Preferred Stock: Liability or Equity?

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Abstract

Accounting for financial instruments has been the most controversial area in the development of the IASB’s standards. The FASB and the IASB are currently working together towards a comprehensive standard of accounting for financial instruments with characteristics of equity, liability, or both. The main problem is how to distinguish liabilities from equity. According to the FASB, a new standard is necessary because current accounting literature addressing this issue is inconsistent, subject to structuring and difficult to understand and apply.

This paper examines the current situation in classifying preferred stocks. A detailed comparison of common and preferred stocks, and debt securities and preferred stocks is then presented. Three theories of equity (proprietary theory, entity theory and residual equity theory) are described and compared, and the legal and economics approach to determining the difference between liabilities and equity are discussed. Finally, the IASB rules set up in IAS 32 and the Estonian rules set up in Commercial Code and accounting guideline RTJ 3 are discussed.

Journal of Economic Literature Classification numbers: K22, M41

Keywords: IAS 32, financial instrument, equity instrument, liability, preferred stock, preference share(s).

Introduction: Preferred Stocks and Preference Shares

Terminology is essential, especially in understanding a technical subject. In the intensely commercial world in which we live many people find a need for a good understanding of the terminology of Accounting and Finance. An analysis of accounting and finance literature shows that there are some differences between American and British terminology. Some terms can have more than one meaning depending on the context. There may be even as many meanings as there are areas of specialty. ‘Stock’ and ‘shares’ are examples of this. The most usual meanings of the UK terms ‘stock’ and ‘shares’ are translated in the US terms as ‘inventory’ and ‘stock’, respectively. It would be unwise therefore to try to discuss with an American the use of FIFO for stock valuation. In this paper the American term ‘stock’ is considered the equivalent of ‘share(s)’ used by both, the British and Americans.
In general, it is recognised that preferred shares are somewhat hybrid securities – a cross between liability and equity instrument. The American authors have defined preferred stock as

- a class of capital stock that pays dividends at a specified rate and that has preference over common stock in the payment of dividends and the liquidation of assets. Preferred stock does not ordinarily carry voting rights (Downes and Goodman 2007).
- a part of the capital stock of a corporation that enjoys priority over the remaining stock, or common stock, in the distribution of dividends and in the event of dissolution of the corporation, also in the distribution of assets (Crumbley, Friedman, Anders 1994; Friedman 2007).
- a share in the ownership of a corporation having certain designated rights that rank it ahead of common stock. The most common rights associated with preferred stock are the right to receive dividends before common stockholders and the right to receive a portion of liquidation proceeds before common stockholders (Caruth and Stovall 1994).
- kind of equity whose owners are given certain privileges over common stockholders, such as a prior claim on the assets of the firm. Preferred stockholders usually have no voting rights and are paid a fixed dividend (Groppelli and Nikbakht 2006).
- a stock, taking precedence over other stock of the same corporation in regard to dividend liquidation distribution and usually carrying no voting rights, except in cases where the preferred stock category has been created to attract new capital to a floundering corporation (Bonham 2001).
- a stock which entitles the holder to preferential rights to the dividend over other stockholders or to the assets in a liquidation (Wanjialin 2004).
- corporate stock whose owners have some preference as to assets, earnings, and so on, not granted to the owners of common stock of the same corporation (Rosenberg 1986).
- a class of capital stock that has preference over common stock in the event of corporate liquidation and in the distribution of earnings. Except in unusual instances, no voting rights exist (Siegel and Shim 2005).
- a stock that pays a fixed dividend and has claim to assets of a corporation ahead of common stockholders in the event of liquidation (Fitch 2006).
- stock shares that represent a portion of ownership in a company, with the shares normally carrying fixed dividends and voting rights (Shook and Shook 1990).
- security that pays a fixed dividend and in the event of bankruptcy is senior to the claims of common stock on the earnings and assets of a company (Faerber 2006).

Conclusion: There are some differences in wordings but in general the authors agree that preferred stock is a share in the ownership (or part of the capital stock), having certain privileges (designated rights) that rank it ahead of common stock. These privileges include the right to receive dividends at a specified rate before common shareholders and the right to receive a portion of liquidation proceeds before common shareholders. Except in unusual instances, preferred shareholders have no voting rights.

