Accounting Treatment of Preferred Stock Financing

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Abstract: in this paper, the financing situation of preferred stock is elaborated, and relevant accounting standards are combed. Based on the substance and the formal principle, starting from the basic attributes of liabilities, we analyze the contradictions in the accounting treatment of preferred stock and do not conform to the definition of liabilities.

1. Introduction

Thanks to the economic development and national support for entrepreneurship, the number of China's start-up enterprises grows at a rate of nearly 100% every year. Companies in the initial stage and development stage need a lot of capital. Many growth companies have to focus on other external financing channels through private equity,and it has become the main financing channel for a large number of non-public companies.

The following is the accounting treatment problems of preferred shares. Many of them have encountered the accounting treatment of preferred shares at the time of listing, which leads to the problem that the statements can not accurately reflect the company's status, which leads to the research heat of convertible redeemable preferred stock. The accounting treatment method of convertible redeemable preferred stock can not reflect its economic essence, and the accuracy of financial statements, enterprise valuation and payment income tax and other aspects have a very big impact. This situation has triggered the heat of research on preferred stock. How to deal with convertible redeemable preferred stock has become a very practical problem. The current research tends to analyze the defects of accounting treatment from the perspective of economic consequences. This paper attempts to analyze the internal contradictions of accounting treatment of preferred shares from the perspective of accounting standards and financing terms of preferred shares, in order to optimize the accounting treatment of preferred stock.

2. Analysis of Preferred Stock Financing

The future of the enterprise is a huge uncertainty. As a venture capital investor, they want to minimize risks and maximize the benefits. Investors will sign the preferred stock financing provisions including financing agreements. This is the price that growth enterprises must pay to choose this external equity financing method, and exchange the future interests for the current financing. As a new financial instrument, preferred stock financing has become the main financing way of non-public companies because it can not only meet the financing needs of companies, but also can set up protective clauses and gambling agreements to protect the interests of investors. In the course of the actual operation, new problems arise, and the complicated additional clauses bring about the dual attributes of liabilities and interests of the financial instrument.

3. Sorting out Accounting Standards

The most fundamental concept has more basic guiding significance. In order to analyze the recognition of the attributes of financial liabilities and equity instruments of preferred stock financial instruments, in addition to studying the two themselves, it is necessary to make a fundamental distinction between the two basic concepts, namely liabilities and owner's equity, so as to detail the basic connotation of preferred stock attributes.

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3.1 Distinction between Liabilities and Owners' Equity

Liabilities and owner's equity are the most basic elements of accounting. Assets equal to liabilities plus owners' equity constitute accounting equation, which is the foundation of financial accounting.

With the increasing degree of economic globalization, it is more and more necessary for accounting standards to achieve international convergence. Generally speaking, there are three types of liability nature explained in each standard framework:

(1) The nature of debt is an obligation or economic responsibility, which can not be avoided by independent choice

(2) Liabilities are formed by past transactions or events;

(3) Liabilities will lead to the outflow of economic benefits from the enterprise.

The definition of owner's equity is relatively uniform in each standard system. According to the accounting equation, assets equal to liabilities plus owners' equity, the definition of owner's equity is “residual interest of principal assets after deducting all liabilities.”

3.2 Distinction between Financial Liabilities and Equity Instruments

The current international accounting standards define financial instruments that meet the following conditions as financial liabilities.

(1) Contractual obligations to deliver cash or other financial assets to other parties;

(2) Contractual obligations to exchange financial assets or financial liabilities with other parties under potential adverse conditions;

If the contract is to be settled with or available to the enterprise's own equity instruments, financial liabilities include:

(1) Non derivative instruments for which an enterprise undertakes or may assume the obligation to deliver a variable amount of its own equity instruments;

(2) Derivative instrument contract, except derivative instrument contract in which fixed amount of cash or other financial assets is exchanged with fixed amount of own equity instrument. Equity instrument is defined as a contract that can prove the residual equity of an enterprise after deducting all liabilities, which is defined by strict obligation method.

