

4

CAPITAL INSTRUMENTS



ACCOUNTING
STANDARDS
BOARD

FINANCIAL REPORTING
STANDARD

*Financial Reporting Standard 4
'Capital Instruments' is issued by the
Accounting Standards Board in respect of its
application in the United Kingdom and by
the Institute of Chartered Accountants in
Ireland in respect of its application in the
Republic of Ireland.*

**FINANCIAL REPORTING
STANDARD**

4

CAPITAL INSTRUMENTS

Financial Reporting Standard 4 is set out in paragraphs 1-67.

The Statement of Standard Accounting Practice set out in paragraphs 18-67 should be read in the context of the Objective as stated in paragraph 1 and the definitions set out in paragraphs 2-17 and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The Application Notes specify how some of the requirements of FRS 4 are to be applied to transactions that have certain features.

The Explanation set out in paragraphs 68-102 and the Application Notes shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

Appendix III 'The development of the FRS' reviews considerations and arguments that were thought significant by members of the Board in reaching the conclusions on FRS 4. The Board adopted the FRS on the basis of the overall considerations; individual members gave greater weight to some factors than to others.

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ADOPTION OF FRS 4 BY THE BOARD

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SUMMARY

- a Financial Reporting Standard 4 'Capital Instruments' requires capital instruments to be presented in financial statements in a way that reflects the obligations of the issuer. The FRS prescribes methods to be used to determine the amounts to be ascribed to capital instruments and their associated costs and specifies relevant disclosures.
- b The amount of shareholders' funds attributable to equity and non-equity interests is to be disclosed. In consolidated financial statements a similar analysis of minority interests is to be disclosed. If any capital instrument other than shares contains an obligation to transfer economic benefits, it is to be classified as a liability. Convertible debt is to be displayed separately from other liabilities. The key distinctions may be summarised as follows:

Item	Analysed between	
Shareholders' funds	Equity interests	Non-equity interests
Minority interests in subsidiaries	Equity interests in subsidiaries	Non-equity interests in subsidiaries
Liabilities	Convertible liabilities	Non-convertible liabilities

- c The direct costs incurred in connection with the issue of capital instruments should be deducted from the proceeds of the issue. This treatment applies only to those costs that can be demonstrated to relate directly to the instrument in question. Other costs are to be charged as expenses when incurred.
- d The finance costs associated with liabilities and non-equity shares are to be allocated to periods at a constant rate based on the carrying amount. The

amount to be attributed to these instruments initially is the net amount of the issue proceeds. The finance cost for a period is added to the carrying amount and payments deducted from it. In the case of a redeemable instrument this will result in the carrying amount at the time it is redeemed being equal to the amount payable at that time.

- e The FRS applies to all reporting entities whose financial statements are intended to give a true and fair view, irrespective of size or ownership.
- f The requirements of the FRS apply to all transactions and to all instruments irrespective of the date at which they are issued.

FINANCIAL REPORTING STANDARD 4

OBJECTIVE

- 1 The objective of this FRS is to ensure that financial statements provide a clear, coherent and consistent treatment of capital instruments, in particular as regards the classification of instruments as debt, non-equity shares or equity shares; that costs associated with capital instruments are dealt with in a manner consistent with their classification, and, for redeemable instruments, allocated to accounting periods on a fair basis over the period the instrument is in issue; and that financial statements provide relevant information concerning the nature and amount of the entity's sources of finance and the associated costs, commitments and potential commitments.

DEFINITIONS

The following definitions shall apply in this FRS and in particular in the Statement of Standard Accounting Practice set out in paragraphs 18-67.

- 2 *Capital instruments:-*
All instruments that are issued by reporting entities as a means of raising finance, including shares, debentures, loans and debt instruments, options and warrants that give the holder the right to subscribe for or obtain capital instruments. In the case of consolidated financial statements the term includes capital instruments issued by subsidiaries except those that are held by another member of the group included in the consolidation.
- 3 *Companies Act 1985:-*
The Companies Act 1985 as amended by the Companies Act 1989.
- 4 *Companies (Northern Ireland) Order 1986:-*
The Companies (Northern Ireland) Order 1986 as amended by the Companies (Northern Ireland) Order 1990 and the Companies (No 2) (Northern Ireland) Order 1990.
- 5 *Companies (Amendment) Act 1986:-*
The Republic of Ireland Companies Acts 1963-1990 and the European Communities (Companies: Group Accounts) Regulations 1992.
- 6 *Debt:-*
Capital instruments that are classified as liabilities.
- 7 *Equity shares:-*
Shares other than non-equity shares.
- 8 *Finance costs:-*
The difference between the net proceeds of an instrument and the total amount of the payments (or

other transfers of economic benefits) that the issuer may be required to make in respect of the instrument.

9 *Investment companies:-*

Investment companies as defined in section 266 of the Companies Act 1985, or in section 274 of the Companies (Northern Ireland) Order 1986, or in section 47(3) of the Companies (Amendment) Act 1983.

10 *Issue costs:-*

The costs that are incurred directly in connection with the issue of a capital instrument, that is, those costs that would not have been incurred had the specific instrument in question not been issued.

11 *Net proceeds:-*

The fair value of the consideration received on the issue of a capital instrument after deduction of issue costs.

12 *Non-equity shares:-*

Shares possessing any of the following characteristics:

a) any of the rights of the shares to receive payments (whether in respect of dividends, in respect of redemption or otherwise) are for a limited amount that is not calculated by reference to the company's assets or profits or the dividends on any class of equity share.

b) any of their rights to participate in a surplus in a winding up are limited to a specific amount that is not calculated by reference to the company's assets or profits and such limitation had a commercial effect in practice at the time the shares were issued or, if later, at the time the limitation was introduced.

c) the shares are redeemable either according to their terms, or because the holder, or any party other than the issuer, can require their redemption.

- 13 *Participating dividend:-*
A dividend (or part of a dividend) on a non-equity share that, in accordance with a company's memorandum and articles of association, is always equivalent to a fixed multiple of the dividend payable on an equity share.
- 14 *Share:-*
Share in the share capital of the reporting company (or, in the context of consolidated financial statements, the holding company of a group), including stock.
- 15 *Shareholders' funds:-*
The aggregate of called up share capital and all reserves, excluding minority interests.
- 16 *Term (of a capital instrument):-*
The period from the date of issue of the capital instrument to the date at which it will expire, be redeemed, or be cancelled.
- If either party has the option to require the instrument to be redeemed or cancelled and, under the terms of the instrument, it is uncertain whether such an option will be exercised, the term should be taken to end on the earliest date at which the instrument would be redeemed or cancelled on exercise of such an option.
- If either party has the right to extend the period of an instrument, the term should not include the period of the extension if there is a genuine commercial possibility that the period will not be extended.
- 17 *Warrant:-*
An instrument that requires the issuer to issue shares (whether contingently or not) and contains no obligation for the issuer to transfer economic benefits.

STATEMENT OF STANDARD ACCOUNTING PRACTICE

Scope

- 18 Financial Reporting Standard 4 applies to all financial statements intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure) for a period. The terminology used in this statement will be appropriate for those reporting entities that are companies. Entities other than companies should adapt the terminology as appropriate.
- 19 The FRS applies to accounting for capital instruments by entities that issue them. It does not address accounting for investments in capital instruments issued by other entities.
- 20 The scope of the FRS includes capital instruments denominated in a foreign currency. However, the FRS does not address the translation of foreign currency amounts relating to such instruments into the reporting currency or the accounting for foreign exchange differences arising from such translations.
- 21 The requirements of the FRS apply to all capital instruments with the following exceptions:
- a warrants issued to employees under employee share schemes;
 - b leases, which should be accounted for in accordance with SSAP 21;
 - c equity shares issued as part of a business combination that is accounted for as a merger.
- 22 In applying the requirements of the FRS, capital instruments that are issued at the same time in a composite transaction should be considered together. They should be accounted for as a single instrument

unless they are capable of being transferred, cancelled or redeemed independently of each other.

Classification of capital instruments

- 23 All capital instruments should be accounted for in the balance sheet within one of the following categories:
- liabilities,
 - shareholders' funds,
 - in the case of consolidated financial statements, minority interests.
- 24 Capital instruments (other than shares, which are addressed at paragraphs 37-45 below) should be classified as liabilities if they contain an obligation to transfer economic benefits (including a contingent obligation to transfer economic benefits). Capital instruments that do not contain an obligation to transfer economic benefits should be reported within shareholders' funds.

Debt

Convertible debt

- 25 Conversion of debt should not be anticipated. Convertible debt should be reported within liabilities and the finance cost should be calculated on the assumption that the debt will never be converted. The amount attributable to convertible debt should be stated separately from that of other liabilities.
- 26 When convertible debt is converted, the amount recognised in shareholders' funds in respect of the shares issued should be the amount at which the liability for the debt is stated as at the date of conversion. No gain or loss should be recognised on conversion.

Carrying amount and allocation of finance costs

- 27 Immediately after issue, debt should be stated at the amount of the net proceeds.
- 28 The finance costs of debt should be allocated to periods over the term of the debt at a constant rate on the carrying amount. All finance costs should be charged in the profit and loss account, except in the case of investment companies, which are addressed in paragraph 52.
- 29 The carrying amount of debt should be increased by the finance cost in respect of the reporting period and reduced by payments made in respect of the debt in that period.
- 30 Accrued finance costs may be included in accruals rather than in the carrying amount of debt to the extent that the finance costs have accrued in one accounting period and will be paid in cash in the next. Any such accrual should be included in the carrying amount of the debt for the purposes of calculating finance costs and gains and losses arising on repurchase or early settlement.
- 31 Where the amount of payments required by a debt instrument is contingent on uncertain future events such as changes in an index, those events should be taken into account in the calculation of the finance costs and the carrying amount once they have occurred.

Repurchase of debt

- 32 Gains and losses arising on the repurchase or early settlement of debt should be recognised in the profit and loss account in the period during which the repurchase or early settlement is made.

