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The FASB's Basic Ownership Approach and a Reclassification of Preferred Stock as a Liability

EXECUTIVE SUMMARY

In *Preliminary Views: Financial Instruments with Characteristics of Equity,* the FASB expresses a preference for a basic ownership approach for distinguishing between liabilities and equity. Under this approach, preferred stock, long considered a component of shareholders' equity, would be reported as a liability. If this change takes place, the impact on the balance sheet and income statement, including measures of leverage and interest coverage will be great, especially for companies that have relied heavily on preferred stock for financing.

In this study, consistent with the proposal, we revise balance sheet and income statement measures of leverage, interest coverage and pretax income and seek to identify sectors and some companies where the effects will be greatest. Debt covenants for companies that use significant amounts of preferred stock may need to be revised. There may also be pressure to refinance outstanding preferred stock with debt or common equity. Overall, we find that the median firm with outstanding preferred stock would see its liabilities to equity ratio increase by 4.17%. The median company would see a decline of 5.99% in times interest earned and a 6.37% decline in pretax income.

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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The FASB's Basic Ownership Approach and a Reclassification of Preferred Stock as Debt

Introduction

Seeking comments from interested parties on the classification of liabilities and shareholders' equity, late last year the FASB issued *Preliminary Views: Financial Instruments with Characteristics of Equity*[1]. While considering many possible approaches for distinguishing between equity and liabilities, the Board reached the preliminary view that the basic ownership approach should be used. In the basic ownership approach, only the lowest residual interests in an entity are classified as equity. Other interests or claims, including perpetual instruments such as preferred stock, are classified as liabilities and excluded from equity. Accordingly, claims with differing priorities would not be commingled, providing a clearer picture of the ultimate residual ownership interests in an entity.

As a claim on an entity's assets and earnings, preferred stock has features of both liabilities and equity. As a perpetual instrument, nonredeemable preferred stock is similar to equity in that it has no repayment requirement.[2] However, most such preferred issues carry a dividend requirement, which is similar to a liability.

Under current GAAP, classifying nonredeemable preferred stock as equity focuses attention on the perpetual nature of the claim. Like equity, there is no requirement for repayment. The proposed basic ownership approach focuses attention more on the dividend service requirement and the fact that the preferred has a claim senior to common on the distribution of assets in liquidation.

The FASB's basic ownership approach for distinguishing between equity and liabilities or assets has appeal. It would simplify greatly the classification problems that can arise when dealing with instruments that have compound elements of liabilities and equity. It would also reduce or eliminate a certain gamesmanship that can arise when issuers structure agreements to gain equity classification for claims that are senior to those of the basic owners.

If nonredeemable preferred stock were to be classified as a liability, our traditional understanding of what constitutes equity would be changed. Both balance sheet and income statement measures of leverage and coverage would be impacted. Some companies, especially those that have used nonredeemable preferred stock as a means of raising capital without the appearance of increased leverage, could be affected significantly. These companies may wish to revisit debt covenants. They may even consider refinancing their preferred offerings – repurchasing them and issuing debt or common equity. Analysts and investors will want to be alert to these new pressures and the potential risk-raising and dilution effects that this proposed reporting change could engender.

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[1] Financial Accounting Standard Board, *Preliminary Views: Financial Instruments with Characteristics of Equity.* (Norwalk, CT: FASB, Nov. 30, 2007).

[2] According to SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, (Norwalk, CT: FASB, May 2003), redeemable preferred stock is already classified as a liability.

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In this report, for companies with preferred stock outstanding, we look at the effects on the balance sheet and income statement of reclassifying preferred stock as a liability. On the balance sheet, our focus is on how liabilities and equity will change, together with the leverage ratio, liabilities to shareholders' equity. On the income statement we look at how interest expense will change if preferred dividends were instead reclassified to interest. Here we look at the coverage ratio, times interest earned, to see how that measure will be impacted. Throughout the paper, we seek to identify the names of companies and industries where the proposed change in accounting will have a greater impact. The managements of these companies may wish to review and revise outstanding debt covenants to avoid unexpected violations. These companies may also have a stronger incentive to consider refinancing their outstanding preferred equity with common equity or even debt that would afford a tax deduction for interest paid.