The British authors have defined preference share(s) as

- shares normally having preference over ordinary shares for dividend payments and for the return of capital if a company is wound up, i.e. ordinary dividends cannot be paid in a particular year until the preference dividend, which is usually a fixed percentage, has been paid (Nobes 2001).
shares in a company that give their holders an entitlement to a dividend but which do not usually carry voting rights. In the event of a winding up, preference shares are usually repayable at par value, and rank above the claims of ordinary shareholders (Briscoe 2007).

a share in a company yielding a fixed rate of interest rather than a variable dividend. The rights of preference shareholders vary from company to company and are set out in the articles of association. Voting rights are normally restricted often only being available if the dividend payments are in arrears (The Oxford Dictionary … 1993).

shares that entitle the owner to preference in the distribution of dividends and the proceeds of liquidation in the event of bankruptcy (Chartered Management …2003).

shares, often with no voting rights, which receive their dividend before all other shares and are repaid first at face value if the company goes into liquidation (Collin 2004).

Conclusion: There are some differences in wordings but in general the authors agree that preference shares (or preferred stock according to US terminology) are shares having preference over ordinary shares (or common stock according to US terminology) including preference in the distribution of dividends and the liquidation of assets. Voting rights of preference shareholders are normally restricted. It is important to note that in American usage, the term ‘preference share(s)’ has a different meaning and refers to pre-preferred stock.

So American and British viewpoints are very close. The main differences arise from different terminology.

1. Comparison of Common Stock and Preferred Stock

It is recognised that preferred shares are somewhat hybrid securities – a cross between equity and debt. The comparison of some characteristics of common shares and preferred shares is presented in Table 1.

Table 1. Comparison of Common (ordinary) Shares and Preferred Shares

<table>
<thead>
<tr>
<th>Similarities and differences</th>
<th>Common (ordinary) shares</th>
<th>Preferred shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Similarities</td>
<td>1.1. Common stock dividends are not a contractual obligation which, if unpaid, could precipitate bankruptcy proceedings.</td>
<td>1.1. Preferred stock dividends are not a contractual obligation which, if unpaid, could precipitate bankruptcy proceedings.</td>
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<tr>
<td></td>
<td>1.2. In the event of bankruptcy or other dissolution, common stockholders will be paid after holders of debt securities. The equity of common stockholders is a residual interest.</td>
<td>1.2. In the event of bankruptcy or other dissolution, preferred stockholders will be paid after holders of debt securities. The equity of preferred stockholders is a residual interest subordinate to debt.</td>
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<tr>
<td></td>
<td>1.3. Common dividends are not deductible for tax purposes.</td>
<td>1.3. Preferred dividends are not deductible for tax purposes.</td>
</tr>
</tbody>
</table>
2. Differences

2.1. The common stockholders are the residual owners of the corporation after the preferred stockholders have received their dues.

2.2. Common stockholders have not a stipulated dividend rate.

2.3. Common stock is voting.

2.4. Common stockholders’ dividends depend on payment of dividends to preferred stockholders.

2.5. Common dividends are noncumulative.

2.6. Return on the investment of common stockholders (dividend) is not fixed.

2.7. Common stock is riskier than preferred stock.

2.8. Issuance of common stock dilutes common equity.

2.9. Common stock is more costly to issue than preferred stock.

2.1. In the event of bankruptcy or other dissolution, preferred stockholders will be paid a specific amount (usually at least equal to the par or stated value of their shares) before any distribution is made to common stockholders.

2.2. Preferred stockholders have usually a stipulated dividend rate.

2.3. Preferred stock is usually nonvoting.

2.4. Preferred stockholders have preference over the common shares in the receipt of dividends.

2.5. Preferred dividends are usually cumulative.

2.6. Preferred stockholders receive a fixed or limited return on their investment regardless of profitability. Dividend preference practically ensures a relatively fixed return.