The maturity of debt

- 33 An analysis of the maturity of debt should be presented showing amounts falling due:
- a in one year or less, or on demand;
 - b between one and two years;
 - c between two and five years; and
 - d in five years or more.
- 34 The maturity of debt should be determined by reference to the earliest date on which the lender can require repayment.
- 35 Where committed facilities are in existence at the balance sheet date that permit the refinancing of debt for a period beyond its maturity, the earliest date at which the lender can require repayment should be taken to be the maturity date of the longest refinancing permitted by a facility in respect of which all the following conditions are met:
- a The debt and the facility are under a single agreement or course of dealing with the same lender or group of lenders.
 - b The finance costs for the new debt are on a basis that is not significantly higher than that of the existing debt.
 - c The obligations of the lender (or group of lenders) are firm: the lender is not able legally to refrain from providing funds except in circumstances the possibility of which can be demonstrated to be remote.
 - d The lender (or group of lenders) is expected to be able to fulfil its obligations under the facility.

- 36 Where the maturity of debt is assessed by reference to that of refinancing permitted by facilities in accordance with paragraph 35, the amounts of the debt so treated, analysed by the earliest date on which the lender could demand repayment in the absence of the facilities, should be disclosed.

Shares and warrants

- 37 Shares and warrants should be reported as part of shareholders' funds. In the period in which shares or warrants are issued, the net proceeds should be reported in the reconciliation of movements in shareholders' funds.
- 38 The balance sheet should show the total amount of shareholders' funds.
- 39 Where shares are repurchased or redeemed, shareholders' funds should be reduced by the value of the consideration given.

The analysis of shareholders' funds

- 40 Shareholders' funds should be analysed between the amount attributable to equity interests and the amount attributable to non-equity interests. The amount of shareholders' funds attributable to equity interests is the difference between total shareholders' funds and the total amount attributable to non-equity interests. The amount attributable to non-equity interests is the aggregate of amounts relating to all classes of non-equity shares and warrants for non-equity shares.

The amount attributable to non-equity shares within the analysis of shareholders' funds and the allocation of finance costs

- 41 Immediately after the issue of a non-equity instrument the amount of non-equity shareholders' funds attributable to it should be the net proceeds of the

issue. This amount should be increased by the finance costs in respect of the period and reduced by dividends or other payments made in respect of the instrument in that period.

- 42 The finance costs for non-equity shares should be calculated on the same basis as the finance costs for debt set out in paragraphs 27-31 above.
- 43 Where the entitlement to dividends in respect of non-equity shares is calculated by reference to time, the dividends should be accounted for on an accruals basis except in those circumstances (for example where profits are insufficient to justify a dividend and dividend rights are non-cumulative) where ultimate payment is remote. All dividends should be reported as appropriations of profit.
- 44 Where the finance costs for non-equity shares are not equal to the dividends the difference should be accounted for in the profit and loss account as an appropriation of profits.

Equity shares and warrants

- 45 The net proceeds from the issue of equity shares and warrants for equity shares should be credited direct to shareholders' funds. The amount attributed to equity shares or warrants should not be subsequently adjusted to reflect changes in the value of the shares or warrants.
- 46 When a warrant is exercised, the amount previously recognised in respect of the warrant should be included in the net proceeds of the shares issued.
- 47 When a warrant lapses unexercised, the amount previously recognised in respect of the warrant should be reported in the statement of total recognised gains and losses.

Scrip dividends

- 48 Where shares are issued (or proposed to be issued) as an alternative to cash dividends, the value of such shares should be deemed to be the amount receivable if the alternative of cash had been chosen. Where the number of shareholders who will elect to receive the shares is uncertain, the whole amount should be treated as a liability to pay cash dividends.

Shares issued by subsidiaries

- 49 Shares issued by subsidiaries (other than shares held by companies within the group) should be accounted for in consolidated financial statements as liabilities if the group taken as a whole has an obligation to transfer economic benefits in connection with the shares, for example where another member of the group has given a guarantee of payments to be made in respect of the shares. In all other cases they should be reported as minority interests.
- 50 The amount of minority interests shown in the balance sheet should be analysed between the aggregate amount attributable to equity interests and amounts attributable to non-equity interests.
- 51 The amounts attributed to non-equity minority interests and their associated finance costs should be calculated in the same manner as those for non-equity shares. The finance costs associated with such interests should be included in minority interests in the profit and loss account.

Investment companies

- 52 Investment companies may include the finance costs in respect of capital instruments and any gains or losses recognised in accordance with paragraph 32 in the statement of total recognised gains and losses to the extent that these items relate to capital. The amount

so treated should be disclosed within the statement, and the accounting policy for determining the allocation of finance costs between revenue and capital should be stated.

Disclosures

- 53 The disclosures required by the following paragraphs should be made in addition to those required by paragraphs 25, 33, 36, 38, 40, 50 and 52 above.
- 54 Where the disclosures required by paragraphs 25, 40 and 50 of convertible debt, non-equity interests in shareholders' funds and non-equity interests in minority interests are given in the notes to the financial statements rather than on the face of the balance sheet, the relevant caption on the face of the balance sheet should state that convertible debt or non-equity interests (as the case may be) are included.

Disclosures relating to shares

- 55 An analysis should be given of the total amount of non-equity interests in shareholders' funds relating to each class of non-equity shares and series of warrants for non-equity shares.
- 56 A brief summary of the rights of each class of shares should be given. This should include the following:
- a the rights to dividends;
 - b the dates at which the shares are redeemable and the amounts payable in respect of redemption;
 - c their priority and the amounts receivable on a winding up;
 - d their voting rights.

This information will usually make clear why a class of

share has been classified as equity or non-equity, but, if necessary, additional information should be given to explain the classification. Where rights vary according to circumstances, these circumstances and the variation should be described.

- 57 The disclosure required by paragraph 56 need not be given for equity shares that have all the following features:
- a no right to dividends other than those that may be recommended by the directors;
 - b no redemption rights;
 - c unlimited right to share in the surplus remaining on a winding up after all liabilities and participation rights of other classes of shares have been satisfied;
 - d one vote per share.
- 58 Where warrants or convertible debt are in issue that may require the company to issue shares of a class that is not currently in issue the information set out in paragraph 56 should be given in respect of that class.
- 59 The aggregate dividends for each class of share should be disclosed including the total amount in respect of each of: dividends on equity shares; participating dividends; and other dividends on non-equity shares. Any other appropriation of profit in respect of non-equity shares should also be disclosed. Where there are amounts relating to non-equity shares and the above information is not given on the face of the profit and loss account the relevant caption should make clear that such amounts are included.

Disclosures relating to minority interests

- 60 The minority interests charge in the profit and loss

account should be analysed between equity and non-equity minority interests.

- 61 Where there are non-equity minority interests a description should be given of any rights of holders of the shares against other group companies.

Disclosures relating to debt

- 62 In respect of convertible debt, details of the dates of redemption and the amount payable on redemption should be disclosed. The number and class of shares into which the debt may be converted and the dates at or periods within which the conversion may take place should be stated. It should also be stated whether conversion is at the option of the issuer or at that of the holder.
- 63 A brief description should be given of the legal nature of any instrument included in debt where it is different from that normally associated with debt, for example where the debt is subordinated or where the obligation to repay is conditional. Where amounts are included in debt that represent instruments in respect of which the amount payable, or the claim that would arise on a winding up, is significantly different from that at which the instrument is stated in the financial statements, that amount should be stated. This information may be summarised and need not be given for each individual instrument.
- 64 Gains and losses arising on the repurchase or early settlement of debt should be disclosed in the profit and loss account as separate items within or adjacent to 'interest payable and similar charges'.

General

- 65 Where the brief summaries required by paragraphs 56, 58, 61, 62 or 63 cannot adequately provide the

information necessary to understand the commercial effect of instruments, that fact should be stated in the accounts together with particulars of where the relevant information may be obtained. The principal features of the instruments should, in any event, be stated.

Date from which effective

- 66 The accounting practices set out in the FRS should be regarded as standard in respect of financial statements relating to accounting periods ending on or after 22 June 1994. Earlier adoption is encouraged but not required.

Withdrawal of UITF Abstract 1 and Abstract 8

- 67 The FRS supersedes UITF Abstract 1 and Abstract 8.

EXPLANATION

Capital instruments

- 68 The definition of capital instruments, given in paragraph 2, includes all kinds of shares and debt instruments as well as options and warrants to obtain such instruments. It characterises capital instruments as a means of raising finance: an instrument may be within the definition whether or not the consideration given for its issue takes the form of cash. Capital instruments may take the form of contracts between two parties (for example a borrower and its bank) as well as an issue of transferable securities.

Identification of distinct capital instruments

- 69 In order to apply the requirements of the FRS it is necessary to determine whether instruments issued at the same time should be accounted for individually or not. Accounting for the individual instruments is required by paragraph 22 if (and only if) the instruments are capable of being transferred, cancelled or redeemed independently of each other. For example, if debt and warrants are issued simultaneously and the warrants can be transferred, cancelled or redeemed independently of the debt, the two components should be accounted for separately. It would be necessary in such a case to apportion the proceeds of the issue to each component.

The classification of capital instruments

- 70 The FRS contains requirements for determining whether capital instruments should be accounted for as liabilities. Special considerations, discussed at paragraphs 82-87 below, arise in connection with shares of the entity and these requirements accordingly do not apply to them.

- 71 The FRS requires capital instruments to be accounted for as liabilities if they contain an obligation to transfer economic benefits (paragraph 24). The most common example of such an obligation is the requirement to make cash payments to the holder of the instrument, but an obligation to transfer other kinds of property would also cause the instrument to be classified as a liability. The payments may be described in various ways, for example as interest, or as an amount payable on redemption: how the obligation is described is not relevant to the classification of the instrument.
- 72 If a capital instrument contains an obligation for the issuer to transfer economic benefits to another party it should be classified as debt even if the obligation is contingent. For example an instrument that gives the holder the right to require either the transfer of cash or the issue of an equity share imposes an obligation on the issuer and should therefore be classified as a liability. The only obligations to transfer economic benefits that should not be taken into account are those that would not be considered in accordance with the going concern concept, that is, those that would arise only on the insolvency of the issuer and, where the issuer is expected to be able to comply with covenants on loan and similar agreements, those that would follow a breach of those covenants.

The term of debt

- 73 The FRS requires debt and non-equity interests to be accounted for by allocating finance costs over the term of the instrument at a constant rate. The term of the instrument is usually self-evident but where either party has the option to extend the term, or to require the instrument to be redeemed early, such options should be carefully evaluated. If there is an option for early redemption, the term should be taken to end on the earliest date the option could be exercised, unless there is no genuine commercial possibility that the

option will be exercised. The term should not include any period for which the instrument might be extended unless such an extension is virtually certain at the time the instrument is issued: that is, there is no genuine commercial possibility that the period will not be extended.

