares × $35)		1,435,000
		Paid-In Capital in Excess of Par—		
		Common Stock [41,000 shares × ($63 – $35)]		1,148,000
July	13	No entry required.		
Aug.	12	Stock Dividends Distributable	1,435,000	
		Common Stock		1,435,000

PE 13-5A

Jan.	31	Treasury Stock (22,500 shares × $31)	697,500	
		Cash		697,500
Apr.	20	Cash (12,800 shares × $40)	512,000	
		Treasury Stock (12,800 shares × $31)		396,800
		Paid-In Capital from Sale of		
		Treasury Stock [12,800 shares × ($40 – $31)]		115,200
Oct.	4	Cash (9,700 shares × $28)	271,600	
		Paid-In Capital from Sale of		
		Treasury Stock [9,700 shares × ($31 – $28)]	29,100	
		Treasury Stock (9,700 shares × $31)		300,700

PE 13-5B

May	27	Treasury Stock (75,000 shares × $8)	600,000	
		Cash		600,000
Aug.	3	Cash (54,000 shares × $11)	594,000	
		Treasury Stock (54,000 shares × $8)		432,000
		Paid-In Capital from Sale of Treasury		
		Stock [54,000 shares × ($11 – $8)]		162,000
Nov.	14	Cash (21,000 shares × $7)	147,000	
		Paid-In Capital from Sale of Treasury		
		Stock [21,000 shares × ($8 – $7)]	21,000	
		Treasury Stock (21,000 shares × $8)		168,000

PE 13-6A

Stockholders' Equity			
Paid-in capital:			
Common stock, $2 par (100,000			
shares authorized, 75,000 shares			
issued)	$ 150,000		
Excess over par	2,250,000		
Paid-in capital, common stock		$2,400,000	
From sale of treasury stock		60,000	
Total paid-in capital			$ 2,460,000
Retained earnings			10,880,000
Total			$13,340,000
Treasury stock (5,000 shares at cost)			(140,000)
Total stockholders' equity			$13,200,000

PE 13-6B

Stockholders' Equity			
Paid-in capital:			
Common stock, $120 par (500,000			
shares authorized, 400,000 shares			
issued)	$48,000,000		
Excess over par	6,400,000		
Paid-in capital, common stock		$54,400,000	
From sale of treasury stock		4,500,000	
Total paid-in capital			$ 58,900,000
Retained earnings			63,680,000
Total			$122,580,000
Treasury stock (40,000 shares at cost)			(5,200,000)
Total stockholders' equity			$117,380,000

PE 13-7A

ROCKWELL INC. Retained Earnings Statement For the Year Ended June 30, 20Y5		
Retained earnings, July 1, 20Y4		$3,900,000
Net income	$ 714,000	
Dividends declared	(150,000)	
Increase in retained earnings		564,000
Retained earnings, June 30, 20Y5		$4,464,000

PE 13-7B

NORIC CRUISES INC. Retained Earnings Statement For the Year Ended October 31, 20Y9		
Retained earnings, November 1, 20Y8		$12,400,000
Net income	$2,350,000	
Dividends declared	(475,000)	
Increase in retained earnings		1,875,000
Retained earnings, October 31, 20Y9		$14,275,000

PE 13-8A

a. **20Y3: Earnings per Share**

$$= \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Avg. Number of Common Shares Outstanding}}$$

$$= \frac{\$448{,}750 - \$40{,}000}{75{,}000 \text{ shares}}$$

$$= \frac{\$408{,}750}{75{,}000 \text{ shares}} = \$5.45$$

20Y2: Earnings per Share

$$= \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Avg. Number of Common Shares Outstanding}}$$

$$= \frac{\$376{,}000 - \$40{,}000}{60{,}000 \text{ shares}}$$

$$= \frac{\$336{,}000}{60{,}000 \text{ shares}} = \$5.60$$

b. **The decrease in the earnings per share from $5.60 to $5.45 indicates an unfavorable trend in the company's profitability.**

PE 13-8B

a. **20Y6: Earnings per Share**

$$= \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Avg. Number of Common Shares Outstanding}}$$

$$= \frac{\$2{,}485{,}700 - \$50{,}000}{115{,}000 \text{ shares}}$$

$$= \frac{\$2{,}435{,}700}{115{,}000 \text{ shares}} = \$21.18$$

20Y5: Earnings per Share

$$= \frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Avg. Number of Common Shares Outstanding}}$$

$$= \frac{\$1{,}538{,}000 - \$50{,}000}{80{,}000 \text{ shares}}$$

$$= \frac{\$1{,}488{,}000}{80{,}000 \text{ shares}} = \$18.60$$

b. **The increase in the earnings per share from $18.60 to $21.18 indicates a favorable trend in the company's profitability.**

EXERCISES

Ex. 13-1

		1st Year	2nd Year	3rd Year	4th Year
a.	Total dividend declared…………	$36,000	$90,000	$115,000	$140,000
	Preferred dividend (current)……	$36,000	$60,000	$ 60,000	$ 60,000
	Preferred dividend in arrears….	—	24,000	—	—
b.	Total preferred dividends………	$36,000	$84,000	$ 60,000	$ 60,000
	Preferred shares outstanding…	÷40,000	÷40,000	÷ 40,000	÷ 40,000
	Preferred dividend per share….	$ 0.90	$ 2.10	$ 1.50	$ 1.50
	Dividend for common shares (a.–b.)……………………………	$ —	$ 6,000	$ 55,000	$ 80,000
	Common shares outstanding….		÷100,000	÷100,000	÷100,000
	Common dividend per share…..		$ 0.06	$ 0.55	$ 0.80

Ex. 13-2

		1st Year	2nd Year	3rd Year	4th Year
a.	Total dividend declared…………	$36,000	$58,000	$75,000	$124,000
	Preferred dividend (current)……	$36,000	$44,000*	$50,000	$ 50,000
	Preferred dividend in arrears….	—	14,000	6,000	—
b.	Total preferred dividends………	$36,000	$58,000	$56,000	$ 50,000
	Preferred shares outstanding…	÷ 40,000	÷ 40,000	÷ 40,000	÷ 40,000
	Preferred dividend per share….	$ 0.90	$ 1.45	$ 1.40	$ 1.25

* $44,000 = $58,000 – $14,000

		1st Year	2nd Year	3rd Year	4th Year
	Dividend for common shares (a.–b.)……………………………	$ —	$ —	$ 19,000	$ 74,000
	Common shares outstanding….			÷ 100,000	÷ 100,000
	Common dividend per share…..			$ 0.19	$ 0.74

Ex. 13-3

a.

