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The Curious Case of Redeemable Preference Shares

On 28 September 2019, the Companies (Amendment) Act 2019 ("**the Amendment Act**") which amends certain provisions of the Companies Act 2016 ("**CA**"), was gazetted. At the time of publication, the Amendment Act has yet to come into force.
One of the key changes under the Amendment Act is in relation to redemption of redeemable preference shares ("**RPS**").

Under the CA, preference shares are redeemable out of profits, a fresh issue of shares, or capital of the company. Pursuant to section 72(5), where preference shares are redeemed out of profits or capital of the company, the company would be required to transfer, out of profits, an equivalent amount into the share capital of the company.

Once the Amendment Act comes into force, section 72(5) will be amended to provide that only shares redeemed out of profits would require a transfer by the company of an equivalent amount from its profits into the share capital account. This change removes the ambiguity of redemption of preference shares out of capital, which would then only require the satisfaction of the solvency statement obligation.

Nonetheless, there are issues relating to redemption of preference shares that the Amendment Act does not address.

Paragraph 18 of the Malaysian Financial Reporting Standards 132 ("**FRS132**") provides that the substance of a financial instrument, rather than its legal form, governs the classification of the entity's financial position. While substance and legal form are commonly consistent, they are not always as some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities.

For example, a preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount is considered a financial liability.

By virtue of section 244 of the CA, companies incorporated in Malaysia must comply with the applicable approved accounting standards i.e. accounting standards issued or adopted by the Malaysian Accounting Standards Board ("**MASB**"). FRS132 is one of the approved accounting standards issued by MASB. In the event there is a conflict or inconsistency between the CA and the applicable approved accounting standards, subsection 244(7) provides that the applicable approved accounting standards prevail.

Bearing this in mind, if a company properly classifies its RPS as a financial liability pursuant to FRS132, how must the company account for the redemption of the RPS?
There are at least two questions that must be addressed:

- whether the company can redeem the RPS from its available cash balances in bank or bank borrowings (i.e. other than from its profits, or fresh issue of shares, or capital, as required under section 72(4) of the CA); and

- whether the company must transfer a sum equal to the amount of the RPS redeemed from its profits upon redemption of the RPS as required under section 72(5) of the CA?

For the purpose of illustration, in a hypothetical scenario where Company X does not have enough profit or capital to redeem its RPS, which has been classified as a financial liability, and there is no existing shareholder or new investor who is willing to inject new capital to redeem the RPS, does it mean that Company X cannot legally redeem its RPS? A strict literal interpretation of the existing section 72(4) may pose this problem. Unfortunately, the recent Amendment Act does not address this. Does it mean then that Company X cannot do anything other than to suffer winding up proceedings that may potentially be commenced by the RPS holder after the redemption becomes due?

Let's say that Company X's board of directors decides, despite the provisions in section 72(4), to take up a new bank loan to redeem the RPS which has been classified as a financial liability, must the board of directors then effect: (1) a transfer of whatever balance in Company X's profit ("**Balance Profit**") into the share capital account, and (2) charge the deficient amount to its Statements of Profit or Loss and Other Comprehensive Income ("**Deficient Amount**") to make up the entire sum equal the redemption amount, for the purpose of complying with the provisions in section 72(5)? By doing this, Company X would have to (A) recognise the Deficient Amount as a loss in its Statements of Profit or Loss and Other Comprehensive Income, and (B) correspondingly inflate its share capital in the Statements of Financial Position by the sum of the Balance Profit and Deficient Amount.

If the RPS were classified as equity (instead of financial liability), the transfer from the profit account into the share capital account in accordance with section 72(5) would be logical and make perfect sense. This is to ensure that the capital is maintained post redemption of RPS. However, confusion arises where the RPS is classified as a financial liability, as not only does the transfer not serve the original legislative intent of capital maintenance, the resultant share capital (after the transfer) would not represent the true and fair view of the actual financial position of the company. Like in the case of Company X as illustrated above, its resultant share capital would be artificially inflated by the sum that equals the redemption amount.

In communicating about the Amendment Act to the public, the Companies Commission of Malaysia explained on its website that the amendment was to address feedback from stakeholders on the need for several provisions to be amended to ensure good practices and better compliance with the law. However, based on the issues as highlighted as above, it remains to be seen whether the amendment will ensure better compliance with the law as claimed.

If you have any questions or require any additional information, please contact Ahmad Zulkharnain Musa or the Zaid Ibrahim & Co. partner you usually deal with.