- 74 In evaluating the commercial possibilities of options, it should be assumed that the parties will act in accordance with their economic interests. A severe deterioration in the creditworthiness of the issuer should not be anticipated, but should be taken into account when it occurs. For example, in the case of a zero coupon bond, the return to the lender consists entirely of the amount received at maturity. If the lender under such an instrument had the right to require early redemption, but on exercise of that right he would receive only the original issue price, it would be unrealistic to assume that he would exercise it unless the issuer's creditworthiness deteriorated to a significant extent. The term of such a bond would therefore normally be taken to extend to its final maturity.

Finance costs

- 75 The FRS requires finance costs to be recognised at a constant rate on the carrying amount of debt. In some instances the nominal yield on the debt will not be materially different from the amount required by the FRS to be recognised and in these circumstances calculations will not be necessary in order to derive the information required by the FRS.
- 76 The FRS also requires all finance costs to be charged in the profit and loss account. However, the FRS does not prohibit the capitalisation of finance costs as part of the cost of an asset by way of a simultaneous transfer from the profit and loss account that is separately disclosed.

The maturity of debt

- 77 The FRS requires the maturity of debt to be assessed according to the earliest date on which the lender could demand repayment, taking account of facilities granted by the same lender before the balance sheet date that may permit the refinancing of the debt. For example, a bank loan may fall due three months after the balance sheet date but the borrower may have obtained a commitment from the bank before the balance sheet date to provide a further loan for the same amount for a further three years. In such a case, providing the conditions required by the FRS are met, the debt would be included in the analysis of the maturity of debt as falling due between two and five years from the balance sheet date.
- 78 The restriction to facilities provided by the same lender or group of lenders ensures that the facility and the borrowings in question are related. It is also consistent with the requirements of companies legislation*. For this purpose lenders should be regarded as part of the same group if they are parties to the same agreement or course of dealing, even if it is not always the same members of the group who participate in individual financings entered into under that agreement or in the course of dealing. This may be the case for some multi-option facilities. However, under commercial paper arrangements funds are raised from lenders who are not parties to an agreement that provides for finance beyond the maturity of existing indebtedness. The maturity of such arrangements should therefore be taken to be that of the existing debt, even if there is an agreement with other lenders to refinance the debt if fresh commercial paper cannot be issued.

* *Companies Act 1985, Schedule 4 paragraph 85. The equivalent legislation in Northern Ireland is the Companies (Northern Ireland) Order 1986, Schedule 4 paragraph 84, and in the Republic of Ireland is the Companies (Amendment) Act 1986, the Schedule paragraph 67.*

- 79 An increase in the price of debt is as significant as its refinancing: for this reason the FRS requires the maturity of borrowings to be assessed by reference to borrowings under related facilities only where the finance costs for the new debt are not on a basis that is significantly higher than that of the existing debt. Where the cost of finance under a facility is determined by reference to a base rate (such as LIBOR) a change in that base rate should not be regarded as an increase in the level of finance costs for this purpose.
- 80 It would be right to have regard to facilities only if there are objective grounds for believing that the lender will fulfil its commitment. The FRS therefore requires that the facilities must be committed and that there must be no circumstances expected or likely that would either permit the lender to refrain from providing new borrowings or prevent it from providing them. The expectation that the new borrowings will be available, if required, must have existed at the balance sheet date and be reviewed in the light of any post balance sheet events to ensure that it remains reasonable on the date the financial statements are approved by the directors.
- 81 Particular care should be taken in considering the circumstances in which the lender may refrain from providing new borrowings. If these circumstances are described in a way that may be interpreted subjectively—for example if further finance may be withheld if the borrower's financial condition suffers an 'adverse change' and that term is not further defined—it will be unsafe to rely on borrowings under the facility being available. For that reason, the FRS requires that it can be demonstrated that any circumstances that would enable the lender to withhold finance are remote.

Shares and warrants

- 82 The FRS requires all shares to be reported within shareholders' funds. Warrants are also required to be reported within shareholders' funds since, by definition, they do not contain an obligation to transfer economic benefits.
- 83 Certain kinds of shares have features that make them economically similar to debt. Nonetheless, the requirement to classify capital instruments as debt if they contain an obligation to transfer economic benefits does not apply to shares. The legal status of shares is well established and understood and there are specific conditions in UK and Irish legislation that have to be satisfied if any payment is made in respect of them. In addition, the balance sheet formats prescribed by companies legislation require called up share capital to be stated separately from liabilities.
- 84 The FRS requires shareholders' funds to be analysed to show the amount relating to equity and non-equity interests. The definition of non-equity shares is widely drawn, so that any right to a dividend or to a redemption payment that is for a limited amount will have the effect that the shares will be considered non-equity shares, irrespective of the other rights they may enjoy.
- 85 It is possible that in rare circumstances shares will be classified as non-equity shares in accordance with the requirements of the FRS even though they fall within the definition of equity share capital contained in companies legislation. If this situation arises further explanation would be required to clarify the position.
- 86 As financial statements are usually prepared on a going concern basis, rights of shares to participate on a winding up do not usually affect the accounting for the shares. But if winding up is foreseeable when shares are issued, the limitation of rights has a

commercial effect. Such a circumstance could arise, for example, where a group raises finance by way of an issue of shares of a special purpose subsidiary with a pre-determined life. For this reason the definition requires that a limitation on the rights to participate on a winding up is taken into account only where, at the date it was introduced, it was likely that it would have a commercial effect in practice.

- 87 Shares that the issuer may or will be required to redeem are classed as non-equity shares, since they do not form part of the residual interest in the company. Furthermore, since the amount payable in respect of redemption must be fixed prior to redemption, the rights of the shares in respect of redemption will be restricted.

Shares issued by subsidiaries

- 88 Usually, where subsidiaries have shares in issue that are not held by another company in the group they are reported in the consolidated financial statements within minority interests but in some cases they are required by the FRS to be reported within liabilities, that is, as debt.
- 89 Consolidated financial statements are prepared on the basis that the undertakings included in the consolidation form a single entity ('the group'). Therefore, where a subsidiary has shares in issue it is necessary to look at the effect on the group as a whole when the consolidated financial statements are being prepared and to consider the rights attaching to the shares in conjunction with any agreements to which other group companies are a party. For example, if another company in the group has provided guarantees in respect of dividends or redemption, or has undertaken to purchase the shares in the event of the subsidiary failing to make the expected payments, the group as a whole will be unable to avoid the transfer of economic benefits irrespective of the

financial condition of the subsidiary: accordingly the issue will constitute a liability of the group and should be reported as such. This will also be the case where the shares are issued by a subsidiary incorporated in a jurisdiction where it cannot avoid paying dividends or amounts in respect of redemption even if there are insufficient profits, in which case funds would have to be provided by other group companies.

- 90 Particular care is necessary in assessing the effect of subordinated guarantees given by group companies in respect of shares issued by subsidiaries, as the degree of subordination varies widely. The intent of some such guarantees is that the rights of the holder of the shares against the group are the same as those of the holder of preference shares of the parent. All the rights and remedies of the holders of the subsidiary undertaking's shares against group companies should be considered and the shares should be reported as liabilities unless it is clear that the intended equivalence of the rights to those attaching to preference shares of the parent is actually attained. If it is, the shares should be reported as non-equity minority interests.*
- 91 Where it is determined that it is appropriate to report shares issued by subsidiaries in consolidated financial statements within minority interests rather than as a liability, it is necessary to determine whether they represent an equity interest or a non-equity interest. Companies legislation** requires the balance sheet to show as minority interests the amount of capital and reserves attributable to shares in subsidiary

* *Even if the rights of the holders of shares in a subsidiary against all companies in a group are equivalent to those of holders of a class of shares in the parent, the precise means by which those rights will be enforced, if the need arises, will differ. There will also inevitably be a risk that future events will show that the presumed equivalence does not exist. For these reasons, it would never be right to show shares issued by a subsidiary within the shareholders' funds of the group.*

** *Companies Act 1985, Schedule 4A paragraph 17. The equivalent legislation in Northern Ireland is the Companies (Northern Ireland) Order 1986, Schedule 4A paragraph 17, and in the Republic of Ireland is the European Communities (Companies: Group Accounts) Regulations 1992, the Schedule, paragraph 8.*

undertakings included in the consolidation held by or on behalf of persons other than the parent company and its subsidiary undertakings. Where the shares are equity shares the relevant amount of minority interests will be the proportionate share of net identifiable assets. If the shares are non-equity shares the amount of capital and reserves attributable to the shares will correspond to the amount determined by the requirements of the FRS: that is the net proceeds plus recognised finance costs less payments made.

Issue costs

- 92 The FRS requires issue costs, as defined, to be accounted for as a reduction in the proceeds of a capital instrument. Such costs are not assets as defined in the Board's draft Statement of Principles because they do not provide access to any future economic benefits.
- 93 In the case of shares, issue costs are integral to a transaction with owners and for this reason the FRS requires them to be taken into account in determining the net proceeds that are reported in the reconciliation of movements in shareholders' funds. They should not be disclosed in the statement of total recognised gains and losses.
- 94 In the case of most debt instruments, the issuer has the use of funds during the life of the instrument, and in return pays interest. The benefit obtained from the issue costs is reflected in the interest expense: indeed, issue costs are in some cases economically indistinguishable from a discount on issue. Issue costs are therefore appropriately accounted for as an adjustment to the amount of the liability, which effectively results in their being charged over the life of the instrument. If it became clear that the instrument would be redeemed early, then the amortisation of the issue costs and any discount on issue would have to be accelerated.

- 95 Where the life of an instrument is indeterminate, the benefit of the issue costs is reflected in terms of the financing indefinitely. In such a case, the issue costs are therefore not taken to the profit and loss account until such time as the instrument is redeemed or cancelled.
- 96 Care should be taken in the determination of the amount that falls to be treated as issue costs to avoid the danger of overstating finance costs over the life of the instrument in question. For this reason, the definition of issue costs is deliberately restrictive. The definition does not admit costs of researching and negotiating sources of finance or of ascertaining the suitability or feasibility of particular instruments, nor allocations of internal costs that would have been incurred had the instrument not been issued: for example management remuneration. The costs incurred in connection with a financial restructuring or renegotiation also do not qualify as issue costs; such costs relate to previous sources of finance and not to any instrument that may be issued following the restructuring or renegotiation. Costs that do not qualify as issue costs should be written off to the profit and loss account as incurred.
- 97 The requirement of the FRS that issue costs are reflected in the amounts charged to the profit and loss account over the term of a capital instrument is not intended to prohibit the subsequent charging of issue costs to the share premium account by means of a transfer between reserves. The amounts that may be charged to the share premium account are determined by the requirements of companies legislation.

