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Preference shares: analysis of Sharīʿah issues

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Abstract

Purpose – The purpose of this paper is to analyze the different features of preference shares from accounting and Sharīʿah perspectives. It also aims to study Sharīʿah issues arising from preference shares and to subsequently propose solutions for identified issues that will help in structuring Islamic preference shares.

Design/methodology/approach – The paper uses a qualitative method by analyzing relevant documents and literature to understand the subject matter and Sharīʿah-related issues.

Findings – The paper finds that several features of conventional preference shares, such as capital guarantee, loss sharing disproportionate to capital contribution, fixed profit, profit guarantee and waiver of rights before realization of profit, make them a Sharīʿah non-compliant instrument.

Research limitations/implications – The paper is conceptual in nature; however, it provides directions for future empirical research.

Originality/value – The paper provides a practicable solution to structure Sharīʿah-compliant preference shares.

Keywords Equity, liability, debt, capital guarantee, preference shares

Paper type Research paper

Introduction

From their original feature of mere preference in dividend distributions (Evans, 1929), preference shares have evolved significantly to the present time with a range of other rights granted to their holders. In financial reporting based on International Financial Reporting Standards (IFRS), a preference share can be classified as an equity or a liability instrument, or even as a compound instrument, comprising both equity and liability components. These classifications depend on the rights of preference shareholders and the obligations of the issuing entity, and there is no one classification that fits all. One common feature is that preference shareholders have a prior claim over ordinary shareholders on the issuing entity's distributable earnings and on net assets at the time of liquidation (Bursa Malaysia, 2017), but they are subordinate to bonds and other types of debts. The preferential rights over ordinary shares raise concerns from a Sharīʿah standpoint about the classification and acceptability of preference shares.

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Features of preference shares

The features of preference shares are identified based on the rights given to preference shareholders. For example, the features identified from the prospectuses for preference shares issued by Allianz Malaysia Berhad (2010), Dolomite Corporation Berhad (2012) and Insas Berhad (2014) include cumulative/non-cumulative, redeemable/irredeemable and convertible/non-convertible. Accordingly, the rights granted to preference shareholders are grouped into three: dividend rights, redemption rights and conversion rights.

This paper identifies the primary factor that results in a liability classification in an IFRS-based financial reporting. This is if the issuing entity has a contractual obligation to deliver cash or another financial asset to another entity (i.e. in this case, to preference shareholders). For an equity classification, the issuing entity must have the unconditional right to deny any dividend payment or capital redemption (IFRS Foundation, 2016).

This paper also addresses convertible preference shares. The most important issue here is whether conversion involves a fixed or variable number of the entity's own equity instruments. The paper finds that conversion into a fixed number of instruments results in an equity classification in IFRS-based reporting, whereas conversion into a variable number of instruments results in a liability classification (IFRS Foundation, 2016).

Findings based on Sharīʿah analysis of preference shares

This paper analyzes the Sharīʿah issues arising from preference shares based on two premises: whether the underlying contract is an equity contract or a debt contract. The rulings of *mushārakah* (partnership) are applied when deliberating on preference shares as an equity contract, and the rulings of *qarḍ* (loan) are applied when deliberating on preference shares as a debt instrument.

Preference shares as equity contracts

Five Sharīʿah issues are identified in the premise that preference shares are equity contracts. These are:

(1) capital guarantee;

(2) loss sharing disproportionate to capital contribution;

(3) fixed profit;

(4) profit guarantee; and

(5) waiver of right prior to realization of profit.

The capital guarantee happens in the following situations:

- *If preference shares are redeemable at the issue price*: The redemption right is agreed upon at the time of subscription to the preference shares and puts the issuer under liability to pay back the full amount of the invested capital to the preference shareholders upon redemption.
- *If preference shares are converted into a variable number of ordinary shares equal to the value of the issue price*: Because of this conversion, even though the preference shareholders will not get back their invested capital in the form of cash, they will get ordinary shares that are equal to the value of their invested capital.

Loss sharing disproportionate to capital contribution arises when preference shareholders have the privilege of claiming their capital before ordinary shareholders at the time of liquidation and winding up. Based on this prioritization, ordinary shareholders may not receive any of their capital back or may receive only part of it. This is because it is subject to the availability of liquidation proceeds after settling all payments to the prioritized parties, i.e. creditors and preference shareholders.

