TYPES OF SHARES

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Abstract:
This article focuses on equity instruments. There are presented the characteristics of ordinary and preference shares. There are described the types and characteristics of preference shares such as: cumulative preference shares, participating preference shares, convertible preference shares, callable preference shares and redeemable preference shares. Treasury shares are also described. The accounting records are based on IAS 32 Financial Instruments: Presentation. There are presented the conditions when a puttable instrument is classified either as equity or as financial liabilities under IFRS.

Keywords: equity instrument, ordinary shares, common stock, dividends, preference shares, cumulative preference shares, treasury shares, par value, outstanding capital, authorized capital, puttable instrument

JEL: G32 – Financing Policy; Financial Risk and Risk Management; Capital and Ownership Structure; Goodwill; H32 - Firm M41 – Accounting.

"An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all its liabilities, liabilities, where liabilities are defined as the present obligations of the entity arising from past events, the settlement of which are expected to result in an outflow from the entity of resources embodying economic benefits (i.e., an outflow of cash or other assets of the entity)" (Barry J. Epstein and Eva K. Jermakowicz, 2010, page 820).

The shares (named also stocks in U.S.A.) of an entity may be divided into two major types: ordinary shares or equity shares (named also common stock in U.S.A.) and preference or preferred shares (preferred stock in U.S.A.) Both may be split into smaller classes of shares. Owners of shares are referred to as shareholders or stockholders. Ordinary shares and preference shares have different rights.

Generally, ownership stock conveys the next four rights to shareholders:

a) sharing of profits and losses from the present year and/or and previous years;
b) voting rights;
c) liquidation rights; and
d) the opportunity to purchase additional shares if issued its class.

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The holders of preference shares (preference shareholders) have the right to receive income – as dividends -before any holders of ordinary shares (ordinary shareholders). In other words the dividends for preference shares must be paid before the dividends for ordinary shares (Sunil Parameswaran, 2011, page 119).

"Preferences as to assets exist when the preferred shares have a stipulated liquidation value. If a corporation were to liquidate, these preferred holders would be paid a specific amount before the common shareholders would have a right to participate in any of the proceeds. In practice, preferred shares are more likely to have preferences as to earnings than as to assets" (Barry J. Epstein and Nadira M. Saafir, 2010, page 332).

The same rule must be applied also if the entity is liquidated. The proceeds of sale of all assets of the entity are distributed- first - to the creditors and -second - to shareholders of the entity. Creditors of the entity are paid first and all that remains is distributed to the shareholders. When the proceeds are distributed between owners' entity, preference shareholders are given preference over ordinary shareholders. We can say that preference shareholders have an advantage over the ordinary shareholders because the preference shareholders receive the liquidation value of their shares before any distribution to the ordinary shareholders. This makes ordinary shares riskier than debt or preference shares.

A) Ordinary shares (common stock, equity shares)

Ordinary shares are a type of financial claim issued by the firm to investors. In return for their investment, the shareholders are conferred with ownership rights. An entity must have at least one shareholder. Generally there is no restriction regarding the maximum number of shareholders of an entity. Also there is no restriction on the total number of shares that may be issued by an entity. At the moment when an entity is incorporated, a specific number of shares will be authorized for issue. The value of these shares is named authorized capital of the entity. Sometimes not the entire authorized capital is raised immediately due to the fact that a portion of authorized capital can be held for issue at a later date. The outstanding capital represents the value of the shares that are currently held by the investors (Sunil Parameswaran, 2011, page 97).

Ordinary shares have a par value (named also stated value or nominal value or face value). Often the issue price of a share is different than par value. The difference between issue price and par value of a share is named: share premium or additional paid-in capital, if the issue price is higher than par value, or discount share when the issue price is less than par value. The ordinary share does not have a maturity date (Barry J. Epstein and Nadira M. Saafir,2010, page 333; Sunil Parameswaran, 2011, page 99).

When ordinary shares are issued it should be considered five matters:

a) accounting for par value share;
b) accounting for no-par value share;

c) accounting for shares issued in combination with other securities;
d) accounting for shares issued in noncash transactions; and
e) accounting for costs of issuing shares.