Investment companies

- 98 Paragraph 52 of the FRS permits investment companies (provided certain conditions are met) to deal with some gains and costs relating to capital instruments in the statement of total recognised gains and losses

rather than in the profit and loss account. This exemption has been included in view of the requirements of companies legislation that such companies distinguish revenue and capital and distribute as dividends a large proportion of their revenue and none of their capital. If special provisions were not included in respect of investment companies, the introduction of the FRS might result in inequitable consequences: for example, in the case of split capital investment trusts the distribution of returns as between one class of shareholder and another might be changed in a way that was contrary to the previous expectations of the shareholders and the company. The Board is considering whether guidance on accounting by investment companies, including the distinction between revenue and capital, is required.

Scrip dividends

- 99 The FRS requires that where scrip dividends are issued or proposed the value of shares issued or to be issued should be taken to be the amount of the cash dividend. Where, as is often the case, a scrip dividend takes the legal form of a bonus issue of shares, the appropriation should be written back as a reserve movement, and appropriate amounts transferred between reserves and share capital to reflect the capitalisation of reserves.

Disclosure requirements

- 100 The FRS requires non-equity interests in shareholders' funds, non-equity interests in minority interests, and convertible debt to be disclosed separately from amounts relating to equity interests and non-convertible debt respectively. Because these distinctions have fundamental implications for the forecasting of future cash flows, they are extremely important and in many cases where such instruments are in issue it will be necessary for this information to

be given on the face of the balance sheet. In the assessment of materiality in connection with convertible securities, consideration should be given not only to their carrying amount but also to the implications of conversion. In some cases, however, on grounds of materiality, this information may be disclosed in the notes to the financial statements rather than on the face of the balance sheet. Where this is the case, paragraph 54 requires that the caption on the face of the balance sheet should indicate that the balance sheet total includes non-equity interests or convertible debt. Similarly, paragraph 59 requires the captions used in the profit and loss account to indicate the existence of non-equity interests the details of which are disclosed only in the notes.

- 101 There is a presumption that amounts included in debt relate to conventional borrowing agreements. As this may not always be the case, paragraph 63 requires a brief description of the obligations and legal arrangements relating to any debt that are different from those usually associated with debt. This would apply, for example, to subordinated debt, to non-recourse debt and to those shares issued by subsidiary undertakings that are classified as debt in accordance with the FRS.
- 102 Although the FRS does not require the disclosure of the market values of capital instruments, such information may be useful to users of financial statements as it provides an insight into the economic burden represented by the debt. Where information on market values would assist users, its disclosure should be considered.

APPLICATION NOTES

These Application Notes specify how some of the requirements of FRS 4 are to be applied to transactions that have certain features. However, the Notes are not an exhaustive guide to all the requirements that may be relevant and should therefore be read in conjunction with the FRS itself.

Capital instruments may have a combination of features and accordingly more than one Note may be relevant to a single capital instrument.

The illustrations shown in the shaded areas are provided as an aid to understanding and shall not be regarded as part of the Statement of Standard Accounting Practice.

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Auction Market Preferred Shares ('AMPS')

Features

AMPS are preference shares that are entitled to dividends determined in accordance with an auction process in which a panel of investors participates, the shares being transferred at a fixed price to the investor who will accept the lowest dividend. If the auction process fails—for example because no bids are received—the shares remain in the ownership of the former holder and the dividend is increased to a rate, known as the default rate, that is calculated in accordance with a prescribed formula. (This default rate may change if there is any change in the credit rating of the issuer.) In some cases dividends may be passed at the option of the issuer and in any event will not be paid by a UK company if there are insufficient distributable profits. If the dividend is not paid the holders of the AMPS do not obtain any additional rights, for example to demand redemption. AMPS are redeemable at the option of the issuer, usually at the issue price.

Analysis and required accounting

As AMPS are shares, dividends cannot be paid in respect of them except out of distributable profits, nor can they be redeemed unless the redemption is financed out of distributable profits or by a fresh issue of shares. Because they are redeemable at a fixed amount, and because the dividend rights are limited, AMPS constitute non-equity shares.

In accordance with the requirements of the FRS, AMPS should be reported within shareholders' funds as non-equity shares and included in the amount attributable to non-equity shares (paragraph 40). The finance cost for each period should be the dividend rights accruing in respect of the period.

Capital contributions

Features

Capital contributions are sometimes made by a holding company to its wholly-owned subsidiary in order to provide the finance necessary for the subsidiary where it is not desired that this should be by way of debt and there would be adverse consequences (for example, tax consequences) arising from a subscription for new shares. Whilst a capital contribution enhances the value of the holding company's investment in its subsidiary, there is no requirement for the subsidiary to bear any servicing cost, nor can it be required to repay the contribution.

Analysis and required accounting

From the standpoint of the subsidiary, a capital contribution does not contain an obligation to transfer economic benefits. In accordance with paragraph 24 of the FRS it should be reported within shareholders' funds. In the year in which the capital contribution is made, it should be reported in the reconciliation of movements in shareholders' funds.

Convertible capital bonds

Features

The detailed provisions of convertible capital bonds vary but the following are typical. Convertible capital bonds are debt instruments on which interest is paid periodically, issued by a special purpose subsidiary incorporated outside the UK. Prior to maturity they may be exchanged for shares of the subsidiary which, at the option of the bondholder, are either immediately redeemed or immediately exchanged for ordinary shares of the parent. The bonds and payments in respect of the shares of the subsidiary are guaranteed by the parent. The parent has the right to

issue convertible redeemable preference shares of its own in substitution for the bonds should it wish to do so.

Analysis and required accounting

From the standpoint of the subsidiary, convertible capital bonds are clearly debt since the obligation to pay interest is an obligation to transfer economic benefits. In addition, paragraph 25 of the FRS requires that conversion of debt should not be anticipated. In the subsidiary's financial statements the bonds should therefore be accounted for as debt.

From the standpoint of the group they are also liabilities. Even though the parent has the option to issue convertible preference shares in substitution for the bonds, the requirements of paragraph 25 of the FRS again entail that such conversion should not be anticipated. Whilst non-equity shares have a particular legal status that justifies their inclusion in shareholders' funds, this does not justify reporting within shareholders' funds an instrument that does not have that status and may never be converted into one that does.

Since the liabilities are convertible, the amount attributable to convertible capital bonds should be included in the amount of convertible debt, which should be stated separately from other liabilities.

Convertible debt with a premium put option

Features

Convertible debt with a premium put option contains an option for the holder to demand redemption (either at the maturity of the debt or at some earlier date) for an amount that is in excess of the amount originally received for the debt. At the time the debt is issued, it is uncertain whether the debt will be converted before the redemption option may be

exercised, and hence whether the premium on redemption will be paid.

Analysis and required accounting

The premium put option provides a higher guaranteed return to the holder of the debt than would be received on identical debt without such a put option. Often this higher return corresponds to that which the holder would have expected to receive on non-convertible debt. The holder's decision as to whether to exercise the option will depend on the relative values of the shares to which he would be entitled on conversion and the cash receivable, including the premium, on exercise of the option.

In accordance with the definition of the term of an instrument contained in paragraph 16 of the FRS, the term of convertible debt with a premium put option should be considered to end on the earliest date at which the holder has the option to require redemption. The premium payable on exercise of the premium put option falls to be included in the calculation of the finance costs for the debt.

On conversion, in accordance with paragraph 26 of the FRS, the proceeds of the shares issued should be deemed to be the carrying amount of the debt, including accrued premium, immediately prior to conversion.

Convertible debt with enhanced interest

Features

As an alternative to the premium put structure discussed above, convertible debt may contain an undertaking that the interest will be increased at a date in the future. At the time the debt is issued, it is uncertain whether the debt will be converted before the enhanced interest is payable.

Analysis and required accounting

The enhanced rate of interest increases the guaranteed return to the holder. Often this higher return corresponds to that which the holder would have expected to receive on non-convertible debt. The holders' decision as to whether to convert the debt will take into account the interest forgone by such a decision.

In accordance with the definitions set out in paragraphs 8 and 16 of the FRS, the interest for the full term of the convertible debt should be taken into account in the allocation of finance costs, which should be allocated at a constant rate in accordance with paragraph 28.

Illustration

Convertible debt is issued on 1 January 2000 for £1,000 and is redeemable at the same amount on 31 December 2014. It carries interest of £59 a year (a nominal rate of 5.9 per cent) for the first five years, after which the rate rises to £141 a year (a nominal rate of 14.1 per cent).

In order to comply with paragraph 28 of the FRS the finance costs should be allocated to accounting periods at the rate of 10 per cent a year. The movements on the carrying amount over the term of the debt would be as follows:

Year ending	Balance at beginning of year	Finance costs for year (10%)	Cash paid during year	Balance at end of year
	£	£	£	£
31.12.2000	1,000	100	(59)	1,041
31.12.2001	1,041	104	(59)	1,086
31.12.2002	1,086	109	(59)	1,136
31.12.2003	1,136	113	(59)	1,190
31.12.2004	1,190	119	(59)	1,250
31.12.2005	1,250	125	(141)	1,234
31.12.2006	1,234	124	(141)	1,217
31.12.2007	1,217	122	(141)	1,198
31.12.2008	1,198	120	(141)	1,177
31.12.2009	1,177	118	(141)	1,154
31.12.2010	1,154	116	(141)	1,129
31.12.2011	1,129	113	(141)	1,101
31.12.2012	1,101	110	(141)	1,070
31.12.2013	1,070	107	(141)	1,036
31.12.2014	1,036	105*	(141 +1,000)	—

Debt issued with warrants

Features

Debt is sometimes issued with warrants. The issue is often made for the par value of the debt and the debt will be redeemed at the same amount. The warrants and the debt are capable of being transferred separately.