Oct.	31	Cash (400,000 shares × $18)	7,200,000	
		Common Stock (400,000 shares × $10)		4,000,000
		Paid-In Capital in Excess of Par—Common		
		Stock [400,000 shares × ($18 – $10)]		3,200,000
Nov.	19	Cash (50,000 shares × $80)	4,000,000	
		Preferred Stock (50,000 shares × $75)		3,750,000
		Paid-In Capital in Excess of Par—Preferred		
		Stock [50,000 shares × ($80 – $75)]		250,000

b. $11,200,000 ($4,000,000 + $3,200,000 + $3,750,000 + $250,000)

Ex. 13-4

a.

Feb.	12	Cash (1,000,000 shares × $1.20)	1,200,000	
		Common Stock (1,000,000 shares × $0.25)		250,000
		Paid-In Capital in Excess of Stated Value—		
		Common Stock [1,000,000 shares ×		
		($1.20 – $0.25)]		950,000
Aug.	3	Cash (10,000 shares × $21)	210,000	
		Preferred Stock (10,000 shares × $15)		150,000
		Paid-In Capital in Excess of Par—Preferred		
		Stock [10,000 shares × ($21 – $15)]		60,000

b. $1,410,000 ($250,000 + $950,000 + $150,000 + $60,000)

Ex. 13-5

Apr.	5	Land (30,000 shares × $112)	3,360,000	
		Common Stock (30,000 shares × $80)		2,400,000
		Paid-In Capital in Excess of Par—		
		Common Stock [30,000 shares × ($112 – $80)]		960,000

Ex. 13-6

a.

Cash	100,000	
Common Stock (100,000 shares × $1)		100,000

b.

Organizational Expenses	3,000	
Common Stock (3,000 shares × $1)		3,000
Cash	45,000	
Common Stock (45,000 shares × $1)		45,000

c.

Land	60,000	
Building	225,000	
Interest Payable*		5,200
Mortgage Note Payable		180,000
Common Stock (99,800 shares × $1)		99,800

* An acceptable alternative would be to credit Interest Expense.

Ex. 13-7

Oct.	1	Cash (120,000 shares × $31.50)	3,780,000	
		Common Stock (120,000 shares × $30.00)		3,600,000
		Paid-In Capital in Excess of Par—Common		
		Stock [120,000 shares × ($31.50 – $30.00)]		180,000
Oct.	1	Buildings	2,380,000	
		Land	840,000	
		Preferred Stock (35,000 shares × $80)		2,800,000
		Paid-In Capital in Excess of Par—Preferred		
		Stock [35,000 shares × ($92 – $80)]		420,000

Ex. 13-8

July	1	Cash	2,800,000	
		Common Stock (400,000 shares × $7)		2,800,000
	1	Organizational Expenses	7,000	
		Common Stock (1,000 shares × $7)		7,000
Aug.	7	Land	250,000	
		Buildings	400,000	
		Equipment	70,000	
		Common Stock (80,000 shares × $7)		560,000
		Paid-In Capital in Excess of Par—Common		
		Stock [80,000 shares × ($9 – $7)]		160,000
Sept.	20	Cash (25,000 shares × $44)	1,100,000	
		Preferred Stock (25,000 shares × $40)		1,000,000
		Paid-In Capital in Excess of Par—Preferred		
		Stock [25,000 shares × ($44 – $40)]		100,000

Ex. 13-9

Jan.	12	Cash Dividends	135,000	
		Cash Dividends Payable		135,000
Mar.	13	No entry required.		
Apr.	12	Cash Dividends Payable	135,000	
		Cash		135,000

Ex. 13-10

a. (1)	Stock Dividends [(500,000 shares × 2%) × $13]	130,000	
	Stock Dividends Distributable		
	(10,000 shares × $4)		40,000
	Paid-In Capital in Excess of Par—		
	Common Stock [10,000 shares × ($13 – $4)]		90,000
(2)	Stock Dividends Distributable	40,000	
	Common Stock		40,000

b. (1) $3,000,000 ($2,000,000 + $1,000,000)
(2) $33,500,000
(3) $36,500,000 ($3,000,000 + $33,500,000)

c. (1) $3,130,000 ($2,000,000 + $1,000,000 + $40,000 + $90,000)
(2) $33,370,000 ($33,500,000 – $130,000)
(3) $36,500,000 ($3,130,000 + $33,370,000)

Ex. 13-11

a. 150,000 shares (50,000 × 3)

b. $70 per share ($210 ÷ 3)

Ex. 13-12

	Assets	Liabilities	Stockholders' Equity
(1) Authorizing and issuing stock certificates in a stock split	0	0	0
(2) Declaring a stock dividend	0	0	0
(3) Issuing stock certificates for the stock dividend declared in (2)	0	0	0
(4) Declaring a cash dividend	0	+	–
(5) Paying the cash dividend declared in (4)	–	–	0

Ex. 13-13

Jan.	8	No entry required. The stockholders' ledger would		
		be revised to record the increased number of		
		shares held by each stockholder.		
Apr.	30	Cash Dividends {[(18,000 shares × $0.75) +		
		(150,000 shares × $0.28)] = $13,500 +		
		$42,000 = $55,500}	55,500	
		Cash Dividends Payable		55,500
July	1	Cash Dividends Payable	55,500	
		Cash		55,500
Oct.	31	Cash Dividends {[(18,000 shares × $0.75) +		
		(150,000 shares × $0.14)] = $13,500 +		
		$21,000 = $34,500}	34,500	
		Cash Dividends Payable		34,500
	31	Stock Dividends [(150,000 shares × 5% ×		
		$52) = $390,000]	390,000	
		Stock Dividends Distributable		
		(7,500 shares × $40)		300,000
		Paid-In Capital in Excess of Par—Common Stock		
		[7,500 shares × ($52 – $40)]		90,000
Dec.	31	Cash Dividends Payable	34,500	
		Cash		34,500
	31	Stock Dividends Distributable	300,000	
		Common Stock		300,000

Ex. 13-14

a.

