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HEARD ON THE STREET

More Truth-in-Labeling For Accounting Carries Liabilities

By MICHAEL RAPOPORT and JONATHAN WEIL
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The nation's accounting-rule makers finally have taken a side in a longstanding neither-fish-nor-fowl debate -- and some companies could wind up in a foul mood over what that decision will do to their balance sheets.

At issue: How to classify certain types of preferred securities, often called "mandatorily redeemable" or "trust preferred" stock, which companies are required to buy back at fixed future dates or under predetermined circumstances. The popularity of these types of securities has soared in recent years, in part because they allowed companies to raise money without having to show more debt on their books.

While such instruments have characteristics of both debt and equity, historically these securities have been placed on corporate balance sheets as neither. Instead, they have shown up in what is called the "mezzanine" section -- a kind of no-man's-land on the balance sheet between liabilities and equity.

But that is about to change for a lot of preferred securities. Under a little-publicized May action by the Financial Accounting Standards Board, companies will have to begin classifying them as liabilities.

The standard will boost some companies' reported debt and make them look more leveraged than they appeared before. In addition, companies will be reclassifying as interest expenses the dividends paid to holders of these securities. The rule takes effect in the current quarter for most public companies.

Consider **CMS Energy** Corp. As a result of the rule, the utility company cautioned in its latest quarterly report that its Consumers Energy unit will approach the debt limits spelled out in its covenant agreements with bank lenders. While the report said CMS believes it will be able to resolve any issues by securing amendments to those covenants, failure to do so could hinder its ability to access financing or raise money and could "result in defaults under one or more of these agreements."

Accounting specialists say the FASB still has a way to go in its quest to ensure truth in labeling for liabilities on corporate-balance sheets. But they say the latest step is a good start. FASB next plans to tackle accounting treatment for instruments like convertible bonds, which are more prevalent than mandatorily redeemable or trust-preferred securities.

"What they're doing is labeling elements of the financial statements as they really are," says Charles Mulford, an accounting professor at Georgia Institute of Technology in Atlanta. The result will be "a more accurate representation of companies' true financial position."

Preferred securities of the kind used by CMS have been a favorite vehicle for companies raising cash. Their hybrid nature, under the old accounting treatment, allowed companies to avoid scrutiny from existing creditors, who worried about excess leverage, and existing shareholders worried about excess dilution. The new, tougher accounting standard could reduce demand for such products.

In CMS's case, the new standard, called FASB Statement 150, will shift $663 million from the mezzanine section of the company's balance sheet into long-term debt, says Glenn P. Barba, the company's chief accounting officer. At June 30, the company showed $6.6 billion of long-term debt. "We're pretty confident we'll be able to have discussions with our bank lenders and go ahead and renegotiate the covenant calculations," he says, adding that the new standard represents "a purer way to classify these securities on the balance sheet."

Most companies' reported shareholder equity or book value -- defined as assets minus liabilities -- won't be affected, because these securities effectively are already counted as liabilities for those purposes. But a handful of companies will see their equity levels decline. **AOL Time Warner** Inc., for instance, will see a $1.5 billion hit to shareholder equity, from reclassifying as liabilities a like amount of preferred securities that are in the equity section of the balance sheet instead of the mezzanine section. At June 30, AOL reported $56 billion of shareholder equity. The company's deputy controller, Pascal Desroches, says "as it relates to the company's debt covenants, this security does not impact them in any way."

Only a few companies face potential covenant discomfort from the new rule. Many companies already had been taking the affected securities into account when calculating debt loads or other figures for purposes of measuring compliance with lending covenants. Some companies exclude them from covenant calculations entirely. Standard & Poor's said in a recent report that while the new rule theoretically could bring companies close to violating covenants, the ratings agency "has not identified this as a major problem for companies that it rates."

Net income in future years likely won't be affected either, because the added interest payments simply move costs from one income-statement line item to another. Some companies, however, may have to record charges to earnings this year upon adopting the new rule. **Aon** Corp., for example, has disclosed that it will take a $73 million charge this quarter to adopt the new standard. The insurance broker will reclassify $752 million of its securities as liabilities.

The shift also highlights how some companies may have been providing confusing disclosures about how these preferred securities have been classified on their balance sheets.

The vast majority of companies' balance sheets make clear what goes where -- that is, what is in the mezzanine section that gets subtracted from assets to help calculate book value, and what is in the equity section along with things like common stock and retained earnings. By contrast, **Xerox** Corp.'s balance sheet bunches the two sections together. As a result, it is hard to tell how Xerox's $1.7 billion of mandatorily redeemable securities are classified now. And making matters even murkier, the company doesn't expressly state a figure for shareholder equity on its balance sheet.

In fact, the securities are classified as mezzanine in nature. That means they effectively are treated as liabilities that count against Xerox's equity, though Xerox says only $696 million of the $1.7 billion actually will be reclassified as liabilities. Kara Choquette, a Xerox spokeswoman, says the company's disclosure and accounting treatment is "consistent with the specific guidance" issued by the Securities and Exchange Commission on the subject. She said the company's balance sheet is presented in accordance with generally accepted accounting principles, adding that GAAP doesn't require Xerox to break out shareholder equity on the balance sheet.

Natural-gas company **Kinder Morgan** Inc. has $275 million of mandatorily redeemable trust-preferred securities, and may add up to that amount to its debt, depending on a separate pending accounting change. That would boost Kinder Morgan's debt load to about $3.3 billion from $3 billion.

C. Park Shaper, the company's chief financial officer, said the new rule won't have a significant impact on Kinder Morgan. The company, he explains, is focusing on paying down debt rather than trying to borrow more. But he acknowledged that "no question, we would prefer the accounting to stay the way it is."

Kinder Morgan has a debt covenant requiring it to keep its debt to below 65% of capital. Mr. Shaper said the current level is about 51% or 52%. It isn't clear whether the new standard will boost that level under the terms of Kinder Morgan's debt covenants, Mr. Shaper says. But even if it does, he says, it would be by a few percentage points at most. That would still leave it well below the threshold, though edging upward.

Write to Michael Rapoport at michael.rapoport@dowjones.com[1] and Jonathan Weil at jonathan.weil@wsj.com[2]

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Hyperlinks in this Article:
(1) mailto:Michael.Rapoport@dowjones.com
(2) mailto:jonathan.weil@wsj.com

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