2.7. Preferred stock is less risky than common shares.

2.8. By issuing preferred stock, the firm avoids the dilution of common equity.

2.9. Preferred stock is less costly to issue than common stock.

The comparison of some characteristics of debt securities and preferred stock is presented in Table 2.

Table 2. Comparison of Debt Securities and Preferred Stock

<table>
<thead>
<tr>
<th>Similarities and differences</th>
<th>Debt securities</th>
<th>Preferred stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Similarities</td>
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<tr>
<td>1.1. In the event of bankruptcy or other dissolution, holders of debt securities will be paid before any distribution is made to common (= ordinary) stockholders.</td>
<td>1.1. In the event of bankruptcy or other dissolution, preferred stockholders will be paid before any distribution is made to common stockholders.</td>
<td>1.1. In the event of bankruptcy or other dissolution, preferred stockholders will be paid before any distribution is made to common stockholders.</td>
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<tr>
<td>1.2. Debt securities are nonvoting.</td>
<td>1.2. Preferred stock is usually nonvoting.</td>
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<tr>
<td>1.3. Holders of debt securities have no direct control over the affairs of the company.</td>
<td>1.3. Preferred stockholders have no direct control over the affairs of the company.</td>
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<tr>
<td>1.4. Holders of debt securities continue receiving income (interest) during hard times.</td>
<td>1.4. Dividend preference practically ensures a relatively fixed return for preferred stockholders.</td>
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<tr>
<td>1.5. Debt securities have a specified interest rate.</td>
<td>1.5. Preferred shares have usually a specified rate per share, just as debt securities’ interest rate. Specified dividend rate and dividend preference actually assure a relatively fixed return.</td>
<td></td>
</tr>
<tr>
<td>1.6. Debt security offers the lower yield of a preferred share.</td>
<td>1.6. Preferred share can offer the higher yield of a debt security.</td>
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</tbody>
</table>

### 2. Differences

<table>
<thead>
<tr>
<th>2.1. Holders of debt securities have a legally enforceable claim against an issuer who defaults on an interest payment.</th>
<th>2.1. Unlike interest expense, preferred stock dividends are not a contractual obligation which, if unpaid, could precipitate bankruptcy proceedings.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.2. Holders of debt securities receive only interest and principal repayment.</td>
<td>2.2. Preferred stockholders receive a fixed or limited return on their investment regardless of profitability.</td>
</tr>
<tr>
<td>2.3. Interests are tax deductible (paid from earnings before taxes).</td>
<td>2.3. Preferred dividends are not deductible for tax purposes.</td>
</tr>
<tr>
<td>2.4. In the event of bankruptcy or other dissolution, holders of debt securities will be paid before any distribution is made to preferred stockholders.</td>
<td>2.4. In the event of bankruptcy or other dissolution, preferred stockholders will be paid after holders of debt securities. The equity of preferred stockholders is a residual interest subordinate to debt.</td>
</tr>
<tr>
<td>2.5. Debt securities are less risky than preferred shares.</td>
<td>2.5. Preferred shares are riskier than debt securities. Investors require a higher return on preferred stock than with the purchase of debt securities.</td>
</tr>
<tr>
<td>2.6. Debt securities are less costly to issue than preferred stock.</td>
<td>2.6. Preferred stock is more costly to issue than debt securities.</td>
</tr>
</tbody>
</table>

According to the Estonian accounting guideline RTJ 3 preferred stocks should be classified as debts. As it will be shown later, the main reason seems to be a simplified treatment of IAS 32 and paragraph 238 of the Estonian Commercial Code.

To take a position it is necessary to turn to the theory.

### 2. Theories of Equity

Theories of equity postulate how the balance sheet elements are related and have implications for the definitions of both liabilities and equity. The two prominent theories of equity – *proprietary theory* and *entity theory* – are well-known and imply unique relationships between assets, liabilities and equity. The *residual equity theory*, which is a concept somewhere between the proprietary theory and the entity theory and
2.1. Proprietary Theory

This theory dates back at least as far as the early eighteenth century. The proprietary view of accounting was developed at a time when business firms were small and were mainly sole proprietorships and partnerships.

