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THE PREFERRED STOCK DILEMMA OF APPLLO TECHNOLOGY: THE IMPACT OF SFAS #150

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ABSTRACT

This case involves applying the requirements of SFAS #150: *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* to a company that has recently gone public. As part of its IPO, Appllo Technology has issued two series of Preferred Stock that may fall under the reporting requirements of SFAS #150. The case requires students (who take the role of a staff auditor) to read SFAS #150, critically apply its requirements to Appllo Technology, and summarize their findings in a memo. Further, the case requires that the company's yearly financial statements be adjusted to conform with the recommendations in the audit memo previously completed.

Key words: SFAS #150

INTRODUCTION

Appllo Technology is in the business of developing new wireless communications software products and applications. The primary focus of the company's products is on personal handheld devices, such as palm pilots and mobile telephones. Appllo was founded approximately 10 years ago and operated as a partnership until the beginning of the current year. At the start of this year, the company completed an IPO and is currently a publicly owned company listed on the NASDAQ. The company has indicated that the primary reasons for going public this year were to raise capital needed for its application development processes and to acquire some critical patents. The corporation was chartered in Delaware, but operates primarily out of its facility in Santa Clara, California. Currently, the company has approximately 22 employees: 10 in engineering, 5 in sales and marketing, and the remainder working in management, administration and customer support.

AUDIT BACKGROUND

Appllo used a medium-sized regional CPA firm for the initial public offering, but changed to your larger CPA firm hoping that the wider range of services would be useful to Appllo. Your audit firm accepted Appllo as an audit client shortly after the company went public at the beginning of the year. You have been assigned as the staff auditor on this initial audit. The company's fiscal year has just ended and your senior auditor on the job, Troy Stevens, has received an initial draft of the company's yearly financial statements (excluding the Statement of Cash Flows which the company has yet to complete). Troy indicates that the company's reporting of its Preferred Stock may be an issue for this year's audit based on a recent conversation that he had with Nate Appllo, the company's founder and current CEO, and Luke Appllo, the current CFO. Troy's conversation with Nate and Luke focused on the stock issued by the company, as well as its long-term liabilities. A summary of the key information that Troy shares with you includes:

1. Nate and Luke indicated that the company made the decision to issue Common Stock, as well as two series of Preferred Stocks, when they were developing the company's Articles of Incorporation and its SEC registration statement. This structure allowed the company to go public, while allowing the original partners in the business to acquire a sizeable percentage of the voting Common Stock. Two series of nonvoting Preferred Stock (i.e., Series A and Series B) were sold to help the company acquire the cash needed to grow the business and to develop some new applications. During the final quarter of the year, the company used some of the funds from the IPO to purchase patents that it felt would be critical in the company's product applications development.

2. Nate and Luke provided Troy with excerpts from the Articles of Incorporation that indicate the amount of each type of stock that could be issued along with their respective preferences and legal obligations. Excerpts from the Articles of Incorporation are shown in Table 1.

3. Three million of the authorized shares of Common Stock were sold for $10 per share when the company went public at the beginning of the year. No additional shares of common stock have been issued this year. All of the authorized Preferred Stock was sold when the company

TABLE 1
Excerpts from Appllo Technology's Articles of Incorporation

ARTICLE I

The name of this corporation is Appllo Technology, Inc., (the "Corporation").

ARTICLE II

The address of the Corporation's registered office in the State of Delaware is 6789 Orange Street, City of Wilmington, County of New Castle, Delaware 19801.

ARTICLE III

The purpose of the Corporation is to engage in any lawful act or activity for which a corporation may be organized under the Delaware General Corporation Law.

ARTICLE IV

(A) **Classes of Stock.** The Corporation is authorized to issue three classes of stock to be designated, respectively, "Common Stock," "Preferred Stock–Series A," and "Preferred Stock–Series B." The total number of Common Stock shares which the Corporation is authorized to issue is 5,000,000, each with a par value of $.01 per share. In addition, the company is authorized to issue 2,000,000 Preferred Stock–Series A shares that have a $9 par per share, and 1,500,000 Preferred Stock–Series B shares that have a $10 par per share.