Data Collection and Assumptions

We searched the CompuStat North America database for fiscal 2006 and identified companies reporting preferred stock. The identified names were organized into ten broad sector groups using the Global Industrial Classification System (GICS). We conducted our data analysis for each of the ten sectors separately and for all of the sectors combined. The sector names and the number of companies found in each sector are detailed below.

Sector Name	No. Firms in Sector
UTILITIES	107
TELECOMMUNICATIONS SERVICES	28
INFORMATION TECHNOLOGY	149
FINANCIALS	189
HEALTH CARE	129
CONSUMER STAPLES	30
CONSUMER DISCRETIONARY	110
INDUSTRIALS	86
MATERIALS	41
ENERGY	38
ALL SECTORS	907

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Part I. Balance Sheet Adjustments
To measure the impact on the balance sheet arising from a reclassification of preferred stock, we recalculated shareholders' equity with preferred stock excluded and total liabilities with preferred stock included. We then measured financial leverage, defined as liabilities to shareholders' equity, for our sample firms both before and after the adjustments.

Shareholders' Equity
In our analysis, we used the CompuStat definition of liabilities and shareholders' equity. Measured in this way, reported shareholders' equity includes all preferred stock, whether or not such shares are redeemable. Reported total liabilities exclude preferred shares. Table 1 presents data on the changes to shareholders' equity noted as a result of treating preferred stock as a liability instead of equity. Adjusted shareholders' equity is calculated by removing preferred stock from total shareholders' equity. Companies with negative shareholders' equity before adjustment are not included in the analysis. In the Table we list for each sector and for the entire sample the median percentage decrease in shareholders' equity resulting from the adjustment for preferred stock.

Overall, the median decline in shareholders' equity for the sample of firms reporting preferred stock is 6.11%. However, in some industries, including telecommunications services and information technology, the median decline in shareholders' equity exceeds 40%.

Table 1. Shareholders' Equity Adjusted to Remove Preferred Stock (2006)

Sector Name	No. of Firms in Sector	% Decrease in Shareholders Equity
UTILITIES	107	-2.90%
TELECOMMUNICATIONS SERVICES	16	-41.46%
INFORMATION TECHNOLOGY	106	-41.10%
FINANCIALS	185	-6.34%
HEALTH CARE	92	-13.01%
CONSUMER STAPLES	23	-3.20%
CONSUMER DISCRETIONARY	88	-9.53%
INDUSTRIALS	59	-13.92%
MATERIALS	37	-5.03%
ENERGY	33	-2.48%
ALL SECTORS	746	-6.11%

Notes:
Only firms with positive shareholders' equity and preferred stock are included.
The percentage decrease in shareholders' equity is calculated as the change in shareholders' equity from including preferred stock to excluding it.

In Table 1a we present six companies that would see noteworthy reductions in shareholders' equity if preferred stock were to be excluded.

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Table 1a. Sample Companies with Noted Reductions in Shareholders' Equity (2006) (dollar amounts in millions).

Company Name	Sector Name	Preferred Stock	Shareholders Equity	Adjusted Shareholders Equity	% Decrease in Shareholders Equity
MTM TECHNOLOGIES INC	INFO TECH	54.31	49.32	-4.99	-110.11%
NITCHES INC	CONS DISCRET	0.88	9.26	8.38	-9.50%
EUROBANCSHARES INC	FINANCIALS	10.76	169.88	159.12	-6.33%
STRATEGIC HOTELS & RESORTS	FINANCIALS	347.268	1,317.290	970.022	-26.36%
SCHERING-PLOUGH CORP.	HEALTH CARE	1438.00	7,908.00	6,470.00	-18.18%
CONSTELLATION ENERGY INC	UTILITIES	190.00	4,799.30	4,609.30	-3.96%

Note:
Adjusted shareholders equity is calculated as reported shareholders' equity less preferred stock.

