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SHARE CATEGORIES – Equity or Liability?

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When buying equity shares in a company, one can purchase different category shares, namely 'ordinary shares' (also referred to as 'common stock') and 'preference shares' (also referred to as 'preferred stock'). Shares represent equity in a company. However, in certain circumstances shares may have to be recognised as a liability in stead of equity. This tip will look at when shares are equity and when it represents a liability.

What is the difference between ORDINARY SHARES and PREFERENCE SHARES?

Ordinary shares:

Ordinary shares are shares that represent a normal equity ownership in a company. Ordinary shares also provide shareholders to receive dividends but this is at the discretion of the company.

Preference shares:

Preference shares are shares that give preferential treatment over ordinary shares, as dividends are paid out to preference shareholders before dividends are paid to ordinary shareholders.

ORDINARY SHARES	
ELEMENT - EQUITY	
DIVIDEND DISTRIBUTION	**= EQUITY**

PREFERENCE SHARES			
REDEMPTION ASPECT		**DIVIDEND ASPECT**	
Non-redeemable	**Equity** (if dividends are discretionary)	**Mandatory**	**Liability (dividend to be recognised as 'interest')**
	Liability (if dividends are mandatory)	**Discretionary**	**Equity (dividend to be recognised as distribution)**
Redemption is mandatory	**Liability**		
Redemption is at discretion of holder	**Liability**		
Redemption is at discretion of issuer	**Equity**		

Non-redeemable to be classified based on the other rights attached to them:

- ❖ If dividends are discretionary = share remains equity and dividend is an equity distribution
- ❖ If dividends are mandatory = share is effectively a perpetual debt instrument (liability) and dividend is interest.

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Cumulative / non-cumulative has no bearing on whether the dividend should be classified as a Liability or Equity:

- ➢ Cumulative dividends: must pay out arrear preferential dividends before paying ordinary dividends
- ➢ Non-cumulative dividends: if unpaid in a year, then it need not to be paid (shareholder's right to preferential dividend expires)

Participating / non-participating: participating shares get an extra variable dividend based on profits:

- ➢ Participating shares: must pay a fixed dividend (coupon), which could be discretionary/mandatory, and an extra variable dividend (e.g. % of the ordinary dividend), which is generally discretionary.