(B) **Rights, Preferences, and Restrictions of Preferred Stock.** The rights, preferences, privileges, and restrictions granted to and imposed on the two series of non-voting Preferred Stock are as set forth below.

1. **Dividends.** Both series of Preferred Stock have dividend rates of 7% per annum, payable in one or more installments as declared by the Board of Directors. The Preferred Stock shall not be entitled to any other dividends other than as provided for herein.

2. **Liquidation.** The Preferred Stock–Series A shares shall be entitled to receive (if available) the redemption price noted in paragraph 4 below up to a $20 per share maximum plus any declared, but unpaid dividends upon the liquidation of the company. These amounts shall be paid before any preferences of the Preferred Stock–Series B shares or the Common Shares.

The Preferred Stock–Series B shares shall be entitled to receive (if available) $15 per share plus any and all cumulative undeclared or unpaid dividends

(continued)

TABLE 1 (continued)

since the issue date upon the liquidation of the company. These amounts shall be paid before any preferences of the Common Shares.

3. **Conversion Privileges.** The Preferred Stock–Series A shares may not be converted into Common Stock at any time. The Preferred Stock–Series B shares may be converted into Common Stock on a one share to one share basis for the first six months after original issuance. No conversion privileges will remain after that point. The holders of the Series B shares must provide the company a 15-day written notice of their desire and intent to convert the shares into Common Stock. The delivery of this notice will not serve to extend the conversion privilege beyond the six-month time frame.

4. **Redemption of Preferred Stock.** The Preferred Stock–Series A shares may be redeemed by the shareholders by providing the Corporation a Redemption Election notice 60 days prior to the redemption date. Each share can be redeemed for a set redemption price plus any declared, but unpaid dividends. The redemption price starts at $10 per share during the first year the shares are outstanding with the redemption price increasing by $.50 per share for each additional year they are outstanding. Upon redemption, these shares will lose all rights to any undeclared dividends. This redemption privilege will expire 10 years after the date of the original issuance of the Preferred Stock–Series A shares. At that date this series of Preferred Stock will no longer hold any special conversion or redemption privileges. The Corporation is required to honor the redemption requests made in accordance with this paragraph.

   All outstanding Preferred Stock–Series B shares (that have not been converted into Common Stock) will be redeemed 10 years after its issue date. At that point the holder has the option to receive $15 per share in cash or an equivalent dollar amount of Common Stock. At the redemption point all cumulative, undeclared, unpaid dividends since the original issue date of these shares must be paid in addition to the redemption price noted above. There will be no Preferred Stock–Series B outstanding after this 10 year period has expired.

went public. The Preferred Stock-Series A was sold for $9 per share and the Preferred Stock-Series B was sold for $10 per share.

4. No Preferred Stock-Series B was converted into Common Stock prior to the expiration of the related six month conversion privilege noted in the Articles of Incorporation.

5. During the current year, Appllo declared no dividends for any of the stock issued by the company.

6. Both series of Preferred Stock had fair market values over the course of this year that were equal to the prices those shares were sold for at the beginning of the year.

7. Nate and Luke indicated that the company has very little long-term debt. The only long-term debt is a mortgage payable on the company's building that was taken out right after the company went public at the beginning of the year. It is a $1,500,000, 6%, 15-year mortgage from a local bank. The mortgage requires yearly interest payments to the bank, with the full principal due at the end of the 15-year period.

Troy asks you to review the tentative financial statements that Appllo provided the audit team (shown in Table 2) to determine if the statements reflect the information received from the company management and to determine if the statements are consistent with the requirements of GAAP. In particular, Troy asks you review SFAS #150: *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* to determine if its requirements are applicable to Appllo, and if they are, if the requirements are being properly applied.

