

Question 1 of 44

Hayes Incorporated reported the following stockholders' equity on December 31, 20X6:

Common stock, 85,000 shares at \$50 par value	\$4,250,000
Paid-in capital in excess of par	\$583,000
Retained earnings	\$716,000
Total stockholders' equity	<u>\$5,549,000</u>

On June 30, 20X7, Hayes declared a 5-for-1 stock split. At the time of declaration, shares were selling for \$300 per share. Through the first two quarters of the fiscal year, Hayes recorded a net income of \$103,000. How will Hayes' stockholders' equity section change as a result of this information?

- A. Number of shares will increase to 340,000, par value will remain at \$50 per share, and stockholders' equity will increase to \$17,000,000.
- B. Number of shares will increase to 425,000, par value will decrease to \$10 per share, and stockholders' equity will increase to \$5,652,000. ✓**
- C. Number of shares will increase to 340,000, par value will decrease to \$12.50, and stockholders' equity will increase to \$5,652,000.
- D. Number of shares will increase to 425,000, par value will remain at \$50 per share, and stockholders' equity will increase to \$21,250,000.

Explanation:

(Choice A) When a company declares a stock split, the number of shares authorized, issued, and outstanding increases by the factor of the stock split. In addition, the par value per share decreases by the inverse of the factor of the stock split. The total common stock, paid-in capital, and retained earnings stay the same as a result of the stock split. Retained earnings increases from net income. The number of new shares for Hayes is 340,000, but the total shares will be 425,000 ($85,000 \times 5$). In addition, par value per share will decrease to \$10 per share ($\$50 \div 5$), not stay the same. Finally, total stockholders' equity will be \$17,000,000 if the 340,000 shares are multiplied by the \$50 par value per share. These are the incorrect figures and the wrong way of determining total stockholders' equity. Therefore, this is an incorrect answer.

(Choice B) When a company declares a stock split, the number of shares authorized, issued, and outstanding increases by the factor of the stock split. In addition, the par value per share decreases by the inverse of the factor of the stock split. The total common stock, paid-in capital, and retained earnings stay the same as a result of the stock split. Retained earnings increases from net income. In this example, Hayes's number of shares will increase to 425,000 ($85,000 \times 5$), par value will decrease to \$10 per share ($\$50 \div 5$), retained earnings will increase to \$819,000 ($\$716,000 + \$103,000$),

and total stockholders' equity will increase to \$5,652,000 ($\$4,250,000 + 583,000 + 819,000$). Therefore, this is the correct answer.

(Choice C) When a company declares a stock split, the number of shares authorized, issued, and outstanding increases by the factor of the stock split. In addition, the par value per share decreases by the inverse of the factor of the stock split. The total common stock, paid-in capital, and retained earnings stay the same as a result of the stock split. Retained earnings increases from net income. In this example, Hayes's retained earnings will increase to \$819,000 ($\$716,000 + \$103,000$) and total stockholders' equity will increase to \$5,652,000 ($\$4,250,000 + 583,000 + 819,000$). However, the number of shares will be 340,000 and the par value per share \$12.50 per share if the stock split was 4 to 1, not 5 to 1 ($85,000 \times 4$ and $\$50 \div 4$). Therefore, this is an incorrect answer.

(Choice D) When a company declares a stock split, the number of shares authorized, issued, and outstanding increases by the factor of the stock split. In addition, the par value per share decreases by the inverse of the factor of the stock split. The total common stock, paid-in capital, and retained earnings stay the same as a result of the stock split. Retained earnings increases from net income. In this example, Hayes's number of shares will increase to 425,000 ($85,000 \times 5$). However, par value per share will decrease to \$10 per share ($\$50 \div 5$), not stay the same. Finally, total stockholders' equity would be \$21,250,000 if the 425,000 shares are multiplied by the \$50 par value per share. These are the incorrect figures and the wrong way of determining total stockholders' equity. Therefore, this is an incorrect answer.

Question 2 of 44

Brendan Bishop Scientific is considering acquiring a new plant and paying for it with common stock at par value. However, the CFO is not in favor of the acquisition. Which of the following is the **most likely** reason for the CFO's disagreement?