Under the proprietary theory, financial reporting is based on the premise that the owner is the primary focus of the financial statements. The proprietary theory views the net assets of the firm as belonging to the firm’s owners, the liabilities are their obligations, and ownership equities accrue to the owners. Under this theory, equity is equal to the net worth of the owners. The proprietary theory relationship is articulated as

\[
\text{Assets} - \text{Liabilities} = \text{Equities}
\]

According to IASB Framework’s definition, equity is the residual interest in the assets of the entity after deducting all its liabilities. Therefore, owners’ equity is not an obligation to transfer assets, but a residual claim. This definition is clearly related to the proprietary theory relationship.

The proprietary theory assumes that the owners and the firm are virtually identical – the firm is considered to be the owner’s equity investment or net assets. The primary objective of the proprietary theory is the determination and analysis of the proprietor’s net worth. The proprietary theory is balance sheet oriented. Assets are valued and balance sheets are prepared to measure the changes in the proprietary interest or wealth.

To a large extent, the present accounting practice is based on the proprietary theory. There are significant accounting policies that can be justified only through acceptance of the proprietary theory. For example, the calculation and presentation of earnings per share figures are relevant only if we assume that those earnings belong to the stockholders prior to the declaration of dividends.

The comprehensive income concept adopted by the FASB and IASB is based on the proprietary theory. The equity method for accounting for nonconsolidated investments in subsidiaries also implies a proprietary concept. The parent’s proportionate share of each year’s profit is added to the investment account on the theory that the profit of the subsidiary accrues to the stockholders, including the parent corporation as the major stockholder. The parent company is seen as ‘owning’ the subsidiary. Minority interest, from the point of view of the ‘owner’ of the subsidiary, represents the claim of a group of outsiders. Although minority interest does not fit into the FASB’s as well as IASB’s definition of a liability, under the parent company theory there is no choice but to consider it a liability on the balance sheet.

According to the proprietary theory, the entity is the “agent, representative or management through which the individual entrepreneurs or shareholders operate.” (Belkaoui 2004). The proprietary theory sees the corporation simply as an instrument of the owners rather than an entity separate from the stockholders.

Although the proprietary theory is generally viewed as primarily adaptable to proprietorships and partnerships, the influence of the proprietary theory may be found in some of the accounting techniques and terminology used by widely-held corporations. For example, the corporate concept of profit, which is arrived at after treating interest and income taxes as expenses, represents net profit to the stockholders rather than to all providers of capital. Similarly, terms such as ‘earnings per share’, ‘book value per
share’ and ‘dividend per share’ connote a proprietary emphasis. Dividends paid are considered a distribution of earnings, and interest on debt and income taxes are considered expenses because the owner’s viewpoint (proprietary concept) is taken. For a sole proprietorship and partnership, salaries paid to owners who work in the business are not considered an expense, because the owner and the firm are the same entity, and one cannot pay oneself and deduct that as an expense.

The proprietary theory can assume at least two forms, which differ on the basis of who is included in the proprietary group. In the first form (it could be economics approach) only the common stockholders are part of the proprietary group and preferred stockholders are excluded. This narrow form of the proprietary theory is identical to the residual equity concept. In the second form of the proprietary theory (it could be legal approach), both common stock and preferred stock are included in the proprietor’s equity. This wider view of the theory focuses attention on the stockholders’ equity section of the balance sheet and the amount to be credited to all stockholders on the income statement.

Conclusion: According to the proprietary theory, the position of preferred stockholders remains debatable.