Feb.	**11**	**Treasury Stock (180,000 shares × $17)**	**3,060,000**	
		Cash		**3,060,000**
Apr.	**30**	**Cash (90,000 shares × $20)**	**1,800,000**	
		Treasury Stock (90,000 shares × $17)		**1,530,000**
		Paid-In Capital from Sale of Treasury		
		Stock [90,000 shares × ($20 – $17)]		**270,000**
Aug.	**22**	**Cash (30,000 shares × $15)**	**450,000**	
		Paid-In Capital from Sale of Treasury		
		Stock [30,000 shares × ($17 – $15)]	**60,000**	
		Treasury Stock (30,000 shares × $17)		**510,000**

b. **$210,000 ($270,000 – $60,000) credit**

c. **Lava Lake may have purchased the stock to support the market price of the stock, to provide shares for resale to employees, or to reissue to employees as a bonus according to stock purchase agreements.**

Ex. 13-15

a.

Jan.	**31**	**Treasury Stock (50,000 shares × $51)**	**2,550,000**	
		Cash		**2,550,000**
June	**14**	**Cash (24,000 shares × $60)**	**1,440,000**	
		Treasury Stock (24,000 shares × $51)		**1,224,000**
		Paid-In Capital from Sale of Treasury		
		Stock [24,000 shares × ($60 – $51)]		**216,000**
Nov.	**23**	**Cash (18,000 shares × $56)**	**1,008,000**	
		Treasury Stock (18,000 shares × $51)		**918,000**
		Paid-In Capital from Sale of Treasury		
		Stock [18,000 shares × ($56 – $51)]		**90,000**

b. **$306,000 ($216,000 + $90,000) credit**

c. **$408,000 (8,000 shares × $51) debit**

d. **The balance in the treasury stock account is reported as a deduction from the total of the paid-in capital and retained earnings.**

Ex. 13-16

a.

May	14	Treasury Stock (23,500 shares × $75)	1,762,500	
		Cash		1,762,500
Sept.	6	Cash (14,000 shares × $81)	1,134,000	
		Treasury Stock (14,000 shares × $75)		1,050,000
		Paid-In Capital from Sale of Treasury		
		Stock [14,000 shares × ($81 – $75)]		84,000
Nov.	30	Cash (9,500 shares × $72)	684,000	
		Paid-In Capital from Sale of Treasury		
		Stock [9,500 shares × ($75 – $72)]	28,500	
		Treasury Stock (9,500 shares × $75)		712,500

b. **$55,500 ($84,000 – $28,500) credit**

c. **Stockholders' equity section**

d. **Biscayne Bay Water Inc. may have purchased the stock to support the market price of the stock, to provide shares for resale to employees, or to reissue to employees as a bonus according to stock purchase agreements.**

Ex. 13-17

Stockholders' Equity			
Paid-in capital:			
Preferred 2% stock, $120 par			
(85,000 shares authorized,			
70,000 shares issued)	$8,400,000		
Excess over par	210,000		
Paid-in capital, preferred stock		$8,610,000	
Common stock, no par, $14 stated			
value (375,000 shares authorized,			
320,000 shares issued)	$4,480,000		
Excess over par	480,000		
Paid-in capital, common stock		4,960,000	
From sale of treasury stock		45,000	
Total paid-in capital			$13,615,000

Ex. 13-18

Stockholders' Equity			
Paid-in capital:			
Common stock, $45 par			
(80,000 shares authorized,			
68,000 shares issued)	$3,060,000		
Excess over par	272,000		
Paid-in capital, common stock		$3,332,000	
From sale of treasury stock		115,000	
Total paid-in capital			$ 3,447,000
Retained earnings			20,553,000
Total			$24,000,000
Treasury stock (9,000 shares at cost)			(324,000)
Total stockholders' equity			$23,676,000

Ex. 13-19

Stockholders' Equity			
Paid-in capital:			
Preferred 1% stock, $150 par			
(50,000 shares authorized,			
48,000 shares issued)	$ 7,200,000		
Excess over par	384,000		
Paid-in capital, preferred stock		$ 7,584,000	
Common stock, $36 par			
(300,000 shares authorized,			
280,000 shares issued)	$10,080,000		
Excess over par	420,000		
Paid-in capital, common stock		10,500,000	
From sale of treasury stock		340,000	
Total paid-in capital			$18,424,000
Retained earnings			71,684,000
Total			$90,108,000
Treasury common stock			
(24,000 shares at cost)			(1,008,000)
Total stockholders' equity			$89,100,000

Ex. 13-20

SUMTER PUMPS CORPORATION Retained Earnings Statement For the Year Ended January 31, 20Y2		
Retained earnings, February 1, 20Y1		$59,650,000
Net income	$ 8,160,000	
Dividends declared	(3,600,000)	
Increase in retained earnings		4,560,000
Retained earnings, January 31, 20Y2		$64,210,000

Ex. 13-21

1. **Retained earnings is not part of paid-in capital.**
2. **The cost of treasury stock should be *deducted* from the *total* stockholders' equity.**
3. **Dividends payable should be included as part of current liabilities and not as part of stockholders' equity.**
4. **Common stock should be included as part of paid-in capital.**
5. **The amount of shares of common stock issued of 825,000 times the par value per share of $20 should be extended as $16,500,000, not $17,655,000. The difference, $1,155,000, probably represents paid-in capital in excess of par.**
6. **Organizing costs should be expensed as Organizational Expenses when incurred and not included as a part of stockholders' equity.**

