Accounting for Capital Formation: Financial Accounting, Income Tax, and Auditing Issues of Related Party Loans at Unrealistic Interest Rates

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Abstract: *The student confronts ethical, financial, tax, and auditing issues, and makes judgments based on research and sound professional reasoning. The case is fictitious and appropriate for graduate or capstone undergraduate classes.*

INNOVATIVE AND UNORTHODOX, OR JUST PLAIN DECEPTIVE?

Looking across the table, Donald Faircloth can't help but pick up on the intensity emanating from Steve Bullock. It's clear to Donald, even if he didn't know Steve, and he does, that Steve is not interested in even the cursory pleasantries. So Donald skips the comments on the humidity and the "how's the family." Steve looks Donald directly in the eye and speaks deliberately, and even more slowly than usual. "Donald, we will have Blackadar Extreme producing kayaks in 90 days. Unlike most of my other start-ups, we will be generating reasonable cash flows from the beginning. Even so, the up front costs will require a capital investment on my part of about $10,000,000. I will be the sole shareholder. What I want you to do is to take a look at my plans for capital formation and give them your blessing. I plan to get Blackadar started the right way and to sell my interests two or three years down the road. We will need audited financial statements which are clean and beyond reproach."

Steve stops as the waitress refills coffee, and then continues with the same deliberation. "I will invest $20,000,000 cash through a common stock purchase of 200,000 shares at $100 each. In addition, I will transfer the patent to Blackadar in exchange for 100,000 shares of common. We will carry the patent on Blackadar books at $10,000,000, which is what I consider its fair market value to be."

Donald sips coffee and tries to absorb the plan. His first worry is putting the patent on the books at $10,000,000. Steve anticipates his concern. "Don't worry about the value of the patent. It's legitimate. I purchased the patent two months ago. I paid $800,000 cash on the barrel. You know me. Had my people do the homework. It's a revolutionary process, and I can tell you straight up that I wouldn't sell it today for a penny less than $10,000,000."

"Ah, yea, OK." Donald mutters, digesting what he has heard. His worry about the patent valuation has hardly dissipated. Donald has another concern, and questions Steve. "Why are you putting $20,000,000 cash in the company? I thought $10,000,000 would cover the up front costs?"

Steve, of course, has again anticipated the question and responds, increasing the intensity of the eye contact and elevating the slow and deliberate enunciation, all of which conspire to create an aura of authority, which permeates Steve's persona, and makes him, well, Steve. "True, I only need $10,000,000 to meet cash flow requirements. The extra $10,000,000 is to improve the balance sheet. I do not like thinly capitalized firms. I think you will agree that $20,000,000 in stockholders' equity looks better than $10,000,000. Besides, I'll immediately have Blackadar loan me the extra $10,000,000 back. I will give them a three year, 18% interest bearing note, and pay the interest annually. That will have a couple of advantages. One, it will reduce my initial cash investment in the company to the $10,000,000 needed for operations, and two, it will produce $1,800,000 interest revenue for each of the first three years, which will substantially improve the profit and loss statement of Blackadar. Then I can deduct the $1,800,000 annual interest on my 1040 and Blackadar will have enough of a startup loss from operations to offset the $1,800,000 interest revenue, so it will in effect be tax free to them."

Steve handed Donald a pro forma analysis (see Exhibit I), showing the proposed accounting for the transactions and leaned back in his chair, signaling that his presentation was concluded. Donald detected at least a hint of a rare smile from Steve, who seemed to be quite pleased with himself.

JUDGMENT DAY, INTEREST RATES, AND A POUND OF GOURMET COFFEE

Donald, as a CPA, knew Steve had great respect for his knowledge and experience in financial reporting and tax matters. Donald knew Steve wanted advice about the accounting and tax implications of his plans and he knew it would take some time to fully think through Steve's ideas for the capital formation of Blackadar. He also knew Steve expected an answer in the morning. Free floating through the space of his mind were the concepts of related party transactions, generally accepted accounting principles, substance over form, full disclosure, representational faithfulness, and financial transparency, to name just a few. He would have to take all of this back to the office and think it through. But while he had Steve here, one more question remained. "Steve, where does the 18% come from? Didn't you just get a large unsecured loan from Bank of America for 9%?"

"Actually it was 8%," Steve replied, finishing his coffee. "But the 18% helps both me, with a bigger tax deduction, and Blackadar, with a better income statement. It's kind of a way for me to get a tax deduction for investing in the company and it's a way to improve the profitability of the company.

At the cashier, Steve picked up the check. Because Steve was paying, Donald picked up a pound of French Roast gourmet coffee and had it added to the check. He knew it was going to be a late night.

Exhibit I
Blackadar Extreme
Pro Forma

Journal Entries:

Cash	$20,000,000	
Common Stock		$20,000,000

Cash investment by Steve Bullock to purchase 200,000 share of no-par common stock @ $100 per share (beginning of year 1)

Patent	$10,000,000	
Common Stock		$10,000,000

Issue of 100,000 shares of common stock in exchange for patent (beginning of year 1)

Notes Receivable	$10,000,000	
Cash		$10,000,000

Loan Steve Bullock $10,000,000 in exchange for a three year, 18% interest bearing note with interest payable annually and principal due at the end of the three years (beginning of year 1)

Cash	$1,800,000	
Interest Income		$1,800,000

Record interest revenue from the note (end of years 1,2, and 3)

Teaching Note/Instructor Manual available from the Journal of Business Cases and Applications.