2.2. The Entity Theory

Dissatisfaction with the orientation of the proprietary theory led to the development of the entity theory. The theory has been developed by Paton (Paton 1922). Under the entity theory, the firm and its owners are separate beings. Net worth of the proprietor is not a meaningful concept, because the entity is the centre of attention. The entity theory depicts the accounting equation as

\[ \text{Assets} = \text{Equities (including liabilities)} \]

The entity theory views the entity as something separate and distinct from those who provide capital to the entity. The essence of the entity theory is that creditors as well as stockholders contribute resources to the firm, and the firm exists as a separate and distinct entity apart from these groups. The entity view of the firm focuses on the firm’s assets. Who provided those assets (whether creditors or stockholders) is of secondary importance. The assets belong to the firm itself; both liability and equity holders are investors in those assets with different rights and claims against them. According to the entity theory, there is no fundamental difference between liabilities and owners’ equity. Both provide capital to the business entity and receive income in return in the form of interest and dividends. Under entity theory, liabilities and equity would require separate line disclosure in the balance sheet, but there would be no subtotals for total liabilities or total equity, and no need for separate or distinct definitions for each. Under this theory, all the items on the right-hand side of the balance sheet, except retained earnings that belong to the firm, are viewed as claims against the assets of the firm, and individual items are distinguished by the nature of their claims. Some items are identified as creditor claims and others as owner claims; nevertheless, they are claims against the firm as a separate entity. Thus under the entity theory debt-to-equity ratios would not provide relevant information for investor decision making.

Under the orthodox entity theory there is a dual nature to both the owners’ equity accounts and the question of the primary claim to income. Stockholders have rights relative to receiving dividends when declared, voting at the annual corporate meeting, and sharing in net assets after all other claims have been satisfied. Income does not belong to capital providers until both interest and dividends are declared or interest
becomes due. In measuring income, both interest and dividends represent distributions of income to providers of capital. Hence, both are treated the same way and neither is a deduction from income.

The increase in the stockholders’ equity is considered income to the stockholders only if a dividend is declared.

Belkaoui (Belkaoui 2004) expresses that the entity theory is most applicable to the corporate form of business enterprise, which is separate and distinct from its owners. The impact of the entity theory may be found in some of the accounting techniques of terminology used in practice. For example, the entity theory favours the adoption of LIFO rather than FIFO inventory valuation because LIFO valuation achieves a better income determination, due to its application under the proprietary theory. Salaries to corporate employees who are also stockholders are considered an expense. The use of profit and cost centres for internal purposes is premised on the entity concept.

For the entity theory, emphasis is on the determination of profit, and therefore the income statement is more relevant than the balance sheet.

Conclusion: According to the entity theory, there is no distinction between debts and preferred equity as well as common equity and preferred equity.

2.3. Residual Equity Theory

The development of the residual equity approach has been relatively recent. The residual equity theory or investor theory has been developed by Staubus (Staubus 1959, 1961), but its roots also lie in the work of Paton (Paton 1922). Based on the accounting objective of providing information to suppliers of capital, Staubus argues that accounting functions and financial statements should take the point of view of investors. Investors are stockholders and creditors. The residual equity holders are that group of equity claimants whose rights are superseded by all other claimants. This group would be common stockholders, though its members can change if an event such as reorganization occurs.

The accounting equation under this approach would be

\[ \text{Assets} - \text{Specific Equities} = \text{Residual Equity} \]

According to residual equity theory, specific equities are the liabilities and preferred stock. So, the residual equity theory is identical to the narrow form of proprietary theory.

Although the assets are still owned by the firm, they are held in a trust type of arrangement and the management’s objective is maximization of the value of the residual equity. Income (= profit) accrues to the residual equity holders after all other claims have been met. Interest and preferred dividends (but not common dividends) would be deductions in arriving at profit available to common stockholders. Staubus’ theory sees stockholders as investors with little power to determine what is happening in the company, and therefore, must rely on financial statements.

The finance literature has found that preferred stockholders’ claims are viewed as debt, that is, however, subordinate to ‘pure’ debt holders. The residual concept has a different meaning in the context of the earnings per share computations; however, it can be considered an extension of the residual equity theory. A good example of this is the calculation and current financial statement presentation of basic earnings per share: the net profit available for common stockholders (i.e. after deduction of preferred dividends) is divided by the weighted average number of common shares outstanding during the accounting period. This is consistent with the residual equity theory.
Common stockholders are generally thought to have a residual equity in the income of the firm and in the net assets upon final liquidation. In certain cases where losses have been large or in bankruptcy proceedings, the equity of the common stockholders may disappear and the preferred stockholders or even the bond holders may become the residual equity holders. To emphasise this possibility some authors express the accounting equation as

\[ \text{Assets} = \text{Specific Equities} + \text{Residual Equity} \]