CASE REQUIREMENTS

Part A - Memo Preparation on the Applicability of SFAS #150

Troy, your senior auditor, asks that you **prepare a memo** to assess whether Appllo stock, and any related dividends, are being properly reported on the company's tentative financial statements based on the requirements of SFAS #150. Troy asks that the following concerns be specifically addressed in your memo:

a. Describe what you believe Appllo's motivation was in issuing the two series of Preferred Stock. Troy explains that understanding the motivation for a transaction is often very beneficial in getting to the proper accounting.
b. Do the requirements of SFAS #150 appear to be relevant to Appllo? Explain.
c. Based on your understanding of SFAS #150, how should the Common Stock, Preferred Stock–Series A and Preferred Stock–Series B be reported on Appllo's current Balance Sheet?
d. Troy is also concerned about the proper reporting of dividends, particularly given the rather unusual preferences given to the two series of Preferred Stocks in the Articles of Incorporation. He asks that you provide a full explanation of how and when you believe any dividends related to the common stock and to the two Preferred Stock series should be reported on the financial statements for this year and for future years.
e. Based on your analysis of the above issues, indicate which recommended accounting adjustments are likely to cause the most concern to Appllo's management.

TABLE 2
Company Prepared Tentative Financial Statements

Appllo Technology
Statement of Operations
For the year ended December 31, 20XX
(In thousands of dollars)

Revenue		$9,100
Cost of Revenue		(3,200)
Gross Margin		5,900
Operating Expenses:		
Research and Development	$1,200	
General and Administrative	1,800	
Sales and Marketing	2,000	
Depreciation and Amortization	350	
Total Operating Expenses		(5,350)
Income from Operations		550
Other Revenues/Expenses:		
Interest Revenue	50	
Mortgage Interest Expense	(90)	(40)
Net Income		**$510**

Basic and Diluted EPS:

$$\frac{\text{\$510,000 Net Income}}{\text{3,000,000 Common Shares}} = \text{\$.17 profit per share}$$

Appllo Technology
Statement of Retained Earnings
For the year ended December 31, 20XX
(In thousands of dollars)

Beginning Retained Earnings	$ 0
Plus: Net Income	510
Less: Dividends	0
Ending Retained Earnings	**$510**

(continued)

TABLE 2 (continued)

Appllo Technology
Balance Sheet
December 31, 20XX
(In thousands of dollars)

ASSETS	
Cash and cash equivalents	$25,750
Accounts Receivable, net of an allowance of $150	3,000
Inventories	6,000
Prepaid Expenses	660
Total Current Assets	**$35,410**
Investments	$5,000
Property, Plant and Equipment (net)	4,000
Intangibles (net)	19,000
Other Assets	3,000
Total Assets	**$66,410**
LIABILITIES	
Accounts Payable	$800
Note Payable	100
Other Current Liabilities	500
Total Current Liabilities	**$1,400**
Mortgage Payable (6%, Due in 15 years)	$1,500
Total Liabilities	**$2,900**
SHAREHOLDERS' EQUITY	
Common Stock and Additional Paid-in-Capital	$30,000
(5,000,000 shares authorized; 3,000,000 issued and outstanding; $.01 par)	
Preferred Stock–Series A	18,000
(2,000,000 shares authorized, issued and outstanding; $9 par)	
Preferred Stock–Series B	15,000
(1,500,000 shares authorized, issued and outstanding; $10 par)	
Retained Earnings	510
Total Shareholders' Equity	**$63,510**
Total Liabilities and Shareholders' Equity	**$66,410**

Part B - Financial Statement Preparation and Review of Debt-to-Assets Ratio

a. Based on your recommendations in the memo prepared in Part A, Troy asks that you adjust Appllo's three financial statements to apply the requirements of SFAS #150. Also, compute EPS amounts based on your revised financial statements.

b. Briefly discuss how the Net Income and the EPS values have changed in your adjusted financials in comparison to the tentative financial statements prepared by the client.

c. Troy also asks that you be prepared to discuss any change in the company's debt-to-assets ratio since your audit firm will have to review the impact of any SFAS #150 related changes with Appllo's management. In addition, Troy wants you to be prepared to discuss the likelihood of SFAS #150 impacting loan covenants imposed by lenders in the future.

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the "For Contributors" page of the journal website, http://gpae.bryant.edu.