Liabilities

Table 2 presents changes in total liabilities as a result of treating preferred stock as a liability. The adjusted total liabilities value is calculated by adding preferred stock to reported liabilities.

Overall, the median increase in total liabilities for the sample of firms reporting preferred stock is 3.13%. We saw particularly high increases in total liabilities in the information technology and health care industries, where the median increase in total liabilities is 18.52% and 17.62%, respectively.

Table 2. Total Liabilities Adjusted to Include Preferred Stock (2006)

Sector Name	No. Firms in Sector	% Increase in Liabilities
UTILITIES	107	1.12%
TELECOMMUNICATIONS SERVICES	28	7.49%
INFORMATION TECHNOLOGY	149	18.52%
FINANCIALS	189	0.81%
HEALTH CARE	129	17.62%
CONSUMER STAPLES	30	3.54%
CONSUMER DISCRETIONARY	110	4.10%
INDUSTRIALS	86	5.51%
MATERIALS	41	2.56%
ENERGY	38	3.85%
ALL SECTORS	907	3.13%

Notes:
Only firms with preferred stock are included.
The percentage increase in liabilities is calculated as the change in total liabilities before the inclusion of preferred stock and after its inclusion.

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Financial Leverage

We measured the effects on financial leverage of excluding preferred stock from shareholders' equity and including it in liabilities. We calculated the leverage ratio, total liabilities to shareholders' equity, both before and after adjusting for preferred stock. The results are presented in Table 3. Because this measure of leverage is undefined for negative equity, the results include only companies with positive shareholders' equity. Accordingly, the results are actually biased toward showing a lower increase in financial leverage than would be seen if all companies were included.

As presented in Table 3, the median increase in adjusted financial leverage for the overall sample is 4.17%. The telecommunications services sector has the highest median increase in leverage, calculated at 78.12%. We also saw significant increases in leverage for the financials, at 9.70%, and the consumer discretionary sector, at 9.15%.

Table 3. Financial Leverage Recalculated with Preferred Stock Included in Liabilities (2006)

Sector Name	No. of Firms in Sector	% Increase in Liabilities/Shareholders' Equity
UTILITIES	107	4.09%
TELECOMMUNICATIONS SERVICES	16	78.16%
INFORMATION TECHNOLOGY	106	0.42%
FINANCIALS	185	9.70%
HEALTH CARE	92	0.57%
CONSUMER STAPLES	23	2.59%
CONSUMER DISCRETIONARY	88	9.15%
INDUSTRIALS	59	2.46%
MATERIALS	37	4.25%
ENERGY	33	5.76%
ALL SECTORS	746	4.17%

Notes:
Only firms with positive shareholders' equity and preferred stock are included in each sector.
The percentage increase in liabilities to shareholders' equity is calculated as the change in the ratio using reported liabilities and shareholders' equity and using liabilities and shareholders' equity revised to include preferred stock in liabilities and exclude it from shareholders' equity.

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Part II. Income statement adjustments

In the Preliminary Views document, the FASB did not decide whether or how to re-measure a perpetual instrument such as preferred stock that is classified as a liability. That is, what about changes in the fair value of a perpetual instrument? Should such changes be taken into account and recorded in the income statement?

Changes in the fair value of preferred claims would impact directly the claims of residual equity owners. For example, declines in the value of preferred stock outstanding due to rising interest rates would afford the issuing firm an opportunity to repurchase those shares at a gain. As such, if a full fair-value approach to financial reporting were adopted, changes in the fair value of such preferred claims should be reflected in earnings attributable to common shareholders. In our study, however, we did not have estimates of fair value or sufficient resources to enable us to estimate the fair value of the outstanding preferred shares of our sample companies. Accordingly, we did not measure the effects on earnings of changes in that fair value.

