



FAS 150 and the Case of the Mysterious Disappearing Equity

Quick: How do you take a \$2 million company and turn it into a big, fat balance-sheet zero overnight?

Sadly, the answer is not some snappy punchline. Thanks to a controversial accounting change, the “joke” may be on the private business owner.

Last May, the Financial Accounting Standards Board (FASB) adopted Financial Accounting Statement (FAS) 150, “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity.” FAS 150 requires any financial instrument that can be converted to a specific monetary value to be classified as debt on the company’s balance sheet.

In particular, this accounting change will force closely held companies to book popular “buy-sell” agreements as a liability on their balance sheet. As a result, many S corporations may show a surprising negative net worth once FAS 150 is implemented. Here’s how it could happen:

Spacely Sprockets, a \$2 million private company, has shares of common stock outstanding held by several employee shareholders. The parties enter into an agreement for the company to repurchase the shares upon termination of employment or death. Absent other provisions in the agreement, here’s how the simplified balance sheet would look:

<i>Total assets</i>	<i>\$2,000,000</i>
<i>Liabilities other than shares</i>	<i>\$1,000,000</i>

Shares subject to mandatory redemption + 1,000,000
Total liabilities *\$2,000,000*

In this example, application of FAS 150 eliminates all equity for the company. Even if this liability is partially or fully insured by the corporation, it does not reduce the recognition of the full purchase price. Scary thought.

Explain *That* to the Bank

So, imagine the scene when *Spacey* execs sit down with their banker and present their newly revised financial statement. On paper at least, the company's net worth has disappeared. Without some clear explanation (and an understanding lender!), the company can expect its credit capacity to take a huge hit.

While FAS 150 does not impact the cash flow of companies — just the accounting presentation — it could conceivably trigger bank credit line covenant defaults. Many debt covenants define “debt” as whatever Generally Accepted Accounting Principles (GAAP) currently say it is. A company that has been historically compliant may be thrown into default simply because of FAS 150-mandated accounting changes.

Exceptions to the Rule

Of course, there are exceptions. Treatment of a buy-sell agreement as a liability, for example, is only required when there is an unconditional obligation on the part of the issuing company to repurchase. If the obligation is conditional (e.g., a right of first refusal is attached), liability treatment is not required.

Bottom line: Privately held companies will need to communicate clearly with their financial statement users (banks, vendors, bonding companies, etc.) in the wake of FAS 150.

As you work with your closely held business clients, don't hesitate to contact the accounting professionals in our office for guidance on this major accounting change.

Callout: Due in large part to protests from small business trade groups, the Financial Accounting Standards Board has recently delayed until December 2004 the date that closely held companies must implement FAS 150.