Imagine being a potential lender or vendor reviewing the following financial statements to determine if the companies qualify for a new loan or additional credit and what terms (e.g. interest rate and financial covenants) will be offered. Or put yourself in the shoes of a potential customer reviewing the financial statements to determine if the companies are strong enough financially to meet the demand of a significant order they would like to place.

A lender or vendor may view Company A as less credit worthy or higher risk due to the larger amount of debt and lower equity than Company B. The lender or vendor may decide either to forgo additional credit to the Company or charge a higher rate of interest due to the higher perceived risk. A customer may be concerned that Company A has no equity at risk and therefore may be at risk of not being able to meet their demand. But what if Company A and Company B were the exact same with the exception of one term within the preferred stock agreement. In this example, both Company’s provide a 15% preferred return to the preferred stockholder’s, but Company A’s preferred stock
agreement includes a provision requiring the Company to purchase the preferred stock 5 years from the balance sheet date. Company B does not include such a provision.

In addition to the Balance Sheet impact shown above, Company A will also have to record the 15% preferred return as interest expense on its income statement. Company B will only have to show the 15% preferred return as an allocation within equity (i.e. no income statement impact).

Based on the example above, you can see how the same company can look completely different to a lender, customer or vendor based on the inclusion of the provision requiring Company A to purchase back the preferred stock. Although it is hard to determine the actual cost to Company A of the presentation of the preferred stock as debt, it is easy to see why Company A will spend more time and resources explaining the difference in presentation and may incur increase costs or losses of revenue due to such inclusion.

This article will explain the triggers that cause an equity instrument to be treated as debt in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) and how they can be avoided and is only intended to be an overview to allow the reader to understand the potential consequences of how an equity instrument is structured. Every equity instrument is unique and management should consult with their CPA on the expected treatment of any new instruments prior to finalizing the structure in order to determine the potential impact.

The primary trigger for Equity Instruments to be treated as Debt

It is common for an investor to infuse capital into a company for future growth and include certain preferential incentives for the new investor such as a preferred return or warrants with favorable purchase prices. The preferred provisions can include the ability to force the company to purchase the equity instrument back from the investor for cash or a note payable, which is commonly referred to as a “put option.” The ability to force the company to buy back the instrument for cash is the primary reason the instrument could be treated as debt under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 480, Distinguishing Liabilities from Equity. In addition to the opening example, the following are examples of equity instruments that would be treated as debt due to such buy back provisions:

a) Warrants to purchase stock issued in connection with debt – This is a common type of structure that is typically seen with Mezzanine debt instruments where the investor receives a debt instrument with a stated interest rate as well as an equity instrument (normally a warrant to purchase stock at a set price). The original value of the warrant is recorded as a liability (or equity if the instrument does not include the ability to force the company to buy back the warrant for cash) and a discount on the debt.

Example - Investor A provides $1,000,000 in cash to Company B in exchange for a note payable to the investor from Company B of $1,000,000 and a stock warrant
to purchase 1,000 shares of stock of Company B (with a fair value of $4 at the date of issuance) for $1. The stock warrant includes the ability for the holder to force Company B to repurchase the warrants from Investor A for a cash purchase price based on the difference between the stock price at the date elected and the exercise price of the warrant of $1. Company B would record a note payable of $700,000 (net of discount) and a $300,000 ($4 fair value less $1 exercise price multiplied by 1,000 shares) warrant liability. The $300,000 debt discount would be recognized within interest expense over the holding period (i.e. from inception until the note is due) and the warrant liability would be adjusted at each reporting date based on the difference between the fair value of the stock and exercise price. If the warrant in this example did not include the ability to force Company B to buy back the warrants for cash, it would be treated as equity and the $300,000 value would be included within equity with no further adjustment for the change in fair value required.