On 30 November 2007, the FASB issued for public comment a Preliminary Views document on how to distinguish liabilities from equity. This document is heavily expressing residual equity theory\(^1\). According to the basic ownership approach, which is preferred by the FASB (the others are the ownership-settlement approach and the reassessed expected outcomes approach); only the lowest-level residual interests in an entity qualify for equity classification. Preferred stocks and other perpetual instruments (other than those that qualify as basic ownership interests) should be classified as liabilities.

**Conclusion:** According to the residual equity theory, preferred stockholders are in principal equal to debt holders.

### 3. Legal Approach and Economics Approach

The distinction between equity and debts (liabilities) has already been discussed in connection with the alternative theories of equity. However, within the prevailing proprietary theory there are two rather different approaches to drawing the line between equity and liabilities: the legal approach and economics approach. Both approaches are consistent with the IASB’s Framework definition of equity, in paragraph 49 (c) as ‘the residual interest in the assets of the entity after deducting all its liabilities’. In economics, the owners of the equity of a firm are the persons entitled to enjoy the profits. Hence in economics, the suppliers of finance to the firm are divided between

- the suppliers of debt whose claims are stated at a fixed amount of money, irrespective of whether or not the firm makes profit;
- the equity which is entitled to receive the surplus after these prior claims have been settled.

With the economics approach equity is considered to be the residual interest in the assets and the income of the enterprise after all prior claims have been satisfied. The fundamental difference between the economics approach and the legal approach is that in assessing the stockholders’ equity, the economics approach deducts, in addition to the legal obligations, certain future claims on the assets of the corporation that are not legal obligations.

In many cases, the legal approach and the economics approach yield the same answer. This is notably the case of a corporation where the equity consists entirely of ordinary shares and the liabilities consist entirely of debts. However, there are a number of items that do not fit neatly into the straightforward debt and equity dichotomy. This is illustrated by the matrix\(^2\) presented in Table 3:

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1. Some authors (Cheng 2007) mistakenly express that it corresponds with proprietorship approach.
2. The basic matrix is taken from [Flower 2002] and is modified by the author of this paper.
### Table 3. The Legal Approach versus Economics Approach

<table>
<thead>
<tr>
<th>Legal Approach</th>
<th>Economics Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Not residual interest</td>
</tr>
<tr>
<td>Legal obligation</td>
<td>A: Debts.</td>
</tr>
<tr>
<td>Borderline case</td>
<td>D: Compulsorily redeemable preferred shares.</td>
</tr>
</tbody>
</table>

The rows represent the legal approach, with a division between a legal obligation and no legal obligation, with borderline cases in the middle. The columns represent the economics approach, with columns for the residual interest, the non-residual interest and borderline cases in the middle. The various combinations are represented by the cells of the matrix, which are identified by the letters A to I. The most straightforward cases are cells A and I, where the legal approach and the economics approach yield the same logical answer: debts are a legal obligation and are not part of the residual interest; the common shares are the residual interest and not a legal obligation. However, the remaining cells of the matrix present examples of cases where either the legal approach and the economics approach yield the same logical answer or the answer is ambiguous, being a borderline case. They refer to two types of financing instruments that pose particular problems in drawing the line between equity and liabilities: preferred shares and convertible debt.

**Conclusion:** In economic terms, preferred stock is not part of the residual interest and therefore not equity. As long as the corporation pays the preferred dividend, preferred stock is, in economic terms, akin to debt, but, if the corporation falls behind in the dividend payments, the preferred stock becomes more like equity. From a legal standpoint, preferred stock is clearly equity: in liquidation, preferred stock ranks junior to debt, it pays dividend rather than interest, and failure to pay the dividend does not constitute a default. It should be especially emphasised that according to the legal approach, preferred stock is not a liability since the preferred stockholders may not sue the corporation for non-payment of dividends.