Analysis and required accounting

In accordance with paragraph 22 of the FRS, the proceeds of the issue should be allocated between the debt and the warrants. As a result, the amount of the

* Increased by £1 rounding difference

proceeds deemed to relate to the debt will be less than par value. The discount on issue should be treated as finance costs and apportioned to accounting periods so that the total finance costs on the debt will have a constant relationship to the outstanding obligation.

Accounting for warrants is specified at paragraphs 45-47 of the FRS.

Illustration

Debt and warrants are issued together for £1,250. The debt is redeemable at the same amount. The term of the debt is five years from 1 January 2000 and it carries interest at 4.7 per cent (£59 a year). It is determined (for example by reference to the market values for the debt and the warrants immediately after issue) that the fair value of the debt and the warrants are respectively £1,000 and £250.

The debt would initially be recognised at £1,000. The finance cost of the debt is the difference between the payments required by the debt which total £1,545 ($(5 \times £59) + £1,250$) and the deemed proceeds of £1,000, that is, £545. In order to allocate these costs over the term of the debt at a constant rate on the carrying amount (as required by paragraph 28 of the FRS) they must be allocated at the rate of 10 per cent. The movements on the carrying amount of the debt over its term would be as follows:

Year ending	Balance at beginning of year £	Finance costs for year (10%) £	Cash paid during year £	Balance at end of year £
31.12.2000	1,000	100	(59)	1,041
31.12.2001	1,041	104	(59)	1,086
31.12.2002	1,086	109	(59)	1,136
31.12.2003	1,136	113	(59)	1,190
31.12.2004	1,190	119	(1,250 + 59)	—

Deep discount bonds

Features

Deep discount bonds are bonds that carry a low nominal rate of interest and accordingly are issued at a discount to the value at which they will be redeemed. In the extreme case where no interest at all is payable they are sometimes referred to as zero coupon bonds.

Analysis and required accounting

The cost to the borrower of issuing a deep discount bond comprises the discount on issue as well as any interest payments. It is clear that deep discount bonds represent liabilities of the issuer since they contain an obligation to make cash payments. In accordance with the definition of 'finance costs' in paragraph 8 of the FRS the finance costs will constitute the difference between the net proceeds and the total payments that the issuer may be required to make in respect of the instrument. In accordance with paragraph 28 of the FRS the finance costs will be allocated to periods at a constant rate on the carrying amount, with the result that the carrying amount of the bond immediately prior to redemption will equate to the amount at which it is to be redeemed. The discount should not be treated as an asset.

Accounting for a deep discount bond is illustrated above in connection with debt issued with warrants.

Income bonds

Features

The distinctive feature of income bonds is that interest is payable only in the event that the issuer has sufficient reported profits (after allowing for interest on other kinds of debt) to make the payment. If profits are insufficient the issuer is not in default and no additional rights accrue to the holder of the bond, although interest payments may be cumulative. Income bonds must be redeemed by the issuer at a fixed amount on a specific date.

Analysis and required accounting

The requirement to redeem the bonds is an obligation to transfer economic benefits. The bonds must therefore be accounted for as a liability as required by paragraph 24 of the FRS. Even if the issuer were not required to redeem the bonds, they would still be classed as a liability, because of the obligation to pay interest. The fact that the obligation to pay is dependent on the existence of profits makes the obligation contingent, but it does not remove the obligation.

Index linked loans

Features

Sometimes loan agreements do not state a specific amount for the payments: instead they include a formula to be used for their calculation. For example, in the case of floating rate loans, the amount of periodic payments of interest will be calculated by reference to a base rate—e.g. LIBOR + 2 per cent.

Another example is that of index linked loans which may be redeemable at the principal amount multiplied by an index.

Analysis and required accounting

Paragraph 31 requires that finance costs contingent on uncertain events such as changes in an index should be adjusted to reflect those events only once they have occurred. The effect is that the initial carrying amount will take no account of those events but the carrying amount at each subsequent balance sheet date will be recalculated to take account of the changes occurring in that reporting period. The resulting change in carrying amount is accounted for as an increase or decrease in finance costs for the period.

Illustration

A loan of £1,250 is issued on 1 January 2000 on which interest of 4 per cent (£50) is paid annually and the principal amount is repayable based on an index. The balance at the end of each year is found by multiplying the original principal amount by the index at the end of the year: the change in the amount is treated as additional finance costs.

Year ending	Balance at beginning of year	Finance costs for year (10%)	Cash paid during year	Balance at end of year	Index at end of year
	£	£	£	£	£
31.12.2000	1,250	125	(50)	1,325	106
31.12.2001	1,325	100	(50)	1,375	110
31.12.2002	1,375	75	(50)	1,400	112
31.12.2003	1,400	150	(50)	1,500	120
31.12.2004	1,500	175	(1,625 + 50)	—	130

Limited recourse debt

Features

Sometimes debt is raised on terms that the lender's recourse is limited. Although the borrower is expected to meet the obligations of the debt out of his general resources, in the event of default the lender can obtain repayment only by enforcing his rights against the particular security that is identified in the loan agreement. If the proceeds of the security are insufficient to repay the loan, the lender must bear the loss and has no further rights against the borrower.

Analysis and required accounting

Limited recourse debt constitutes an obligation on the part of the borrower to repay, and hence should be accounted for as a liability*. The borrower will normally have all the benefits of the security (including the right to receive the sale proceeds) and will have to meet the obligation to repay the debt in order to preserve these rights. Although if the security declines in value the borrower may possibly be able to elect to hand it over to the lender and thus avoid any further liability in respect of the debt, such an eventuality would be unusual, and therefore should not be reflected in the accounting until such time as the asset is transferred.

Limited recourse debt is one of the kinds of debt envisaged in paragraph 63 of the FRS in that its legal nature differs from that usually associated with debt. A brief description of its nature should be given. An illustration of such disclosure is set out below.

* The Board's project on reporting the substance of transactions addresses the limited circumstances in which non-recourse finance should be accounted for using a linked presentation.

Illustration of disclosures

'The limited recourse debt of £xxx is secured on the company's investment in an industrial warehouse at Allington Industrial Estate, Barsetshire, which has a market and book value of £yyy. In the event of non-payment of the interest or principal on this debt, the lenders have the right to require the sale of the property and will be paid all the sale proceeds up to the amount of the debt but have no other rights against the company.'

*Participating preference shares**Features*

Participating preference shares are similar to other familiar kinds of preference shares except that they are entitled, in addition to a fixed dividend for each accounting period, to a proportion of the dividends paid on equity shares.

Analysis and required accounting

Because participating preference shares contain an entitlement to share in profits that is of a restricted amount and has priority over the other classes of shares, they are non-equity shares in accordance with the definition in paragraph 12 of the FRS and their interest in shareholders' funds should be presented in the balance sheet within the aggregate amount attributable to non-equity shares as required by paragraph 40. The fixed and participating elements of the dividend will be disclosed separately as required by paragraph 59.

Perpetual debt

Features

Perpetual debt is debt in respect of which the issuer has neither the right nor the obligation to repay the principal amount of the debt. Usually, interest is paid at a constant rate, or at a fixed margin over a benchmark rate such as LIBOR.

Analysis and required accounting

Sometimes it is suggested that as the principal amount will never be repaid there is no need for the balance sheet to reflect a liability in respect of the debt. However, the obligation to pay interest is an obligation to transfer economic benefits and hence the instrument is a liability. As there are no repayments of principal the burden of this liability never diminishes.

The FRS is based on the principle that debt should be accounted for having regard to all the payments required by the debt, irrespective of their legal description, in the determination of the appropriate finance charge and capital repayment for each accounting period. In the case of perpetual debt where interest is paid at a constant rate, or at a fixed margin over a benchmark, the correct finance charge will be equal to the coupon payable for each period. Hence no part of the repayments will reduce the carrying amount and the debt will always be shown at the amount of net proceeds. If the amount of the claim that would arise on a winding up is different from the carrying amount of the debt, it should be stated in accordance with paragraph 63.

Repackaged perpetual debt

Features

Sometimes perpetual debt is issued that carries interest at a relatively high rate for a number of years ('the

primary period'), and then bears no further interest, or only a nominal amount. As the debt cannot be required to be redeemed, its value after the primary period has expired is negligible and, in practice, there will usually be arrangements to transfer it to a party friendly to the issuer or to enable the issuer to elect, in effect, to redeem the debt for a token amount.

Analysis and required accounting

The substance of such an arrangement is that the debt is repaid over the primary period. The payments required by the debt should be apportioned between a finance charge for each accounting period and the effective reduction of the principal amount. It would be necessary to make full disclosure of the arrangement in the financial statements.

The finance costs of the debt (as defined in paragraph 8 of the FRS) will be the difference between the net proceeds and the payments which the issuer is required to make. This will be allocated to periods over the primary period at a constant rate on the carrying amount, as required by paragraph 28 of the FRS.

Illustration

On 1 January 2000 a company borrows £1,250 which is stated to be irredeemable and to carry interest of 16.275 per cent for the first ten years after which no further payments are required. The annual payments would be £203. The substance of the arrangement is that the ten payments of £203 would repay the amount borrowed and the finance charge would be allocated using a rate of 10 per cent. The accounting would be as follows:

Year ending	Balance at beginning of year £	Finance costs for year (10%) £	Cash paid during year £	Balance at end of year £
31.12.2000	1,250	125	(203)	1,172
31.12.2001	1,172	117	(203)	1,086
31.12.2002	1,086	108	(203)	991
31.12.2003	991	99	(203)	887
31.12.2004	887	88	(203)	772
31.12.2005	772	77	(203)	646
31.12.2006	646	64	(203)	507
31.12.2007	507	50	(203)	354
31.12.2008	354	35	(203)	186
31.12.2009	186	17*	(203)	—

Stepped interest bonds

Features

The stated rate of interest payable in respect of stepped interest bonds increases progressively over the period of issue.

Analysis and required accounting

In the case of stepped interest bonds, the stated rate of interest for each accounting period does not reflect the true economic cost of borrowing in any period during the time the bond is outstanding, since low rates of interest in one period are compensated for by higher rates in another.

Under the requirements of paragraph 28 of the FRS the pattern of the interest payments does not affect the

* Reduced by £1 rounding difference

allocation of finance costs. The payments required by the debt should be apportioned between a finance charge for each accounting period at a constant rate on the outstanding obligation and a reduction of the carrying amount. The effect of this accounting on a stepped interest bond is that the overall effective interest cost will be charged in each accounting period: an accrual will be made in addition to the cash payments in earlier periods and will reverse, partially offsetting the higher cash payments, in later periods. It would be necessary to make full disclosure of the arrangement in the financial statements.

