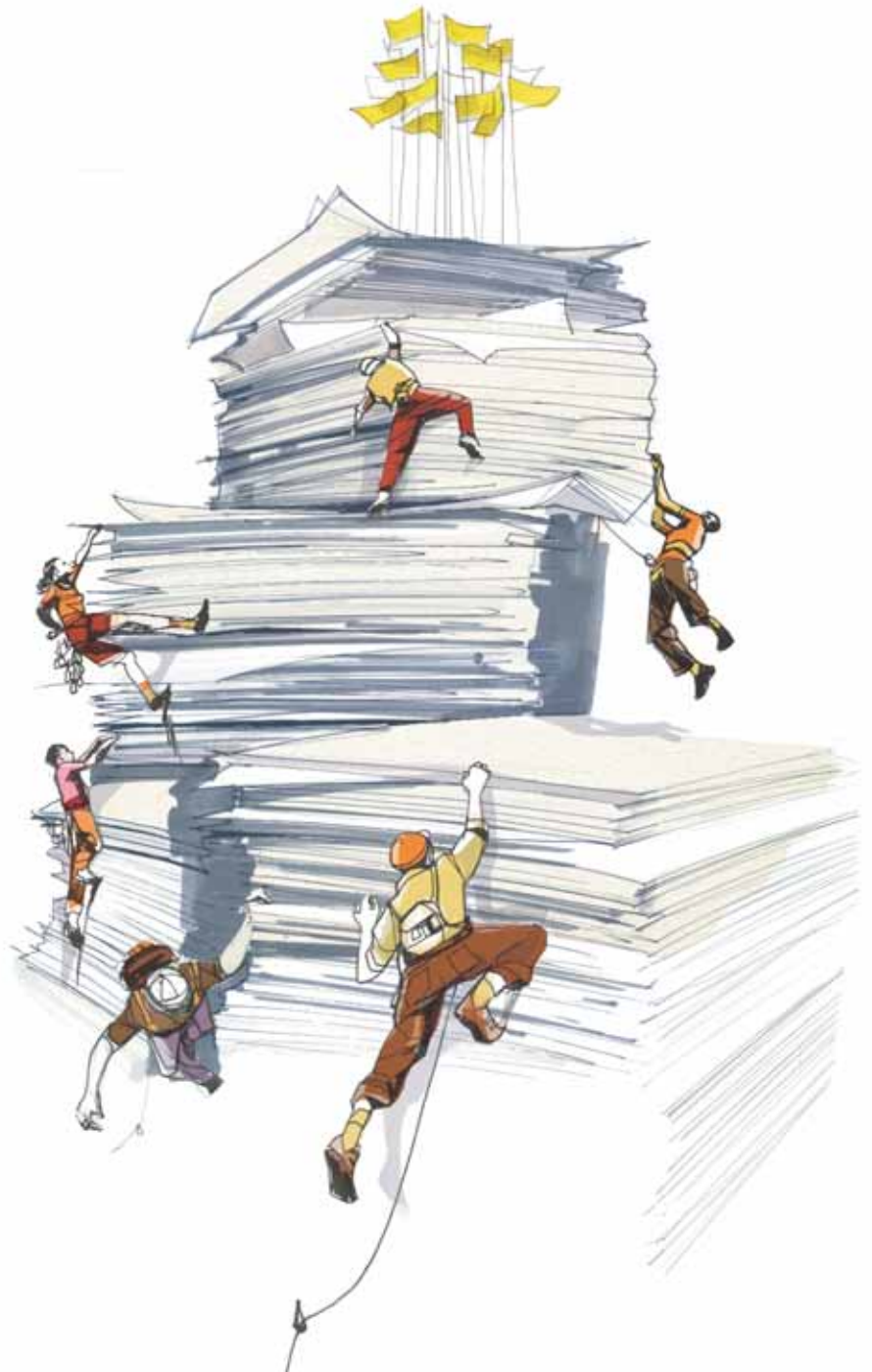


Raising capital finance

A finance director's guide to financial reporting

Capital funding – what every finance director should know



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Raising capital finance – a finance director’s guide to financial reporting

What is the key issue?

Accounting for new issues of capital under UK GAAP used to be a relatively simple matter. But since the introduction of FRS 25¹, those businesses that have previously issued non-standard share capital now face increasingly complex accounting rules.

Although some businesses have only standard ordinary share capital and will have been relatively unaffected by this accounting standard, the resulting issues are especially prevalent where companies have more than one class of shareholder – for example, in venture capital backed businesses.

Are you affected?

Raising funding with any of the following features should be carefully considered, to ensure that the appropriate accounting is acknowledged at the earliest opportunity:

- share capital that includes any non-standard terms; for instance, contractual obligations to redeem shares or pay dividends, even if these are based on future contingent events, or uncertain or ‘contingent’ amounts (for example dividends based on a percentage of profits)
- loans that include any right to convert to share capital, or shares that are convertible to other classes of shares

- loans issued in combination with share capital.

How this publication can help

If you are a director of a company who is thinking about issuing share capital with non-standard terms², this publication is essential reading – we’ll guide you through the issues that we have frequently seen in practice, including:

- share capital being classed as liabilities, with a corresponding impact on gearing
- unforeseen breaches of banking covenants
- changes in the measurement of liabilities, with a corresponding impact on profits
- increased volatility arising from changes in measurement bases.

And if you are a director who is already familiar with the impact of FRS 25 when dealing with non-standard funding, but is now negotiating modifications to the terms of this funding, we also highlight the key issues arising from modifications to terms.

If your company reports under UK GAAP, you may have so far avoided the complexities of fair value accounting. This is because in non-FRS 26 UK GAAP, fair value accounting principles do not normally apply to accounting for financial instruments. Debt accounted for

under FRS 4 is normally initially carried at “net proceeds” and thereafter at historical cost as adjusted for finance costs. However, as described in this publication, where a debt resides within certain types of financial instrument (known as compound instruments), FRS 25 requires fair value principles to be used in respect of initial recognition, which in turn impacts on the subsequent carrying amount. We will clarify the difficulties and give you straightforward guidance on the concepts and procedures you need to understand.

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¹ The accounting standard FRS 25 (IAS 32): Financial Instruments: Presentation was issued, applicable to all UK GAAP entities not accounting under the Financial Reporting Standard for Smaller Entities (FRSSE), for periods commencing on or after 1 January 2005.

² This publication deals with the accounting of the issuer (ie the company issuing the capital), and does not address in any detail the accounting for the holder.

Raising capital – the accounting framework

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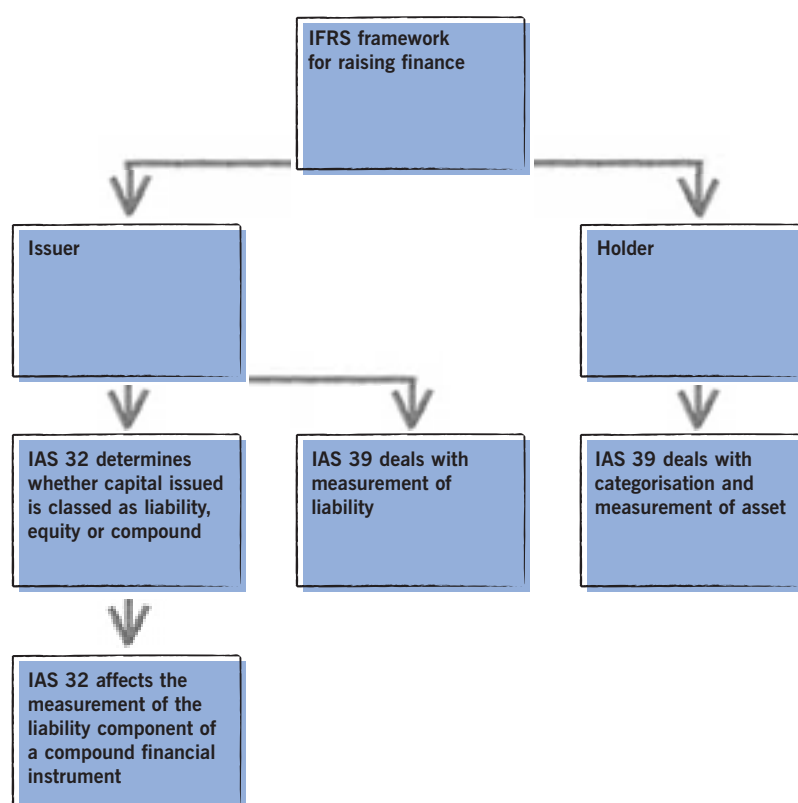
In the UK, all fully listed groups must apply International Financial Reporting Standards (IFRS), as must all groups listed on AIM for accounting periods beginning on or after 1 January 2007. All other companies can choose whether to apply UK GAAP or IFRS.

FRS 25 is directly based on IAS 32, which deals with financial instruments' presentation and defines whether capital issued is classed as equity, financial liability (that is, debt) or a compound instrument.