3.3 Strict Liability Method

The strict liability method is based on the definition of liabilities. An instrument is classified as a liability only when it has the obligation to deliver economic resources. Other claims are classified as equity instruments, which belongs to the concept of “residual equity”. This method is a strict liability method based on the definition. Based on the differentiation requirements of the strict liability method, the strict liability method should also be used to identify whether the financial liabilities meet the definition of liabilities. Other financial instruments that do not meet the definition of liabilities belong to the category of equity instruments.

4. Analysis on Accounting Treatment of Preferred Stock

4.1 Preferred Stock Clause

At present, the financing terms of convertible redeemable preferred stock are usually as follows:

(1) Dividend terms, stipulating the payment of interest;

(2) In the case of successful listing, the company can convert preferred shares into ordinary shares;

(3) Buy back clauses are divided into mandatory repurchase and voluntary repurchase. In fact, for the risk protection mechanism of investors, in actual transactions, the company is required to

buy back the preferred shares according to the amount of principal plus interest on the condition that the operation fails to meet the required standards or listing failure.

4.2 Accounting Treatment of Preferred Stock

According to international accounting standards, the key to distinguish financial liabilities from equity instruments is that the issuers of financial instruments have such contractual obligations. The issuers need to deliver cash or other financial assets to the holders or exchange other financial assets with the holders under potentially unfavorable conditions. When these contractual obligations exist, the issued financial instruments meet the definition of financial liabilities, regardless of the settlement method of such contractual obligations.

According to the accounting standards, the current accounting treatment for preferred stock financing is to list the convertible redeemable preferred stock as “financial liabilities included in profit and loss at fair value” in the balance sheet, which is initially recognized at fair value, and the change of its fair value is included in the current profit and loss. When the company's valuation increases, the fair value of the convertible redeemable preferred shares will also rise. This increase in fair value needs to be recognized as a “fair value loss” in the income statement. On the contrary, if the company's valuation declines, the fair value of the convertible redeemable preferred shares will also decline. The corresponding decline in fair value is recognized as “fair value income” in the income statement, which causes the counter intuitive contradiction that the higher the enterprise grows, the greater the loss. At the same time, it has a great impact on the capital structure and tax of the company.

4.3 Analysis on Accounting Treatment of Preferred Stock

Based on the accounting theory, according to the principle that reality is more important than form, there is a contradiction between the financial liability attribute of preferred stock and the attribute of its basic concept liability under the current accounting standards, that is, the recognition of preferred stock may meet the financial liabilities but fail to meet the liability conditions.

In practice, venture investors often start the investment exit stage with the listing node, because once the company is listed successfully, investors and private equity funds can obtain a lot of investment benefits through the conversion of preferred shares. If the company is not listed well, it will have a huge blow to the company. Investors can ask the company to repay and redeem the preferred shares in time through the repurchase clause in order to withdraw investment.

From the perspective of the company, the good operation of the company will accumulate a huge amount of changes in the fair value of preferred shares, resulting in a huge increase in financial liabilities.

(1) Once the listing is successful, the huge financial liabilities will disappear. If the shares are converted into the common shares of the company according to the corresponding number of shares, the essence is consistent with the principle of “fixed for fixed”.

(2) Once encountering adverse circumstances, the company will face repayment. What needs to be paid is not the total amount of financial liabilities, but only the amount agreed in accordance with the repurchase terms.

That is to say, it is unreasonable to recognize the full amount of preferred shares as financial liabilities because the economic benefits that the company will flow out will be the repayment part of the repurchase clause under adverse circumstances.

5. Conclusion

This paper analyzes the financing situation of preferred stock and sorts out the relevant accounting standards. According to the principle of substance over form, starting from the basic attribute of liabilities, this paper concludes that the accounting treatment of preferred shares does not conform to the definition of liabilities. In the process of converting preferred shares into shares,

there may not be any actual benefit outflow, but the actual benefit outflow is the agreed amount when faced with repurchase. Therefore, this point should be considered in the accounting treatment of such preferred shares. Starting from the reality, the accounting treatment should be carried out from the Perspective of splitting the preferred shares, and the actual unfavorable situation should be paid back as financial liabilities according to the terms, which can better meet the economic needs and accounting principles.

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