Illustration

A loan of £1,250 is entered into on 1 January 2000 under which interest is payable according to the following schedule:

Year ending	Rate of interest (as a percentage of nominal amount)	Amount of interest £
31.12.2000	6.0	75
31.12.2001	8.0	100
31.12.2002	10.0	125
31.12.2003	12.0	150
31.12.2004	16.4	205

The overall effective rate can be found to be 10 per cent. The movement on the loan over its period in issue would be as follows:

Year ending	Balance at beginning of year £	Finance costs for year (10%) £	Cash paid during year £	Balance at end of year £
31.12.2000	1,250	125	(75)	1,300
31.12.2001	1,300	130	(100)	1,330
31.12.2002	1,330	133	(125)	1,338
31.12.2003	1,338	134	(150)	1,322
31.12.2004	1,322	133	(1,250 + 205)	—

Subordinated debt

Features

Subordinated debt is debt under which the rights of the lender are not as great as those of other creditors of the issuer. The methods of subordination vary widely. For example, one method is for subordinated debt to be repaid only when certain conditions are met, which are intended to ensure that the interests of other creditors are not impaired by the repayment. Another method of subordination is a prohibition on repayment of the debt whilst other creditors remain unpaid.

Analysis and required accounting

Irrespective of the means of subordination that is used, the lender on subordinated terms does not forgo the right to be repaid: he simply accepts that under certain conditions repayment will be postponed. It follows that, despite the subordination, the company has an obligation to repay (that is, an obligation to transfer economic benefits) and therefore subordinated debt should be accounted for as a liability.

Subordinated debt is one of the kinds of debt envisaged in paragraph 63 of the FRS in that its legal nature differs from that usually associated with debt. A brief description of its nature should be given. An illustration of such disclosure is set out below.

Illustration of disclosures

'The only event of default in relation to the subordinated debt is non-payment of principal or interest. The only remedy available to the holders of the subordinated debt in the event of default is to petition for the winding up of the company. In a winding up no amount will be paid in respect of the subordinated debt until all other creditors have been paid in full.'

ADOPTION OF FRS 4 BY THE BOARD

Financial Reporting Standard 4 - 'Capital Instruments' was approved for issue by the eight members of the Accounting Standards Board.

David Tweedie (Chairman)

Allan Cook (Technical Director)

Robert Bradfield

Ian Brindle

Sir Bryan Carsberg

Michael Garner

Donald Main

Graham Stacy

APPENDIX I

NOTE ON LEGAL REQUIREMENTS

- 1 The following note sets out certain of the requirements of the law relating to accounting for capital instruments and, where necessary, explains the relationship between the requirements of the FRS and the legal requirements.

Great Britain

Presentation of shareholders' funds

- 2 Paragraph 40 of the FRS requires the aggregate amount of shareholders' funds to be analysed between the amount attributable to equity interests and the amount attributable to non-equity interests. It is envisaged that this analysis will be presented as supplementary to the information required by the Companies Act 1985 (the amounts of called up share capital, share premium account, revaluation reserve, other reserves (with a sub-analysis of this amount) and profit and loss account). The FRS does not require any of the individual components of shareholders' funds to be analysed between equity and non-equity interests.
- 3 Sections 130-133 of the Companies Act 1985 contain requirements for amounts to be taken to the share premium account and for the application of that account. The FRS does not contain any requirements concerning the amounts to be taken to the share premium account or called up share capital and therefore does not conflict with these requirements of the law. For example, nothing in the FRS affects the availability of merger relief under section 131 of the Act.

Minority interests

- 4 Paragraph 1 of Schedule 4A to the Companies Act 1985 requires group accounts to be prepared as if the group were a single company. Paragraph 17 of that Schedule requires the amount of capital and reserves attributable to shares in consolidated subsidiary undertakings held by persons other than the parent company or other group companies to be shown under minority interests. Paragraph 49 of the FRS addresses the interaction of those requirements where the shareholder of a subsidiary has other rights against group companies, for example under a guarantee given by a parent. It requires the accounting to reflect such an obligation, by recognising a liability in respect of it. Where this accounts entirely for the arrangement there will be no amount remaining that represents an interest in the capital and reserves of the subsidiary.

Discount on issue and premium on redemption

- 5 Paragraph 24 of Schedule 4 to the Companies Act 1985 permits the excess of the amount repayable on a debt over the consideration received to be treated as an asset. As this treatment is not, however, mandatory, the FRS, which, in accordance with its principles, requires a different treatment, is not in conflict with the Act.
- 6 Paragraph 3(2) of Schedule 4 to the Companies Act 1985 prohibits treating the expenses of and commission on any issue of shares or debentures as an asset.

Maturity of debt

- 7 Paragraph 85 of Schedule 4 to the Companies Act 1985 requires a loan to be treated as falling due for repayment on the earliest date on which the lender could require repayment if he exercised all options and

rights available to him. The requirements of the FRS are consistent with this requirement.

Other requirements

- 8 Schedule 4 to the Companies Act 1985 also requires the following information to be disclosed:
- (a) In respect of shares (paragraph 38(1))
 - (i) the authorised share capital; and
 - (ii) where there are shares of more than one class, the number and aggregate nominal value of shares of each class allotted.
 - (b) In the case of allotted redeemable shares (paragraph 38(2))
 - (i) the earliest and latest dates on which the company may redeem them;
 - (ii) whether redemption is mandatory, or is at the option of either the company or the shareholder; and
 - (iii) whether any (and, if so, what) premium is payable on redemption.
 - (c) Where the company has allotted any shares during the year (paragraph 39)
 - (i) the reason for the allotment;
 - (ii) the classes of shares allotted; and
 - (iii) in respect of each class of shares, the number allotted, their aggregate nominal value and the consideration received by the company.

(d) In respect of contingent rights to the allotment of further shares (such as options to subscribe or rights relating to the conversion of shares or securities) the following information (paragraph 40)

(i) the number, description and amount of the shares involved;

(ii) the period during which the right is exercisable; and

(iii) the price to be paid for the shares allotted.

(e) Where the company has issued any debentures during the year (paragraph 41(1))

(i) the reason for making the issue;

(ii) the classes of debentures issued; and

(iii) in respect of each class of debentures, the amount issued, and the consideration received by the company.

(f) Particulars of any redeemed debentures which the company has power to reissue (paragraph 41(2)).

(g) Where debentures are held by a nominee or trustee for the company, the nominal amount and the amount at which the debentures are stated in the accounting records (paragraph 41(3)).

(h) In respect of each item under creditors (paragraph 48)

(i) the total amount that is not repayable by instalments and is not due for repayment within five years of the balance sheet date;

- (ii) the total amount that is repayable by instalments, some of which fall due beyond five years from the balance sheet date, disclosing separately the amount that falls due beyond five years. (This is not required for amounts that are included in a category of creditors falling due within one year);
 - (iii) the terms of repayment and interest on each debt details of which are given under (i) or (ii) above; or, if this would result in a statement of excessive length, a general indication of the terms of payment or repayment and the rates of interest; and
 - (iv) the total amount in respect of which any security has been given, and an indication of the nature of the security.
- (i) In respect of dividends and reserve transfers
- (i) the profit and loss account must show the amounts set aside to or withdrawn from reserves and the aggregate amount of any dividends paid and proposed (paragraph 3(7));
 - (ii) the aggregate amount which is recommended for distribution by way of dividend (paragraph 51(3)); and
 - (iii) the amount of any arrears of fixed cumulative dividends on any class of the company's shares, and the period for which they are in arrears (paragraph 49).
- (j) The amount of interest on or similar charges in respect of each of (paragraph 53(2))
- (i) bank loans and overdrafts, and other loans which are not repayable by instalments and fall due within five years of the balance sheet date;

(ii) bank loans and overdrafts, and other loans which are repayable by instalments the last of which falls due for payment within five years of the balance sheet date;

(iii) other loans.

(k) The amount of convertible loans shall be shown separately from other debenture loans (note (7) on the balance sheet formats).

Banking and insurance companies and groups

- 9 Schedule 4 to the Companies Act 1985 does not apply to banking and insurance companies and groups. Requirements equivalent to those of Schedule 4 for banking companies and groups are contained in Schedule 9 (as amended by the Companies Act 1985 (Bank Accounts) Regulations 1991); those for insurance companies and groups are contained in Schedule 9A to the Companies Act 1985, which is expected to be amended shortly by the Companies Act 1985 (Insurance Companies Accounts) Regulations.

Northern Ireland

- 10 The Companies (Northern Ireland) Order 1986 requires similar information in respect of share capital and reserves to that required by the Companies Act 1985, as referred to in paragraph 2 above.
- 11 Articles 140-143 of the Companies (Northern Ireland) Order 1986 are similar to sections 130-133 of the Companies Act 1985, referred to in paragraph 3 above.
- 12 Schedules 4 and 4A to the Companies (Northern Ireland) Order 1986 are similar to Schedules 4 and 4A to the Companies Act 1985.

- 13 Schedule 9 to the Companies (Northern Ireland) Order 1986, as amended by the Companies (1986 Order) (Bank Accounts) Regulations (Northern Ireland) 1992 is similar to Schedule 9 to the Companies Act 1985 (as amended by the Companies Act 1985 (Bank Accounts) Regulations 1991). Schedule 9A to the Companies (Northern Ireland) Order 1986, which is expected to be amended shortly, is similar to Schedule 9A to the Companies Act 1985.

Republic of Ireland

- 14 The Companies (Amendment) Act 1986 requires similar information in respect of share capital and reserves to that required by the Companies Act 1985, as referred to in paragraph 2.
- 15 Section 62 of the Companies Act 1963 is similar to section 130 of the Companies Act 1985. There are no requirements in the legislation of the Republic of Ireland equivalent to sections 131-133 of the Companies Act 1985.
- 16 The following table shows the references to the requirements of legislation of the Republic of Ireland which correspond to the provisions of Schedule 4A to the Companies Act 1985 mentioned above.