One possible corrected Stockholders' Equity section of the balance sheet using Method 1 of Exhibit 8 is as follows:

Stockholders' Equity			
Paid-in capital:			
Preferred 2% stock, $80 par			
(125,000 shares authorized			
and issued)	$10,000,000		
Excess over par	500,000		
Paid-in capital, preferred stock		$10,500,000	
Common stock, $20 par (1,000,000			
shares authorized, 825,000			
shares issued)	$16,500,000		
Excess over par	1,155,000		
Paid-in capital, common stock		17,655,000	
Total paid-in capital			$ 28,155,000
Retained earnings*			96,400,000
Total			$124,555,000
Treasury stock (75,000 shares at cost)			(1,755,000)
Total stockholders' equity			$122,800,000

* $96,700,000 – $300,000. Since the organizing costs should have been expensed, the retained earnings should be $300,000 less.

Ex. 13-22

I-CARDS INC. Statement of Stockholders' Equity For the Year Ended December 31, 20Y9					
	Common Stock, $40 par	Paid-In Capital in Excess of Par	Treasury Stock	Retained Earnings	Total
Balance, Jan. 1, 20Y9	$4,800,000	$ 960,000	—	$11,375,000	$17,135,000
Issued 30,000 shares					
of common stock	1,200,000	300,000			1,500,000
Purchased 12,000 shares					
as treasury stock			$(552,000)		(552,000)
Net income				3,780,000	3,780,000
Dividends				(276,000)	(276,000)
Balance, Dec. 31, 20Y9	$6,000,000	$1,260,000	$(552,000)	$14,879,000	$21,587,000

Ex. 13-23

$$\text{Earnings per Share} = \frac{\text{Net Income – Preferred Dividends}}{\text{Avg. Number of Common Shares Outstanding}}$$

$$= \frac{\$316{,}000 - (\$1.60 \times 15{,}000 \text{ shares})}{40{,}000 \text{ shares}}$$

$$= \$7.30 \text{ per share}$$

Ex. 13-24

a.

$$\textbf{Earnings per Share} = \frac{\textbf{Net Income – Preferred Dividends}}{\textbf{Avg. Number of Common Shares Outstanding}}$$

$$\textbf{Year 3 Earnings per Share} = \frac{\$888 - \$14}{484 \text{ shares}}$$

= **\$1.81 per share**

$$\textbf{Year 2 Earnings per Share} = \frac{\$1{,}450 - \$14}{468 \text{ shares}}$$

= **\$3.07 per share**

$$\textbf{Year 1 Earnings per Share} = \frac{\$828 - \$14}{444 \text{ shares}}$$

= **\$1.83 per share**

b.

	Year 3	Year 2	Year 1
Earnings per share……………………………………	\$1.81	\$3.07	\$1.83
Growth as a percent of Year 1 (base year)…………	–1%	68%	100%
Net income………………………………………………	\$888	\$1,450	\$828
Growth as a percent of Year 1 (base year)…………	7%	75%	100%

Earnings per share and net income varied significantly over the three-year period. Earnings per share grew 68% in Year 2 from Year 1, but declined in Year 3 by 1% of Year 1's earnings per share. Net income increased significantly in Year 2 to 75% of Year 1's net income. However, net income in Year 3 was only 7% of Year 1's net income. Thus, the changes in earnings per share and net income were similar.

The variability of earnings per share and net income is partially explained by the unpredictable nature of Pacific Gas and Electric's regulatory environment. For example, Pacific Gas and Electric is regulated by the California Public Utilities Commission (CPUC). The CPUC has jurisdiction over the rates, terms, and conditions of service for the company's electricity and natural gas distribution operations, electricity generation, and natural gas transmission and storage services. The CPUC also has jurisdiction over the company's issuances of securities, dispositions of utility assets and facilities, energy purchases on behalf of the company's electricity and natural gas retail customers, rates of return, rates of depreciation, oversight of nuclear decommissioning, and aspects of the siting of facilities used in providing electric and natural gas service. The CPUC has the right to conduct investigations and issue penalties against the company.

Ex. 13-25

a. Caterpillar Inc.

$$\text{Earnings per Share} = \frac{\text{Net Income}}{\text{Avg. Number of Common Shares Outstanding}}$$

$$\text{Year 2: Earnings per Share} = \frac{\$2{,}102}{594 \text{ shares}}$$

$$= \$3.54 \text{ per share}$$

$$\text{Year 1: Earnings per Share} = \frac{\$3{,}695}{599 \text{ shares}}$$

$$= \$6.17 \text{ per share}$$

Deere & Company

$$\text{Earnings per Share} = \frac{\text{Net Income}}{\text{Avg. Number of Common Shares Outstanding}}$$

$$\text{Year 2: Earnings per Share} = \frac{\$1{,}940}{334 \text{ shares}}$$

$$= \$5.81 \text{ per share}$$

$$\text{Year 1: Earnings per Share} = \frac{\$3{,}162}{363 \text{ shares}}$$

$$= \$8.71 \text{ per share}$$

b.

	Earnings per Share	
	Year 2	**Year 1**
Caterpillar	**$3.54**	**$6.17**
Deere	**$5.81**	**$8.71**

c. Deere's earnings per share for Year 1 and Year 2 are higher than Caterpillar's. However, from Year 1 to Year 2, the earnings per share for both companies declined. Caterpillar's earnings per share declined by 43% [$6.17 − $3.54) ÷ $6.17], while Deer's earnings per share declined by 33% [$8.71 − $5.81) ÷ $8.71]. The slowing world economy contributed to the declines from Year 1 to Year 2. Overall, Deere appears to be the more profitable company.

PROBLEMS

Prob. 13-1A

1.