An entity may have more than one class of ordinary shares. Each class (Class A, Class B, Class C, and so on) may have different rights to earnings or voting. Generally there is no limit concerning the number of different classes of ordinary shares which may be issued by an entity.

Puttable/Non-puttable ordinary shares (puttable/non - puttable common stock)

Under IAS 32, as a general definition, a puttable instrument is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset. It can also be automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder ((Barry J. Epstein and Eva K. Jermakowicz, 2010, page 182). So we can say that puttable ordinary shares are ordinary shares that give the investors- unlike non – puttable ordinary shares - the right /option to put the shares back to the issuer for a predetermined price usually for a limited stipulated time period.

B) Preference shares (preferred shares, preferred stock)

An entity may chose to issue preference shares. Like ordinary shares, preference shares also represent equity because they are financial claims that confer ownership rights on the shareholders. Unlike ordinary shares, this kind of shares has certain associated privileges. Preference shareholders have a claim on income, assets and liquidation value (if the entity is liquidated) ahead of that of ordinary shareholders. Also, current dividends due on the preference shares must be paid before any dividends for the year can be declared for ordinary shareholders. In case of liquidation of the entity, the proceeds of sale of the assets are distributed in the following order: creditors and bondholders, preference shareholders and ordinary shareholders. With other words we can say that preference shareholders are owners who have certain rights superior to those of common shareholders. Unlike ordinary shareholders, preference shareholders usually do not have voting rights. Unlike creditors or bondholders, preference shareholders do not have a legal claim to receive the dividend and they cannot force the entity into bankruptcy for failure to pay the dividends. Generally the dividend for a preference share is fixed (Barry J. Epstein and Nadira M. Saafir, 2010, page 332; Sunil Parameswaran, 2011, page 120)

Like in the case of ordinary shares, an entity may issue different classes of preference shares. Each class of preference shares may have different dividends rates and rights. The ordinary shares- as mentioned before - are never issued with a maturity date but the preference share may be issued with or without a maturity date. The preference shares issued without a maturity date is named perpetual preferred stock or perpetual preference **(http://www.investopedia.com/terms/p/perpetual-preferred-stock.asp).**

The preference shares can be divided in the following categories: (i) callable / non-callable, (ii) cumulative / noncumulative, (iii) convertible / nonconvertible, and (iv) participating / non-participating.

B1) Callable/ Noncallable preference shares (redeemable / nonredeemable preference shares or **Callable/ Noncallable preferred stock)**

This kind of preference share gives the issuer the **right** to buy the shares from the holders at a predetermined price after a defined date. If the entity wants to buy back the issued shares, it must to exercise the call option and to pay the predetermined price, also named as call price. "Thus, callable preferred shares, which are redeemable at the issuer's option, and convertible preferred shares, which are redeemable at the holder's option, are not mandatorily redeemable shares" (Barry J. Epstein and Nadira M. Saafir, 2010, page 254). In other words the issuer can prematurely recalled or retired such preference share, if the established price is paid, unlike the plain vanilla preference shares, which are noncallable. This kind of share presents an advantage for the issuer and, in the same time, a disadvantage for the investor.

The redeemable preference shares confer to the issuer, by exercising the call option, the possibility of decreasing the cost of capital if interest rates decline or if it can issue the shares at a lower dividend rate at a later date. From the investor point of view, if the issuer decided to call the preference shares, this will be faced with the prospect of reinvesting the proceeds at a lower dividend or interest rate (Sunil Parameswaran, 2011, page 120 – 121)

There are cases when the issuer is **obliged** to redeem the shares at the option of the holders or at a determinate moment in the future according to the mutual agreement between the issuer and shareholders.

B2) Cumulative / Noncumulative preference shares (cumulative/ noncumulative preferred stock)

In the case of cumulative preference shares, any unpaid dividend in one year must be paid next year or years before any other dividend for noncumulative preference shares is paid and before any ordinary shares dividend is paid. In other word, if a preference share dividend is cumulative, than any unpaid dividend in one period is carried – over year to year – till it is paid. If the dividend for noncumulative preference shares is not paid in one period, than the dividend is lost and it is not paid in other future period.

