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Surprise - New Consolidation Rule May Affect Private Equity

Last January, the Financial Accounting Standards Board (FASB) released FIN 46, a new accounting rule on consolidation originally intended to address perceived abuses of special purpose entities (SPEs). Critics had contended that many companies were using SPEs to house a variety of activities, most notably low margin operations, debt and other commitments that should appear in financial statements. Since the structured finance tools typically associated with SPEs are worlds away from the more traditional types of transactions prevalent in private equity, principals may erroneously assume that the new rule has few consequences for their business.

However, the impact on traditional private equity deals such as LBOs, club deals, recapitalizations and minority investments can be dramatic and requires careful consideration during the deal process. Private equity investors will have to pay more attention to the structures they use because, in some circumstances, this rule can raise deconsolidation issues that could derail a deal. They must also consider the accounting treatment of their portfolio companies' off-balance sheet activities, as these can affect financial statements, debt covenants and ultimately the exit strategy.

Most members of the private equity community assumed that the new consolidation rule would not affect them, since it was primarily designed to address structured finance tools such as securitizations and leasing that are typically not used in private equity takeovers. However, FASB's new consolidation rule has a far broader reach than anyone expected. The reason is that, given difficulties in defining SPEs, the FASB decided to require all entities to consider the new rule. In a complex scoping exercise, the new rule essentially divides all entities into two buckets: those that assess the consolidation under the old and familiar "voting control" model and those that must apply the model in FIN 46. In FIN 46, the FASB rolled out "variable interest entities" (VIEs), a new term that encompasses most SPEs and much more. Any entity is potentially a VIE that would be subject to the new consolidation rule. This means that private equity players need to assess the impact of FIN 46 on every deal they consider and on many transactions that their portfolio companies execute. Here, then, is the big surprise for private equity firms: the new rule can have a dramatic effect on traditional M&A and joint venture transactions, and not just those that involve SPEs.

Myth: The new rule applies only to special purpose entities

Reality: The new rule can apply to normal operating companies as well as special purpose entities

Exhibit #1 Source: *PricewaterhouseCoopers*

The new rule affects private equity participants in two ways. First, the structure used to acquire a corporate target or fund a joint venture may inadvertently be subject to the new rule. In this case, a lack of attention to detail could result in deconsolidation issues for the seller or JV partner, and lengthen or derail the deal process. A divestiture, or even a joint venture, that does not achieve deconsolidation accounting for the seller is generally a non-starter. Even worse, the issue might be discovered after the closing. Second, portfolio companies or potential targets that have used or are using off-balance sheet structures are most likely subject to FIN 46.

New transactions must comply with FIN 46 to achieve off-balance sheet treatment. More urgently, continued off-balance sheet treatment may require amendment of past transactions. Without amendment, off-balance sheet leverage and/or low margin operations may be reported in the portfolio company's financial statements. Post-acquisition, managers should assess and address the related effect on covenants, and ultimately on exit strategy, in advance of new or amended transactions.

This thought deserves emphasis: the new rule also applies to old deals. Portfolio companies that used the structured finance tools such as securitizations, synthetic leases or even factoring to achieve off-balance sheet effects in the past need to take a fresh look. Existing joint ventures also warrant renewed interest since one partner or another may have to reconsolidate venture operations. Under FIN 46, the related debt and operations may come back on the balance sheet, affecting covenants and/or the ultimate exit strategy. In unusual circumstances, old structures used to sell a business may have to be reassessed for consolidation by the

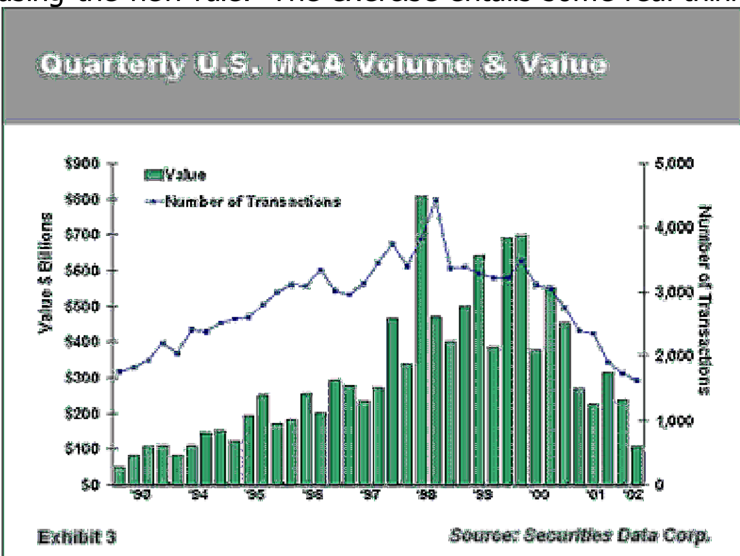
seller. The seller might then ask the fund to renegotiate terms on old deals that require reconsolidation under the new rule.