		Preferred Dividends		Common Dividends	
Year	Total Dividends	Total	Per Share	Total	Per Share
Year 1………	$ 80,000	$ 80,000	$0.32	$ 0	$0.00
Year 2………	90,000	90,000	0.36	0	0.00
Year 3………	150,000	130,000*	0.52	20,000	0.04
Year 4………	150,000	100,000	0.40	50,000	0.10
Year 5………	160,000	100,000	0.40	60,000	0.12
Year 6………	180,000	100,000	0.40	80,000	0.16
			$2.40		$0.42

* $130,000 = (Year 1 dividends in arrears of $20,000) + (Year 2 dividends in arrears of $10,000) + (Year 3 current dividend of $100,000)

2. Average annual dividend for preferred: $0.40 per share ($2.40 ÷ 6)
   Average annual dividend for common: $0.07 per share ($0.42 ÷ 6)

3. a. 1.6% ($0.40 ÷ $25.00)
   b. 0.4% ($0.07 ÷ $17.50)

Prob. 13-2A

May	11	Building	3,375,000	
		Land	1,500,000	
		Common Stock (125,000 shares × $35)		4,375,000
		Paid-In Capital in Excess of Par—		
		Common Stock [125,000 shares ×		
		($39 – $35)]		500,000
	20	Cash (40,000 shares × $52)	2,080,000	
		Preferred Stock (40,000 shares × $50)		2,000,000
		Paid-In Capital in Excess of Par—		
		Preferred Stock [40,000 shares ×		
		($52 – $50)]		80,000
	31	Cash	4,000,000	
		Mortgage Note Payable		4,000,000

Prob. 13-3A

a.	**Cash (400,000 × $11)**	**4,400,000**	
	Common Stock (400,000 × $8)		**3,200,000**
	Paid-In Capital in Excess of Par—Common		
	Stock [400,000 × ($11 – $8)]		**1,200,000**
b.	**Cash (5,000 × $90)**	**450,000**	
	Preferred Stock (5,000 × $75)		**375,000**
	Paid-In Capital in Excess of Par—Preferred		
	Stock [5,000 × ($90 – $75)]		**75,000**
c.	**Treasury Stock (150,000 × $10)**	**1,500,000**	
	Cash		**1,500,000**
d.	**Cash (80,000 × $13)**	**1,040,000**	
	Treasury Stock (80,000 × $10)		**800,000**
	Paid-In Capital from Sale of Treasury Stock		
	[80,000 × ($13 – $10)]		**240,000**
e.	**Cash (20,000 × $9)**	**180,000**	
	Paid-In Capital from Sale of Treasury Stock		
	[20,000 × ($10 – $9)]	**20,000**	
	Treasury Stock (20,000 × $10)		**200,000**
f.	**Cash Dividends**	**328,500***	
	Cash Dividends Payable		**328,500**
g.	**Cash Dividends Payable**	**328,500**	
	Cash		**328,500**

* Calculation of cash dividends:	Outstanding Shares of Stock	
	Preferred Stock	Common Stock
Beginning of year	80,000 shares	3,000,000 shares
(a)		400,000
(b)	5,000	
(c)		(150,000)
(d)		80,000
(e)		20,000
	85,000 shares	3,350,000 shares
Cash dividends per share	× $1.50	× $0.06
Dividends paid in (f)	$127,500	$201,000

Total dividends paid $328,500 ($127,500 + $201,000)

Prob. 13-4A

1. and 2.

Common Stock

				Jan.	1	Bal.	7,500,000
				Apr.	10		1,500,000
				Aug.	15		360,000
				Dec.	31	Bal.	9,360,000

Paid-In Capital in Excess of Stated Value—Common Stock

				Jan.	1	Bal.	825,000
				Apr.	10		300,000
				July	5		90,000
				Dec.	31	Bal.	1,215,000

Retained Earnings

Dec.	31		493,800	Jan.	1	Bal.	33,600,000
				Dec.	31		1,125,000
				Dec.	31	Bal.	34,231,200

Treasury Stock

Jan.	1	Bal.	450,000	June	6		450,000
Nov.	23		570,000				
Dec.	31	Bal.	570,000				

Paid-In Capital from Sale of Treasury Stock

				June	6		200,000

Stock Dividends Distributable

Aug.	15		360,000	July	5		360,000

Stock Dividends

July	5		450,000	Dec.	31		450,000

Cash Dividends

Dec.	28		43,800	Dec.	31		43,800

Prob. 13-4A (Continued)

2.

Jan.	22	Cash Dividends Payable	28,000	
		[(375,000 shares – 25,000 shares) × $0.08]		
		Cash		28,000
Apr.	10	Cash	1,800,000	
		Common Stock (75,000 shares × $20)		1,500,000
		Paid-In Capital in Excess of Stated Value—		
		Common Stock [75,000 shares × ($24 – $20)]		300,000
June	6	Cash (25,000 shares × $26)	650,000	
		Treasury Stock (25,000 shares × $18)		450,000
		Paid-In Capital from Sale of Treasury Stock		
		[25,000 shares × ($26 – $18)]		200,000
July	5	Stock Dividends [(375,000 shares +		
		75,000 shares) × 4% × $25]	450,000	
		Stock Dividends Distributable		
		(18,000 shares × $20)		360,000
		Paid-In Capital in Excess of Stated Value—		
		Common Stock [18,000 shares × ($25 – $20)]		90,000
Aug.	15	Stock Dividends Distributable	360,000	
		Common Stock		360,000
Nov.	23	Treasury Stock (30,000 shares × $19)	570,000	
		Cash		570,000
Dec.	28	Cash Dividends [(375,000 shares + 75,000 shares +		
		18,000 shares – 30,000 shares) × $0.10]	43,800	
		Cash Dividends Payable		43,800
	31	Retained Earnings	493,800	
		Stock Dividends		450,000
		Cash Dividends		43,800

Prob. 13-4A (Concluded)

3.

MORROW ENTERPRISES INC. Retained Earnings Statement For the Year Ended December 31, 20Y5		
Retained earnings, January 1, 20Y5		$33,600,000
Net income	$1,125,000	
Dividends:		
Cash dividends	(43,800)	
Stock dividends	(450,000)	
Increase in retained earnings		631,200
Retained earnings, December 31, 20Y5		$34,231,200

4.