"Cumulative preference dividends in arrears. If an entity has preferred share outstanding, and does not pay cumulative dividends on the preference shares annually when due, it will be required by statute to pay these arrearages in later years, before any distributions can be made on common (ordinary) shares. When there are several series of preferred shares, the individual share indentures will spell out the relative preference order, so that, for example, senior preferred series may be paid dividends even though junior preferred shares has several years' arrearages. Although practice varies, most preference shares are cumulative in nature. Preference shares that do not have this feature are called noncumulative preference shares" (Barry J. Epstein and Eva K. Jermakowicz, 2010, page 824).

B3) Convertible/Nonconvertible preference shares (convertible/ nonconvertible preferred stock)

This kind of preference share gives the investor the right to convert the preference shares- usually anytime after a predetermined date - into ordinary shares a predetermined rate of exchange. The most convertible preference shares are exchanged at the request of the investor but, there are situations, when an entity can issue mandatory convertible preference shares. This kind of preference share compels the issuer to convert them into a fixed number of ordinary shares within a specific period of time.

The mandatory convertible preference shares present advantages for both parties (issuer and investor). From the issuer's point of view, these mandatory preference shares are attractive because the issuer is released from the obligation to pay preference dividend but instead it is forced to convert them into ordinary shares. From the investors 'point of view, mandatory convertible preference share offer the right to convert – only within specific period – these shares into ordinary shares (Sunil Parameswaran, 2011, page 121)

B4) Participating/Nonparticipating preference shares (Participating/ Nonparticipating preferred shares)

The investor, who holds a participating preference share, has the right to receive a share of the entity's earnings according to predetermined conditions. This share of earnings is either in addition to a stated preference dividend or varies according to the ordinary share dividend. The additional dividend paid to preference shareholders is commonly structured to be paid only if the amount of dividends that ordinary shareholders receive exceeds a specified per-share amount. The most preference shares are nonparticipating in nature. "In exchange for the preferences, the preferred shareholders' other rights or privileges often are limited. For instance, the right to vote may be restricted to common shareholders.

The most important right denied to the preferred shareholders, however, is the right to participate without limitation in the earnings of the corporation. Thus, if the corporation has exceedingly large earnings for a particular period, most of these earnings would accrue to the benefit of the common shareholders. This statement is true even if the preferred stock is participating (a fairly uncommon feature) because participating preferred stock usually has some upper limitation placed on the extent of participation" (Barry J. Epstein and Nadira M. Saafir, 2010, page 332).

Usually all the shares issued by an entity are hold by sundry investors (corporations, entities or individuals) which are different than the issuer. However there are situations when the issuer holds its own shares by repurchasing them from the investors. These kinds of shares held by the issuer are named treasury shares or treasury stock.

C) Treasury shares (Treasury stock)

Treasury shares are represented by the entity's shares that were at one point in time issued to the public but they have been reacquired or bought back by the entity. Treasury shares are also the shares that have never been issued to the public in the first place. These shares are kept by the entity in their own treasury. Treasury shares have no voting rights and are not included in share outstanding calculations (such as earnings per shares or profit per share). A buyback program will increase the earnings per share.

"Treasury stock. Shares of a corporation that have been repurchased by the corporation. This stock has no voting rights and receives no cash dividends. Some states do not recognize treasury stock. In such cases, reacquired shares are treated as having been retired" (Barry J. Epstein and Nadira M. Saafir, 2010, page 332).

Often the issuer buys its own share in order to avoid a potential takeover. The buyback of the own shares may represent an advantage for the management of the issuer and a disadvantage for the rest of the shareholders. By reducing the shares in circulation, the management of the issuer can obtain a better control. In some situations, by reducing the shares in circulation, the share's market price may increase. These shares are not eligible to receive cash dividends. These shares are held by the issuer in their treasury and can be subsequently reissued to the investors or employees (Sunil Parameswaran, 2011, page 107).

