# Technical Briefing

October 2014

| | |
|---|---|
| **Subject** | Preferred shares: A liability or equity? |
| **Effective date** | Accounting standards currently in effect |
| **Impact** | Preferred shares may be classified as either liabilities or equity under current accounting standards based on the substance of the contract, not its legal form |

Portfolio companies of venture capital funds in the UK may issue preferred shares to the funds or as an incentive to management so that a class of shareholders can receive a return for performance, or if an event does or does not occur, prior to the other shareholders of the portfolio company. Accounting standards (including both IFRS and UK GAAP) require financial instruments to be classified as either liabilities or equity. This paper has been produced to assist the BVCA's members in understanding the implications of current accounting standards on the classification of preferred shares. It sets out illustrative examples for firms to consider when drafting share agreements and additional disclosures that could be included in financial statements to assist users' understanding of the terms attached to preferred shares. In cases where such instruments are being considered, early consultation with the auditors is essential.

**The impact of accounting standards**

Accounting standards establish principles for classifying financial instruments as either liabilities or equity. The classification is based on the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. The impact of this is that issuers of financial instruments must consider the substance of the contract in place rather than its legal form. Therefore, portfolio companies of venture capital funds issuing preferred shares may find that these instruments are classified as debt under accounting standards even though their legal form is that of a share. This can significantly impact the presentation of the balance sheet and the profit and loss account which in turn could have further consequences for a business unless these differences are clearly discussed with all relevant stakeholders, e.g. banks, potential investors, staff etc. Once a classification has been determined, it generally cannot be subsequently changed unless the terms of the financial instrument change; therefore effective communication at the outset is critical.

Under IFRS and UK GAAP, the key principles state that if the return is in any way pre-determined so that the issuer does not have an unconditional right to avoid settling in cash or by delivery of another financial asset and where the settlement is dependent on the occurrence or non-occurrence of an uncertain future event beyond the control of the issuer or holder, the financial instrument must be classified as a liability (unless certain exceptions apply – see further below). This applies even when settlement is made from distributable profits and includes settling in such a way as to create a financial liability.

Equity is defined as the residual interest in the net assets of an entity after deducting all of its liabilities. Technical reference material is set out at the end of this note.

*This update has been prepared by the BVCA Legal & Technical Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this briefing. Specific advice should always be taken in each situation.*

In simple terms, where an entity can control whether or not a settlement is made by way of a return of funds (cash or another financial asset) together with any income thereon, the financial instrument will typically be treated as equity, with all other situations being treated as a liability. When determining how to classify preferred shares, 'settlement' is based on contractual or legal rights as opposed to economic compulsion.

There are exceptions from the key principles of the accounting standards for certain puttable instruments meeting specific criteria and certain obligations arising on liquidation. The accounting standards also cover the treatment of complex arrangements, including compound instruments. These exceptions and complex arrangements are outside of the scope of this Technical Briefing.

For the purposes of this Technical Briefing, the examples assume that the preferred ordinary shares are not held by management as the benefit of such shares could fall to be classified as employee benefits which might change the classification of such financial instruments as a liability under accounting standards. For employee benefits, the most likely eventuality regarding settlement would have to be taken into account and it is this which would drive the classification.

**Illustrative examples**

The following examples show how accounting standards are applied in practice and venture capital firms should consider these when drafting agreements.

***Examples that result in an equity classification***

***Example 1 – preferred shares, fixed cumulative cash dividend, redemption options***

***The terms set out in the following example are included in the BVCA's model documents for early stage venture capital investments (as published in October 2014). However, specific advice should be taken in advance to ensure the equity classification is appropriate.***

A company issues preferred shares which give the holder the right to a fixed cumulative quarterly cash dividend of 8% per annum of the issue price of each preferred share. The company may, with the approval of the board in its sole discretion and before application of any profits to reserve or for any other purpose, pay all, part or none of the dividend in respect of each preferred share. After a specified date, if and to the extent that the company does not declare and pay in full the dividend each quarter, the unpaid amount will carry interest at twice the prescribed rate which will roll up until the actual date of payment which will continue to be at the sole discretion of the Board.

The preferred shares can be redeemed only subject to: (i) certain conditions as set out in the articles of association; and (ii) approval of the board in its sole discretion. On an IPO, share sale or asset sale, which the board would have to approve, an obligation would arise to convert the preferred shares to a variable number of ordinary shares based on the value of the preferred shares (including the arrears in dividend and interest) and the value of the ordinary shares at the time.



*This update has been prepared by the BVCA Legal & Technical Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this briefing. Specific advice should always be taken in each situation.*

In this example, even though there are negative consequences of not paying dividends on the preferred shares as agreed contractually, the company can avoid the obligation to deliver cash. The preferred shares do have redemption provisions but these are not mandatory and are at the sole discretion of the Board and therefore the shares are classified as equity. For the conversion on an IPO or exit, it is in the company's power to decide whether an IPO or an Exit will occur so legally it can avoid any payment, even though again there may be economic reasons for making such payment.

