



THE HEMPSTEAD Bulletin

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Stock Buyback Obligation Combined With New FASB Standard Can Wipe Out a Company's Net Worth

On May 31, 2003, the Financial Accounting Standards Board (FASB) issued a new standard that is designed to clarify whether a company's outstanding financial instruments are to be considered debt or equity. Statement of Accounting Standards No. 150 (SFAS 150) addresses a key issue that arose in the Enron scandal and, not surprisingly, the overall intent of the pronouncement is to take a hard look at things that used to be called equity, and to reclassify some of them as debt. Under SFAS 150 reclassifications from debt to equity will be rare.

We want to alert our friends and clients to one particular result of SFAS 150, namely, the treatment of outstanding shares of stock that a company has an obligation to redeem. Such redemption obligations are often found in shareholder or buy-sell agreements entered into by the shareholders of privately held companies. Under such agreements, the company is often required to redeem stock upon the death or termination of employment of a shareholder. Since these are events that are certain to occur, the new accounting pronouncement requires the stock to be classified as a liability, rather than as equity.

Let's assume, for example, that a company has assets of \$5 million, liabilities of \$3 million, and shareholders' equity of \$2 million. If the company has a future obligation to redeem the shares at book value (\$2 million) upon the death of a shareholder, the new FASB pronouncement requires the company to rechristen this \$2 million of shareholder equity as a \$2 million **liability**. Accordingly, our new balance sheet will show assets of \$5 million, liabilities of \$5 million (the original \$3 million plus the new \$2 million from the reclassified equity), and a **net worth of zero**.

To make matters worse, if the company is obliged to buy back the stock at a price greater than book value, for example fair market value, the reclassification described above can result in a **deficit net worth** (equal, in the example, to the amount by which the fair value of the stock exceeds book value).

Needless to say, an outcome like this could significantly affect a company's bank lending covenants and, for contractors, the way that bonding companies will look at the contractor's bonding capacity. Since the new rules begin to take effect for private companies for fiscal years beginning after December 15, 2003, there is still time to review and, if necessary, modify shareholder agreements in a way so as to prevent this unwelcome evaporation of net worth.

Alternatively, companies and their advisors will need to work with lenders to establish covenants that reference agreed-upon, fixed definitions of key terms (such as the "debt/equity ratio") rather than definitions based on generally accepted accounting principles (GAAP). If lenders will not agree to non-GAAP definitions, companies should insist that calculations be based on GAAP definitions as of the date credit is established or negotiate significant cushions in covenants to allow for future changes in GAAP.

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