Companies Act 1985 Schedule 4A paragraph 1
European Communities (Companies: Group Accounts) Regulations paragraph 15

Companies Act 1985 Schedule 4A paragraph 17
European Communities (Companies: Group Accounts) Regulations, the Schedule paragraphs 8-9

- 17 The following table shows the references to the requirements of legislation of the Republic of Ireland which correspond to the provisions of Schedule 4 to the Companies Act 1985 mentioned above.

Great Britain: Companies Act 1985 Schedule 4	Republic of Ireland: Companies (Amendment) Act 1986 Schedule (unless otherwise stated)
Paragraph 3(2)	Section 4(12)
3(7)	Section 4(15)
24	Paragraph 12
38(1)	26(1)
38(2)	26(2)
39	27
40	No equivalent
41(1)	28(1)
41(2)	28(2)
41(3)	28(3)
48	34
49	35
51(3)	37(3)
53(2)	39(2)
85	67
Note (7) on the balance sheet formats	Note (5) on the balance sheet formats

- 18 Schedule 6 to the Companies Act 1963, as amended by the European Communities (Credit Institutions: Accounts) Regulations 1992 is similar to Schedule 9 to the Companies Act 1985 (as amended by the Companies Act 1985 (Bank Accounts) Regulations 1991). Schedule 6 to the Companies Act 1963, insofar as it relates to insurance companies, is expected to be amended shortly to implement the EC Insurance Accounts Directive.

APPENDIX II

COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

The requirements of the FRS are consistent with existing International Accounting Standards. However, the International Accounting Standards Committee ('IASC') has issued an exposure draft (E40) that is a draft of a proposed standard on Financial Instruments.

The principal areas where the proposals of the IASC exposure draft and the FRS are at variance are:

a The IASC exposure draft proposes that certain preferred shares, for example those where the holder has the right to require redemption, should be accounted for as liabilities. For the reasons given in paragraphs 5-6 of Appendix III, the FRS requires all shares to be reported within shareholders' funds.

b The IASC exposure draft proposes that the proceeds of instruments that have both liability and equity rights should be allocated between the component parts. For the reasons given in paragraphs 14-18 of Appendix III, the FRS requires such instruments to be accounted for wholly as a liability.

The IASC has announced that a revised exposure draft, E48, Financial Instruments will be published on 1 January 1994. It is not expected that the proposals of E48 will differ from those of E40 in respect of the above matters.

APPENDIX III

THE DEVELOPMENT OF THE FRS

- 1 The Board undertook the development of an FRS on accounting for capital instruments in view of the increasing number and variety of capital instruments that have been introduced in recent years. Accounting for some of the new instruments has not always been uniform, and a variety of arguments have been advanced to justify differing treatments. Some of these arguments have called into question methods of accounting for capital instruments that have been used for many years and had previously appeared uncontroversial. The central issues that required resolution were the criteria to be used to determine whether a capital instrument represents debt or equity and the treatment of instruments such as convertible debt that will or may be exchanged for other instruments.
- 2 The contents of the FRS are closely based on the proposals contained in FRED 3 'Accounting for Capital Instruments' which was issued in December 1992. In turn, the proposals in that FRED were based on those set out in the Board's Discussion Paper 'Accounting for Capital Instruments' which was published in December 1991. The considerations that the Board found persuasive in framing the principal proposals in the FRS are summarised in paragraphs 3-23 below. Paragraphs 24-44 summarise the principal comments made by respondents to the FRED and discuss consequent modifications to the proposals of the FRED that have been made in response to those comments.

The rationale of the FRS

The distinction between debt and equity

- 3 The Board's draft Statement of Principles defines a liability as follows:

Liabilities are an entity's obligations to transfer economic benefits as a result of past transactions or events.

- 4 Thus the criterion used in the FRS to determine whether a capital instrument represents a liability is whether it contains an obligation to transfer economic benefits.
- 5 This criterion is not, however, used to determine the accounting for a company's shares. Shares have a distinct legal status reflected (*inter alia*) in the limitations imposed by companies legislation on the circumstances in which payments may be made in respect of them. It is also impossible to classify shares as liabilities within the constraints of the statutory formats for the balance sheet.
- 6 Although there are practical and legal difficulties in classifying shares as liabilities, another distinction—that between equity and non-equity shares—is practicable and is of great significance in assessing the financial position of the company. Equity shares represent the residual interest in a company. They have no claim on the company's assets that ranks prior to any other claim, but obtain the exclusive right to any increase in the net assets. Therefore the FRS requires the interests of equity shareholders in the company to be stated prominently, clearly distinguished from those of shares that have any element of priority. Priority requires some limitation in the amount to which priority attaches, and so the definition of 'non-equity shares' focuses on limitation of rights.
- 7 As explained in paragraphs 88–91 of the Explanation, it is sometimes the case that shares issued by subsidiaries, when considered in the context of the group, are liabilities of the group. Where this is the case, the FRS requires them to be accounted for as liabilities. In other cases, the FRS proposes that an

analysis be presented of minority interests between the amount attributable to equity and non-equity interests. This analysis is similar to that of shareholders' funds and is required for the same reasons.

Warrants

- 8 When a company issues warrants its only obligation is to issue shares at a fixed price, if so required by the holder.
- 9 The price paid for a warrant can be thought of as part of the subscription price for a share that may (or may not) be issued at a future date. For this reason, the FRS requires warrants to be reported within shareholders' funds.
- 10 Once the warrant expires unexercised the amount paid for the warrant accrues to the benefit of the shareholders. For this reason, the FRS requires that on the expiry of a warrant the amount previously recognised in shareholders' funds be recognised in the statement of total recognised gains and losses. Showing the gain in that statement rather than in the profit and loss account is consistent with the role of the statement of total recognised gains and losses as providing a summary of changes in total reserves.
- 11 The Board acknowledges that the subject of warrants raises wider issues than are dealt with in the FRS. In particular, it is sometimes argued that, when the amount paid on exercise of warrants is lower than the fair value of the shares issued, there is an additional, implicit consideration that needs to be reflected in the financial statements. If this view is accepted, the question arises whether the estimate of fair value for this purpose should be made as at the issue date of the warrants or as at the exercise date.

- 12 Another view of warrants, which is that of a minority of the Board, is that, in substance, they are transactions with owners. Those who subscribe to this view would disagree with the proposal of the FRS that where a warrant lapses unexercised the amount previously recognised should be reported in the statement of total recognised gains and losses as they consider that that statement should not be affected by capital transactions between owners and the company. The Board rejected this view as it considers that the warrant holders are not owners of the company; the issue of warrants that are not subsequently exercised therefore represents a gain that should be reflected in the statement of total recognised gains and losses.
- 13 The problem involves conceptual and practical issues requiring research and consultation that the Board believes would be better conducted as a separate project. The FRS, therefore, excludes from its scope warrants and share options issued under employee share schemes, which are the most common example of warrants giving rise to these wider issues. If and when the Board addresses these issues it will also review the definition and treatment of warrants specified in this FRS.

Convertible instruments

- 14 There are a number of possible approaches to the accounting for convertible debt, but the most usual is to report it as a liability. Although this is uncontroversial where conversion is uncertain or unlikely, it is sometimes argued that where conversion is probable convertible debt should be reported outside liabilities.
- 15 The FRS, however, requires convertible debt to be reported within liabilities irrespective of the probability of future conversion. This is because the balance sheet is a record of the financial position of

the company at a point in time, rather than a forecast of future events. (This is not, of course, to deny that financial statements may be useful in forming an assessment of future events.) There are difficulties with the idea that convertible debt should be classified according to the probability of conversion, notably in specifying how the probability of conversion should be judged, whether convertible debt should be reclassified if the probability of conversion changes, and whether the interest on convertible debt that is not reported as a liability should be deducted in arriving at profit before taxation.

- 16 One of the criticisms of reporting convertible debt as a liability is that it ignores the equity rights that are inherent in an issue of convertible debt. Two methods of accounting that attempt to address this are 'split accounting' and 'the imputed interest method'.
- 17 The IASC's exposure draft E40 proposes that split accounting should be required for convertible debt. Under this method the proceeds of an issue of convertible debt are allocated between two components: the equity rights, and the liability. Because the amount at which the liability is initially recognised is reduced, compared with more conventional accounting, the reported finance charges over the term of the debt are increased, and would normally be similar to those that would arise on an issue of non-convertible debt. The overall accounting effect is similar to that of an issue of debt issued with warrants as illustrated in the Application Notes.
- 18 The Discussion Paper illustrated 'split accounting' and 'the imputed interest method' and sought respondents' views on them, although it did not propose that these methods should be required. The FRED also sought respondents' views on methods of accounting for convertible debt. The majority of the respondents who addressed the issue agreed that these methods should not be required, giving as their reasons complexity and subjectivity.

Accounting for debt and non-equity interests

- 19 The FRS requires finance costs to be allocated to periods at a constant rate of interest on the outstanding amount. This method reflects the fact that finance costs are a function of the amount outstanding and the passage of time. It is also a familiar method because it is already required by SSAP 21 to be used by lessees to account for their obligations under finance leases.
- 20 A minority of the Board believes that the method by which the FRS requires finance costs to be allocated can result in significant distortions, for example where long-term debt is issued at a time when interest rates are expected to change significantly. For this reason, the minority takes the view that the FRS should at least have permitted finance costs to be spread by reference to the term structure of interest rates implicit in the terms of the financing. The Discussion Paper discussed this method and also methods based on the market values of liabilities. They were rejected mainly on grounds of subjectivity and complexity. The Discussion Paper also rejected the allocation of finance costs on a straight line basis because it does not reflect the relationship between finance costs and the amount outstanding.

Scope of the FRS

- 21 Although the FRS applies to the majority of capital instruments, certain exclusions have been made.
- 22 The FRS does not deal with accounting for warrants and options issued to employees under employee share schemes, for the reasons explained at paragraphs 8-13 above.
- 23 Equity shares issued as part of a business combination that is accounted for as a merger, and leases have been excluded from the scope of the FRS as the Board did

not wish to reconsider accounting for business combinations or for leases as part of the development of this FRS. The Board issued FRED 6 'Acquisitions and Mergers' in May 1993 and expects to issue an FRS on that subject in due course. The Board has not yet determined whether it will reconsider accounting for leases.

Matters considered in the light of responses to the FRED

- 24 Most of the respondents to the FRED agreed with its principal proposals. The following paragraphs describe those points on which respondents expressed concern and, where appropriate, explain the Board's reasons for the changes from the proposals of the FRED.

