REPORTING OF PREFERENCE SHARES IN THE FINANCIAL STATEMENTS

REFLECTAREA ACȚIUNILOR PREFERENȚIALE ÎN SITUAȚIILE FINANCIARE

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Abstract. *In essence, preference shares acts like a mix of a common share and a bond, with each preference share normally paid a guaranteed, relatively high dividend. Therefore, special characteristics of preference shares can affect its reporting in the financial statement. It is generally considered that both common and preference stock are reported in the stockholders' equity section of the balance sheet. In some particular cases, companies might find it challenging to classify complex financial instruments that combine some features of both debt (liabilities) and ordinary shares (equity instruments). Moreover, international regulations now require companies to report mandatorily redeemable preference stock as liability rather than equity. In this article will be provided some classification features that can offer insofar an explanation to this issue.*

Keywords: preference shares, equity, common shares, liability, financial statement.

JEL Classifications: G10, M41

Introduction

The classification of debt and equity in an entity's statement of financial position is not always easy for specialists who prepare financial statements. It is generally considered that both common and preferred stock are reported in the stockholders' equity section of the balance sheet. However, special characteristics of preferred stock that have both features can affect its reporting in the balance sheet. International Accounting Standard (IAS) 32 *Financial Instruments: Presentation* defines rules for when a financial instrument is to be classified as equity or liability. It works well for most financial instruments. However, financial analysts find it challenging to classify complex financial instruments that combine some features of both debt (liabilities) and ordinary shares (equity instruments). Moreover, both International Financial Reporting Standards (IFRSs) and US-GAAP now require companies to report mandatorily redeemable preferred stock as liability rather than equity.

This study aims to give understanding how to account for preference shares in the financial statements.

Basic Content of the Paper

Preference (preferred) shares are often issued as a means of raising capital, without giving up ownership and without diluting the voting power of the ordinary shareholders. In exchange for a higher income and relative safety, preference stock is not entitled to share the profit of the business. Being compared to common shares it is a cheaper way for companies to raise money, and missing dividends will not force the firm into bankruptcy unlike missing interest payments. Comparing with debt they are much more expensive way of financing because of lack of tax shield from interest since bond interest payments are tax deductible.

Preference share is a hybrid asset meaning that it shares features of both equity and debt. Similar to bonds, preference stock generally pay its holders a fixed amount of interest, in the form of dividends, and therefore it is related to fixed income securities. However, unlike bonds, the issuer can decide to withhold the dividend without facing bankruptcy [1]. In this order,

preference shares, unlike debt, does not mature and can be considered as an investment in perpetuity.
Preference stock is similar to common stock in the sense that owning preference stock issued by a company implies owning a share in the company, even if with less or no voting rights. On the other hand, preference stock has a more senior claim on company assets comparing to common stock when it comes to dividend payments and in the event of liquidation of the company, which means all obligations to holders of preference stock must be met before common stock holders get any payments [1]. Overall most debt instruments, including bonds, are senior to preference stocks, meaning they are paid before holders of preference stock are paid. Furthermore, dividends to preference stockholders are not since they are paid after tax.
Companies issue many different types of preferenced stock all at once. These may include adjustable-rate preferred stock, convertible preferred stock, first preferred stock, participating preferred stock, participating convertible preferred stock, prior preferred stock, and second preferred stock. Preferred stock may also be redeemable, meaning that they can be purchased back by the issuer at par value at a specific date. On dividends paid, preferred stock can be cumulative or non-cumulative. In contrast to debt, the company can decide to withhold dividends. In the case of an unpaid dividend, for cumulative preferred stock, all previous unpaid dividends must be paid before any dividends are paid to the common shareholders. For non-cumulative preferred stock, unpaid dividends are seen as expired.
Following what was described above can be revealed that preference shares often have preferred rights over the ordinary shares for the purpose to compensate the investors for the limitation of voting power. Such preferential rights, which include fixed dividends and/or redemption rights, as well as preference on liquidation offered may create a contractual obligation to deliver cash. Due to this preference shares to be recognized as a liability in part or in full rather than equity.
In order to determine whether a preference share is related to a financial liability, equity, or a compound instrument containing elements of both, it is necessary to analyse the characteristics of each issue. These refer to:

- Redemption at the option of the holder. If the company is obliged to redeem the shares for cash or another financial asset (i.e. it cannot avoid redeeming the shares), a contractual obligation exists and therefore the instrument includes either a financial liability element or is a financial liability in its entirety. Examples include preference shares with a fixed redemption date and/or those which give the holder the right to demand redemption.
- Obligation to pay dividend (i.e. the extent to which there is a contractual obligation of the issuer of the shares to deliver cash or another financial asset to the holder). If the company is obliged to pay a dividend (i.e. it cannot avoid payment), a contractual obligation exists and therefore the instrument includes either a financial liability element or is a financial liability in its entirety. Examples include preference shares with a fixed (and/or cumulative) coupon and those which require a mandatory distribution of a percentage of the profits of the company.