D) Issued stocks / shares are always a component of Stockholders' Equity/ Shareholders' Equity?

An entity which issues a financial instrument has to classify - at initial recognition - the issued financial instrument as either a financial liability or as equity according to the substance of the contractual agreement and the definitions of a financial liability and equity mentioned bellow. IAS 32 Financial Instruments: Presentation does not look to the legal form of financial instruments. Instead, it focuses on the financial instruments' contractual obligations. There are situations when financial instruments (e.g puttable shares) as may have the legal form of equity but, under IAS 32, to be classified as liabilities.

Classification of an instrument as liability or equity

Equity is the residual interest in the assets of an entity after deducting all its liabilities. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. A financial liability is „any liability that is:

1. A contractual obligation to deliver cash or another financial asset to another entity
2. A contractual obligation to exchange financial instruments with another entity under conditions that are potentially unfavorable
3. A contract that will or may be settled in the entity's own equity instruments and is a nonderivative for which it is or may be obligateed to deliver a variable number of its own equity instruments
4. A contract that will or may be settled in the entity's own equity instruments and is a derivative that will or may be settled other than by an exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments (which excludes puttable financial instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation—classified as equity, and instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments)" (2010 Interpretation and Application of International Financial Reporting Standards, Barry J. Epstein and Eva K. Jermakowicz, Published by John Wiley & Sons, Inc., Hoboken, New Jersey, page. 191)

Any contract that evidences a residual interest in the assets of an entity after deducting all its liabilities is an **equity instrument**. "An obligation to issue an equity instrument is not a financial liability because it results in an increase in equity and cannot result in a loss to the entity" (Hennie van Greuning, 2009, page 532).

A puttable instrument can be presented, under revised IAS 32, either as a financial liability or equity. The puttable financial instruments that impose on the issuer an obligation to deliver a pro-rata share of net assets of the entity only on liquidation are equity, and thus should not be presented as liabilities.

Under revised IAS 32, puttable financial instruments are now to be presented as equity if and only if all of the following criteria are met:

1. The instrument entitles the holder to a pro rata share of the entity's net assets on liquidation;

2. The instrument is part of a class of instruments that is subordinate to all other classes of instruments;
3. The instruments is in the class of instruments that is the most subordinate and all instruments in that class have identical features;
4. The instrument has no other characteristics, except the put future, that would meet the definition of a financial liability; and

The total expected cash flows attributable to the instrument over its life are based substantially on either: (i) profit or loss, (ii) the change in the recognized net assets, or (iii) the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of the instrument itself);

5. The issuer must have no other financial instrument or contract that has (a) total cash flows based substantially on the profit or loss, the change in the recognized net assets or the change in the fair value of the recognized and unrecognized net assets of the entity (excluding any effects of such instrument or contract) and (b) the effect of substantially restricting or fixing the residual return to the puttable instrument holders.

Shares that are puttable at fair value, but which are not the most subordinate class of instrument issued, must still be classified as liabilities. The appropriate classification is determined by the entity at the point of initial recognition. The issuer must consider all terms and conditions agreed between itself and the investors who hold the instruments of the issuer. The issuer has to distinguish between those cases in which it is forced, under the agreement, to deliver cash or other financial assets and those in which it has the discretion over paying out cash or other financial assets.

Instruments That Will or May Be Settled in Own Equity

Contracts that will or may be settled in the entity's own equity instruments are classified as equity instruments of the entity if they (Abbas Ali Mirza et. al, 2011, page 228):

1) Are non-derivative contracts and will be settled by issuance of a fixed number of the entity's own equity instruments
2) Are derivative contracts and will be settled by the exchange of a fixed number of the entity's own equity instruments and a fixed amount of cash

Due to the fact that such instruments are classified as own equity, any consideration received for such an instrument is added directly to equity and any consideration paid is deducted directly from equity. Changes in fair value of such instruments are not recognized.

Option is a contract that gives the investor (option holder) the right, but not the obligation, to acquire (call option) from or sell (put option) to the option seller (option writer) a certain quantity of an underlying security or commodity, at a specified price (the strike price) and up to a specified date (the expiration date).

