

Case 92-7

Accounting for an Equity Kicker

In 1992, your client Fit-or-Fat (Fit), a privately held chain of health clubs, which is considering a public offering, purchased 100% of Healthnuts, another chain of health clubs, for \$5.4 million. Lenders Bank (Lenders) financed Fit's purchase by making two loans at prime plus 2% with Healthnuts' assets as collateral. One loan for \$2 million was made to Fit, which required Healthnuts to assume the loan. Another \$3 million was loaned directly to Healthnuts. As part of the financing transaction, Fit gave Lenders Bank an "equity kicker" (ownership interest) as additional compensation in the form of mandatorily redeemable preferred stock (preferred stock) in Fit. The stock is redeemable in 1998 at 25% of the fair market value of Healthnuts at that time. (The preferred stock had no liquidation or dividend rights.) At the date of acquisition, Fit received an appraisal of Healthnuts as a going concern.

The accounting you originally contemplated was as follows:

- Record the value of the preferred stock at the date of issue using the discounted amount of 25% of the appraised value of Healthnuts - i.e., as if the purchase price was paid for a 75% interest.
- Calculate an estimated redemption value for the preferred stock using information in the appraisal, which projects the fair market value of Healthnuts in 1998.
- Record the estimated redemption value as debt issue cost and amortize it by the interest method over the life of the issue.
- Recognize the difference between the estimated fair market value of the preferred stock at date of issue and the estimated mandatory redemption value through periodic accretions using the interest method with a related charge to retained earnings.

As a result of your discussion of this accounting treatment with management, Fit's CFO sought a second opinion from Doolittle & Co., Healthnuts' auditors. Doolittle disagreed with the accounting treatment that you proposed and told Fit's management that they believe that Lenders Bank is a joint venturer in the acquisition. Therefore, the cost of redeeming the preferred stock is a part of the purchase price, which should be recorded as goodwill and amortized over 40 years.

Required:

- Is the redeemable preferred stock in substance debt or is it equity?
- At what amount should Fit record the preferred stock?
- How should Fit account for the amount payable to Lenders Bank in 1998?