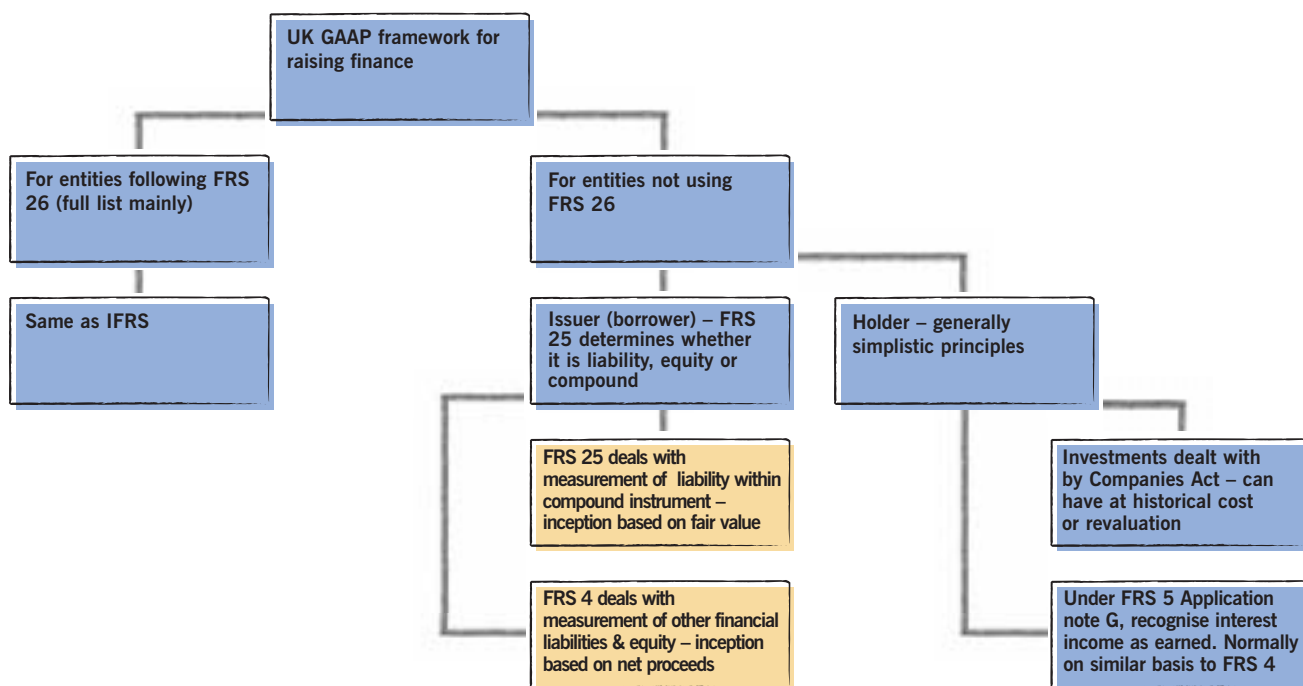
IAS 39 Financial Instruments: Recognition and Measurement is the financial instruments' measurement standard. It is generally considered one of the most complex financial reporting standards in issue. The measurement basis used depends on the classification of the asset or liability. It requires financial instruments to be accounted at their fair value at inception. Subsequently, some financial instruments are recorded at amortised cost and in other cases they are carried at fair value. IAS 39 also details how to account for many other instruments, such as derivatives and embedded derivatives.

IAS 32 is also partly relevant to measurement. Its rules directly influence the measurement of the financial liability component of a compound instrument. The definition of a compound instrument is covered in more detail on page 10, but, broadly, it contains both a debt component and an equity component.

IFRS framework for raising finance – presentation and measurement



UK GAAP framework for raising finance



FRS 4 is an established standard in the UK, dealing with issues of new capital. It requires capital issues to be accounted for initially at net proceeds. This is normally the net amount of cash received when issuing the instrument. It also covers the treatment of subsequent finance costs.

FRS 26, on the other hand, will usually only apply to full list entities reporting under UK GAAP. It also applies in the rare instances in which companies opt to use the Companies Act fair value accounting rules. FRS 26 is directly based on IAS 39 and makes considerable use of fair value accounting principles.

This publication is primarily directed at non-listed entities reporting under UK GAAP (that is, using FRS 4 alongside FRS 25 and not FRS 26). They may often have, therefore, avoided the difficulties of fair value accounting.

FRS 25 is directly based on IAS 32. It determines whether an issued instrument is a financial liability, equity or a compound instrument. If it is a financial liability, then you look to the relevant standard (FRS 26 or FRS 4)

to account for it. Under FRS 4, both financial liabilities and equity instruments should be accounted for at net proceeds.

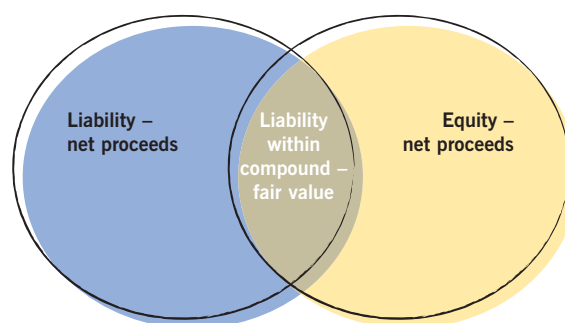
A compound instrument is a financial instrument containing both a financial liability and an equity component. These are very common, particularly when raising funds via venture capital. FRS 25 requires accounting for the financial liability within a compound instrument at fair value on inception.

This means that for non-FRS 26 entities using UK GAAP, there are two very different concepts for accounting at inception – fair value and net proceeds.

If your company uses IFRS you may be familiar with fair value accounting. But entities in UK GAAP have generally been used to a more straightforward historical cost type approach (ie initial accounting on net proceeds) and may not anticipate the relevance of fair values. When it comes to capital issues, FRS 25 can lead to the fair value approach on inception applying to UK GAAP entities. This creates a clash of concepts, causing many surprises in capital raising.

In the next section we expand on the key differences between fair value and net proceeds.

UK GAAP under FRS 4 and FRS 25 – the clash of concepts



Net proceeds versus fair value

Contents



In the previous section, we showed how there could be a clash of concepts in non-FRS 26 UK GAAP from an issuer's (borrower's) perspective. In this section we explain the concepts of net proceeds and fair value.

Net proceeds

FRS 4.11 defines net proceeds as: "The fair value of the consideration received on the issue of a capital instrument after deduction of issue costs." FRS 4.27 says: "Immediately after issue, debt should be stated at the amount of the net proceeds." Net proceeds forms the basis of the initial carrying value of the debt in the issuer's books.

So if A issues an instrument to holder B, and B in return gives consideration of £1,000, the net proceeds are £1,000.

Fair value

FRS 26 (IAS 39) does not usually apply to the entities that this publication is aimed at, but its principles for defining fair value are directly relevant where entities are pushed into a fair value basis.

FRS 26 (IAS 39) defines fair value as: "... the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." It adds that for a financial liability or debt instrument issued on an arm's length basis as a stand-alone instrument, the transaction value provides the best evidence of the fair value at the time of the transaction.

But in other circumstances, mainly in the context of a liability within a compound instrument, the fair value of a financial liability would be based on the discounted cash flows arising from that instrument. FRS 26.AG79 says: "In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made."

FRS 25 (IAS 32) requires the liability component of a compound instrument, at inception, to be based on fair value. In the FRS 25 application guidance and illustrative examples, the fair value of the debt on inception is based on the present value of the contractual future cash flows. The discount rate used in the present value calculation is derived by reference to the rate of interest applied at that time by the market to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the equity component.

Example

A issues an unsecured loan to B, in exchange for £1,000 on 1 January X0. The loan is repayable in full in three

years' time (at £1,000). No interest is charged. At 1 January X0, if A had issued a loan of similar collateral, repayment profile and maturity at arm's length terms, it is considered it would pay interest at 12% a year. The net proceeds are £1,000. Therefore, if accounted for under FRS 4 (and not issued in combination with equity, etc), the loan would be accounted for as a 0% loan at £1,000. However, if the loan was issued as a component of a compound instrument, it would need to be accounted for at fair value on inception. The fair value at 1 January X0 is the net present value of paying £1,000 in three years' time discounted using a rate of 12%. This equates to £712. So, the loan would be recorded at £712 at inception, and then interest would be charged over the three-year period, bringing the liability up to £1,000 by its repayment date.

The entity is in UK GAAP and does not apply FRS 26 – when does the issuer need to consider fair value?

Fair value is directly relevant to accounting on inception in compound instruments. See page 10 for the section on Compound instruments – the fair value challenge.

Fair value is also relevant where a straight debt is issued in combination with equity (ie debt and equity issued at the same time to the same investor). This is explained in the section headed Instruments issued in combination (page 17).

Classification under FRS 25 – it's all in the contract

FRS 25 has a different view of debt versus equity

You may be surprised by the definitions of debt and equity used by FRS 25. Traditionally, some think of debt as referring to bank loans with set repayment terms and fixed returns and equity as involving a higher level of risk with returns dependent on profits.

But FRS 25 views debt and equity differently.

In the FRS 25 definition, debt comprises contractual requirements to make future payments to the holder of the instrument, even if those payments are based on contingent future events. It also classes certain obligations to issue an entity's own equity instruments as a liability, if the terms of the equity settlement fail, to agree with terms the 'fixed for fixed' test (see below).

FRS 25 defines an equity instrument as "any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities."

This means that many instruments that traditionally would have been treated as equity (in terms of risk) are classed as financial liabilities under FRS 25.

Financial liability (debt)

Basic definition of a financial liability

FRS 25.11 defines a financial liability as:

"(a) a contractual obligation:

- (i) to deliver cash or another financial asset to another entity; or

- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) a contract that will or may be settled in the entity's own equity instruments and is:
 - (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments."

This definition can be so difficult to interpret in practice that it is usual to have to turn to the detailed additional guidance in FRS 25 in all but the simplest of circumstances.

The following sections give guidance based on our experience of the main complexities encountered when applying FRS 25.

