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HRO Alert

FASB 160 and Its Effects on Minority Holdings Under Credit Facilities and in M&A Transactions¹

In December, 2007, the Financial Accounting Standards Board (FASB) adopted Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51 (Statement No. 160). Many credit agreements contain leverage ratios or net worth covenants based on the financial position of the borrower, and other financial ratios based on the net income, EBITDA, or other calculations of the earnings of the borrower. Similarly, in many M&A transactions, the purchase price is calculated based on a multiple of EBITDA or other calculations of earnings. In each case, common practice is to start with financial position or net income as set forth in the applicable GAAP financial statements. Until the adoption of Statement No. 160, limited guidance existed as to the reporting of minority interests in subsidiaries.

Determination of Consolidated Net Income in Subsidiaries

On the income statement, most parent companies currently account for the allocable portion of the net income of a subsidiary attributable to a minority interest holder in the subsidiary as an expense that reduces the net income of the parent company (and therefore reduces EBITDA or other earnings calculations based on the net income of the parent company). Under Statement No. 160, that allocable portion of net income will be included in the consolidated net income of the parent.

If a company with a credit facility receives a boost in their earnings and EBITDA as a result of the adoption of Statement No. 160, it could improve its ability to satisfy financial ratios under its credit facility. In addition, in many M&A transactions the purchase price is based on a multiple of EBITDA or other earnings multiplier. After the adoption of Statement No. 160, purchasers in the M&A context may want to consider deducting the income attributable to minority interests in the calculation of EBITDA and other earnings calculations for purposes of determining purchase price.

Determination of Consolidated Equity in Subsidiaries

On the balance sheet, many parent companies currently account for the interests of minority holders in a subsidiary of the parent company as a liability, or include the minority interests in a “mezzanine” section between liabilities and equity. Statement No. 160 will require the interests of minority holders in the subsidiaries of a parent company to be included in the consolidated equity of the parent company (although Statement No. 160 will require minority equity interests to be clearly identified in the financial statements).

Companies that are subject to leverage ratios and net worth covenants in their credit facilities may also benefit by their adoption of Statement No. 160 by the addition of minority interests in equity or the exclusion of minority interests from liabilities. Depending on the provisions of the particular loan, without specific language the change in accounting treatment could result in a decrease of interest rates based on leverage ratios, an increase in borrowing bases, and allow borrowers under credit facilities to satisfy covenants in situations that were not intended at the time of the loan.

¹ Although matters of law and accounting are often intertwined, Holme Roberts & Owen LLP is not intending to offer any advice on accounting principles or other accounting matters. Clients and prospective clients are urged to discuss the matters discussed herein with their respective accountants, and should not rely on any statements made herein with respect to any such accounting principles and matters.

Effective Date

Although Statement No. 160 is not effective until fiscal years beginning on or after December 15, 2008, borrowers and lenders should consider the impacts of Statement No. 160 on existing loans and new loans that extend to fiscal years impacted by Statement No. 160. To address the impacts of unexpected changes in GAAP, many credit agreements provide that GAAP will be applied as in effect on the original date of the credit agreement. Borrowers and lenders should consider reviewing their current credit agreements for such a provision. Purchasers in M&A transactions should consider how Statement No. 160 might affect their purchase price calculations after Statement No. 160 becomes effective.

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