

To the Point

FASB – final guidance

FASB issues initial measurement guidance for paid-in-kind dividends on equity-classified preferred stock

The guidance reduces complexity and improves comparability of financial reporting information for entities that issue PIK dividends on equity-classified preferred stock.

What you need to know

- ▶ The FASB issued guidance requiring entities to initially measure paid-in-kind (PIK) dividends on equity-classified preferred stock using the PIK dividend rate stated in the preferred stock agreement.
- ▶ The guidance applies to preferred stock classified as either permanent or temporary equity.
- ▶ The guidance is effective for fiscal years beginning after 15 December 2026, including interim reporting periods within those fiscal years. Entities can apply the guidance either prospectively to PIK dividends recognized on preferred stock on or after the effective date or on a modified retrospective basis for PIK dividends on preferred stock that is outstanding as of the initial application date. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB) issued an **Accounting Standards Update** (ASU) requiring entities to initially measure PIK dividends on equity-classified preferred stock using the PIK dividend rate stated in the preferred stock agreement. The guidance applies to equity-classified preferred stock, including preferred stock classified as temporary equity under Accounting Standards Codification (ASC) 480-10-S99-3A.¹

Issuers typically satisfy PIK dividends by issuing additional preferred stock with the same terms as the original preferred stock or by increasing the original preferred stock's liquidation value.

The ASU, which is based on a recommendation of the Emerging Issues Task Force, is intended to address stakeholder concerns about the lack of authoritative guidance on how an issuer should initially measure PIK dividends on equity-classified preferred stock.

Stakeholders observed that issuers use different methods to measure PIK dividends on equity-classified preferred stock, including:

- ▶ At the fair value of the additional preferred stock issuable on the date the dividends are recognized
- ▶ At the stated PIK dividend rate, in accordance with the terms of the preferred stock agreement
- ▶ At fair value or the stated PIK dividend rate, depending on whether the PIK dividend is discretionary or nondiscretionary

The diversity in practice affects the measurement of equity-classified preferred stock presented in the statement of financial position and, for entities that report earnings per share, the amount of income available to common shareholders. This diversity also reduces the comparability of financial reporting information for entities that issue these dividends.

While the new guidance addresses how issuers initially measure PIK dividends on equity-classified preferred stock, it doesn't affect an entity's determination of when to recognize them.

Key considerations

The ASU applies to convertible and nonconvertible equity-classified preferred stock, including preferred stock that is classified as temporary equity. It is not intended to modify the subsequent measurement of PIK dividends on preferred stock that is classified as temporary equity.

Entities are required to initially measure PIK dividends on equity-classified preferred stock using the PIK dividend rate stated in the preferred stock agreement. For example, if the agreement specifies that PIK dividends are calculated by multiplying the PIK dividend rate by the liquidation value of the outstanding preferred stock, the entity will measure the PIK dividend at that amount. When preferred stock is not issued at a discount or premium, the liquidation value is generally the stock's original issue price.

The scope of the guidance is limited to equity-classified preferred stock meeting the following conditions:

- ▶ Dividends are satisfied by either (1) issuances to the preferred shareholders of additional preferred stock with the same terms as the original preferred stock or (2) increases to the value of the original preferred stock in accordance with the preferred stock agreement (e.g., increases to the original preferred stock's liquidation value).
- ▶ The monetary value of the PIK dividends varies based on either (1) the additional preferred stock issued to preferred shareholders with the same terms as the original preferred stock or (2) increases in the original preferred stock's liquidation value. The guidance does not apply if the issuer satisfies its dividend obligations by issuing a variable number of shares of the preferred stock for a fixed monetary amount.

The ASU does not apply to (1) preferred stock classified as a liability under ASC 480, *Distinguishing Liabilities from Equity*, (2) dividends on preferred stock payable in equity securities with terms that are different from the original preferred stock (e.g., dividends on preferred stock payable in shares of common stock), (3) nonmonetary distributions of assets accounted for under ASC 845, *Nonmonetary Transactions*, or (4) separate transactions that represent a deemed dividend (e.g., certain redemptions of preferred stock).

How we see it

The ASU requires a single measurement approach that will enhance comparability across reporting entities and improve the decision usefulness of information provided to investors.

The ASU will also reduce complexity by eliminating the need for judgmental estimates as the issuer should have all the necessary information in the preferred stock agreement to measure the PIK dividend amount.

Effective date and transition

The amendments are effective for fiscal years beginning after 15 December 2026, including interim reporting periods within those fiscal years.

Entities have the option to apply the guidance either (1) prospectively to PIK dividends recognized on equity-classified preferred stock on or after the effective date (i.e., regardless of whether the preferred stock was issued before or after the initial application date) or (2) on a modified retrospective basis by recognizing a cumulative-effect adjustment to retained earnings (or other appropriate components of equity) as of the beginning of the earliest period presented. The modified retrospective approach applies to PIK dividends recognized on preferred stock that is outstanding as of the effective date.

Early adoption is permitted in both interim and annual financial statements that have not yet been issued or made available for issuance. An entity that adopts the guidance in an interim period is required to do so as of the beginning of the fiscal year that includes that interim period.

Transition disclosures

All entities are required to disclose in both the interim period (if applicable) and the annual reporting period of initial application (1) the nature of the change in accounting principle, including an explanation of the newly adopted accounting principle, and (2) the method used to apply the change.

Entities that apply the guidance using the modified retrospective approach are also required to disclose (1) the cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the earliest period presented and (2) the effect of the change on income available to common shareholders, any other affected financial statement line items, and any affected per-share amounts for the current reporting period and any prior reporting periods that were retrospectively adjusted.

Endnotes:

¹ ASC 480-10-S99-3A, *Distinguishing Liabilities from Equity* — SEC Staff Announcement: *Classification and Measurement of Redeemable Securities*.

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