Contractual obligation to pay cash or other financial assets

The first key point is the meaning of the term contractual obligation. To be classed as a financial liability, a contract must have an obligation to pay cash or other financial assets. For instance, in the context of share capital, the contract would normally be set out in the articles of association, possibly accompanied by a shareholders' agreement. For example, the following are financial liabilities:

- a contractual agreement that a dividend will be paid
- a contractual agreement that shares will be redeemed
- where contractual obligations allow the holder to demand payment of a dividend or redemption (for example a "puttable" instrument whereby the holder has the option to ask for redemption).



These contractual obligations do not necessarily need to be current. For instance, if the contractual obligations give the holder a right to require redemption in the future, that is still a financial liability.

Certain obligations to settle via issue of own equity (including the 'fixed for fixed' test)

Part (b) of the financial liability definition¹ is such that certain contracts requiring settlement via the issue of own equity can be deemed a financial liability. This is often called the fixed for fixed rule. The fixed for fixed rule is also described in more detail in FRS 25.16.

The fixed for fixed rule: examples

Example 1

Entity A has British pounds as its functional currency. On 1 September X6, entity A enters into a contract with entity B to issue 100 equity shares at £1 each on 31 December X6. This contract is a forward contract to issue a fixed number of shares for a fixed amount of currency. The forward contract is an equity instrument.

Example 2

Entity A has British pounds as its functional currency. On 1 September X6, entity A enters into a contract with shareholder B to redeem 100 equity shares at £1 each on 31 December X6.

The forward purchase contract is equity as it meets the fixed for fixed definition. However, although the contract itself is an equity instrument, the obligation to repay £100 creates a financial liability (FRS 25.23).

Example 3

Entity A has British pounds as its functional currency. On 1 September X6, entity A enters into a contract with entity B to issue 100 equity shares on 31 December X6 for such an amount of cash as is equal to 100 ounces of gold. This contract does not meet the definition of fixed for fixed because the price of gold is variable, so this is a financial liability in A's accounts (FRS 25.24). The financial instrument would be likely to meet the FRS 26 (IAS 39) definition of a derivative.

Additionally, there are scenarios where the fixed for fixed rule is breached in less obvious ways. This is particularly important in the context of convertible instruments. It would be wrong to assume that conversion rights (to equity shares) are always equity instruments or components.

Contractual obligations contingent on future events

FRS 25.25 deals with "contingent settlement provisions" and notes:

"A financial instrument may require the entity to deliver cash or

another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless:

- (a) the part of the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not genuine; or
- (b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer."

¹ "(b) a contract that will or may be settled in the entity's own equity instruments and is: (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments."

FRS 25.AG28 clarifies that “not genuine” refers to “extremely rare, highly abnormal and very unlikely to occur”.

In cases other than pre-contracted liquidation, FRS 25.25 clarifies that obligations occurring only on liquidation are not financial liabilities. In all other cases, obligations that are contingent and are outside the control of the issuer are deemed financial liabilities.

FRS 25.25 also clarifies that an entity’s own revenues and net income are outside its control. So, a contractual obligation to pay future dividends based on a percentage of profits is a financial liability because the issuer cannot control the future profits.

FRS 25 and IAS 32 amendment to debt and equity classifications in restricted circumstances

On 14 February 2008 the International Accounting Standards Board (IASB) published a revised version of IAS 32 Financial Instruments: Presentation. The amendment will reclassify some financial instruments that are currently classified as liabilities as equity instruments. The amendment comes into effect for periods commencing on or after 1 January 2009 in respect of IFRS, although earlier adoption is permitted. In the UK, the Accounting Standards Board similarly amended FRS 25 during August 2008, although has not allowed adoption earlier than periods commencing 1 January 2009.

It affects certain instruments that:

- the holder is entitled to redeem (referred to as “puttable instruments”); and
- impose on the entity an obligation to deliver a pro-rata share of the net assets of the entity only on liquidation.

In a very small number of cases, the amendment will cause a reclassification to equity for items that had been liabilities under IAS 32 or FRS 25. In practice, we anticipate that there will be only a very small number of changes to IAS 32 or FRS 25 classifications because of significant restrictions to the amendment.

For instance, entities that have liabilities due to contractual obligations to pay dividends as a percentage of profits will not normally be affected by the amendment (ie they will still be accounted for as financial liabilities, often within compound instruments). Similarly, most cases in which the holder has a right to require redemption will also still be financial liabilities (ie although it might be “puttable”, the restrictive conditions within the amendment mean that the instrument is still a financial liability under the revised IAS 32).

The cases most likely to be affected, and where particular care is needed, are those involving partnerships, unit trusts, investment trusts and co-operatives.

Equity

FRS 25.11 defines an equity instrument as “any contract that evidences a residual interest in the

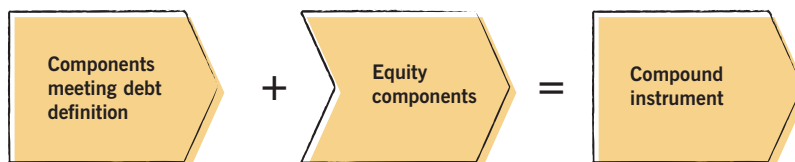
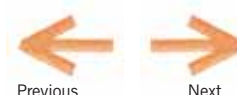
assets of an entity after deducting all of its liabilities.” So, equity is any instrument that gives the holder the ability to participate in what is left after deducting liabilities.

Contractual obligation versus economic pressure from shareholders

FRS 25 notes that dividends and redemptions entirely at the discretion of the issuer are equity. Further, FRS 25.AG26 clarifies that the equity or liability classification is determined irrespective of whether there is a history of paying dividends or an intention to pay dividends. In other words, shareholder pressure to pay dividends does not indicate a financial liability unless there is a contractual obligation to do so. UITF 39.4 notes: “Many financial instruments, including members’ shares, have characteristics of equity, including voting rights and rights to participate in dividend distributions.”

So, if the requirement to pay dividends is not set out in a contract there is no liability, even if the reality is that shareholders will use votes and shareholder pressure to achieve a dividend.

FRS 25 does not specifically mention the situation where the company’s management and shareholders are the same people. However, given the focus on contractual obligations, we consider that FRS 25 requires the assessment to be based on an analysis of the contract between shareholder and company, even if the shareholders are also the company’s management.



Example

X Ltd issues A ordinary and B ordinary shares.

Set out in the articles or shareholders' agreement for the A ordinary shares is a requirement that X Ltd will pay a dividend each year of 20% of profits to their holders. The requirement to pay dividends is a contractual obligation and so meets the definition of a financial liability.

The B ordinary shares do not carry any contractual obligations to pay dividends (or make any other redemptions, etc). The articles state that dividends are payable at the discretion of the company. In practice, the shareholders have indicated their wish for the directors to declare a dividend each year of 20% of profits, and this has been past practice. These shares are classed as equity because FRS 25.AG26 states that the equity or liability classification is determined irrespective of whether there is a history of paying dividends or an intention to pay dividends.

What is a compound instrument?

A compound instrument is one that contains both a liability component and an equity component (FRS 25.28). As noted above, the financial liability component of a compound instrument is accounted for, initially, at fair value on inception. Therefore the identification of a compound instrument can have a significant impact on the measurement of a financial liability, when applying pre-FRS 26 UK GAAP. Examples of compound instruments are:

- convertible bonds (where the conversion terms meet the fixed for fixed test)
- shares that contain a financial liability but also contain an equity component (such as shares containing a contractual obligation to pay dividends or redeem, but which also let the holder participate in the residual via further discretionary dividends).

Compound instruments are very common in venture capital funded businesses. This is because the shares will often include a contractual dividend or redemption and an equity component (such as an ability to participate in a further discretionary dividend).

What does an equity component look like?

FRS 25 does not give extensive examples of equity components, but it is important to note that they let the holder participate in the residual after deduction of the liabilities.

We consider the following to be examples of equity components:

- where the holder has the possibility of obtaining discretionary dividends – a discretionary dividend is an equity component (FRS 25.AG37)
- where the holder has the option to convert to equity instrument, provided that conversion meets the fixed for fixed test (FRS 25.29)
- where the holder has the ability to participate in the residual in the event of a liquidation – FRS 25.25(b) says that redemption only in the event of liquidation is not a liability, therefore implying it is an interest in the residual. Our current view in respect of a redemption term only arising on liquidation is that:
 - if the redemption on liquidation is a percentage of profits then it is an equity component
 - if the redemption on liquidation is only at original issue price (ie return of original capital) then this is not a residual interest, otherwise perpetual debt instruments would always be classed as compound; and
- where the holder has voting rights with the commercial effect that the holder may participate in the residual (voting rights are not referred to directly in FRS 25, but are referred to in IFRIC 2.4 (UITF 39.4)).

What if a company has negative reserves?

If a company has negative reserves preventing it from paying dividends, this does not stop its obligation to do so being classed as a financial liability. FRS 25.AG25 notes: “The potential inability of an issuer to satisfy an obligation to redeem a preference share when contractually required to do so, whether because of a lack of funds, a statutory restriction or insufficient profits or reserves, does not negate the obligation.”

However, where fair value is relevant to the carrying value at inception (for example in a liability contained within a compound instrument), our view is that the existence of negative reserves could impact on the timing of contractual dividend and redemption cash flows and hence impact the fair value of a share capital based liability. This in turn could affect the carrying value of the financial liability where accounting at inception is based on fair value as opposed to net proceeds.

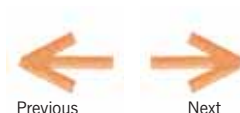
The thought process

The principles underpinning the classification of a financial instrument under FRS 25 are far from simple. See the flow charts in Appendix 1. To clarify whether an instrument is a financial liability (debt), equity or compound, follow diagrams 2A, 3 and 4.



