**Accounting 352**

**Case 1 – (Group B)**

**DUE February 11**

**Hearts ‘R Us**

Hearts ‘R Us (“Hearts” or “the Company”) is an early-stage research and development medical device company. Hearts has no current products in the marketplace but is in the final stages of going to market with the Heart Valve System. All preliminary trials have been approved by the FDA, and the Company is in the final trial; once the final trial is complete, the Company will present the product to the FDA for final approval. If approved by the FDA, the Heart Valve System will revolutionize the way medical professionals repair heart valve defects.

Bionic Body (“Bionic”), a SEC registrant, is a biological medical device company that focuses on the development of implantable biological devices, surgical adhesives, and biomaterials. Bionic could benefit from the approval of the Heart Valve System since it has a supplementary device that could be used in tandem with the Heart Valve System.

As part of a financing strategy to support its operations, Hearts sold Bionic $3.5 million of Series A Preferred Shares (the “Shares”) of the Company with a par value of $1 per Share. The transaction was completed on November 30, 2011. As part of the Series A Preferred Stock purchase agreement, Bionic has the following rights:

• **Board Rights** — As the holder of the preferred stock, Bionic is entitled to appoint one member to the Company’s board of directors (the “Board”). In addition, Bionic has the right to appoint an observer to receive all information provided to the Board and to be present at meetings of the Board.

• **Mandatory Conversion Right** — The Shares will be converted to the Company’s common stock upon execution of an initial public offering (IPO) that nets at least $50 million in proceeds.

• **Contingent Redemption Right** — The Shares will be redeemed for par value on the fifth anniversary of the date of purchase conditioned upon the event that Hearts has not obtained FDA approval for the Heart Valve System.

• **Additional Protective Rights** —Bionic has the right to limit future equity and debt issuances as well as the right to participate in future funding rounds to protect its investment percentage.

• **Right of First Refusal and Co-Sale Rights** — Bionic has the right of first refusal to purchase and right of co-sale on sale of shares by identified key holders of Hearts’ shares.

The Company is a calendar year-end company. The Company plans to go through an IPO in the near future and Hearts’ management (“Management”) has begun to think about how it may record its transactions in accordance with the applicable U.S. GAAP for public registrants. Currently, Hearts prepares financial statements to comply with the covenants of its outstanding debt, but such financial statements are not required to be filed with the SEC. Hearts is not required to comply with SEC regulations when preparing financial statements and currently has not elected to do so.

Four years after issuing the shares and classifying them as equity, Hearts is still in the process of filing for FDA approval; however the clinical testing and administrative process for filing for the FDA approval have taken much longer than initially anticipated. In addition, the trial results have been worrisome because of certain post-surgery issues that have been experienced by patients who received the Heart Valve System. The Company has determined that it is certain the product will not receive FDA approval by end of Year 5. The controller is unsure if the difficulties in getting FDA approval and the unfavorable test results might require a reclassification of the securities.

**Required:**

Prepare a one page memo addressed to Heart’s controller (S. Smoke) in which you explain whether or not Heart needs to do anything about the securities classification. Your memo must include reference to the appropriate accounting regulations (FARS) with correct citations.

**Attach a copy of the** [**grading rubric**](http://www.csun.edu/~hfact004/352/studentcritical%20thinking%20grading%20rubric.doc) **to your memo.**