***Example 2 – arrangements including step up clauses***

A company issues preferred shares which give the holder the right to a fixed cumulative cash dividend of 6% per annum of the issue price of each preferred share. The preferred shares have no redemption rights. The company may, with the approval of the board in its sole discretion and before application of any profits to reserve or for any other purpose, pay all, part or none of the dividend in respect of each preferred share.

The terms include a step up clause whereby the dividend rate increases each year by 0.5% if the company does not declare and pay in full the dividend each year. Under this scenario, the potential economic compulsion could become very high, thus incentivising the issuer to act so as to remove the step up. Even if in practice the company pays the dividend each year, as the payment is contractually at the company's discretion, the shares are classified as equity.

As in the above example, the shares could become payable or converted to ordinary shares based on value upon an event that is in the company's control such as an IPO or Exit.

***Example 3 – arrangements including dividend blockers***

A company issues a non-redeemable preferred share (or one which is redeemable at the company's option) with the following terms:

- A discretionary annual coupon or dividend is to be paid up to a capped maximum amount to preferred shareholders; and
- Unless a full discretionary coupon or dividend is paid, no dividend can be paid to the ordinary shareholders.

This is referred to as a 'dividend blocker' clause. A dividend blocker or dividend stopper is a contractual term that requires no dividend to be paid to ordinary shareholders if a payment is not made on another specified financial instrument. In this example, as the issuer can avoid the obligation to settle the annual dividend, the shares are classified as equity.

However, this might not be useful for many venture capital investments where dividends are not normally paid out anyway. This structure could be improved if the dividend was payable, after a period of time in a fixed number of ordinary shares thus diluting the ownership rights of the other ordinary shareholders. The benefit of this is that it would provide an incentive by diluting the holders of the ordinary shares to the benefit of the venture capital fund holding their preference shares if an event, such as an IPO or Exit, did not happen. Such a structure would not work with a variable amount of shares calculated based on a fixed monetary amount, as in Example 1,



*This update has been prepared by the BVCA Legal & Technical Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this briefing. Specific advice should always be taken in each situation.*

because that would be treated as a liability as the recipient would not be taking share price risk. This is potentially a complex area of accounting and will depend on the full facts and circumstances; the commentary above is at a high level only.

***<u>Examples that result in a liability classification</u>***

***Example 4 – preferred shares with a fixed dividend and mandatory redemption***

A company issues preferred shares that pay a dividend at a fixed rate of 10% of the issue price and are mandatorily redeemable at par in 8 years. The dividend is paid without any need for a resolution of the board or of the company and before application of any profits to reserve or for any other purpose. A contractual obligation exists to deliver cash which the company cannot avoid. Therefore the preferred shares should be classified as a liability on the balance sheet.

***Example 5 – perpetual instruments***

A company issues preferred shares which give the holder a coupon of 5% into perpetuity. The shares are not mandatorily redeemable. As the value of the financial instrument is derived from the coupon stream and a contractual obligation exists to deliver cash which the company cannot avoid, the shares are classified as a liability.

***Example 6 – profit sharing arrangements, no discretion on payments***

A company issues preferred shares which give the holder the right to a fixed percentage of profits of the company. The profits accrue to the holders of the preferred shares and are paid out on a certain date if an IPO or Exit has not happened by that date. The timing of the IPO or Exit of the company is likely to be uncertain, and although there is an expectation on the part of both the issuer and holder that this will occur by the set date, triggering such an event is beyond the control of the issuer. As the company cannot avoid payment of the profit distribution if an IPO or Exit is not achieved, the shares are classified as a liability.

**Additional disclosures where preferred shares are classified as liabilities**

Where a company does not meet the recognition criteria above to classify preferred shares as equity, and does have ordinary share capital in issue, additional disclosures can be provided to the users of the financial statements to support their understanding of the financial information presented. This is important in scenarios where investors require mandatory redemption rights to be attached to their investment.

On the face of the balance sheet itself, further detail can be included on what comprises 'Creditors: amounts falling due after more than one year' so the users of the financial statements can see the element attributable to preferred shares.



*This update has been prepared by the BVCA Legal & Technical Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this briefing. Specific advice should always be taken in each situation.*

For example:

| | £m |
|---|---|
| Fixed assets | X |
| .... | X |
| **Total assets less current liabilities** | **X** |
| | |
| **Creditors: Amounts falling due after more than one year** | |
| Amounts owed to group undertakings | 10 |
| Accruals and deferred income | 10 |
| Preferred shares classified as liabilities | 20 |
| | **40** |
| **Net assets** | **X** |
| | |
| **Capital and reserves** | |
| Called-up share capital | X |
| Profit and loss account | X |
| **Shareholders' funds** | **X** |

Companies may wish to consider other presentation options bearing in mind the requirements of Schedule 1 to the Accounting Regulations[1] that prescribes the form and content of the balance sheet. These would need to be prepared carefully to ensure they comply with legal requirements so early consultation with the auditors is recommended. Options include:

