



corporate | FRS 25 - financial instruments

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objective

The objective of FRS 25 is to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cash flows.

requirements

The requirements of the standard deal with:

- classification of financial instruments into liabilities and equity
- classification of related interest, dividends, losses and gains.

definitions

A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Examples include debtors, creditors, equity securities and derivative instruments such as forward contracts.

A financial asset is any asset that is cash, an equity instrument of another entity, a contractual right to receive cash or a contractual right to exchange financial instruments with another entity.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another entity.

financial liability or equity

The most common implication of FRS 25 will be the consideration of what should be presented as equity and what should be presented as a financial liability.

As noted above, the critical feature in differentiating a financial liability from an equity instrument is the existence of a **contractual obligation** of one party to the financial instrument (the issuer) to deliver cash or another financial asset to the other party (the holder).

Where such a contractual obligation exists, that financial instrument meets the definition of a financial liability regardless of the manner in which the contractual obligation will be settled.

an example

A company holds both "A" preference shares and 8% cumulative redeemable preference shares.

The "A" preference shares are only redeemable at discretion of the directors. Whereas the cumulative redeemable preference shares have a coupon rate of 8% per annum and are redeemable by the company no later than 30 June 2010.

The "A" preference shares have no contractual obligation to deliver cash or another financial instrument to the holders and they should be presented as equity. Whereas the 8% cumulative redeemable preference shares have the contractual obligation to pay **both** the annual coupon rate of 8% and the obligation to redeem the shares by 30 June 2010 and they should be presented as a financial liability in the balance sheet.

The 8% dividend relating to the financial liability should be recognised as an expense in the profit and loss account irrespective of whether the company has the distributable reserves to legally pay these dividends.

called up share capital	£	£
Authorised		
100 Ordinary Shares of £1 each	100	100
500,000 'A' preference shares of £1 each	500,000	500,000
200,000 8% cumulative redeemable preference shares of £1 each	200,000	200,000
	<hr/>	<hr/>
	700,100	700,100
		As restated
Allotted, called up and fully paid		
100 ordinary shares of £1 each	100	100
238,968 'A' preference shares of £1 each	238,968	238,968
	<hr/>	<hr/>
	239,068	239,068
	<hr/>	<hr/>
Shares classed as financial liabilities		
174,000 8% cumulative redeemable preference shares of £1 each	174,000	164,000
	<hr/>	<hr/>

classification of compound instruments by the issuer

FRS 25 requires the separate presentation on an issuer's balance sheet of liability and equity elements created by a single financial instrument, an example of which would be a convertible bond that may be converted by the holder into a fixed number of shares of the issuer.

From the issuer's perspective, such an instrument comprises two components, a financial liability to deliver cash and an equity instrument – a call option granting the holder the right to convert into a fixed number of ordinary shares. It should be noted that the classification is not changed as a result of any changes in the likelihood of the exercise of the conversion option.

The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the carrying amount that would be ascribed to the instrument as a whole.

- Firstly, the issuer determines the carrying amount of the liability component by measuring the fair value of a similar liability.
- Secondly, the carrying amount of the equity instrument represented by the option to convert the instrument into common shares is calculated by deducting the carrying amount of the financial liability from the amount of the compound instrument as a whole.

an example

An entity issues 2,000 convertible bonds at the start of year one. The bonds have a three-year term and are issued at par with a face value of £1,000 per bond, giving total proceeds of £2,000,000. Interest is payable annually in arrears at a nominal interest rate of 6%. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%.

The liability component is measured first with the present value of the liability component calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights as shown below.

Present value of the principal - £2,000,000 payable at the end of three years	1,544,367
Present value of the interest - £120,000 payable annually in arrears for three years	<u>303,755</u>
Total liability component	1,848,122
Equity component (balancing figure)	<u>151,878</u>
	2,000,000
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Over the three year life of the bonds, the discount rate on the liability component unwinds (through debits to the profit and loss account) such that at the end of that period the carrying value is £2m.

interest and dividends

- Distributions to holders of equity instruments shall be debited by the entity directly to equity.
- Dividend payments on shares are treated as liabilities are classified as expenses in the same way as interest on a loan and recognised as charges in the profit and loss account.

Dividends classified as an expenses may be presented in the profit and loss account either with interest on other liabilities or as a separate item.

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