If a financial instrument requires the issuer to repurchase its own issued equity instruments for cash or other financial assets, there is a financial liability for the present value of the repurchase price (redemption amount). The liability is recognized by reclassifying the amount of the liability from equity. If it is classified as a financial liability measured at amortized cost, the difference between the repurchase price and the present value of the repurchase price is amortized to profit or loss as an adjustment to interest expense using the effective interest rate method.

E) Examples

Example 1) Entity ABC issues 1,000 ordinary shares of its CU20 par value each share. Each share was sold for an exercise price of CU22. Shareholders are entitled to a pro rata share of any dividends or other distributions of the entity. The issuer has the right to decide whether or not to pay dividends.

The issuer does not have a contractual obligation to deliver cash or another financial asset to the shareholders. Therefore these ordinary shares should be classified as equity.

Total proceeds for selling the shares	22,000
Value of share capital - ordinary shares	20,000
Additional paid in capital in excess of par	2,000

Dr Cash (financial asset)		22,000	
	Cr Share capital (equity)		20,000
	Cr Share premium (equity)		2,000

Example 2) Entity ABC issues two types of shares: 2,000 ordinary shares with no par value but, instead, with a stated value of CU1 and 600 redeemable preference shares at CU10 par value. The shares are redeemable at the option of the issuer. The preference shares are noncumulative. All issued shares were sold at an exercise price of CU32 for ordinary shares and CU55 for preference shares.

The issuer has the right to redeem the shares. The issuer has no obligation to redeem the shares and consequently there is no obligation to deliver cash or other financial asset. So, these preference shares are classified as equity. Also, the issuer has no obligation for paying dividends and consequently they are not liabilities.

	Ordinary shares	Preference shares	Total
Value of share capital	2,000	6,000	8.000
Additional paid in capital in excess of par	62,000	27,000	89.000
Total proceeds for selling the shares	64,000	33,000	97.000

Dr Cash (financial asset)	64,000	
Cr Share capital (equity)- ordinary shares		2,000
Cr Share premium (equity) – ordinary shares		62,000

Dr Cash (financial asset)	33,000	
Cr Share capital (equity)- preference shares		6,000
Cr Share premium (equity) – preference shares		27,000

Example 3) Entity ABC issues at 01/04/2012 a number of 1,000 mandatory redeemable preference shares at par of CU50 per share with a 7 per cent fixed dividend on the par value payable annually (assume that 7 per cent is the market rate of interest for this type of instrument).The preference shares are cumulative.

The issuer has a contractual obligation to deliver - at the time of redemption - cash or another financial asset to the share holders for the preference shares. The preference shares are classified as financial liabilities due to the fact that the issuer cannot avoid the redemption of the shares. Because the dividend payments are not at the discretion of the issuer, it could not avoid paying those dividends and consequently they are liabilities.

Dr Cash (financial asset)	50,000	
Cr Preference shares (Liability)		50,000

Recognition of financial liabilities for the accumulated dividends at the end of the year: Number of months: 9 months; Value of dividends: 9/12 x 7% x 50,000 = CU2, 625

Dr Finance costs (profit or loss)	2,625	
Cr Preference shares dividends (financial liability)		2,625

Example 4) Entity ABC issues two types of shares: 1,000 ordinary share and 1,000 redeemable preference shares. The issuer will redeem the preference shares at the option of the shareholders. The preference shares are noncumulative.

There is a contractual obligation to deliver cash exists to buy back the shares at the request of the shareholders. That present obligation is a liability. According to the contractual agreement the issuer cannot avoid redeeming the shares. Because the dividend payments are at the discretion of the issuer, it could avoid paying those dividends and consequently they are not liabilities.

Note: If the preference shares are cumulative that the issuer has the obligation that, any unpaid dividends in one year, to be paid next year or years before any other dividends for noncumulative preference shares and/or before any ordinary shares dividends are paid. These dividends have to be recognized as liabilities at the end of the year.