Consistency between FRS 4 and 'Reporting the Substance of Transactions'

- 25 Several respondents expressed concern that the proposals in FRED 3 seemed to be inconsistent with those contained in FRED 4 'Reporting the Substance of Transactions'. They contrasted the objective of FRED 4 that transactions should be accounted for in accordance with their substance, with the proposals of FRED 3 which, in their view, suggested that the legal form of capital instruments rather than their substance should determine how they were accounted for. Examples that were cited included the proposal that convertible debt should be reported as a liability until such time as it is actually converted, irrespective of the probability of conversion. Some respondents suggested that if conversion was probable, the substance of the instrument was that of equity.
- 26 The Board noted that convertible debt typically contains an obligation to make payments in respect of interest up to the time of conversion and that this alone would be sufficient to justify reporting it as a

liability. More fundamentally, however, it concluded that, even where conversion is probable, this does not affect the substance of the relationship prevailing between the issuer and the holder of convertible debt prior to conversion which is that of debtor and creditor. Although FRED 4 states that exercise of an option should be assumed where there is no genuine commercial possibility that the option will not be exercised, it will not typically be the case that the option to convert debt is of this kind, given the volatile changes that affect companies and hence the value of their equity. Although conversion of convertible debt is sometimes probable, it is not usually certain. Furthermore, the legal nature of the relationship between the issuer and the holder of the debt has important economic consequences: for example in the case of a deterioration in the financial condition of the issuer the holder of convertible debt has a much more valuable set of legal rights to secure recovery of his investment than a shareholder. Indeed in some cases this may be why the investor has chosen to make his investment in the form of convertible debt. The Board therefore concluded that requiring convertible debt to be accounted for as a liability was faithful both to its economic substance and to its legal form.

- 27 Another proposal that respondents considered to require accounting that was inconsistent with the substance of an instrument was that non-equity shares should be reported within shareholders' funds rather than as a liability. The Board's reasons for not requiring non-equity shares to be reported as liabilities are explained at paragraphs 5 and 6 above. The Board takes the view that whilst some non-equity shares may have characteristics of liabilities, the clear distinction of the amount attributable to such shares from equity shareholders' funds ensures that the amount of equity shareholders' funds is clearly stated and alerts the user to the existence of non-equity shares, the characteristics of which may need to be analysed carefully.

Disclosure requirements

- 28 Most respondents agreed with the items for which FRED 3 proposed disclosure, and accordingly they have largely been retained in the FRS. Several respondents, however, disagreed with the proposals of the FRED that certain distinctions should be drawn on the face of the primary financial statements, which they considered excessive; in their view making this disclosure in this way could make the accounts more difficult to understand.
- 29 As stated in paragraph 100 of the Explanation, the Board believes that the items for which separate disclosure on the face of the balance sheet was proposed are important, and that such disclosure will be necessary in many cases. Although the Board does not agree with respondents that disclosure on the face of the primary financial statements will often result in excessive detail, it decided that it would be adequate for the FRS to leave it to the discretion of preparers as to where this information was best given in their particular circumstances, provided that in making a decision they bear in mind the fundamental requirement for the accounts to give a true and fair view and that, if the information is given in the notes, that fact is indicated on the face of the primary financial statements.
- 30 The FRS does not retain the requirement proposed in the FRED to disclose the accounting policy used for capital instruments. The Board agreed with respondents that disclosure of this was already required by SSAP 2 and, in the case of companies that prepare their accounts in accordance with Schedule 4, by paragraph 36 of that Schedule.
- 31 Another disclosure requirement that was proposed in the FRED but has not been retained in the FRS is that of the market value of debt and non-equity shares, where such a value could be readily ascertained. Such a

disclosure is useful to users of financial statements as it provides an insight into the economic burden represented by the debt. However, respondents, and some Board members, objected to this requirement on the grounds that the disclosure might be misleading; for example, it might imply that a company would be able to take advantage of short-term changes in the value of its debt when it was not, in fact, able to do so. The information might also be considered to be of limited usefulness as the market value disclosure would often be given for only part of a company's total exposure. In particular it is beyond the scope of the FRS to develop similar disclosure requirements for off balance sheet instruments. The Board concluded that it would not be appropriate to require disclosure of market values at this time, but that it should be encouraged, and that the desirability of such disclosure would be considered in the Board's future work in conjunction with that of other standard-setting bodies.

- 32 The requirement to disclose participating dividends separately from other dividends on non-equity shares has been introduced to meet the concern that a division of dividends simply into equity and non-equity failed properly to reflect the fact that participating dividends are directly linked to the dividend on equity shares.

Maturity of liabilities

- 33 The FRS retains the proposal of the FRED that in general the maturity of debt should be assessed by reference to its contractual maturity and that a departure from this should be made only where the same lender (or group of lenders) has agreed to provide a further loan on substantially the same terms as the existing debt.

- 34** The Board carefully considered the views expressed by respondents who pointed out that commercial paper (which is a form of short-term debt) is frequently reported as long-term because the issuer holds back-up facilities that would permit its refinancing. Under the proposals of the FRED commercial paper would be reported as short-term notwithstanding the back-up facilities because the facility is not granted by the lender but by another party and because the rate of interest on the debt permitted by the facility is greater than that payable on the commercial paper. The considerations that influenced the Board in reaching its decision are summarised below.
- 35** The Board noted that issuers who regard commercial paper as a long-term source of funds normally expect to be able to refinance commercial paper by further issues of commercial paper. The purpose of the back-up facility is to provide funds in the event that further commercial paper cannot be issued, a circumstance that may arise either for reasons specific to the issuer or because of events of a more general nature. Although the possibility of an issuer's not being able to issue commercial paper may be remote in the larger markets for such paper, this is not necessarily the case where commercial paper is issued in smaller markets. As noted above, the borrowings that the issuer may make under a back-up facility are not similar to borrowings under commercial paper. The Board does not therefore consider that such facilities could reasonably be regarded as an extension of the indebtedness created by the commercial paper; rather they are arrangements entered into to safeguard the issuer from the remote possibility that it may be unable to finance the redemption of commercial paper from a fresh issue or from other sources. The Board was also aware that it was sometimes suggested that back-up facilities might not be available in the circumstances where fresh commercial paper cannot be issued.

- 36 The analysis of maturity that is secured by the requirements of the FRS indicates the time at which new borrowings may have to be entered into. This is important information for users of accounts because entering into new borrowings causes the price and other terms of the borrowings to change. The Board noted that, given the range of financial instruments that are now available, no single analysis will provide all the information that a user of financial statements may require. It considers, however, that the most objective and relevant basis for financial reporting is that which is founded on the actual instruments in issue, rather than one which reports the combined effect of various arrangements that may not always be intrinsically linked, which consequently may obscure the underlying financial flexibility. The Board noted that its statement on the Operating and Financial Review encourages companies to give a narrative discussion of their capital structure and liquidity. The Review provides an opportunity to explain the company's overall financial structure and how the instruments reflected in the accounts integrate with other instruments and facilities for the execution of its financial policy.
- 37 The Board also noted that the Companies Act requires that "*A loan is treated as falling due for repayment ... on the earliest date on which the lender could require repayment ... if he exercised all options and rights available to him.*" (Companies Act 1985, Schedule 4 paragraph 85). The Board takes the view that the requirements of the FRS are consistent with that requirement, but that alternatives favoured by respondents might not be.

Repurchase of debt

- 38 The FRS includes requirements in respect of repurchase of debt, which was not specifically addressed in the FRED. The subject was addressed in Abstract 8 of the Board's Urgent Issues Task Force, issued in March 1993. The requirements of the FRS are substantially the same as those of the Abstract.

- 39 The FRS requires gains and losses arising on the repurchase or other settlement of debt to be recognised at that time and not deferred, for example over the period of the original borrowing. This requirement is based on the view that the finance cost reported by an entity should normally reflect only its current borrowing arrangements, and not be influenced by any previous borrowings that have now been terminated.
- 40 UITF 8 included two exceptions to the requirement for immediate recognition of a gain or loss arising on the repurchase of debt. The first prohibited a gain or loss being recognised where the agreement to repurchase the debt was coupled with its re-financing on substantially the same terms; the second prohibited a gain or loss being recognised where the repurchase was not at fair value and the shortfall or excess was compensated for by other terms of the transactions. As explained in FRED 4 'Reporting the Substance of Transactions', the substance of such a series of transactions should be determined by viewing the series as a whole. Accordingly, gains and losses on such linked transactions should be recognised only where justified by a change in the substance of the entity's assets and liabilities.

Renegotiation of debt

- 41 In response to comments made on the FRED, the Board considered whether the FRS should address the accounting for the renegotiation of debt, that is the agreement by a creditor to a reduction or a deferral of payments due under the debt with the effect that the borrower's obligations are significantly reduced.
- 42 The question arises in such circumstances whether the concession should be recognised as a gain at the time it is granted or whether its effect should be spread over the remaining period of the debt as a reduction in finance charges. Deferral of the recognition of the

effect of a renegotiation can have the result that an agreement that has significant economic consequences is not reported in the period in which those consequences arise and that liabilities and finance costs for subsequent periods are shown at amounts that do not properly represent the agreement then in force. The Board therefore concluded that in principle the gain should be recognised in the period in which renegotiation is concluded. Proposals to that effect were published in July 1993.

- 43 A further question is whether, in recognising the gain and determining the subsequent finance costs, the accounting should be based on the market values prevailing at the time of renegotiation or whether the revised payments should be discounted at the rate inherent in the original debt. The Board's proposals were that the market values prevailing at the time of the renegotiation should be used, as this would result in the carrying amount of the debt following the renegotiation and finance costs for subsequent periods that reflected the economic circumstances that prevailed at the time of renegotiation. Several respondents objected to this aspect of the proposals, pointing out that if (as would often be the case in practice) fair values had to be estimated by a process of discounting, it seemed wrong to use a relatively high rate reflecting the distressed circumstances of the borrower, since this would increase the recorded gain. The Board also noted that the IASC was preparing a revised exposure draft on Financial Instruments that differed from its original exposure draft on this point in that it proposed the use of the original inherent rate.
- 44 In the light of these concerns, the Board concluded that the FRS should not address accounting for renegotiation of debt. The Board will continue to monitor the developments of the IASC project and may re-address the issue at a later date.

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