### 4. The IASB’s Rules for Preferred Stock

Often when a company is financially weak, it is forced to offer preferred stock to induce investors to risk their money. Such preferred stock can be entitled to specific dividends and can also have other conditions such as redemption dates like those given to bonds, as well as certain conversion privileges. According to the IASB Framework for the Preparation and Presentation of Financial Statements in assessing whether an item meets the definition of a liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form (Framework … F51). IAS 32 sets out the definitions of financial instruments, financial assets and financial liabilities, distinguishes between financial liabilities and equity instruments. It is necessary to express that IAS 32 is very prescriptive in the area of distinguishing between financial liabilities and equity instruments. Alfredson et al. (Alfredson, Leo et
al. 2007, p. 202) note that this area, commonly known as the debt versus equity distinction, is of great concern to many reporting entities because instruments classified as liabilities rather than equity affect

- an entity’s leverage and solvency ratios;
- debt covenants with financial institutions;
- whether periodic payments on these instruments are treated as interest or dividends;
- regulatory requirements for capital adequacy (banks and other financial institutions are required by their regulators to maintain a certain level of capital, which is calculated by reference to assets and equity).

IAS 32 deals with the classification of preferred shares and convertible debt in the following terms:

Paragraph 11. A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Paragraph 11. A financial liability is any liability that is:

(a) a contractual obligation:
   (i) to deliver cash or another financial asset to another entity; or
   (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity’s own equity instruments and is:
   (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity’s own equity instruments; or
   (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity’s own equity instruments. For this purpose the entity’s own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity’s own equity instruments.

It is necessary to express that part (b) of the definition was added in amendments made to IAS 39 in 2003 and 2004. The amendments were made in response to issues arising from the classification of certain complex financial instruments as liabilities or equity.

An equity instrument is defined in IAS 32, paragraph 11 and IFRS 2, Appendix A: An equity instrument is a contract that evidences residual interest in the assets of an entity after deducting all of its liabilities.

IAS 32, paragraph 15, states that the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, financial asset and an equity instrument.

IAS 32, paragraph 16 repeats and clarifies the definition of a financial liability. It states that an instrument shall be classified as an equity instrument if, and only if, both conditions (a) and (b) below are met:

(a) The instrument includes no contractual obligation:
   (i) to deliver cash or another financial asset to another entity; or
   (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

(b) If the instrument will or may be settled in the issuer’s own equity instruments, it is:
   (i) a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
(ii) a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Part (a) is referring to the definition of financial liability. The rules in part (b) are trying to establish who bears equity risk in complex transactions where an entity issues a financial instrument that will or may be settled in its own shares. The concept of equity risk is useful for determining whether an instrument is equity or liability. For example, Mobius (Mobius 2007, p. 72) expressed that many kinds of preferred stock assure their owners of a steady stream of predetermined dividends that are not related to company performance. In these cases the stock begins to look like a bond because of the steady income. The revenue from preferred stock with assured dividends is, however, more risky than bonds, because a company can decide not to pay the dividend without incurring the legal liabilities inherent in defaulting on payment of a bond coupon.

Paragraph 18 of IAS 32 expresses that the substance of a financial instrument rather than its legal form, governs its classification in the issuer’s balance sheet. Preferred stock may be issued with various rights. According to IAS 32.AG25, in determining whether a preferred stock is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the stock to determine whether it exhibits the fundamental characteristic of a financial liability. Epstein and Mirza express that when combined with a cumulative dividend preference, the compulsory redemption feature causes the preferred stock to have the characteristics of debt, especially when the stock is to be redeemed in five to ten years (Epstein and Mirza 2006). The dividend payments represent interest and redemption is the repayment of principal (Epstein and Mirza 2006). According to IAS 32.AG25, a preferred stock that provides for redemption on a specific date or at the option of the holder contains a financial liability because the issuer has an obligation to transfer financial assets to the holder of the stock. The potential inability of an issuer to satisfy an obligation to redeem a preferred stock when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation. So when a preferred stock provides for compulsory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the share at or after a particular date for a fixed or determinable amount, the instrument meets the definition of a financial liability and is classified as such. A preferred stock that does establish such a contractual obligation explicitly may establish it indirectly through its terms and conditions. For example, a preferred stock that does not provide for compulsory redemption or redemption at the option of the holder may have a contractually provided accelerating dividend such that, within the foreseeable future, the dividend yield is scheduled to be so high that the issuer has little, if any, discretion to avoid redeeming the instrument. Similarly, if a financial instrument labelled as a share gives the holder an option to require redemption upon the occurrence of a future event that is highly likely to occur, classification as a financial liability on initial recognition reflects the substance of the instrument.