There is also the outstanding question of how to treat preferred stock dividends. Consistent with reporting preferred stock as a liability, should preferred dividends be reported as interest expense?

If preferred stock were reported as a liability, it would also be appropriate to record dividends on that preferred stock as an interest cost, a cost of liability financing. That way, earnings attributable to residual ownership claims are measured after senior claims, such as debt and preferred stock, are taken into account. However, given differences in the inherent nature of the payments, it would be helpful to financial statement users if the components of total interest expense – amounts attributable to borrowings and to preferred stock – would be disclosed. In the study we adjusted interest expense to include preferred dividends. We examined the effects of this adjustment on an important measure of debt coverage, times interest earned, and on pretax income.

Interest Expense

We began by adjusting interest expense to include preferred dividends and calculated the resulting percent change. The results are presented in Table 4. As noted in the Table, median interest expense would increase by 9.17% if all companies reporting preferred dividends were instead to classify that charge as interest. We found the highest median increase in interest expense, 78.54%, in the telecommunications services sector. Other industries showing significant increases in interest expense include healthcare and information technology, with percentage increases of 34.25% and 33.52%, respectively.

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Table 4. Interest Expense Adjusted to Include Preferred Dividends (2006)

Sector Name	No. of Firms in Sector	% Increase in Interest Expense
UTILITIES	98	2.69%
TELECOMMUNICATIONS SERVICES	20	78.54%
INFORMATION TECHNOLOGY	71	33.52%
FINANCIALS	165	8.60%
HEALTH CARE	61	34.25%
CONSUMER STAPLES	17	11.47%
CONSUMER DISCRETIONARY	58	20.82%
INDUSTRIALS	47	11.85%
MATERIALS	27	10.63%
ENERGY	28	18.47%
ALL SECTORS	592	9.17%

Notes:
Only firms with preferred stock and preferred dividends are included in each sector.
The percentage increase in interest expense is calculated as the change in interest expense from excluding preferred dividends to including them.

Times Interest Earned

Including preferred dividends in interest expense would be expected to impact directly a common measure of debt coverage, times interest earned. Calculated as EBITDA (earnings before interest, taxes, depreciation and amortization) divided by interest expense, times interest earned measures the number of times that a crude measure of cash flow available for liability claims, EBITDA, covers those claims. While the inclusion of preferred dividends in interest would not alter EBITDA, it would likely lower times interest earned considerably by increasing interest expense. In this analysis, we limited our sample to companies reporting positive EBITDA.

In Table 5 we present for each sector the median decline in EBITDA to interest. As noted in the Table, the median decline in EBITDA to interest for the entire sample is 5.99%. As expected, companies in some industries are affected more than others by the adjustment. For example, the median decline in EBITDA to interest for the information technology sector is 36.79%. The decline is also significant in the health care and consumer discretionary fields, with declines in EBITDA to interest of 22.18% and 16.92%, respectively.

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Table 5. Interest Coverage Recalculated with Preferred Dividends Included in Interest Expense (2006)

Sector Name	No. of Firms in the Sector	% Decrease in EBITDA/ Interest Exp.
UTILITIES	97	-2.38%
TELECOMMUNICATIONS SERVICES	11	-5.99%
INFORMATION TECHNOLOGY	24	-36.79%
FINANCIALS	159	-7.85%
HEALTH CARE	15	-22.18%
CONSUMER STAPLES	12	-5.22%
CONSUMER DISCRETIONARY	41	-16.92%
INDUSTRIALS	26	-8.65%
MATERIALS	22	-8.01%
ENERGY	26	-14.85%
ALL SECTORS	433	-5.99%

Notes:
Only firms with preferred stock, preferred dividends and positive EBITDA are included.
The percentage decrease in EBITDA to interest expense is the calculated change in the ratio from excluding preferred dividends in interest expense to including them.

