Dechert LLP

Private Equity

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FASB Statement on Financial Instruments With Debt and Equity Characteristics:

Implications for Private Equity Portfolio Companies

The Financial Accounting Standards Board (FASB) recently issued Statement of Financial Accounting Standards (FAS) No. 150, “Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.” The Statement requires companies to reclassify as liabilities a number of financial instruments that were previously accounted for as equity. FAS 150 is part of the FASB’s ongoing liabilities and equity project. The next phase of the project is expected to address the accounting of various equity instruments not covered by FAS 150.

The application of the new accounting requirements is still unclear in some respects and detailed answers will depend on the evolution of accounting practices. It is clear, however, that FAS 150 may have major implications for portfolio companies of private equity funds. This Update highlights these implications.

Overview of FAS 150

The Statement requires an issuer to classify the following instruments as liabilities:

- **Mandatorily Redeemable Shares**: A financial instrument in the form of shares that embodies an unconditional obligation by the issuer to redeem it by transferring assets (1) at a specified date (e.g., July 1, 2008) or (2) upon an event that is certain to occur (e.g., the death of the holder).

The Statement does not cover preferred stock that can be redeemed at the option of the issuer, the option of the holder, or upon some contingent event outside the control of the issuer and the holder. Accordingly, present practice still applies and preferred stock with these features may be classified as equity unless it also contains a mandatory redemption feature. The FASB announced that puttable and contingently redeemable stock will be addressed in the next phase of its liabilities and equity project.

- **Freestanding Repurchase Obligations**: A financial instrument, other than an outstanding share, that embodies an obligation to repurchase the issuer’s equity shares, or is indexed to such an obligation, and that requires the issuer to settle the obligation by transferring assets (e.g., a written put option on the issuer’s equity shares).

The different treatment of freestanding put options seems to result in a strange dichotomy. It appears that a put right created by the terms of the equity security itself (e.g., a Certificate of Designation) is not within the scope of the Statement, while a put right contained in a separate written agreement would be within the scope.

- **Obligations to Issue a Variable Number of Shares**: A financial instrument that embodies an obligation that the issuer must or may settle by issuing a variable number of its equity shares if the monetary value of the obligation is based solely or predominantly on: a fixed monetary amount known at inception, variations in something other than the fair value of the issuer's equity shares (e.g., a stock index), or variations inversely related to changes in the fair value of the issuer's equity shares.

In general, financial instruments covered by the Statement must initially be measured at fair value. Subsequent changes in fair value are recognized in earnings. Payments or accruals of dividends and similar amounts to holders of equity instruments classified as liabilities must be reported as interest cost.

The Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, with one exception. For mandatorily redeemable shares of a nonpublic entity, the Statement is effective for existing or new contracts for fiscal periods beginning after December 15, 2003. "Nonpublic entity" is defined to include privately held companies with registered high-yield debt.

Implications for Portfolio Companies of Private Equity Funds

The capital structure of many portfolio companies of private equity funds may include equity instruments within the scope of the Statement. Two basic categories need to be scrutinized:

- Most classes or series of preferred stock issued to private equity investors contain redemption features, even though in practice the right is rarely exercised. If the stock is redeemable on a fixed date, e.g., the fifth anniversary of the date of issuance, FAS 150 applies. Other types of preferred stock terms do not provide for mandatory redemption and, instead, provide for redemption at the option of the holder after a fixed date or upon the occurrence of a change of control or other contingent events. These redemption features currently do not fall under FAS 150 until the redemption right is actually exercised or triggered. However, the bifurcation may be temporary. As indicated above, the FASB will address other redemption features in its ongoing project, and there seems to be a consensus in the accounting profession that the next phase will be completed in the near future.
- Holders of preferred or common stock may also be entitled to contractual put options apart from the redemption feature of preferred stock. Primary examples are agreements permitting the put of (1) vested incentive stock upon termination of employment or a change of control, (2) shares underlying equity kicker warrants, (3) shares issued as consideration in acquisitions, and (4) stock issued in connection with strategic alliances. In light of the Statement's artificial distinction between freestanding instruments and redemption provisions, the actual application to various put option arrangements is not apparent and should be analyzed with the company's accountants.

If an instrument is classified as a liability, the implications go beyond financial statement presentation and may complicate compliance with debt covenants. Debt instruments typically define the core terms of their financial covenants, such as "Indebtedness" or "Interest Expense," by reference to GAAP as "in effect from time to time." Companies that are required to reclassify equity as debt, and dividends as interest, must analyze their financial covenants to assure continued compliance.

What should a company do if the reclassification of equity instruments results in covenant compliance issues?

- The company may want to seek an amendment to its debt instruments to neutralize the effect of the reclassification. This may be feasible in the case of senior or subordinated loan agreements, but will probably not be a viable option in the case of high-yield bonds.
- If the company has preferred stock with scheduled redemption, consider an amendment to provide for redemption at the option of the issuer or holder, as applicable. However, this and other types of redeemable preferred stock will have to be reanalyzed upon the announcement of further accounting rules addressing puttable and callable shares.
- As long as the accounting window for puttable shares remains open, companies may be able to replicate contractual put options by creating special classes of stock with corresponding optional redemption rights.

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We will update you on further developments affecting the accounting treatment of hybrid instruments frequently encountered in the capital structure of portfolio companies.

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