Compound instruments – the fair value challenge

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As noted above, any financial liability contained within a compound instrument is measured initially at fair value on inception. In practice this can often be a challenge.

How does the accounting work? – a simple example

FRS 25 specifies the accounting method and states that the liability component is separated based on a fair value calculation. The equity is then the residual. Consider the following example:

Example

A Ltd issues 1,000 convertible bonds on 1 July X0 at par value of £1,000 each, giving £1 million proceeds. The bonds have a three-year term and interest at 6% is paid annually in arrears. The bonds are convertible at the option of the holder, at any time until maturity, at a rate of 250 ordinary shares per bond. The prevailing market rate of similar bonds, without the conversion feature, is 9% a year and the market price of each ordinary share at the date of issue of the bonds is £2.80. The values of the opening liability and equity components are calculated as follows:

Present value of principal payable at the end of three years (£1 million discounted at 9% for three years)	£772,183
Present value of interest payable in arrears for three years (£60,000 discounted at 9% for each of three years)	£151,878
Total liability component	£924,061
Proceeds of issue	£1,000,000
Residual – equity component	£75,939

In subsequent years, the profit and loss account is charged with interest of 9% on the debt instrument. Assuming a June year-end the accounting effect may be summarised as follows, assuming in this case that the bond is redeemed rather than converted at the end of its term:

	Cash movement (£)	Finance cost at 9% (£)	Liability (£)	Equity (£)
1 July X0	1,000,000		924,061	75,939
30 June X1	(60,000)	83,165	947,226	75,939
30 June X2	(60,000)	85,250	972,476	75,939
30 June X3 (pre redemption)	(60,000)	87,524	1,000,000	75,939
30 June X3 (redemption)	(1,000,000)	-	-	75,939

If the holder had exercised the option to convert, the carrying value at that time would have been transferred to equity rather than being repaid in cash (see FRS 25 AG32).

The key point is to consider the market rate of interest that would have applied to a similar debt instrument, on an arm's length basis, but without any of the equity components.

What discount rate should be used?

The discount rate will depend on the specific circumstances.

The key point is to consider the market rate of interest that would have applied to a similar debt instrument, on an arm's length basis, but without any of the equity components.

For instance, in the context of the convertible bond example above, a coupon rate of 6% applied to the convertible bond, but in separating the liability and equity components, it was considered that a market rate of 9% would have applied had the bond been issued without the equity component (ie without equity conversion rights).

IAS 39 and FRS 26 contain guidance on defining the fair value of similar debt instruments. They say it is the rate that would apply, on an arm's length basis, to a debt with similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis.

In practice this can prove a substantial challenge for many compound instruments, as is demonstrated in the following example.

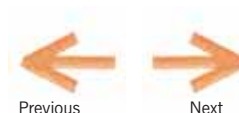
Practical difficulties with the discount rate – an example

Company B issues preference shares to an investor for £1 million on 1 January X0. The shares' terms are such that:

- they are redeemable at any time on or after 1 January X5 at the option of the holder, with the redemption proceeds being £1 million, and
- there is no contractual obligation to pay dividends, but the investor has a possibility of discretionary dividends (the articles say that the directors may declare a dividend to preference shareholders and ordinary shareholders in *pari passu* terms).

These preference shares are a compound instrument. There is both a liability (the redemption obligation) and an equity component (the preference shareholders have the possibility of discretionary dividends).

Under FRS 25 the liability on inception on 1 January X0 is the fair value of the debt, being the net present value of paying £1 million in five years' time. But what discount rate should be used to calculate the net present value? The answer is to try to ascertain what rate the market would charge on a loan of similar credit risk, collateral and maturity as the debt component of the preference shares, but without rights to discretionary dividends. In this case a similar loan would be an unsecured loan of similar credit risk repayable in five years' time. An obvious direct comparison would be what coupon rate would be charged on preference shares repayable in five years' time, but where such preference shares were issued on arm's length terms with no equity components. But in our experience such instruments are rarely seen. In reality, in an arm's length situation a lender and borrower want a pure money lending transaction with no equity characteristics and would typically transact this type of arrangement via a legal loan rather than issue share capital. This is because a legal loan involves a simpler legal process, and because repayment of a loan is not subject to the same legal constraints as share capital. In our experience, when shares are issued in an arm's length situation, they typically have an equity characteristic. The closest comparable instruments would be some types of unsecured but non-convertible mezzanine bank finance, but this is not an exact comparison. For instance, the credit risk on preference shares is typically higher than an unsecured bank loan of similar term, as unsecured creditors rank ahead of legal share capital in the event of a liquidation. The impact of taxation could also have an effect because bank interest on a legal loan is typically tax deductible in the UK, but this would not be the case for interest arising on legal shares and so this would have a corresponding impact on the relevant market rate.



The result is that selecting a comparable instrument is a highly judgmental task and the impact of the estimations involved should be clearly disclosed in the accounts.

In our example we might estimate that the discount rate selected is 22%. This would result in an opening liability of £370,000, and the equity component would be the residual amount, £630,000. The effective interest cost on the liability would then be 22% per annum, building up to £1 million by 1 January X5. This is illustrated in the following table:

Year ending	Liability opening £000	Finance cost at 22% £000	Liability closing £000	Equity Other reserve £000
31 December X0	370	81	451	630
31 December X1	451	99	550	630
31 December X2	551	121	672	630
31 December X3	672	148	820	630
31 December X4	820	180	1,000	630

The fair value challenge – instruments obliged to pay dividends as a percentage of profit

The determination of fair value on inception of an instrument can require considerable judgment. For example, it is common in venture capital backed businesses to have shares (usually held by the venture capital investor) with terms such that dividends are contractually due (ie not discretionary) based on a percentage of profit. The obligation to pay these future dividends meets the definition of a financial liability in FRS 25 despite the fact that the payment is dependent on future profits. This is because FRS 25.25 specifically states that obligations based on the occurrence or non-occurrence of future events that are beyond the control of both the issuer and holder (such as future revenues or net

income) meet the definition of a financial liability. If such obligations are within a compound instrument, FRS 25 requires that the liability on inception is carried at fair value.

In our experience, percentage of profit obligations typically arise in an environment where there are also equity components (for example, rights to further discretionary dividends or ability to participate in profits on wind up). So, percentage of profit dividend obligations are often compound instruments. The liability relating to the dividend obligation would therefore be based on net present value assessments of the future cash flow stream, which in turn is based on estimated future profits. This can provide many challenges, which are dealt with later in this publication, and require careful judgment.

Common issues with venture capital funding

Why are these issues common in venture capital backed businesses?

Venture capitalists typically invest in businesses by taking what was traditionally thought of as at least some equity risk. This often means that the return to a venture capitalist depends to some extent on the entity's future results. Venture capitalists typically look for contractual rights to return as opposed to leaving the payment of dividends or redemption to the company's discretion. They may also look for certain pre-defined exit routes. Achieving those objectives can often lead to contractual terms which prove challenging in the context of the debt and equity model in FRS 25.

While the risks involved may have been traditionally viewed as equity risk, the contractual obligations to pay dividends and redemptions will often meet the definition of a financial liability in FRS 25.

Two of the most common issues are:

- contractual (non-discretionary) obligations to pay dividends in the future based on a percentage of profits – these meet the definition of a financial liability, and
- contractual obligations to redeem share capital in the event of a change of control – these are normally viewed as meeting the definition of a financial liability because the company cannot prevent its shareholders from selling their shares.

Conversely to the change of control scenario, obligations to redeem in the event of an initial public offering (IPO) or listing are not normally viewed as financial liabilities until the IPO or listing event is achieved. This is because management's active participation is needed in order to achieve an IPO or listing, so management effectively has the discretion to avoid a future IPO or listing.

Dividend obligations as a percentage of profits

As noted in the previous section, contractual obligations to pay dividends as a percentage of profits meet the definition of a financial liability under FRS 25.

The liability on initial recognition (that is, day one) will be on the following basis:

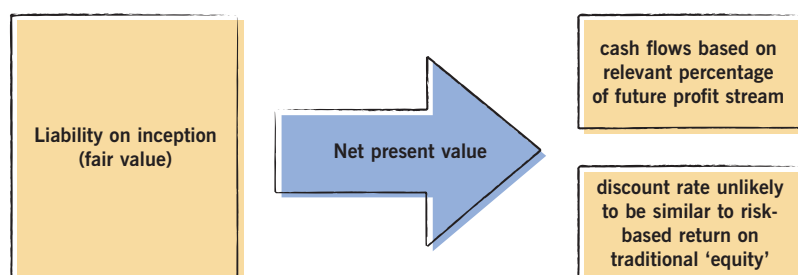
- fair value – in all cases for those entities applying FRS 26 in UK GAAP, but also in the case of a liability within a compound instrument in (pre-FRS 26) UK GAAP

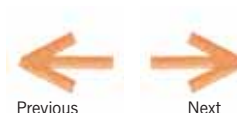
- net proceeds – only in pre-FRS 26 UK GAAP where the liability is not in a compound instrument.

In our experience, these percentage of profits instruments are typically found in compound instruments because they are usually accompanied by some type of equity.

In a percentage of profits instrument, fair value on inception can be summarised by the diagram below. Appendix 2 contains a detailed illustrative example of how this calculation is performed.