For new transactions, the rule was effective beginning April 7, 2003. For public company transactions that closed before February 1, 2003, the rule takes effect on July 1, 2003. Private companies aren't subject to the rule until the first annual financial statements issued after July 1st. Since any transaction covered by the new rule requires new disclosures, immediate action is required for both deals in progress and those that are old and cold.

Several common private equity practices require careful attention and analysis as they can affect how the accounting for a transaction works. In unusual circumstances a seller, or even a debt holder, might have to consolidate post-transaction.

A New Consolidation Model

How does the rule work? First, FIN 46 requires an exercise that serves to divide entities into two buckets: those that qualify for the familiar "voting control" consolidation model, and those that must assess consolidation using the new rule. The exercise entails some real thinking about inherently subjective issues. First, the focus is on equity: is there enough, and if so, does it have the right characteristics? Where the answer is yes, the entity is subject to the voting control model. Where the answer to either part of the question is no, FIN 46 applies, and a risks and the rewards model is used to assess consolidation. In a fairly complex exercise, the risks and the rewards of the entity are identified. The party subject to a majority of either, is considered the primary beneficiary, and must consolidate the entity.



Which consolidation model is preferable, the voting control model or the FIN 46 model? The FIN 46 model is new and uncomfortable, with many unanswered implementation questions. In the end, PWC doesn't believe either model will be preferable. What will be important? Negotiating teams can no longer assume that the old voting control model will remain intact, or that a similar deconsolidation answer will result from the new VIE model. Knowing which model applies and when is critical, so that financial reporting surprises don't crop up in the middle of negotiations.

Is There Enough Equity?

As noted, an entity that has sufficient equity with the right characteristics will be assessed for consolidation under the voting control model. The equity section of the balance sheet (including most common stock and some preferred stock) is the starting point, but certain types of equity are excluded from the assessment. Equity that does not participate significantly in profits and losses is not included. An example may be perpetual preferred with little or no dividend; however, the FASB's intent with respect to this requirement is currently not clear.

How much equity is enough to stay within the voting control model? While lenders infuse a high degree of financial discipline into the process of financing private equity investments, the FASB has its own ideas on equity levels and the resulting accounting. From its perspective, the level of equity must exceed "expected losses," as define by the FASB. This can be a complicated test, one that is still subject to a high degree of interpretation due to its many nuances. In most cases a demonstration that equity exceeds expected losses is required.

Myth: This will not affect pre-existing deals or those currently in the pipeline

Reality: All contemplated and pre-existing transactions are subject to the new rule

Exhibit #2 Source: *PricewaterhouseCoopers*

Does The Equity Have The Right Characteristics?

In order to apply the voting control model, equity holders, as a group, must have certain "customary" equity rights and obligations. This means equity holders must be able to make decisions about the entity's activities through voting or other contractual rights. They must also be obliged to absorb expected losses and have the rights to expected returns.

Decision-making authority warrants special attention from private equity players. The new rule contains language that suggests an entity is a VIE and the voting control model cannot be applied if:

- stockholder economics don't line up exactly with voting rights
- substantially all of the entity's activities involve, or are conducted on behalf of, an investor with reduced vote

Limited partnerships are typical examples of economic interests not lining up with voting interests, since the general partner often controls the entity's activities, but retains only a minority economic stake. Entities that give significant veto rights to minority investors or employ complex capital structures are also at risk. In these cases, the second factor—whether substantially all of an entity's activities involve or are conducted on behalf of the low-vote investor—becomes crucial. Given their nature, veto rights and complex capital structures nearly always result in disproportionate vote. The disproportionate vote feature, a late-breaking change in the FASB's new rule, is particularly relevant for private equity investors.

Consider a tiered private equity investment into a target. There are common and preferred tranches of equity. Some equity investors participate further in the capital structure by taking a preferred or even a subordinated debt tranche. The corporate seller may provide a guaranty. All equity tranches and other financial commitments are considered in determining whether the vote and economics are proportionate. This illustrates why it is difficult to envision a complex capital structure that would not give rise to a disproportionate vote.

