

Alert

August 2003

Issuance of SFAS 150 Impacts Private Companies

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The Financial Accounting Standards Board (FASB) recently issued SFAS 150, dealing with accounting for debt and equity. A security such as a mandatorily redeemable preferred stock can no longer be classified as equity; it must be treated as debt. The logic, which is that at some point the issuer must pay out the principal, is hard to refute. Debt must be paid out at some point; even if it can be refinanced it is still shown as a liability, not equity. So the Board decided that there was little to distinguish required repayment of debt from required repayment of preferred stock.

What has startled privately held companies is that the FASB's logic is also being applied to common equity. If a company must buy back stock held by an employee upon termination of employment (retirement or death), the FASB considers this to be debt.

The following example illustrates the impact of SFAS 150. Assume that all common shares are held by employees and they must sell the shares back if and when they leave. While many companies buy back shares at book value, many more require transactions to be based on the then current Fair Market Value (FMV).

If a company's shares are to be repurchased at book value, then the balance sheet is going to show no equity, and debt equal to the book value of the equity. If the shares are to be repurchased at FMV, then the company will likewise show zero equity, but will then have a deficit net worth equal to the difference between book value and FMV. Thus, if a company's book value is \$5.00 per share, and the FMV is \$60.00 there will not only be no equity, the company's balance sheet will show a deficit of \$55.00 per share.

DOES EQUITY MATTER?

In issuing SFAS 150, the FASB believed that the new accounting requirement should have no impact on a company; adoption of SFAS 150, they believed, would not adversely affect the Fair Market Value of the equity. This may or may not be true.

Banks and other lending institutions analyze a company's balance sheet to determine the firm's financial strength, its ability to ride out short-term economic and business problems. How does a bank, lender or trade creditor view a company with a giant deficit net worth or even with just zero equity? In December 2002 that company appeared to be well capitalized. In December 2003 that same company will now appear to be grossly under-capitalized.

There are two schools of thought. One, the optimistic approach, assumes that lenders and creditors are primarily interested in the target company's cash flows. Reclassifying equity as debt does not affect immediate cash flows; therefore, there should be no change in the credit standing of the closely held company.

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A more pessimistic, and possibly more realistic approach, evaluates how analysts look at a company. Several of the standard credit tests look at the amount of equity, at debt/equity ratios, and return on equity. All other things being equal, if there are two otherwise similar companies, one with significant equity and the other with a deficit equity position, many analysts are going to favor the former over the latter.

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If SFAS 150 starts to affect, for privately held firms, the availability of credit, then the growth potential of those firms will in practice be adversely affected. Such adverse reaction by lenders will in turn affect the underlying FMV of the company itself. This is because if two otherwise similar firms have different access to credit, one will be able to grow faster than the other, with a consequent higher valuation by the marketplace. Thus changing the accounting will, in fact, change the FMV. There is almost a degree of circularity.

VALUATION REQUIREMENT

Readers affected by SFAS 150 should be aware that the Standard requires that the company's equity be valued every year. Changes in that value will go directly to the income statement. The perverse effect of this requirement is that if a company's value goes down say in 2004, then the reported income for 2004 will increase. Likewise, if the company has a good year and its FMV increases, then there will be a charge (reduction) to income the same year. Some observers have called this counter-intuitive; it may be, but that is how the new GAAP rule works.

SHORT TERM POSSIBLE SOLUTION

There appears to be one possible solution for companies with mandatorily redeemable equity. If the company changes its bylaws, it can effect a change in the accounting treatment. Many firms are being advised by their advisors to remove the mandatory redemption feature.

A close substitute would be for the company to put in a **mandatory call**, and simultaneously provide shareholders with a **mandatory put**. This way, when an employee leaves he can require the company to buy back the shares at book value, or FMV as the case may be. If the individual tries to hold on to the stock, the company, at its discretion, can call the stock.

At face value there appears to be virtually no difference between the mandatory redemption, and mandatory puts and calls. So if your company is affected by SFAS 150 and wishes to retain maximum equity, it would pay to explore the put and call option approach. One word of caution, the FASB has begun a Phase II project related to SFAS 150. Some observers feel that in a subsequent Standard the Board is likely to treat the mandatory put and call features as identical to mandatorily redeemable equity. For further information regarding SFAS 150, please contact your Valuation Research representative or Alfred King at (609) 243-7013. **VR**

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