After day one, in pre-FRS 26 UK GAAP, the liability is carried on an amortised cost basis in accordance with FRS 4. In FRS 26, accountants debate whether the instrument is a derivative. There are two approaches. The first is that it is not a derivative and the liability is required to be carried at amortised cost. The second approach is that the instrument is a derivative and so is required to be carried at fair value through profit and loss.





In practice, provided there are no major fluctuations in credit risk or market interest rates, then the amortised cost basis in FRS 26 will not give a substantially different result to the derivative basis. This is because in FRS 26, the impact of FRS 26.AG8 will result in the liability being restated for the updated assessment of profits and so will have volatility not dissimilar to a derivative.

For more detail on the amortised cost basis and the impact of FRS 26.AG8, see the section headed Finance charges under effective interest method (Page 18).

Redemptions arising on a change of control

Some types of share capital include a requirement to redeem shares if the company changes control. This means the company cannot control whether or when a redemption occurs because it cannot prevent its shareholders selling their shares. Therefore, such redemptions are a financial liability. If such a liability is on the fair value basis on inception it can present a challenge because of the uncertain timing of redemption.

In our view, in order to comply with FRS 25, the liability on inception should be measured at the net present value of the best estimate of the cash flows attaching to the liability, which will involve a best estimate of when change of control

might occur. Inevitably, there will be subsequent changes in estimates compared to those made at the time of original inception. In our view, for those entities applying FRS 4 (as opposed to FRS 26) there are two possible methods for coping with subsequent changes in estimates:

- **Method 1 – apply the concept in FRS 26.AG8 by restating the liability at each balance sheet date to the revised net present value (discounted using the original effective interest rate)**
- **Method 2 – apply a more traditional application of FRS 4 and simply alter the effective interest rate at each balance sheet date**

Method 1 would be mandatory when applying FRS 26. These methods are explained in more detail in the section headed Finance charges under effective interest method, and also in Appendix 3.

Redemptions arising in event of a listing

An obligation to redeem in the event of a listing or IPO is not considered in itself to meet the definition of a financial liability. This is because management's active participation is needed in order to achieve an IPO or listing – management effectively has the discretion to avoid a future IPO or listing.

Obligations contingent on directors' remuneration levels

Obligations (such as dividends) that are contingent on directors' remuneration levels are, in our view, not financial liabilities as long as the company has effective control over the level of directors' remuneration that acts as a trigger for the obligation.

Example

C Ltd has issued A ordinary shares. There are no contractual redemption obligations or contractual obligations to pay dividends other than if directors' remuneration exceeds £500,000. If directors' remuneration in a year exceeds £500,000, then a dividend of £100,000 is payable in that year. Current directors' remuneration limits are £300,000. Since management can control the level of directors' remuneration to avoid the requirement to pay the dividend, the A ordinary shares are equity.

Convertible debt instruments are not always compound instruments

It is a common misconception that all convertible debt instruments are accounted for as compound instruments. If the conversion rights pass the fixed for fixed test and hence meet the definition of an equity component, then the instrument would be a compound instrument. If the conversion rights do not pass the fixed for fixed test, the whole instrument is treated as a liability unless there are other equity components.

The conversion option is therefore an equity component if, and only if, it satisfies the FRS 25 fixed for fixed definition. In particular, a conversion right is equity if (and only if):

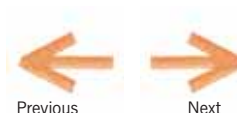
- it is settled only by issuing a fixed number of shares for a fixed amount of cash or another financial asset – the so-called fixed for fixed rule (FRS 25.16(b)(ii)), and
- it contains no non-equity settlement alternatives such as an issuer's or holder's option to pay or take cash equal to the fair value of the conversion option as an alternative to delivering shares (FRS 25.26).

The conversion option in a convertible debt instrument might include terms that vary the number of shares to be issued per bond (the conversion ratio) in certain circumstances. This is sometimes expressed as a change to the exercise price.

The implications of passing or failing the fixed for fixed test can be summarised as follows:

Do conversion rights pass fixed for fixed test?	Is the entity applying FRS 26 or FRS 4?	Accounting required
Yes – fixed for fixed met	FRS 26 or FRS 4	<ul style="list-style-type: none"> • Instrument is treated as a compound instrument under FRS 25 • The liability and equity elements are split on inception • The equity element is not remeasured
No – test failed	FRS 26	<ul style="list-style-type: none"> • Instrument is a hybrid instrument containing a host debt instrument with a conversion right (an embedded derivative) • The instrument is split on inception, but both elements are carried as liabilities • Thereafter, the conversion right must be remeasured at each reporting period and carried at fair value through profit or loss
No – test failed	FRS 4	<ul style="list-style-type: none"> • FRS 25 states that the conversion right is a liability, but does not explicitly tell us how to account for it (see discussion below for some proposed treatments)

Changes to the conversion ratio that are purely anti-dilutive do not, in our view, breach the fixed for fixed requirement (for example, a pro-rata change in the event of a future bonus issue is an obvious anti-dilutive clause). However, there are a number of ways in which the fixed for fixed test might fail. This publication does not address this issue in detail, but it is critical that care should be taken with respect to any terms in the conversion rights that have the effect of varying the number of shares to be issued or varying the conversion price to be paid. Seek professional advice if you find yourself in these circumstances.



It is usually considered challenging for entities applying FRS 26 if a convertible instrument fails the fixed for fixed test. This is because FRS 26 would require those conversion rights to be separated as embedded derivatives. This means that the conversion right would need to be carried as a liability at fair value through profit or loss. This would create profit volatility and also would require valuation techniques to be used to value the conversion right at each reporting date.

But for entities applying FRS 4 alongside FRS 25 the situation is less clear. In our view there are a number of potential treatments which might be applied in this situation. The simplest of these involves the following analysis:

- As the instrument is a debt in its entirety, it is initially carried at net proceeds as opposed to fair value (per FRS 4)
- FRS 25 requires the accounting for the liability to include the conversion right, but no specific method is stipulated by FRS 25 or FRS 4. FRS 4.31 notes: “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.” It is not fully clear how to interpret this in the context of a conversion right.

One interpretation is that it requires changes in the underlying share price to be reflected in the finance cost (ie the intrinsic value of the conversion option). However, in our view, it may also be acceptable to interpret this as saying that no finance charge, in relation to the conversion right, is recognised until conversion occurs. Therefore, before conversion, the finance costs would only reflect the interest or premiums on the host debt (ignoring the conversion rights), but once conversion occurs, an additional finance cost would be charged to reflect the conversion right.

Example

On 1 January X0, A Ltd borrows via the issue of a convertible bond for £1 million. The bond carries interest at 5% a year and the holder has the right to convert it, where the number of shares is calculated according to a formula. The bond has a three-year maturity. It fails the fixed for fixed test. The company is applying FRS 4 alongside FRS 25.

On 31 December X2, the holder exercises the conversion option, in accordance with the terms of the bond. The fair value of the shares at the conversion date, 31 December X2, is £2 million. Under the ‘simpler’ treatment outlined above, A Ltd will recognise the following finance costs:

Year ended	X0	X1	X2
	£	£	£
Interest costs at 5% of £1M	50,000	50,000	50,000
Finance cost on conversion right (£2 million less carrying value of £1M prior to conversion)	-	-	1,000,000
Total finance costs in profit and loss account	50,000	50,000	1,050,000

Instruments issued in combination



Instruments issued in combination

It is not uncommon for a number of instruments to be issued at the same time to the same transacting parties. If the entity is applying FRS 4 alongside FRS 25 and if the amounts ascribed to the individual instruments in the contractual terms are not a fair reflection of the relevant fair values of the various instruments issued in the transaction, then the accounting may lead to a reallocation of the net proceeds.

FRS 4.22 notes: “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.”

FRS 4.69 adds: “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.”

Example of instruments issued in combination

Entity A issues the following instruments to the same party on 1 January X0. The entity is applying non-FRS 26 UK GAAP.

- 1,000 ordinary shares at £1 each (£1,000 in total)
- a loan of £1 million. The loan is repayable in six years' time and carries 0% interest. The loan is unsecured.

In our view, FRS 4.69 and FRS 4.22 require a reallocation of the net proceeds. The requirements of FRS 25 when accounting for compound instruments are, in our view, influential in determining how that allocation might be effected. The accounting applied should therefore be based on the fair value of the loan at inception.

For instance, suppose that a market rate of interest for a similar loan would have been 15% (ie for a comparable six-year unsecured loan). The amount ascribed for accounting purposes to the loan would be the net present value of £1 million, payable in six years' time, discounted using a rate of 15% (ie £1 million divided by 1.15 to the power of 6). This comes to £432,327, which forms the opening carrying value of the loan. The loan would then be carried at an effective interest rate of 15%, building up to £1 million after six years. The balancing £567,673 on inception forms part of equity and on the assumption that it does not form part of share capital for legal purposes, would be credited to other reserves.

Finance charges under effective interest method

Contents



What is meant by the effective interest rate?

FRS 26 uses the term “effective interest method” and includes detailed guidance on its application. FRS 4 does not use the term but requires finance costs to be allocated over the term of the debt at a constant rate on the carrying amount. This rate is the effective interest rate. Another way of thinking about the effective interest rate is that when applied, it results in the liability at maturity date being equal to the amount payable.

Effective interest charge under FRS 4 Premiums payable

Premiums payable form part of the finance costs and so should be taken account of when determining the effective interest rate. The finance costs of an instrument include any costs that are required to be made in respect of that instrument.