- A. The company will have fewer long-term assets.
- B. The company's stock is most likely overpriced.
- C. It is difficult to estimate the net realizable value of the plant and, hence, difficult to estimate the annual depreciation expenses.
- D. The true cost of the plant would be much higher than necessary as the stock's trading value should be considered. ✓**

Explanation:

(Choice A) This answer is incorrect. The long-term assets would increase as a result of the acquisition, not decrease.

(Choice B) This answer is incorrect. If the stock is overpriced, it would potentially allow for fewer shares to be issued in the acquisition, which would be a positive outcome for the company, not a reason to oppose the acquisition.

(Choice C) This answer is incorrect. Annual depreciation expenses have no effect on this decision.

(Choice D) When property, plant, and equipment assets or businesses are acquired through the issuance of stock or other securities, the par value of the stock will be inadequate to measure the true cost of the property. Instead, if the stock is being actively traded, its current market value is used. If the stock value cannot be determined because the stock is not actively traded, an estimate of the market value of the property should be made and used as the basis for recording the value of both the asset and the issuance of the stock.

Question 3 of 44

A publicly-traded corporation issues 10,000 shares of new common stock for \$50 per share. The common stock has a par value of \$5 per share. Which one of the following statements is correct?

*Source: Retired ICMA CMA questions.

- A. Cash increases by \$500,000, and common stock increases by \$500,000.
- B. Additional paid-in capital increases by \$500,000; no other accounts are affected.
- C. Cash increases by \$500,000; common stock increases by \$50,000; and additional paid-in capital increase by \$450,000. ✓**
- D. Cash increases by \$450,000; common stock increases by \$50,000, and additional paid-in capital increases by \$500,000.

Explanation:

(Choice A) Incorrect. When common stock has an assigned par value, the proceeds from stock issuances are divided between the common stock account and the additional paid in capital account.

(Choice B) Incorrect. It is not possible to have a journal entry with only one account.

(Choice C) Correct. When common stock is issued for cash, the cash account increases by the net amount received. In this case, the cash account increases by (is debited for) \$500,000 ($\$50 \times 10,000$ shares). When common stock has an assigned par value, the proceeds from stock issuances are divided between the common stock account and the additional paid in capital account. In this case, the common stock account increases (is credited for) \$5 per share for a total of \$50,000) and additional paid in capital increases (is credited for) the remaining \$45 per share for a total of \$450,000.

(Choice D) Incorrect. Cash increases by \$50 per share, not \$45 per share. In addition, this entry results in debits of \$450,000 and credits of \$550,000.

Question 4 of 44

How does the classification of a cash equivalent differ from the classification of a current asset?

- A. A cash equivalent is an investment with an original maturity of one month or less, whereas a current asset will be turned into cash within six months or less or within the length of the operating cycle, whichever is longer.
- B. A cash equivalent is a trading security, whereas a current asset is all other assets except trading securities.
- C. A cash equivalent is an investment with an original maturity of three months or less, whereas a current asset will be turned into cash within one year or within one operating cycle, whichever is longer. ✓**
- D. There is no difference between the two classifications.

Explanation:

(Choice A) Cash equivalents are investments with an original maturity of three months, not one month. Current assets are assets that are expected to be used or converted into cash within one year or one operating cycle, whichever is longer, not the longer of 6 months or one operating cycle. Therefore, this is an incorrect answer.

(Choice B) Trading securities are investments in debt or equity that a company plans to actively sell to make a profit. Cash equivalents are investments with original maturities of 3 months or less that are highly liquid and easy to sell. They will be turned into cash within three months or less. Their prices are not expected to fluctuate in near term. Current assets are assets that are expected to be used or converted into cash within one year or one operating cycle, whichever is longer. There are other assets in addition to current assets and trading securities. Therefore, this is an incorrect answer.

(Choice C) Cash equivalents are investments with original maturities of 3 months or less that are highly liquid and easy to sell. They will be turned into cash within three months or less. They are a type of current asset. Current assets are assets that are expected to be used or converted into cash within one year or one operating cycle, whichever is longer. Therefore, this is the correct answer.

(Choice D) Cash equivalents are investments with original maturities of 3 months or less that are highly liquid and easy to sell. They will be turned into cash within three months or less. They are a type of current asset. However, they are not the same things. Current assets are assets that are expected to be used or converted into cash within one year or one operating cycle, whichever is longer. Therefore, this is an incorrect answer.