The fixed dividend rate provides a contractual or constructive guarantee that a profit at that rate will be distributed to preference shareholders. The guarantee is contractual if the preference shares have a cumulative feature and constructive if they have a non-cumulative feature.

The element of profit guarantee exists if the preference shares have a cumulative feature. With this feature, if a company does not pay a dividend because of financial distress, liquidity problems, plans for future investment or any other reason, the amount of unpaid dividends gradually builds up until it is paid to the shareholders. Any accrued but unpaid dividends of preference shares with a cumulative feature must be paid to the preference shareholders upon redemption.

The waiver of right to profit by ordinary shareholders occurs prior to profit realization when they consent to the issuance of preference shares at a general meeting. Any profit from investment of this new capital is yet to be generated at that point in time.

Preference shares as debt contracts

The main Sharīʿah issue identified in the premise that preference shares are debt instruments is the existence of *ribā* (interest). A strict Sharīʿah prohibition applies to guaranteeing any return over the debt principal amount. This issue is particularly pertinent in the case of cumulative preference shares.

Proposed solutions for structuring Sharīʿah-compliant preference shares

After identifying the Sharīʿah issues related to preference shares, the paper concludes that the most conventional preference shares are Sharīʿah non-compliant, especially because of the features of capital guarantee and fixed return. The above-mentioned Sharīʿah issues must be avoided to structure preference shares in a Sharīʿah-compliant manner. The paper proposes the following recommendations:

- To avoid the issue of capital guarantee in redeemable and convertible preference shares, the redemption price must be based on the market price or a price agreed upon at the time of redemption. For the conversion, price must be based on a fixed number of preference shares to a fixed number of ordinary shares. This is because the value of ordinary shares at the date of conversion is not necessarily equal to the capital injected upon subscription to the preference shares.
- To avoid loss sharing disproportionate to capital contribution, ordinary shareholders can give a conditional waiver of right to the preference shareholders. This waiver of right can only be confirmed at the point of winding up or liquidation, not at the outset when issuing the preference shares.
- To avoid a fixed profit rate, the distribution between ordinary and preference shareholders can be based on an agreed-upon profit sharing ratio up to a ceiling amount, beyond which a specified amount can be given to the preference shareholders.
- To avoid a profit guarantee, the dividend payment must be based on realization of profit. Moreover, accumulation of dividends based on a pre-determined rate must be avoided. However, any declared but unpaid dividends can be accumulated and become part of the issuer's liabilities. This is because, upon declaring a dividend, the issuer has a legal obligation to pay it. In this case, the debt can be paid in the following year or can be paid upon redemption by including the amount (if any) in the redemption price.

- Regarding waiver of the right to profit prior to its realization the study prefers the view that permits upfront *tanāzul* (waiver) that is done after the existence of the *sabab* (cause) of the right, even though the right itself does not yet exist (Badri and Mohamad, 2014). Thus, even though the profit is not yet realized upfront *tanāzul* is permitted because the cause already exists, i.e. the *mushārakah* contract has been executed. However, the study also proposes other solutions: a promise to waive the right and conditional *tanāzul*. These are alternatives to upfront *tanāzul* for those who consider upfront *tanāzul* impermissible even when the cause of the right already exists.
- In terms of the issue of *ribā* arising in preference shares (when treated as liability), there is no way to make them Sharī'ah-compliant. Therefore, the study concludes that preference shares should be structured based on the *mushārakah* contract and not on the *qarḍ* contract.

Conclusion

This paper has discussed preference shares from both accounting and Sharī'ah perspectives. It finds that in IFRS-based financial reporting, preference shares can be classified as a liability, equity or hybrid instrument.

When preference shares are classified as equity, the principle pertaining to *mushārakah* is observed. When preference shares are categorized as debt/liability instruments, the Sharī'ah ruling pertaining to debt is analyzed.

This paper finds that there are different types of preference shares having different and unique features. Thus, it is not accurate to simply generalize all types of preference shares as either equity or loan without analysing the specific features embedded in each type. This paper also finds that most preference shares are not compatible with the Sharī'ah ruling for either *mushārakah* or loan.

It is found that the combination of principal and profit guarantee, as well as fixed guaranteed return embedded in most conventional preference shares, makes these financial instruments similar to conventional loans. The paper is of the view that a combination of loan features and equity features changes the instrument to a liability. This is the reason for the authors' view that conventional preference shares having those primary loan features are generally classified as a liability. In addition, from the Sharī'ah perspective, this paper finds that a single loan feature is sufficient to classify any preference share in the loan category.

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