According to IAS 32.AG25, an option of the issuer to redeem the stock for cash does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. In this case, redemption of the stock is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the stock exercises its option, usually by formally notifying the stockholders of an intention to redeem the shares.

When preferred shares are non-redeemable, according to IAS 32.AG26 the appropriate classification is determined by the other rights that attach to them.
Classification is based on an assessment of the contractual agreements and the definitions of a financial liability and an equity instrument. When distributions to holders of the preferred shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments. The classification of a preferred stock as an equity instrument or a financial liability is not affected by, for example:
(a) history of making distributions;
(b) an intention to make distributions in the future;
(c) a possible negative impact on the price of ordinary shares of the issuer if distributions are not made (because of restrictions on paying dividends on the ordinary shares if dividends are not paid on the preference shares);
(d) the amount of the issuer’s reserves;
(e) an issuer’s expectation of a profit or loss for a period; or
(f) an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Conclusion: The reference to ‘substance’ rather than ‘legal form’ gives the impression that the IASB adopts the economics approach. However, this is misleading. The IASB’s treatment of preferred shares is not completely logical, clear and consistent. A normal (unredeemable) preferred stock is not classified a liability because the future obligation to pay dividends is not certain, even though in most cases it is highly probable. A redeemable preferred stock where the stockholder holds an option to redeem is classified as liability even though it is not certain that it will be redeemed for cash or a financial asset. And this also applies where the entity holds the option where circumstances are such that it is highly probable that the entity will exercise the option. IASB’s classification criterion excludes compulsorily redeemable preferred stock from the owner’s equity section of the balance sheet. However, this classification may not capture the real economic characteristics of these securities – for example, if a company has issued compulsorily redeemable preferred shares that are convertible into common stock. It is possible that preferred shares with this convertibility feature may never be redeemed by the company – and thus their IASB status as non-equity may be arguable.

5. The Estonian Rules for Preferred Stock

In Estonia the rights of preferred stockholders are provided in Commercial Code. Article 238 of the Commercial Code enacts: ‘If the public limited company does not have distributable profit or if it is insufficient, the dividends to preferred stockholders may be left unpaid in whole or in part. The unpaid part shall be added to the dividend to be paid the following year, including interest in the amount provided by law.’

According to the Estonian accounting guideline RTJ 3 preferred shares shall be classified as debts. As mentioned, the main reason seems to be simplified treatments of IAS 32 and article 238 of the Estonian Commercial Code. The author of this paper believes that the correct approach is expressed in IAS 32.AG26, which states that ‘when preferred shares are non-redeemable, according to AG26 the appropriate classification is determined by the other rights that attach to them. … When distributions to holders of the preferred shares, whether cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments.’ This viewpoint is supported by KPMG (Insights into IFRS … 2006): ‘The terms of certain preference shares provide for the accrual of interest on cumulative discretionary dividends even before such dividends are declared. In other words, interest accrues from that point in time at which the dividend
might have been declared such that if the dividend is declared an amount of interest becomes payable automatically. In our view, the accrual of interest alone does not cause such preference shares to be classified as a liability as long as the dividends remain discretionary, i.e., the entity can avoid the payment of both dividend and interest on unpaid dividends until liquidation of the entity.  

Conclusion: The Estonian case is not anything extraordinary – this is a well-known example of cumulative preferred shares, which according to IAS 32 shall be classified as equity instruments. Until IAS 32 has not been changed, the Estonian accounting guideline RTJ 3 should be brought in line with IAS 32.

References