b) **Employee stock incentives** – It is common for companies to issue stock incentives to key employees in order to incentivize them to increase the value of the company and provide them a share of that return. The most common forms of these incentives are a) stock options, which allow the employee the opportunity to purchase stock of the company at a specified fixed price over a period of time and b) stock appreciation rights (SARs), which provide the ability for the employee to receive cash for the appreciation of the Company’s stock. Since SARs represent future cash payments, the amount is always treated as a liability in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). Employee stock options are treated as liabilities if they contain a provision allowing the employee to force the company to pay cash for the stock option. If the buy-back provision is only based on death or change in control, there would be no requirement to show as debt unless death or change in control is expected to occur. Valuation of employee stock options is a complicated area, but, in general, liability treatment requires the company to revalue the options every reporting period based on the amount that would be paid in cash if the employee were to force the company to buy back the options. In contrast, equity based employee stock options are valued at the date of grant and the expense is recognized over the period the employee is required to perform services for the company in order to have the ability to exercise the options (referred to as the vesting period).

c) **Non-employee (e.g. vendor and customer) stock incentives** – Non-employee stock incentives generally are provided to significant customers to encourage them to increase their sales to the Company. Vendors typically receive stock options as payment for services in lieu of cash payments. Non-employee stock incentives with provisions requiring the company to repurchase the stock incentives with cash are treated as liabilities similar to employee stock incentives discussed in b) above, which requires the incentive to be revalued each period based on the amount that would be paid in cash if the non-employee were to force the company.
to purchase the incentive for cash or other assets. In contrast, non-employee stock incentives that do not include such provisions will in general be included in equity and not revalued each period.

d) **Preferred stock redeemable at a specific date and for a specific amount** – The opening example included this type of instrument due to the date being 5 years from the balance sheet for a specified amount (original balance plus preferred interest). There is some relief related to stock (note this relief does not apply to warrants or options noted above) for nonpublic entities that are not SEC registrants.

**Indefinite deferral of debt treatment for certain redeemable stock**

A mandatorily redeemable financial instrument is defined by U.S. GAAP as any of various financial instruments issued in the form of “shares” that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. FASB ASC 480-10-65-1 indefinitely defers the requirement of mandatorily redeemable financial instruments to be shown as debt for financial statement purposes unless the instrument is redeemable on fixed dates for amounts that are either fixed or determined by reference to an interest rate index, currency index or another external index.

**Example** - a nonpublic entity issues preferred stock for $50 and allows the holder the option to force the company to buy back the stock for cash in the future at a price to be determined by the Board of Directors. There would be no requirement to show the preferred stock as debt since the price is not fixed or determinable.

If the nonpublic entity issued the preferred stock for $50 and included an option for the holder to force the company to repurchase the stock back for cash of $60 in 5 years at the option of the holder, it most likely would not be treated as debt due to there being no guarantee that the option would be exercised and therefore the date not being “certain to occur”. However, be aware that if it becomes obvious that the exercise of the put option is certain to occur as a result of there being no significant reason for the holder not to exercise the put option (i.e. no additional value is expected to be received by holding the instrument for a longer period), it could cause the instrument to be treated as a liability. Also, the definition of mandatorily redeemable financial instruments only includes “instruments issued in the form of shares” therefore it does not apply to warrants or options discussed in a) above, which will be shown as liabilities if they include conditional options requiring the company to settle the instrument in cash or other assets.

**Conclusion**
The classification of stock as debt is a complicated subject that should not be overlooked. The impact to the reporting entity can be substantial if the instrument is required to be treated as debt, which, as discussed above, usually is triggered by the inclusion of a provision requiring the company to repurchase the equity instrument for cash. This can include unwanted implications related to debt covenants, future borrowing abilities, and customers and vendors perception of the company’s strength. Management should review all potential equity instruments with their CPA to ensure they are aware of the impact of the structure of the instrument on the financial statements and to determine if there are any alternatives that would avoid the negative implications of debt treatment while accomplishing the goals of the investor. At a minimum, understanding the impact will allow management to discuss with lenders the proposed financial statement treatment and determine any impacts prior to finalizing the equity agreements.