Some premiums may be based on contingent events. In our view,

Effective interest rate – a simple example

Entity A issues a loan for £100,000 on 1 January X0. Interest of 0% is charged in year X0, but 10% in each of years X1 and X2 (interest payable at the end of each period). The loan is required to be repaid at the end of year three. Excel or iteration can be used to determine the effective interest rate. This calculates to 6.456% as shown:

Year	Opening/ proceeds £	Interest at 6.456% £	Cash outflow £	Closing liability £
X0	100,000	6,456	-	106,456
X1	106,456	6,873	(10,000)	103,329
X2	103,329	6,671	(110,000)	-

whether or not the premium is taken into account would depend on whether or not the entity has control over the outcome. For instance, consider two contrasting examples:

- if a premium were payable in the event of change of control, then that premium is relevant to the effective interest rate method calculation, because the event is outside the control of the issuer
- if the premium were only payable in the event of early discretionary repayment, then under UITF 11 it would not be taken into account in the finance costs calculation, because in this case the issuer has control over the event leading to payment of the premium.

Premiums – a simple example

An instrument issued on 1 January X0 for £100,000 was repayable at £130,000 on 31 December X2 with no interest payable between those dates.

The effective interest rate would be 9.139% over three years.

Year	Opening/ proceeds £	Interest at 9.139% £	Cash outflow £	Closing liability £
X0	100,000	9,139	-	109,139
X1	109,139	9,974	-	119,113
X2	119,113	10,887	(130,000)	-



Finance costs based on changes in indices

FRS 4.31 notes: “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.”

For instance, this would mean that if the finance cost depended on, for example, movements in the gold price then the finance cost would need to reflect changes in that gold price at each balance sheet date.

But FRS 4.31 is not always clear and is open to interpretation. An example of this is seen in the context of convertible instruments that fail the fixed for fixed test and how to account for the conversion right. This is explained above under the section Common issues with venture capital funding, under the heading Convertible debt instruments are not always compound instruments.

Effective interest charge under FRS 26 Effective interest method

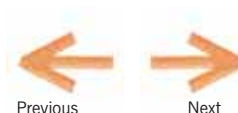
FRS 26 has a more explicit definition of how to apply the effective interest method than FRS 4. The basic definition is in FRS 26.9:

“The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective

interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18), transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).”

There is also some application guidance. In simple cases, the effective interest method will be the same in FRS 26 compared to FRS 4. However, there are also many differences, particularly once applied to scenarios that are more complex.

The finance costs of an instrument include any costs that are required to be made in respect of that instrument.



Changes in estimated cash flows

There are many cases where there are some uncertainties in respect of the future cash flows within a liability. An example would be if the future cash flows depend on future profits, or if a premium is payable but the timing is uncertain. FRS 26.AG8 deals with this. It notes:

“If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument’s original effective interest rate. The adjustment is recognised as income or expense in profit or loss.”

Therefore, where cash flows are uncertain, FRS 26.AG8 requires that at each balance sheet date the liability is restated to equal the net present value of the future expected cash flows discounted by the original effective interest rate. If credit risk and market interest rates remain static this would have a similar impact to fair value adjustments to liabilities. This can create volatility in the profit and loss account.

In our view, the principles of FRS 26.AG8 are particularly suited to scenarios where:

- the accounting on inception is based on fair value, and
- the future cash flows are uncertain.

FRS 4 has no direct equivalent to FRS 26.AG8. In some circumstances, entities that apply FRS 4 might be required to account on inception on the fair value basis. In those limited circumstances, we suggest that entities applying FRS 4 might look to the principles of FRS 26.AG8 in order to account for changing estimates. See Appendices 2 and 3 for more detail.

Finance costs based on index changes – potential embedded derivative

FRS 26 is also subject to detailed rules in respect of embedded derivatives. Those same rules have no direct equivalent in FRS 4 and do not apply to FRS 4 users. However, for those applying FRS 26, embedded derivatives that are not closely related would have to be separated and carried at fair value through profit or loss. An example would be a convertible bond where the conversion right fails the fixed for fixed test. The conversion option would be separated from the host debt contract (based on the fair value of the option at inception) and thereafter, the conversion option would need to be fair valued at each balance sheet date (normally using option modelling techniques) with gains or losses reflected in the profit and loss account.

Dealing with changes in estimated cash flows requires careful thought. There may be more than one method available.

Transaction costs

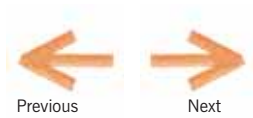
The overall principles in respect of the treatment of transaction costs incurred in respect of a loan issue are similar in FRS 4 and FRS 26, although there can be differences of detail.

The key point is that directly related transaction costs should be offset against the loan liability and amortised to the profit and loss account under the effective interest method. In some cases a shorter period will be required. It is not acceptable to charge these transaction costs to the profit and loss account on a straight line basis as this is not in accordance with the effective interest method.

FRS 4 calls these costs “issue costs” and FRS 26 calls them “transaction costs”.

FRS 4.10 defines issue costs as: “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.”





FRS 4.96 then notes that issue costs do not include the following (and hence these costs would normally be expensed in the profit and loss account unless they qualify for some other asset recognition):

- costs of researching and negotiating sources of finance
- costs of ascertaining the suitability or feasibility of particular instruments
- allocations of internal costs that would have been incurred had the instrument not been issued
- costs incurred in connection with a financial restructuring or renegotiation.

FRS 26.9 defines transaction costs as “incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability... An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.”

FRS 25.35 notes: “Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be debited by the entity directly to equity, net of any related income tax benefit. Transaction costs of an equity transaction, other than costs of issuing an equity instrument that are directly

attributable to the acquisition of a business (which shall be accounted for under FRS 6 Acquisitions and Mergers), shall be accounted for as a deduction from equity, net of any related income tax benefit.”

So, the transaction costs of issuing an equity instrument are debited direct to equity. The exception is costs of an acquisition, although for entities under IFRS, the revised version of IFRS 3 which applies to periods commencing on or after 1 July 2009 will no longer allow transaction costs to be included within the cost of an acquisition. This relates to costs incurred directly in connection with the equity issue. Costs in relation to an abandoned equity issue are expensed in the profit and loss account (FRS 25.37). Transaction costs that relate to a compound instrument are allocated to the liability and equity components on a pro-rata basis (FRS 25.38).

Early repayment options

This publication does not consider the implications of early repayment options in great detail, but their impact can be significant.

FRS 26 treats early repayment options as embedded derivatives. But they only need to be separated (and carried at fair value) where they are not closely related to the host instrument. Whether or not they are closely related depends on a comparison between the cost of early

Transactions costs incurred in connection with a fund-raising should be closely examined.



repayment and the carrying amount of the loan throughout the period during which early repayment could occur.

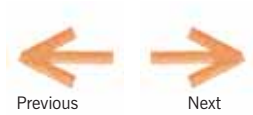
If the two amounts are always approximately equal they are deemed to be closely related and no embedded derivative is separated. However, closely related prepayment options are required to be considered in the overall application of the effective interest method under FRS 26.

Entities under FRS 4 are not subject to the embedded derivatives rules. However, FRS 25 contains some specific rules in respect of early repayment options within a convertible bond, and FRS 4 and UITF 11 also contain some limited principles in respect of early repayment options.

Where an issuer call option is embedded in the liability component of a compound instrument (ie an issuer has the option to repay early), then FRS 25.31 contains specific rules. It requires the fair value of that option at the time of inception to be assessed and offset against the liability component. We interpret FRS 25.31 as defining the issuer call option as the value to the issuer in having an option to pay off the debt, but excluding the value in preventing the holder from exercising the equity conversion. Support for this view is given in FRS 26.AG29, which states: "Generally, multiple embedded derivatives in a single instrument are treated as a

single compound embedded derivative. However, embedded derivatives that are classified as equity (see FRS 25) are accounted for separately from those classified as assets or liabilities. In addition, if an instrument has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other." For instance, if an issuer issues a 5%, five-year maturity convertible loan compound instrument, where the issuer has an early repayment option, then the fair value for the purposes of adjusting the liability component will be the value in repaying a (non-convertible) loan early. The fair value of an issuer early repayment option would be higher in relation to longer-term loans.

FRS 4.16 states that 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. As noted below, UITF 11 alters this principle for issuer call options. However, prepayment options at the option of the holder would be relevant in determining the finance cost assessment.



For issuer call options, UITF 11: Capital instruments: issuer call options is directly relevant. UITF 11 notes that in respect of an early repayment option that can only be exercised by the issuer, any payments that occur in the event of that early repayment do not form part of the finance costs. Such costs would therefore only be reflected on exercise. Where exercise of the issuer call option is uncertain, then, under FRS 4.16, the term of the instrument should end on the date on which the option is exercisable. Therefore, issuer call options have an impact on the amortisation period of transaction costs. UITF 11 only applies to genuine options. If it were clear that the issuer would be commercially obliged to exercise its call option, then UITF 11 would not apply to that option (and hence any payments made on repayment would be taken into account under FRS 4.16).



Restructuring of capital instruments

It is common to restructure capital instruments, and the accounting implications can be wide and varied. The comments below deal with some of these in the context of FRS 4 and FRS 25.

Debt obligations removed

If debt were waived, with no other instruments altered or issued in connection with the transaction, then this may imply that a gain should be reflected in the income statement. This is the view supported by FRS 25.35, which notes that any gains relating to financial liabilities should be recognised in the profit and loss account. Furthermore, FRS 4.32 notes that gains or losses in connection with early settlement of debt should be included in the profit and loss account.