For a clear differentiation, the classification of preference stock in terms of debt or equity is regulated by the International Financial Reporting Standards (IFRS), specifically in IAS 32 where classification of financial instruments is treated. IAS 32 *Financial Instruments: Presentation* currently sets out how a company that issues financial instruments should distinguish financial liabilities from equity instruments.
The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form, and the definitions of financial liability and equity instrument. Accordingly, the entity must classify the financial instrument when initially recognising it (IAS 32.15) based on the *substance over form* principle. In general, this principle requires issuers to measure and present the economic impact of the financial instrument and to state its commercial purpose—

but it does not oblige them to consider local business laws. This can cause confusion because sometimes local laws call for different classifications than the accounting requirements do.
In classifying as a financial liability or an equity instrument according to the substance of the contract, helps to eliminate any uncertainties when accounting for these financial instruments. The entity must make the decision as to the classification of the instrument at the time that the instrument is initially recognized. The classification is not subsequently changed based on changed circumstances. For example, a preference share that is redeemable only at the holder's request may be accounted for as debt even though legally it is a share of the issuer. This could be because the substance of the terms and conditions requires the issuer to deliver cash or another financial asset to settle a contractual obligation.
In determining whether a mandatorily redeemable preference share is a financial liability or an equity instrument, it is necessary to examine the particular contractual rights attached to the instrument's principal and return elements. The critical feature that distinguishes a liability from an equity instrument is the fact that the issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. Such a contractual obligation could be established explicitly or indirectly. However, the obligation must be established through the terms and conditions of the financial instrument.
The distinction between financial liabilities and equity is important because the classification of the instruments affects how a company's financial position and performance are depicted. The classification of a financial instrument by the issuer as either debt or equity can have a significant impact on the reported earnings, reported profit and loss, entity's debt-to-equity ratio, leverage ratio and debt restriction. Equity classification can avoid such impact but may be perceived negatively if it is seen as diluting existing equity interests. The distinction between debt and equity is also relevant where an entity issues financial instruments to raise funds. Liability classification normally results in any payments being treated as interest and charged to earnings, which may affect the entity's ability to pay dividends on its equity shares.
According to IAS 32, a financial instrument is a financial liability only if (a) the instrument includes a contractual obligation to deliver cash or another financial asset to another entity or (b) a contract that will or may be settled in the entity's own equity instruments. Also, if the entity has a contractual obligation to exchange financial asset or financial liability that are potential unfavorable to the entity, then the instrument is treated as liability [2]. So, an issuer of an equity instrument does not have an unconditional obligation to deliver cash or other financial instrument or if it has, it is a fixed amount for fixed number of equity instruments. This part of the classification separates the cash flows from issuer to owner and the nature of this obligation. The most important factor in classification is the outflows from the issuer being voluntary. If it is possible for the issuer to not only defer dividends but not to pay them at all is the important factor in classifying an asset as equity. The second important part in classification is the way the asset matures, stated next: "if entity issues (preferred) shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and therefore, should be recognized as a liability" [IAS 32.18(a)]. In contrast, preference shares that do not have a fixed maturity, and where the issuer does not have a contractual obligation to make any payment are equity. In this example even though both instruments are legally termed preference shares they have different contractual terms and one is a financial liability while the other is equity.
Although the preference share is non-redeemable, the issuer has an obligation to pay dividends and cumulative dividends. When preference shares are non-redeemable it is harder to categorize them from their initial application. It's generally understood that, as soon as the issuer is obliged to settle the instrument in cash on liquidation, it can be classified as financial liability. So, irredeemable fixed-rate cumulative preference shares would be classified as a financial liability. This is because the amount is independent of an entity's available economic

