

CORPORATE ALERT

KNOW YOUR POSITION: DOES FAS 150 AFFECT YOUR ABILITY TO KEEP YOUR LENDER HAPPY?

by Jackie Marzan and Robert Brighton

The Financial Accounting Standards Board (FASB) establishes standards of financial accounting and reporting which govern the preparation of financial statements. Financial statements prepared in accordance with such standards are commonly referred to as being prepared in accordance with generally accepted accounting principles (GAAP). Financial statements prepared in accordance with GAAP provide investors and lenders with a consistent and comparable financial presentation of an entity's economic position.

From a lender's perspective, a consistent and comparable statement of a company's equity and liabilities is critical in determining that company's creditworthiness. Lenders often require a company to observe financial covenants. The company agrees to observe the financial covenants, borrows the money and walks away knowing how to keep its lender happy. The rules are set. Sounds simple, right? Well, it is, unless the rules change. And the rules have changed for public companies and will soon change for private companies. Under the revised rules, your lender may not be so happy after all and neither may you.

Recently, FASB issued "Statement of Financial Accounting Standards Number 150 (FAS 150) - *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*." FAS 150 establishes standards for the circumstances when a company must classify financial instruments that have characteristics of both a liability and equity as a liability. In most cases, such financial instruments were previously classified as equity.

FAS 150 requires an issuer to classify the following defined financial instruments as liabilities:

- Financial instruments issued in the form of shares that are "mandatorily redeemable" where the issuer is unconditionally obligated to redeem such instrument by transferring its assets at a specified or determinable date or upon an event certain to occur.
- Obligations to repurchase the issuer's equity shares by transferring assets.
- Certain unconditional obligations to issue a variable number of shares.

This Corporate Alert focuses primarily on mandatorily redeemable financial instruments as they relate to closely held (private) companies. A mandatorily redeemable financial instrument includes buy/sell agreements where the company is required to purchase or redeem shareholder shares if the shareholder dies or

retires. Pursuant to most buy/sell agreements, the company agrees to buy back or redeem its stock at (i) a certain price or at a price determinable in accordance with a specific formula and (ii) a specified or determinable date upon the occurrence of an event certain to occur. As currently stated, FAS 150 would characterize such a buy/sell agreement of a closely held company as a mandatorily redeemable financial instrument. For purposes of its financial presentation, the company would account for an amount equal to the difference between the book value of the stock and the price at which the company is obligated to purchase or redeem as a liability. For many closely held companies, such a characterization would significantly reduce or eliminate a company's net worth, making it difficult to borrow money or comply with current financial covenants relating to outstanding debt.

FASB poked a position statement dated November 7, 2003, deferring the effective date of FAS 150 for mandatorily redeemable financial instruments issued by companies who are not registered with the Securities and Exchange Commission (SEC). Under the position statement, FASB has deferred the effective date until after December 15, 2004 (for fiscal periods beginning thereafter) for mandatorily redeemable financial instruments which must be redeemed on a fixed redemption date in fixed amounts or in an amount determined in accordance with an external index. FAS 150 is effective for fiscal periods beginning after December 15, 2004 for mandatorily redeemable financial instruments issued by closely held companies, such as buy/sell agreements having an obligation to redeem or purchase at a specified or determinable date or upon an event certain to occur.

FASB has further determined in their November 7, 2003 position statement that application of FAS 150 4 deferred indefinitely for all other mandatorily redeemable financial instruments of companies that are not registered with the SEC pending further FASB action, as well as for non controlling interests in subsidiary companies. Entities registered with the SEC which have sold debt or equity in the public markets have been subject to FAS 150 An mandatorily redeemable financial instruments entered into or modified after May 31, 2003, or otherwise for fiscal periods beginning after June 15, 2003.

Once implemented, FAS 150 will have a profound effect on financial presentations of private as well as public companies. For a closely held company, future borrowings may be difficult if not impossible, depending on their net worth once mandatorily redeemable financial instruments, such as buy/sell agreements, are characterized as liabilities. For those companies with outstanding loans or obligations in place, FAS 150 may be problematic since their financial presentation would have changed from the date of the initial borrowing. In other words, recharacterization of mandatorily redeemable financial instruments as liability could cause companies to be in default under existing financial covenants.

What to do? At a minimum, FAS 150 will cause some companies subject to its provisions to renegotiate existing loan covenants and negotiate future covenants with their lenders in a manner to eliminate defaults based on the application of FAS 150. Clearly, FASB is pondering the impact of FAS 150 on private companies and has even deferred a portion of FAS 150 as it affects them

indefinitely in response to industry concerns such as those described in this Corporate Alert. However, FAS 150 will affect non-public companies in some circumstances, including those mentioned above. It may be necessary to negotiate current financial covenants with lenders prior to December 15, 2004 and/or amend buy/sell agreements. Private companies should know the rules and be prepared before December 15, 2004 when the new rules are implemented. Attorneys in Ruden McClosky's Corporate Law Practice Group can help you prepare for the implementation of FAS 150.