Pre-tax Income

If interest expense were increased to include preferred dividends, net income would be reduced. While earnings available for common shareholders are already measured after preferred dividends are subtracted, net income is measured before preferred dividends. Accordingly, we wanted to see the effects on net income of treating preferred dividends as interest expense. Because of differences in the tax deductibility of interest on borrowed amounts and dividends on preferred stock, we used pretax income to measure the earnings effect of including preferred dividends in interest. Part of our reasoning was that companies with outstanding preferred stock that were forced to reclassify those claims as liabilities may refinance them with debt so as to gain a tax shield. By examining the effects on pretax income of reclassifying preferred dividends to interest, our results are not sensitive to companies' decisions on whether to refinance their preferred stock claims.

In Table 6 we present the median percentage decrease in pretax income for each sector. The median percentage decline for the entire sample is 6.37%. At 15.72%, the financials show the largest decline, while declines in excess of 10% are also seen in the telecommunications, information technology and consumer discretionary industries.

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Table 6. Pretax Income Adjusted to Include Preferred Dividends in Interest Expense (2006)

Sector Name	No. of Firms in Sector	% Decrease in Pretax Income
UTILITIES	98	-1.08%
TELECOMMUNICATIONS SERVICES	20	-12.61%
INFORMATION TECHNOLOGY	71	-10.82%
FINANCIALS	165	-15.72%
HEALTH CARE	61	-5.77%
CONSUMER STAPLES	17	-3.49%
CONSUMER DISCRETIONARY	58	-10.84%
INDUSTRIALS	47	-6.71%
MATERIALS	27	-4.89%
ENERGY	28	-6.30%
ALL SECTORS	592	-6.37%

Notes:
Only firms with preferred stock and preferred dividends are included in each sector.
The percentage decrease in pretax income is calculated as the change in pretax income before including preferred dividends as an expense and after including them.

Table 6a presents a selection of five companies that would see significant declines in pretax income if preferred dividends were instead reported as expense. Of particular note is Strategic Hotels & Resorts, where pretax income would decline by 69.12% if preferred dividends were reported as interest expense. Other companies listed in the Table would see declines in pretax income for amounts exceeding 30%.

Table 6a. Sample Companies with Noted Reductions in Pretax Income (2006) (dollar amounts in millions).

Company Name	Sector Name	Preferred Dividends	Pretax Income	Adjusted Pre-tax Income	% Dec. in Pretax Income
PHARSIGHT CORP	INFO. TECH.	0.746	2.018	1.272	-36.97%
STRATEGIC HOTELS & RESORTS	FINANCIALS	24.543	35.507	10.964	-69.12%
WCA WASTE CORP	INDUSTRIALS	1.603	5.333	3.730	-30.06%
TERRA INDUSTRIES INC	MATERIALS	5.1	13.46	8.360	-37.89%
WESTMORELAND COAL CO	ENERGY	1.585	-10.669	-12.254	-14.86%

Note:
Adjusted pretax income is calculated as reported pretax income less preferred dividends.

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Conclusions

The FASB's proposed basic ownership approach for distinguishing between liabilities and equity has much appeal and will simplify greatly the classification of instruments with compound features. However, the classification of nonredeemable preferred stock as a liability will change dramatically traditional views of what constitutes shareholders' equity. Financial statement measures of leverage, interest coverage and pretax income will be altered. As seen in this study, for some firms, the effects will be significant.

Overall, for the median firm carrying preferred stock, we found that the balance sheet measure of leverage, liabilities to equity, will increase by 4.17%. As to interest coverage, EBITDA to interest, we found that the median firm will see a decline of 5.99%. If preferred dividends were accounted for as an expense, pretax income would decline at the median by 6.37%.

Given the significance of this proposed change in accounting, affected firms may wish to review and revise outstanding debt covenants to avoid unexpected violations. Consideration may also be given to refinancing outstanding preferred stock, employing either common equity or even debt that would afford a tax deduction for interest paid.

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