resources – i.e. an issuer is not required to pay the principal and dividend before liquidation but the fixed-rate dividends accumulate over time. The result of this is that preferred stock with a contractual maturity date is classified as debt.
Challenges in classifying these instruments can result in diverse accounting in practice, which in turn makes it difficult for investors to assess and compare companies' financial position and performance. Various challenges have arisen from the application of IAS 32 to a growing number of financial instruments that combine various features, including different features of both simple bonds and ordinary shares—financial instruments with characteristics of equity. Users of financial statements who wish to understand the consequences of these financial instruments on an entity's financial position and financial performance have raised questions about their classification. Users have also expressed concerns about the limited information provided through presentation and disclosure about various features of these instruments. Furthermore, entities have encountered challenges when applying IAS 32 to particular financial instruments with characteristics of equity [3]. These challenges have been brought to the attention of the International Accounting Standards Board (Board) through responses to various consultations and through the IFRS Interpretations Committee (Committee). In June 2018, the Board issued a Discussion Paper DP/2018/1 *Financial Instruments with Characteristics of Equity.* This was issued to allow the Board to investigate challenges that have been encountered when IAS 32 has been applied in practice. According to the Board's preferred approach, there would be some changes to the classification outcomes compared to applying IAS 32 [3]. Thus, financial instruments with obligations for fixed cumulative returns, such as cumulative perpetual preference shares, would be classified as financial liabilities. Applying IAS 32, some of these obligations for which an entity has an unconditional right to defer cash payment indefinitely are classified as equity instruments.
Applying the Board's preferred approach, an entity would classify as financial liabilities claims such as callable preference shares with a step-up dividend clause and cumulative preference shares without considering whether the entity is obliged to transfer economic resources. That is, because the Board's preferred approach also considers how the amount of the obligation is determined, it would classify as financial liabilities financial instruments that contain an obligation for an amount independent of the entity's available economic resources but allow the entity to defer payment indefinitely. For such claims, the amount of the payment is known, even though the timing of the payment is unknown.
Also, Board's preferred approach refer to the requirement in IAS 32 that the issuer of a non-derivative financial instrument evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component (compound instruments).
Sometimes, a financial instrument specifies a fixed amount that is required to be paid at liquidation, for example in the case of some non-cumulative preference shares. That fixed amount payable at liquidation is independent of the entity's available economic resources and therefore meets the definition of a liability.
Another situation is with amounts that are not independent of the entity's available economic of resources. Assume that an irredeemable non-cumulative preference share with a stated coupon or dividend amount that is a specified rate of return or a specified amount of cash, but the coupon or dividend amount is cancelled if the coupon is not paid by the entity. Because the entity has the unconditional right to avoid paying coupons or dividends, this stream of cash flows is not considered to be independent of the available economic resources. The irredeemable non-cumulative preference share may also require a fixed amount to be paid at liquidation, for example in the form of a principal amount [3]. If so, such instruments are compound instruments.
IAS 32 classifies irredeemable fixed-rate cumulative preference shares as equity instruments because there is no contractual obligation to transfer cash or another financial asset or to deliver

a variable number of shares at a specified time other than at liquidation. In contrast, the Board's preferred approach would classify such cumulative preference shares as financial liabilities because the entity has an obligation for an amount independent of the entity's available economic resources. This is because the fixed-rate dividends accumulate over time and changes in the entity's available economic resources will not result in changes in the amount of the obligation for the cumulative preference shares, even though the entity is only required to transfer economic resources at liquidation [3].

Information about the irredeemable fixed-rate cumulative preference shares is relevant for assessments of balance-sheet solvency and returns. The Board's preferred approach provide information that is useful to those assessments by consistently classifying these instruments as financial liabilities.

Conclusions

This article debates the dilemma tied to the classification of preferred stock. Issues and expected changes in the preferred shares classification were discussed. Firstly, one must examine the details of the contract deeply before deciding on the classification of a financial instrument, since even a tiny detail could cause a change of direction. If the criteria, discussed above, are fulfilled then a preferred stock will be classified as equity or financial liability. Also should not be neglected the principle of substance being very important in regards to classifying assets in particular and accounting in general. This study put in attention the fact that financial innovation and changes in bank capital regulations have generated a wide range of financial instruments that combine various features. This intensifies the need for awareness in order to classify financial assets, especially those that combine features, including features of both simple bonds and ordinary shares (financial instruments with characteristics of equity). The accounting treatment in the financial statements depends on the terms and rights attached to the shares. Regulators as well as preparers of financial statements need to consider more aspects, especially related to hybrid securities in order to accurately account them.

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