Stockholders' Equity			
Paid-in capital:			
Common stock, $20 stated value			
(500,000 shares authorized,			
468,000 shares issued)	$9,360,000		
Excess over stated value	1,215,000		
Paid-in capital, common stock		$10,575,000	
From sale of treasury stock		200,000	
Total paid-in capital			$10,775,000
Retained earnings			34,231,200
Total			$45,006,200
Treasury stock (30,000 shares at cost)			(570,000)
Total stockholders' equity			$44,436,200

Prob. 13-5A

Jan.	5	No entry required. The stockholders' ledger would		
		be revised to record the increased number of shares		
		held by each stockholder and the new par value.		
Mar.	10	Treasury Stock (100,000 shares × $30)	3,000,000	
		Cash		3,000,000
Apr.	30	Cash Dividends {(30,000 shares × $0.25) +		
		[(4,000,000 shares – 100,000 shares) × $0.08]}	319,500	
		Cash Dividends Payable		319,500
June	15	Cash Dividends Payable	319,500	
		Cash		319,500
Aug.	20	Cash (60,000 shares × $40)	2,400,000	
		Treasury Stock (60,000 shares × $30)		1,800,000
		Paid-In Capital from Sale of Treasury		
		Stock [60,000 shares × ($40 – $30)]		600,000
Oct.	15	Cash Dividends {(30,000 shares × $0.25) –		
		[(4,000,000 shares – 40,000 shares) × $0.08]}	324,300	
		Cash Dividends Payable		324,300
	15	Stock Dividends (39,600 shares × $35)	1,386,000	
		Stock Dividends Distributable		
		(39,600 shares × $5)		198,000
		Paid-In Capital in Excess of Par—		
		Common Stock (39,600 shares × $30)		1,188,000
Dec.	19	Cash Dividends Payable	324,300	
		Cash		324,300
	19	Stock Dividends Distributable	198,000	
		Common Stock		198,000

Prob. 13-1B

1.

		Preferred Dividends		Common Dividends	
Year	Total Dividends	Total	Per Share	Total	Per Share
Year 1..........	$ 24,000	$ 24,000	$ 0.96	$ 0	$0.00
Year 2..........	10,000	10,000	0.40	0	0.00
Year 3..........	126,000	101,000*	4.04	25,000	0.25
Year 4..........	100,000	45,000	1.80	55,000	0.55
Year 5..........	125,000	45,000	1.80	80,000	0.80
Year 6..........	125,000	45,000	1.80	80,000	0.80
			$10.80		$2.40

* $101,000 = (Year 1 dividends in arrears of $11,000) +
(Year 2 dividends in arrears of $45,000) +
(Year 3 current dividend of $45,000)

2. Average annual dividend for preferred: $1.80 per share ($10.80 ÷ 6)
Average annual dividend for common: $0.40 per share ($2.40 ÷ 6)

3. a. 1.8% ($1.80 ÷ $100)
b. 8.0% ($0.40 ÷ $5.00)

Prob. 13-2B

Oct.	9	Cash	1,500,000	
		Mortgage Note Payable		1,500,000
	17	Cash (20,000 shares × $126)	2,520,000	
		Preferred Stock (20,000 shares × $120)		2,400,000
		Paid-In Capital in Excess of Par—		
		Preferred Stock [20,000 shares ×		
		($126 – $120)]		120,000
	28	Building	4,150,000	
		Land	800,000	
		Common Stock (300,000 shares × $15)		4,500,000
		Paid-In Capital in Excess of Par—		
		Preferred Stock [300,000 shares ×		
		($16.50 – $15.00)]		450,000

Prob. 13-3B

a.	Treasury Stock (87,500 shares × $8)	700,000	
	Cash		700,000
b.	Cash (55,000 shares × $11)	605,000	
	Treasury Stock (55,000 shares × $8)		440,000
	Paid-In Capital from Sale of Treasury Stock		
	[55,000 shares × ($11 – $8)]		165,000
c.	Cash (20,000 shares × $84)	1,680,000	
	Preferred Stock (20,000 shares × $80)		1,600,000
	Paid-In Capital in Excess of Par—Preferred		
	Stock [20,000 shares × ($84 – $80)]		80,000
d.	Cash (400,000 shares × $13)	5,200,000	
	Common Stock (400,000 shares × $9)		3,600,000
	Paid-In Capital in Excess of Par—Common		
	Stock [400,000 shares × ($13 – $9)]		1,600,000
e.	Cash (18,000 shares × $7.50)	135,000	
	Paid-In Capital from Sale of Treasury Stock		
	[18,000 shares × ($8.00 – $7.50)]	9,000	
	Treasury Stock (18,000 shares × $8)		144,000
f.	Cash Dividends	234,775*	
	Cash Dividends Payable		234,775
g.	Cash Dividends Payable	234,775	
	Cash		234,775

*

	Outstanding Shares of Stock	
	Preferred Stock	Common Stock
Beginning of year	60,000 shares	1,750,000 shares
(a)		(87,500)
(b)		55,000
(c)	20,000	
(d)		400,000
(e)		18,000
	80,000 shares	2,135,500 shares
Cash dividends per share	× $1.60	× $0.05
Dividends paid in (f)	$128,000	$106,775

Total dividends paid $234,775 ($128,000 + $106,775)

Prob. 13-4B

1. and 2.

