



PREFERENCE SHARES – EQUITY OR LIABILITY UNDER FRS 102?

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INTRODUCTION

This helpsheet has been issued by ICAEW's Technical Advisory Service to help members understand how to account for preference shares in the financial statements of both the holder and the issuer under FRS 102.

Members may also wish to refer to the following related helpsheets:

- [Amortised cost calculator](#)
- [Accounting for fixed asset investments under FRS 102](#)

FINANCIAL STATEMENTS OF THE HOLDER

An investment in preference shares is a financial asset (typically presented as a fixed asset investment) and the accounting is determined by Sections 11 and 12 of FRS 102.

An investment in preference shares may be a basic financial instrument (and therefore within the scope of Section 11) or an other financial instrument (and therefore within the scope of Section 12).

Preference shares that ARE the equity of the issuer

Where the preference shares are the equity of the issuer (other than investments in another group entity), and they are publicly traded or the fair value can be measured reliably, the investment should be measured at fair value through profit or loss in line with s11.14(d).

If fair value cannot be established reliably, the investment should be measured at cost less impairment (s11.14(d)). Similarly under s12.8 investments in non-derivative equity instruments of the issuer that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts that will result in the delivery of such instruments, shall be measured at cost less impairment.

For holdings of preference shares that are the equity of another group entity there is an accounting policy choice between:

- cost less impairment;
- fair value through other comprehensive income **or**;
- fair value through profit or loss.

The accounting policy choice would be applied to all investments in a single class.

Preference shares that are NOT the equity of the issuer

Where the preference shares are not equity of the issuer, and the terms meet the conditions of a basic financial instrument under s11.9, the investment should be measured at amortised cost.

Preference shares that don't meet the conditions of a basic financial instrument should be measured at fair value through profit or loss, except as above or where this is prohibited under the Small Company Regulations. Hedging instruments should be accounted for in accordance with s11.23 or s11.24.

FINANCIAL STATEMENTS OF THE ISSUER

The accounting treatment in the financial statements of the issuer depends on the terms and rights attached to the shares.

Classification

Preference shares are often issued as a means of raising capital, without diluting the voting power of the ordinary shareholders. To compensate for the loss of voting power, the shares will often have preferred rights over the ordinary shares, such as fixed dividends and/or redemption rights, as well as preference on liquidation. Such preferential rights, which may create a contractual obligation to deliver cash, can cause shares to be recognised as a liability in part or in full rather than equity. Section 22 of FRS 102 sets out the principles for classifying financial instruments, including preference shares, as financial liabilities or equity.

The terms 'equity' and 'financial liability' are defined in full in the Glossary to FRS 102. In brief, a financial liability is a contractual obligation to deliver cash or another financial asset to another entity, or a contract that will or may be settled in the entity's own equity instruments that meets certain conditions as set out in FRS 102 paragraph 22.3. 'Equity' is the residual interest in the assets of an entity after deducting all of its liabilities.

FRS 102 paragraph 22.5(e) states that 'a preference share that provides for mandatory 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 instrument at or after a particular date for a fixed or determinable amount, is a financial liability.'

The terms of a preference share may also be set such that it contains both equity and liability elements (i.e. a compound instrument). In such cases, it is necessary to identify the liability and equity components and account for each separately.

In order to determine whether a preference share constitutes a financial liability, equity, or a compound instrument, it is necessary to analyse the terms relating to redemption and the payment of dividends (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).

- **Mandatory 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. There is an exception that allows certain puttable instruments, and instruments that contain an obligation to deliver a pro rata share of net assets only on liquidation, to be presented as equity even though they meet the definition of a financial liability. This exception is set out in FRS 102 paragraph 22.4.

- **Mandatory dividend**

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.

Accounting treatment

The requirements for recognition and measurement of preference shares that are equity of the issuer or compound financial instruments are set out in Section 22.

Preference shares that are wholly classified as equity instruments are measured at the fair value of the cash or other resources receivable, net of direct costs of issuing the preference shares, as set out in FRS 102 paragraph 22.8. If payment is deferred and the time value of money is material, the shares must be measured at the present value of the future cash flows.

Preference shares that are wholly classified as financial liabilities are recognised and measured in accordance with Section 11 (if a basic financial instrument) or Section 12 (if an other financial instrument). If basic, initial measurement is at the transaction price, including any transaction costs, and subsequent measurement will generally be at amortised cost using the effective interest method. If other, initial measurement is at fair value (which is usually the transaction price), ignoring transaction costs, and subsequent measurement will be at fair value through profit or loss.

Preference shares with both equity and liability components are initially recognised in accordance with FRS 102 paragraph 22.13. In this situation, the proceeds are allocated between the liability component and the equity component. The amount of the liability component is usually calculated as the present value of the future cash flows, discounted at a market interest rate for a similar liability that does not have the associated equity component. Any residual proceeds are then allocated as the equity component. Transaction costs are allocated between the two components on the basis of their relative fair values. The equity component is not subsequently remeasured (FRS 102 paragraph 22.14). The liability component will be subsequently accounted for in accordance with Section 11 (if basic) or Section 12 (if other), as set out above.

Summary of classification and accounting treatment

The below table assumes that any instruments are issued on an arms-length basis and that all liability components are basic financial instruments.

	Principal	Dividends	Treatment
1	Non-redeemable or redeemable at issuer's discretion	Discretionary	The instrument is an equity instrument as the entity has no obligation to deliver cash or another financial asset. Any dividends are shown as a distribution of profit.
2	Non-redeemable or redeemable at issuer's discretion	Non-discretionary*	The instrument has both equity and liability elements. The liability element is calculated as the present value of the future contractual cash flows, discounted at a market rate of interest for a similar liability that does not have the associated equity component. The interest expense will be calculated using the effective interest method and charged to profit or loss each year. The equity element is calculated as any residual value, i.e. the difference between the proceeds from the issue of the shares less the liability component. The amount calculated as equity would be zero where the dividend represents a market rate of return and the instrument is issued at fair value.
3	Redeemable at a fixed date or at the holder's option	Non-discretionary*	The instrument is a financial liability as the entity cannot avoid the outflow of cash. The instrument is recognised at the transaction price, including any transaction costs. Subsequent measurement is at amortised cost using the effective interest method. The interest expense on the liability element will be calculated using the effective interest method and charged to profit or loss each year.

*Arrears of cumulative preference dividends

Unpaid cumulative preference dividends would accumulate in creditors rather than as part of shareholders' funds. Where the company has insufficient distributable reserves, the company would not have the ability to pay out the dividend under company law; however, FRS 102 still requires the dividend to be accounted for. The unpaid dividend cannot be paid out until there are sufficient accumulated profits available.

EXAMPLE

The following illustration considers the application of FRS 102 to preference shares with both liability and equity components. In this example, the liability component is assumed to meet the definition of a basic financial instrument under Section 11.

Company A issues 2,000 5% £1 cumulative preference shares issued at par. The terms of issue provide that they are redeemable at the option of the issuer and that the dividend will be payable annually on the anniversary of the issue (this situation reflects option 2 in the table above).

Principal

No obligation to redeem, therefore this represents an equity element of the preference share instrument.

Dividend

The terms specify that the dividend will be paid and therefore there is no discretion for the company on payment. This represents a liability element of the preference share instrument.

Presentation

The liability element is the dividend stream discounted at a market rate of interest for a similar liability that does not have the associated equity component. Interest expense will be recorded in profit or loss, calculated using the effective interest rate method.

The equity element, if any, is the remainder, i.e. £2,000 less the liability element. The equity element will be zero where the interest rate on the shares is the market rate of interest for a perpetuity at the date of issue.

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