PREFERENCE SHARES WHETHER – DEBT OR EQUITY?

The Reserve Bank imposed a penalty of ₹2 crore on Kotak Mahindra Bank on 7th June 2019, for not complying with its directions regarding dilution of promoters' shareholding in the company.

As per RBI's banking licensing norms, a private bank's promoter holding has to be brought down to 40 per cent within three years of operations, 20 per cent within 10 years and 15 per cent within 15 years.

In consonance with RBI norms, Kotak Mahindra Bank last August proposed to issue non-convertible perpetual non-cumulative preference shares to reduce promoter stake to 19.7 per cent, worth ₹500 crore at ₹5 apiece, which the RBI shot down arguing that preference shares do not comprise core equity and help promoters retain voting rights.

As a result, the tussle went to Bombay High Court and the matter is still pending with the court.

Now the question arise is whether the preference shares are debt or equity ?

A company issues two type of shares i.e. common (equity shares) and preferred (preference shares). Equity share holders are not mandatory entitled to the fixed dividend unlike the preference shares. They are known as preferred because in case a Company is unable to pay all dividends, claims to preferred dividends will take precedence over claims to dividend paid on equity.

What does IAS 32.15 i.e. – Classification as liability or equity says:

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 it's legal form, and the definitions of financial liability and equity instrument. Two exceptions from this principle are certain puttable instruments meeting specific criteria and certain obligations arising on liquidation. The entity must make the decision at the time the instrument is initially recognised.

Subsequently, the preference shares can be classified as equity, liability, or a combination of the two. The entity must classify the financial instrument when initially recognising it 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.

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.

Following action is determining whether to consider the preference share as debt or equity

- Are the shares redeemable at a fixed date?
- Are the shares redeemable at the option of the holder?
- Is the issuer obliged to make payments in the form either of interest or dividends?
- Do the terms and conditions oblige the issuer to distribute a specific percentage of profits?

If the answer is yes to all of the above, then the preference shares would most probably be classified as a financial liability (debt), because it would seem that the issuer lacks the unconditional right to avoid delivering cash or another financial asset to settle an obligation. On the other hand, if the answers are all negative, and there is thus no mandatory payment clause in the contract, then this may give rise to an equity classification because the entity can delay payment upon liquidation. In this latter case, there is no contractual obligation to deliver cash or another financial asset.

If the answers are a mixture of yes and no, then the classification will vary by case.

Hence, 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. Further ,the Mumbai High Court is expected to hear the matter of Kotak bank in January next year. High Court order will stand, to consider whether the preference shares are debt or equity.