Common Stock

				Jan.	1	Bal.	3,100,000
				Apr.	13		1,000,000
				July	16		123,000
				Dec.	31	Bal.	4,223,000

Paid-In Capital in Excess of Stated Value—Common Stock

				Jan.	1	Bal.	1,240,000
				Apr.	13		600,000
				June	14		61,500
				Dec.	31	Bal.	1,901,500

Retained Earnings

Dec.	31		248,068	Jan.	1	Bal.	4,875,000
				Dec.	31		775,000
				Dec.	31	Bal.	5,401,932

Treasury Stock

Jan.	1	Bal.	288,000	Mar.	15		288,000
Oct.	30		300,000				
Dec.	31	Bal.	300,000				

Paid-In Capital from Sale of Treasury Stock

				Mar.	15		36,000

Stock Dividends Distributable

July	16		123,000	June	14		123,000

Stock Dividends

June	14		184,500	Dec.	31		184,500

Cash Dividends

Dec.	30		63,568	Dec.	31		63,568

Prob. 13-4B (Continued)

2.

Jan.	15	Cash Dividends Payable		
		[(620,000 shares – 48,000 shares) × $0.06]	34,320	
		Cash		34,320
Mar.	15	Cash (48,000 shares × $6.75)	324,000	
		Treasury Stock (48,000 shares × $6.00)		288,000
		Paid-In Capital from Sale of Treasury Stock		
		[48,000 shares × ($6.75 – $6.00)]		36,000
Apr.	13	Cash (200,000 shares × $8)	1,600,000	
		Common Stock (200,000 shares × $5)		1,000,000
		Paid-In Capital in Excess of Stated Value—		
		Common Stock [200,000 shares × ($8 – $5)]		600,000
June	14	Stock Dividends		
		[(620,000 shares + 200,000 shares) × 3% × $7.50]	184,500	
		Stock Dividends Distributable		
		(24,600 shares × $5)		123,000
		Paid-In Capital in Excess of Stated Value—		
		Common Stock [24,600 shares ×		
		($7.50 – $5.00)]		61,500
July	16	Stock Dividends Distributable	123,000	
		Common Stock		123,000
Oct.	30	Treasury Stock (50,000 shares × $6)	300,000	
		Cash		300,000
Dec.	30	Cash Dividends [(620,000 shares +		
		200,000 shares + 24,600 shares –		
		50,000 shares) × $0.08]	63,568	
		Cash Dividends Payable		63,568
	31	Retained Earnings	248,068	
		Stock Dividends		184,500
		Cash Dividends		63,568

Prob. 13-4B (Concluded)

3.

NAV-GO ENTERPRISES INC. Retained Earnings Statement For the Year Ended December 31, 20Y3		
Retained earnings, January 1, 20Y3		$4,875,000
Net income	$ 775,000	
Dividends:		
Cash dividends	(63,568)	
Stock dividends	(184,500)	
Increase in retained earnings		526,932
Retained earnings, December 31, 20Y3		$5,401,932

4.

Stockholders' Equity			
Paid-in capital:			
Common stock, $5 stated value			
(900,000 shares authorized, 844,600			
shares issued)	$4,223,000		
Excess over stated value	1,901,500		
Paid-in capital, common stock		$6,124,500	
From sale of treasury stock		36,000	
Total paid-in capital			$ 6,160,500
Retained earnings			5,401,932
Total			$11,562,432
Treasury stock (50,000 shares at cost)			(300,000)
Total stockholders' equity			$11,262,432

Prob. 13-5B

Jan.	15	No entry required. The stockholders' ledger would		
		be revised to record the increased number of		
		shares held by each stockholder and the new par		
		value.		
Mar.	1	Cash Dividends [(100,000 shares × $0.25) +		
		(800,000 shares × $0.07)]	81,000	
		Cash Dividends Payable		81,000
Apr.	30	Cash Dividends Payable	81,000	
		Cash		81,000
May	31	Treasury Stock (60,000 shares × $32)	1,920,000	
		Cash		1,920,000
Aug.	17	Cash (40,000 shares × $38)	1,520,000	
		Treasury Stock (40,000 shares × $32)		1,280,000
		Paid-In Capital from Sale of Treasury		
		Stock [40,000 shares × ($38 – $32)]		240,000
Sept.	1	Cash Dividends {(100,000 shares × $0.25) +		
		[(800,000 shares – 60,000 shares +		
		40,000 shares) × $0.09]}	95,200	
		Cash Dividends Payable		95,200
	1	Stock Dividends [(800,000 shares – 60,000 shares +		
		40,000 shares) × 1% × $40]	312,000	
		Stock Dividends Distributable		
		(7,800 shares × $30)		234,000
		Paid-In Capital in Excess of Par—		
		Common Stock [7,800 shares × ($40 – $30)]		78,000
Oct.	31	Cash Dividends Payable	95,200	
		Cash		95,200
	31	Stock Dividends Distributable	234,000	
		Common Stock		234,000

CASES & PROJECTS

CP 13-1

Tommy is clearly acting unethically for several reasons. First, he is violating the company's policy on stock purchases. This policy was established to ensure the fair and timely dissemination of information that gives all potential investors the same chance to participate in the stock price increases. The fact that he is purchasing the stock in partnership with his father does not get around the company policy. Second, Tommy has "inside information" that is not available to other potential investors. Purchasing the stock with knowledge of information that is not available to other investors is unethical. Ethical managers and accountants are honest and fair, which means that they do not attempt to profit from "inside information" that is not available publicly. Doing so would give them an unfair advantage to benefit from stock price increases. Trading on "inside information" is also a violation of federal securities laws, which is a crime punishable by fine and/or imprisonment.

CP 13-2

Lou and Shirley are behaving in a professional manner as long as full and complete information is provided to potential investors in accordance with federal regulations for the sale of securities to the public. If such information is provided, the marketplace will determine the fair value of the company's stock.