The requirement that equity holders have the obligation to absorb expected losses along with the rights to expected returns can also be problematic. Has an outside party guaranteed the value of the entity's assets, for instance? Such a guarantee could take many forms, including traditional guarantees, put options on the assets or the entity as a whole, obligations to provide additional funding, or insurance contracts. Equity holders may not be obliged to absorb expected losses if these commonly used techniques are employed. Similarly, does an outside party have a call option on the entity or its assets, or a management contract that siphons away residual returns? If so, the equity holders' rights to the entity's residual returns may be limited.

This scoping exercise helps parties with an interest in an entity determine whether they should apply the voting control consolidation model or the FIN 46 VIE model. If there is not enough equity, or the equity does not have the proper characteristics, the VIE model in FIN 46 applies. Attention to details in the early stages is a must, since results from the VIE model can differ dramatically from those obtained with the voting control model. And in any case, it is obvious that the structuring process will have to consider these new issues.

I'm Scoped In—Now What?

Remember, the party subject to a majority of either the risks or the rewards of the entity is the primary beneficiary and must consolidate. The next step requires that those risks and rewards be identified and allocated to the various parties that hold what the FASB terms "variable interests". Variable interests are contractual, ownership or other interests in an entity that change when the entity's net asset value changes. Variable interests include common stock ownership, but may also include loans, options and other derivatives, guarantees, management or other service contracts, leases, preferred stock, or partnership interests. Basically, anything can be a variable interest.

The process of identifying risks and rewards is another inherently subjective exercise. In most cases, an

analysis of the target's cash flows will be required to identify expected and less probable cash flow outcomes. For example, assume an entity has multiple sets of cash flow scenarios: best case, worst case, expected case and points in between. These scenarios are analyzed further to identify variations, both positive and negative, from the expected cash flow scenario. The variations are then probability-weighted and discounted. The FASB terms the positive variations "expected returns" and the negative variations "expected losses". It is participation in expected returns and exposure to expected losses, as defined by FASB, that determines who consolidates. Exposure to a majority of the expected losses requires consolidation. Where no one party is exposed to a majority of the expected losses, the right to a majority of the expected returns will result in consolidation. These terms will take some getting used to, given that they are at odds with traditional commercial jargon.

Consider a private equity investor who requires a corporate seller to guarantee a portion of the target's debt after a deal closes, a scenario in some private equity deals involving carve-outs of large companies. Because the seller's guarantee limits the equity exposure to expected losses, the entity will likely be deemed a VIE. The seller's guarantee could also bar him from deconsolidating the target, since the guarantee may subject the seller to a majority of the expected losses.

It goes without saying that the FASB's calculation of expected losses and expected returns is a complex and subjective process. Keep in mind that the process is different from the one most dealmakers use to forecast investment returns.

Insights

Private equity investors and their advisors need to understand the impact of the new rule today. Examples of the rule's most likely effects are as follows:

- Corporate sellers may not achieve deconsolidation of target operations in a private equity transaction
- Corporate joint venture partners may not achieve deconsolidation of venture operations
- Existing portfolio companies and potential targets may be required to reconsolidate off-balance sheet structures.

Given its impact both on new investments and portfolio companies, a hard look at the new rule is warranted. The rule is complex and produces outcomes much different from those arising from consolidation models used in the past. And the effects can be dramatic, both for current deals where a seller must deconsolidate, and for portfolio companies that use off-balance sheet techniques in their finance activities.

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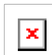
©2007 Bank of America Corporation. All rights reserved. 

Myth: Voting control is still the primary determining factor in consolidation.

Reality: While voting control is important, other considerations (e.g. exposure to a majority of expected losses or returns) need to be considered

Exhibit #4 Source: *PricewaterhouseCoopers*

Myth: To avoid consolidation, all you need is a 10% 3rd party equity investor

Reality: The level of equity must be sufficient to absorb expected losses, regardless of the percentage

Exhibit #5 Source: *PricewaterhouseCoopers*

Myth: Investors who do not own common equity will not consolidate.

Reality: Any vehicle that permits the holder to share in the expected losses or returns of a portfolio company is a variable interest that may trigger consolidation

Exhibit #6 Source: *PricewaterhouseCoopers*