However, there will be many instances where debts, or financial liabilities, will be removed from the balance sheet where there will be other relevant circumstances. For instance, consider the following two contrasting scenarios where the terms of share capital are altered, resulting in the removal of a liability:

- Example 1 – in substance, the liability release is akin to a debt waiver resulting in a gain (where the residual shareholders have a genuine increase in wealth). We consider the gain should be reflected in profit.
- Example 2 – in substance there is no gain. The shares' terms are changed, causing them to be

reclassified to equity but there is no increase in the wealth of residual shareholders. The credit is a release to equity.

Example 1

Company A Ltd has in issue 1,000 Ordinary shares and 1 A Ordinary share.

The A ordinary share is classed as a compound instrument as at 31 December X0. This is because it contains a financial liability whereby the A ordinary shareholder is contractually due an annual dividend of £100,000 in addition to equity components (in this case the ability to participate in the residual profits via further discretionary dividends).

In December X0, a balance sheet liability of £1 million was included in respect of the £100,000 a year perpetual liability. The liability is based on the fair value at inception of a perpetual dividend of £100,000 a year – £1 million being $£100,000/0.1$ due to a 10% discount rate on a similar debt instrument.

The A ordinary share is owned by the managing director, who also owns some of the ordinary shares.

In the year to 31 December X1, the A ordinary shareholder agrees to an amendment to the contractual terms removing the contractual right to the £100,000 a year dividend, for no additional consideration. As the A ordinary share no longer includes a liability it becomes equity. The financial

liability of £1 million is therefore removed from the balance sheet. Should the £1 million release be credited to the profit and loss account or to equity?

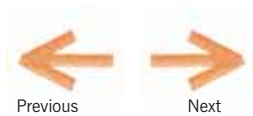
FRS 25.35 states that any gain or loss relating to a liability should be included in the profit and loss account, while a distribution relating to equity should be taken directly to equity. FRS 25.AG32 to FRS 25.AG35 contain guidance on convertible compound instruments, but it is not directly relevant here.

Our current view is that there is a strong argument that the £1 million release should be credited as a gain in the profit and loss account. This is because, in substance, it is similar to a debt waiver whereby the residual equity holders have had an improvement in wealth. A gain has therefore been made in relation to a financial liability, which should be reflected in the profit and loss account.

Example 2

Company B Ltd has in issue 1,000 ordinary shares and 1,000 preference shares. The terms of the preference shares as at 31 December X0 are as follows:

- rights to potential discretionary dividends (an equity component per FRS 25.AG37)
- redeemable at £300,000 at the earliest of change of control, IPO or liquidation.



The redemption on change of control is considered a liability as it is beyond the management's control. The obligation to redeem on IPO or liquidation is not considered a liability under FRS 25.

In the December X0 balance sheet, the preference shares are therefore classed as compound instruments. A liability is included for £70,000 in respect of the redemption on change of control (the opening value on inception based on the fair value of paying £300,000 on expected change of control date).

But in the year to December X1, the preference shareholders agree to alter the terms of the articles to remove the redemption of £300,000 in the event of change of control. The rights remain to the £300,000 redemption in the event of an IPO or liquidation.

As the preference shares' terms no longer include any liability component, they should now be presented in equity. In this case, it is our view that there is a strong argument that this results in no gain and no loss in the income statement. The transaction simply results in a £70,000 credit to equity. The rationale for this view is that in substance there has been no financial gain in the residual interests, it is simply that the terms of the preference shares have been changed in a way which continues to entitle the preference shareholders to the same return, but in a way which is classified as equity (as opposed to a liability). Support for this view is found in FRS 25.23, which notes that where a contractual arrangement containing a

financial liability (due to a holder's option) expires without delivery, then the financial liability is reclassified to equity.

Debt (not previously convertible) instruments converted to equity

Consider the following example:

Entity A has a loan due to B with a carrying value of £80,000 in A's balance sheet. The terms of the loan are that it is non-convertible into equity.

A reaches an agreement with B to satisfy the financial liability by issuing 80,000 of A's £1 ordinary shares to B. The fair value of 80,000 of A's ordinary shares is determined to be £100,000. Should A recognise a loss of £20,000 on settlement of the loan?

Where a financial liability is converted to equity (but was not previously convertible within its terms), then in our view, FRS 25 and FRS 4 do not deal clearly with this issue and an accounting policy choice may be available.

In supporting this view, it is helpful to consider FRS 26, although it does not contain definitive guidance on how to account for the settlement of a non-convertible financial liability by the issue of equity instruments.

One view is that the accounting treatment should be the same as when convertible debt is converted to shares under FRS25.AG32. The entity will derecognise the financial liability and

recognise it as equity. The shares are recorded at the value of the proceeds of £80,000. Although the shares may have been issued at undervalue, there is no accounting gain or loss on conversion. It should be noted that FRS 25.AG32 deals with the conversion of a convertible compound instrument within its original conversion terms and so, arguably, is not easily comparable.

A second view is that the settlement of the non-convertible financial liability by issuing shares represents an extinguishment of that liability, as the entity is legally released from its obligation to pay cash. FRS 26.41 states: "The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss." The entity will derecognise the financial liability and the shares issued should be recognised at fair value of £100,000. A loss of £20,000 will be recognised on extinguishment.

We currently consider that both views are acceptable and the treatment is a matter of accounting policy choice for the entity. But the situation should be monitored to see whether a consistent treatment emerges and becomes best practice.

Redemption of compound instruments other than on the contractual terms

Early repayment

FRS 25 contains specific rules in connection with variations in contractual terms in order to repay a convertible bond early, where the instrument is currently designated as a compound instrument. FRS 25.AG33 and AG34 require that if a convertible compound instrument is extinguished before maturity and where the original conversion terms are unchanged, then:

- the proceeds paid are allocated between debt and equity
- the amount of the proceeds attributed to the debt component is based on a fair value assessment of the liability before redemption, and the difference between the proceeds allocated to the liability and the liability carrying value is included in the profit and loss account
- the proceeds allocated to equity are debited directly to equity.

The effect of this can be seen where a payment made by the issuer reflects a large premium to entice the bond holders to accept payment rather than use their conversion option (usually when the share price has increased such that the option exercise price is significantly in the money). The premium payment essentially has two components. The first cancels the debt component and the second (equity) component cancels the holders' conversion option. The premium will be debited against equity to the extent

that the premium relates to the value of the conversion option (equity component). This will often lead to negligible gain or loss in the profit and loss account.

The gain or loss in respect of the liability component only includes the fair value versus carrying value movements with regard to the debt component. If the credit risk of the entity and market interest rates remain similar to those existing at the time of issue, then the liability component gain or loss will be negligible.

FRS 25's illustrative examples include a worked example of this.

Amendment of terms to induce conversion

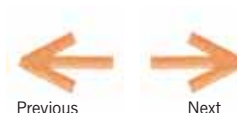
FRS 25.AG35 deals with a scenario in which an entity amends the conversion terms in order to induce early conversion. The difference at the date of amendment between the fair value of the consideration the holder receives on conversion under the revised terms, and the fair value of the consideration the holder would have received under the original terms, is recognised as a loss in the profit and loss account.

FRS 25's illustrative examples include a worked example of this.

The circumstances behind amendments to capital instruments or a debt conversion to equity should always be carefully examined.

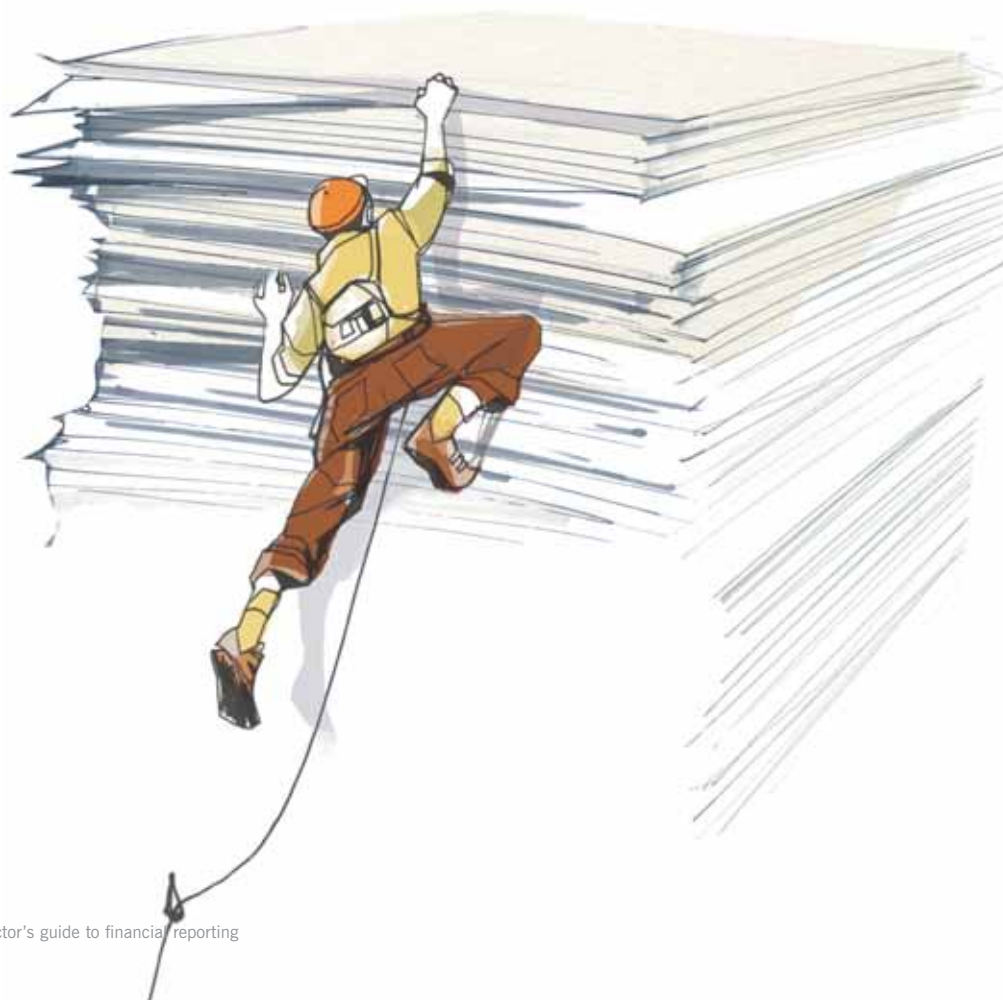
How is the tax affected?