CP 13-3

A sample solution based on Nike Inc.'s Form 10-K for the fiscal year ended May 31, 2015, follows:

1. **Nike, Inc.**
2. **Oregon**
3. **Our principal business activity is the design, development, and worldwide marketing and selling of athletic footwear, apparel, equipment, accessories, and services.**
4. **$21,600 million**
5. **$12,707 million**
6. **$8,893 million ($21,600 million total assets – $12,707 million total liabilities)**
7. **$30,601 million**
8. **$3,273 million**
9. **Class A Common, 200 million authorized; Class B, 1,200 million authorized. Class A issued and outstanding, 178 million; Class B issued and outstanding, 679 million**
10. **Class A and Class B: No par**
11. **Consult current market price**
12. **Consult stock market historical data**
13. **Consult stock market historical data**

CP 13-4

Memo

To: Matt Cengage
From: A+ Student
Re: Fourth Quarter 20Y8 Cash Dividend

In order to declare a dividend prudently for the fourth quarter, the company must have a sufficient Retained Earnings balance from which to declare the dividend. On December 31, 20Y8, Motion Designs has a $4,630,000 balance in Retained Earnings. This balance is more than enough to cover the $90,000 declaration of the normal quarterly cash dividend of $0.50 per share. In addition, the company must have enough cash on hand to pay the dividend while meeting the remaining cash needs of the business. The company has a December 31, 20Y8, cash balance of $250,000, of which $100,000 is committed as the compensating balance under the loan agreement. This leaves only $150,000 to pay the dividend of $90,000 and finance normal operations. Unless the cash balance can be expected to increase significantly in early 20Y9, it is questionable whether the company's cash balance is large enough to both pay the cash dividend and provide for the company's near-term operating needs.

Before declaring a dividend, the company should also consider its working capital and the effect of plant expansion on the current ratio requirement of the loan. On December 31, 20Y8, the company has working capital of $5,000,000 ($7,000,000 – $2,000,000), resulting in a current ratio of 3.5. However, after deducting the $3,000,000 committed to store modernization and product-line expansion, the ratio drops to 2 ($4,000,000 ÷ $2,000,000). If a cash dividend is declared and paid, the current ratio will further drop to 1.955 ($3,910,000 ÷ $2,000,000), which would violate the loan agreement. In addition, working capital commitments and potential near-term capital expenditures could further deplete the company's working capital. As a result, I advise the company to forgo the declaration of a cash dividend in the fourth quarter of 20Y8, as this would likely result in the company violating the terms of the loan.

CP 13-5

At the time of this decision, the WorldCom board had come under intense scrutiny. This was the largest loan by a company to its CEO in history. The SEC began an investigation into this loan, and Bernie Ebbers was eventually terminated as the CEO, with this loan being cited as part of the reason. The board indicated that the decision to lend Ebbers this money was to keep him from selling his stock and depressing the share price. Thus, it claimed that it was actually helping shareholders by keeping these shares from being sold. However, this argument wasn't well received, given that the share price dropped from around $15 per share at the time of the loan to about $2.50 per share when Ebbers was terminated. In addition, critics were scornful of the low "sweetheart" interest rate given to Ebbers for this loan. In addition, many critics viewed the loan as risky, given that it was not supported by any personal assets. WorldCom later entered bankruptcy, Ebbers went to prison, and the Ebbers loan went uncollected.

Some press comments:

1. ***When he borrowed money personally, he used his WorldCom stock as collateral. As these loans came due, he was unwilling to sell at "depressed prices" of $10 to $15 (it's now around $2.50). So WorldCom lent him the money to consolidate his loans, to the tune of $366 million. How a board of directors, representing you and me at the table, allowed this to happen is beyond comprehension. They should resign with Bernie.*** **(Source: Andy Kessler, "Bernie Bites the Dust,"** ***Wall Street Journal,*** **May 1, 2002, p. A18.)**

2. ***It was astonishing to read the other day that the board of directors of the United States' second-largest telecommunications company claims to have had its shareholders' interests in mind when it agreed to grant more than $430 million in low-interest loans to the company's CEO, mainly to meet margin calls on his stock.***

   Yet that's the level to which fiduciary responsibility seems to have sunk on the board of Clinton, Mississippi-based WorldCom, the deeply troubled telecom giant, as it sought to bail Bernard Ebbers out of the folly of speculating in shares of WorldCom itself. Sadly, WorldCom is hardly alone.

   "The very essence of why Mr. Ebbers was granted a loan was to protect shareholder value," said a WorldCom spokesman in mid-March, just as the U.S. Securities & Exchange Commission was unfurling a probe of the loan and 23 other matters related to WorldCom's finances.

   Yes, folks, you read that right. On March 14, 2002, a spokesman for a publicly traded, $20 billion company actually stood up and declared that of all the uses to which the company could have put almost half-a-billion dollars, the

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***best one by far—at least from the point of view of the shareholders—was to spend it on some sort of stock-parking scheme in order to keep the CEO out of bankruptcy court*. (Source: Christopher Byron, "Bernie's Bad Idea," *Red Herring*, April 16, 2002.)**

Note to Instructors: **Bernie Ebbers is currently serving a 25-year prison sentence for conspiracy and securities fraud and for making false statements to securities regulators.**

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1. **This case involves a transaction in which a security has been issued that has characteristics of both stock and debt. The primary argument for classifying the issuance of the common stock as debt is that the investors have a legal right to an amount equal to the purchase price (face value) of the security. This is similar to a note payable or a bond payable. The additional $120 payment could be argued to be equivalent to an interest payment, whose payment has been deferred until a later date.**

   Arguments against classifying the security as debt include the fact that the investors will not receive fixed "annual" interest payments. In fact, if Epstein Engineering Inc. does not generate any sales, the investors do not have a right to receive any payments. One could argue that the payments of 5% of sales are, in substance, a method of redeeming the stock. As indicated in the the case, the stockholders must surrender their stock for $120 per share after the $25 million payment has been made. Overall, the arguments would seem to favor classifying the security as common stock.

2. **In practice, the $25 million stock issuance would probably be classified as common stock. However, full disclosure should be made of the 5% of sales and $120 per share payment obligations in the notes to the financial statements. In addition, as Epstein Engineering Inc. generates sales, a current liability should be recorded for the payment to stockholders. Such payments would be classified as dividend payments rather than interest payments. Dan Fisher should also investigate whether such payments might violate any loan agreements with the banks. Banks often restrict dividend payments in loan agreements. If such an agreement has been violated, Epstein Engineering Inc. should notify the bank immediately and request a waiver of the violation.**