- Stopping the "top half" of the balance sheet at 'Total assets less current liabilities' and combining the presentation of 'Creditors: Amounts falling due after more than one year' and 'Capital and reserves' in the "bottom half" under the heading 'Capital employed'.

| | £m |
|---|---|
| Fixed assets | X |
| .... | X |
| **Total assets less current liabilities** | **X** |
| | |
| **Capital employed** | |
| **Creditors: Amounts falling due after more than one year** | |
| Amounts owed to group undertakings | 10 |
| Accruals and deferred income | 10 |
| Preferred shares classified as liabilities | 20 |
| | **40** |
| **Capital and reserves** | |
| Called-up share capital | X |
| Profit and loss account | X |
| | **X** |
| **Total capital employed** | **X** |

- Separating out the different components of 'Creditors: Amounts falling due after more than one year' and including them in a separate column so a user can still see the prescribed total required under the Accounting Regulations but also see the total of share capital and reserves (including share capital treated as a liability).

[1] The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008



*This update has been prepared by the BVCA Legal & Technical Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this briefing. Specific advice should always be taken in each situation.*

| | £m | £m |
|---|---|---|
| **Assets employed** | | |
| Fixed assets | | X |
| .... | | X |
| **Total assets less current liabilities** | | **X** |
| **Creditors: Amounts falling due after more than one year** | | |
| Amounts owed to group undertakings | 10 | |
| Accruals and deferred income | 10 | |
| | **20** | **(20)** |
| **Total net assets before deduction of preferred shares** | | **X** |
| **Capital and reserves** | | |
| Called-up preferred shares classified as liabilities | 20 | **20** |
| | **40** | |
| Called-up ordinary and deferred share capital | | X |
| | | **X** |
| Profit and loss account | | X |
| **Total capital and reserves** | | **X** |

Further disclosures could be included in **the notes to the financial statements** covering:

- Information on the rights attached to the preferred shares and their ranking alongside ordinary shares.
- An explanation of the reasons for the liability classification.
- A table of non-GAAP information such as a reconciliation showing how the balance sheet and profit and loss account would look if the preferred shares had not been classified as liabilities.

  For example:

| | Note | £m |
|---|---|---|
| Net assets as at 31 December 20XX | | 100 |
| Preferred shares classified as creditors due after more than one year | (1) | 20 |
| **Adjusted net assets as at 31 December 20XX** | | **120** |

*(1) This footnote would explain in more detail what has been reclassified*

| | Note | £m |
|---|---|---|
| Profit for the financial year ended 31 December 20XX | | 10 |
| Interest expense attributable to preferred shares | (2) | 2 |
| **Adjusted profit for the financial year ended 31 December 20XX** | | **12** |

*(2) This footnote would explain in more detail what has been reclassified*



*This update has been prepared by the BVCA Legal & Technical Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this briefing. Specific advice should always be taken in each situation.*

**Summary and key considerations**

Ultimately, the key determinant of whether a preferred instrument is a financial liability under UK GAAP or IFRS are the precise legal rights of the holders and their ability to enforce those rights to receive cash or other financial assets which reduce the net assets of the company concerned.

Firms are advised to discuss the drafting of share agreements with auditors and advisers to ensure the final position takes into account all current financial reporting implications as well as commercial considerations.

Companies that are required to classify preferred instruments as financial liabilities on the balance sheet may wish to consider the extent to which further disclosures and alternative balance sheet presentations could provide additional meaningful information for the users of those financial statements.

---

**Technical reference material**

**Key definitions**

The following definitions are taken from *IAS 32 Financial Instruments: Presentation.* UK GAAP also follows these definitions.

**Financial instrument:** a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

**Financial asset:** any asset that is:

- cash
- an equity instrument of another entity
- a contractual right
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments
  - 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
  - puttable instruments classified as equity or certain liabilities arising on liquidation classified by IAS 32 as equity instruments



*This update has been prepared by the BVCA Legal & Technical Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this briefing. Specific advice should always be taken in each situation.*

**Financial liability:** any liability that is:

- a contractual obligation:
    - to deliver cash or another financial asset to another entity; or
    - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is
    - 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
    - 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; puttable instruments classified as equity or certain liabilities arising on liquidation classified by IAS 32 as equity instruments

**Equity instrument:** Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

A financial instrument is an equity instrument only if (a) the instrument includes no contractual obligation to deliver cash or another financial asset to another entity and (b) if the instrument will or may be settled in the issuer's own equity instruments, it is either:

- a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
- 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. [IAS 32.16]

**If you have any questions on the topics raised in this note, please contact Gurpreet Manku, 020 7492 0454, gmanku@bvca.co.uk**

British Private Equity & Venture Capital Association
5th Floor East, Chancery House, 53-64 Chancery Lane, London WC2A 1QS
T +44 (0)20 7492 0400 F +44 (0)20 7492 0401 bvca@bvca.co.uk www.bvca.co.uk



*This update has been prepared by the BVCA Legal & Technical Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this briefing. Specific advice should always be taken in each situation.*