Example 5) Entity ABC issues - during 2010 - 5,000 convertible preference shares of CU90 par value. The exercise price for these shares was CU155. One preference share can be convertible into three ordinary shares (par value of an ordinary share is CU35). The preference shares will be convertible within 2 years from the date of issue. At the end of 2012, all the issued preference shares were converted.

The issuer has no obligation for delivery cash or other financial asset. The shares are classified as equity. The treatment of convertible preferred shares at its issuance is no different from that of nonconvertible preferred shares.

Total proceeds of selling the preference shares	775,000
Value of share capital - preference shares	450,000
Additional paid in capital in excess of par	325,000

At the date of issue:

Dr Cash (financial asset)	775,000	
Cr Share capital (equity)- preference shares		450,000
Cr Share premium (equity)- preference shares		325,000

Number of ordinary shares issued is 5,000 x 3 = 15,000 ordinary shares
Value of issued ordinary shares: CU525, 000 (15,000 ordinary shares x CU35)
Total proceeds of selling the preference shares: CU775, 000
Additional paid in capital in excess of par: CU250, 000

At the date of converting:

Dr Share capital (equity) - preference shares		450.000	
Dr Share premium (equity) -preference shares		325.000	
	Cr Share capital (equity)-ordinary share		525000
	Cr Share premium (equity)-ordinary share		250.000

Example 6) During 2012, the entity ABC reacquired 20,000 of its CU1 par value ordinary shares. The price paid by the entity is CU12 per each share. In March, 2012 the entity sold 15,000 of treasury shares in exchange for CU10 per each share. In June, 2012 the entity sold the remaining treasury shares in exchange for 7CU per each share. At the end of 2011 statement of financial position included the following:

Share capital – ordinary shares (100,000 shares x CU1/share):	100, 000
Share premium – ordinary shares:	50,000
Retained earnings:	80,000

Treasury shares are not recognized as a financial asset of the entity regardless of the reason for which they are reacquired. An entity shall deduct from equity the fair value of the consideration given for the treasury shares. The entity shall not recognize a gain or loss in profit or loss on the purchase, sale, issue or cancellation of treasury shares.The amount paid for the reacquired ordinary shares is: CU240, 000. The accounting entry at the date of acquisition is:

Dr Treasury shares		240,000	
	Cr Cash		240,000

Proceeds for selling 15,000 treasury shares at CU10 per share are CU150, 000. The entry is:

Dr Cash (financial asset)		150,000	
Dr Share premium – ordinary shares		30,000	
	Cr Treasury shares		180,000

Proceeds for selling 5,000 treasury shares at CU7 per share are CU35, 000. The entry is:

Dr Cash		35,000	
Dr Share premium – ordinary shares		20,000	
Dr Retained earnings		5,000	
	Cr Treasury shares		60,000

Example 7) The entity ABC issues a (written) call option or warrant that gives the holder the right to purchase 10,000 shares for a CU10. The proceeds from issuing the call option is CU80,000.

Dr Cash (financial asset)	80,000	
Cr Option reserve (equity)		80,000

Example 8) A purchased call option that gives the entity ABC the right to repurchase 10,000 shares for CU5. If the price for purchasing the call option is CU20,000 the accounting entry is:

Dr Option reserve (equity)	20,000	
Cr Cash (financial asset)		20,000

Example 9) On January 1, 2012, Entity ABC enters into a forward contract that requires the entity to repurchase 1,000 shares for CU70, 000 on December 31, 2012. No consideration is paid or received at inception of the contract. The market interest rate is 12%.

The entity must to recognize a financial liability at the present value of the repurchase price.
The present value is 70, 000 / (1+12%) = CU62, 500
At January 01:

Dr Treasury shares	62,500	
Cr Forward contracts (liability)		62,500

On December 31, 2012 entity has to recognize the amortization in accordance with the effective interest method and to settle the contract:

Dr Finance costs (profit or loss)	7,500	
Cr Forward contracts (liability)		7,500

Dr Forward contracts (liability)	70,000	
Cr Cash (financial asset)		70,000

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