Contents



The comments in this section are written with respect to the funded company's tax position and not the venture capitalist (VC), although some comments in respect of the VC have been included. Typically the VC investment vehicle will be a partnership, treated as look-through for tax purposes, although sometimes the VC is a corporate entity.

Taxation legislation often uses a company's accounts as the starting position in determining a company's tax liability. The application of FRS 25 to all UK companies since 1 January 2005 has had a significant effect on companies' tax positions. FRS 26 potentially has great significance also, although the assumption in this chapter is that the funded company has not adopted FRS 26.



Shares

The issue of shares for new consideration should have no tax issues for the issuing company. No tax deduction is available for dividends paid by a UK company. Similarly, a UK company receiving those dividends, either directly or as a UK company partner in a look-through VC partnership, is not subject to any UK corporation tax. This generally remains the case even where the shares have been accounted for as debt.

Although unlikely to be directly relevant, it is worth noting that HM Revenue & Customs (HMRC) has introduced anti-avoidance legislation so that the investment by a UK company in shares has the character of debt. Where certain conditions are met, the holder of those shares will be taxed on fair value movements in the value of the investment.

Debt

Debt may come from various sources and have many different descriptions applied to it. Typical variants include senior debt and mezzanine debt, interest bearing or deep discount, term or on-demand or even convertible or exchangeable. Each variant can lead to different accounting and tax complications.

Since March 2005, one of the major concerns for the tax deductibility of finance costs is whether the transfer pricing acting together provisions apply. This legislation was enacted in part to restrict deductions for financing charges in situations where

parties, who are otherwise unconnected, fund a company with what might be considered excessive amounts of debt. Where the legislation applies, deductions will only be available for reduced finance costs.

If the debt is interest bearing, but interest is rolled up rather than paid, then the late paid interest rules may apply to disallow tax deductions on an accruals basis and instead defer relief until the period in which the interest is paid.

Similar restrictions may apply to obtaining tax relief for the discount accruing on deep discount securities. Deep discount securities are often used to avoid the requirement to withhold tax from interest payments made to non-residents or to VCs that have or may have non-resident investors.

Payment in kind (PIK) is a way of avoiding the late paid interest rules through issuing new securities as payment of the accrued interest. In VC funding structures some debt instruments may specifically provide for the payment of interest through the issue of new securities. It is worth noting that for tax purposes the issue of the new securities in this situation is treated for all tax purposes as the payment of an amount of interest equal to the market value of the new securities at their time of issue.

Accounting for convertible or exchangeable debt is a difficult issue. HMRC has introduced specific rules to deal with the situation where an instrument is split into a debt component and another component.

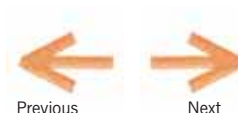
In summary, the tax position is often based on the accounting position, although there are many variations to this. It is strongly advisable in each case to obtain professional advice on the accounting and then obtain specialist tax advice on the resulting taxation impact.

Looking to the future

If you foresee your company adopting FRS 26 or IFRS within its individual accounts, its tax position should be reviewed in the period before those standards are adopted. It may be necessary to consider and indeed file various elections with HMRC before the start of the period for which those standards are adopted.

Appendix 1 – FRS 25 – the thought process

Contents



Caveats

The diagrams that follow summarise the typical thought processes in classifying a financial instrument. The flowcharts are designed to help in some non-complex cases, but in most situations reference will be necessary to the relevant standard. In some instances these diagrams may not contain all the necessary steps, so should not be used as the sole source of reference.

The terms 'liability' and 'debt' are used interchangeably in these appendices and both should be taken as abbreviated terms for financial liability as defined in FRS 25.

The diagrams involve looking at financial instruments on a standalone basis; caution is required where more than one instrument is issued at the

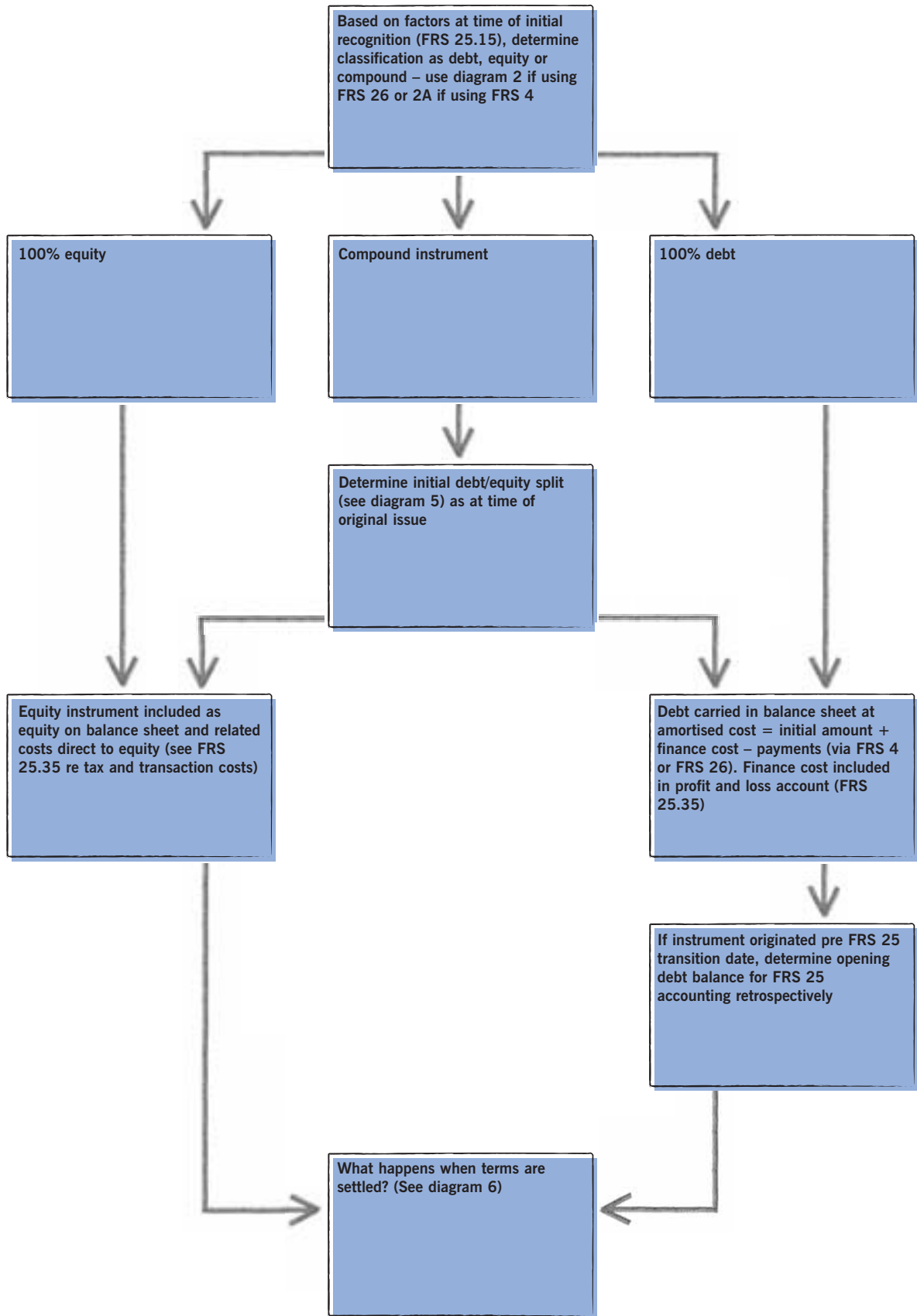
same time to the same investor. In these circumstances consideration of the substance of the arrangements may require either a reallocation of the net proceeds or that the instruments should be considered in combination.

The diagrams do not deal with the additional considerations necessary when, during the life of a financial instrument, its original terms are changed or the contract is cancelled.

A further scenario not dealt with specifically in these diagrams is where instruments are issued with obligations inherent in the instrument that are higher than the market rate of a similar debt instrument (for example preference shares issued with an obligation to pay dividends at 30% a year where the rate on a similar debt instrument is considered to be 20%).

The appropriate accounting is likely to vary depending on the reason for the above-market rate and may vary according to whether FRS 4 or FRS 26 is applied.

For IFRS, the guidance in this document applies equally to IAS 32, although references would be to the equivalent paragraphs in IAS 32 and IAS 39 rather than FRS 25 and FRS 26. But FRS 4 has no IFRS equivalent, as measurement under the latter is dealt with in IAS 39, for which the UK equivalent is FRS 26.



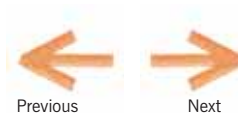


Diagram 2 – classification process (FRS 25 with FRS 26)

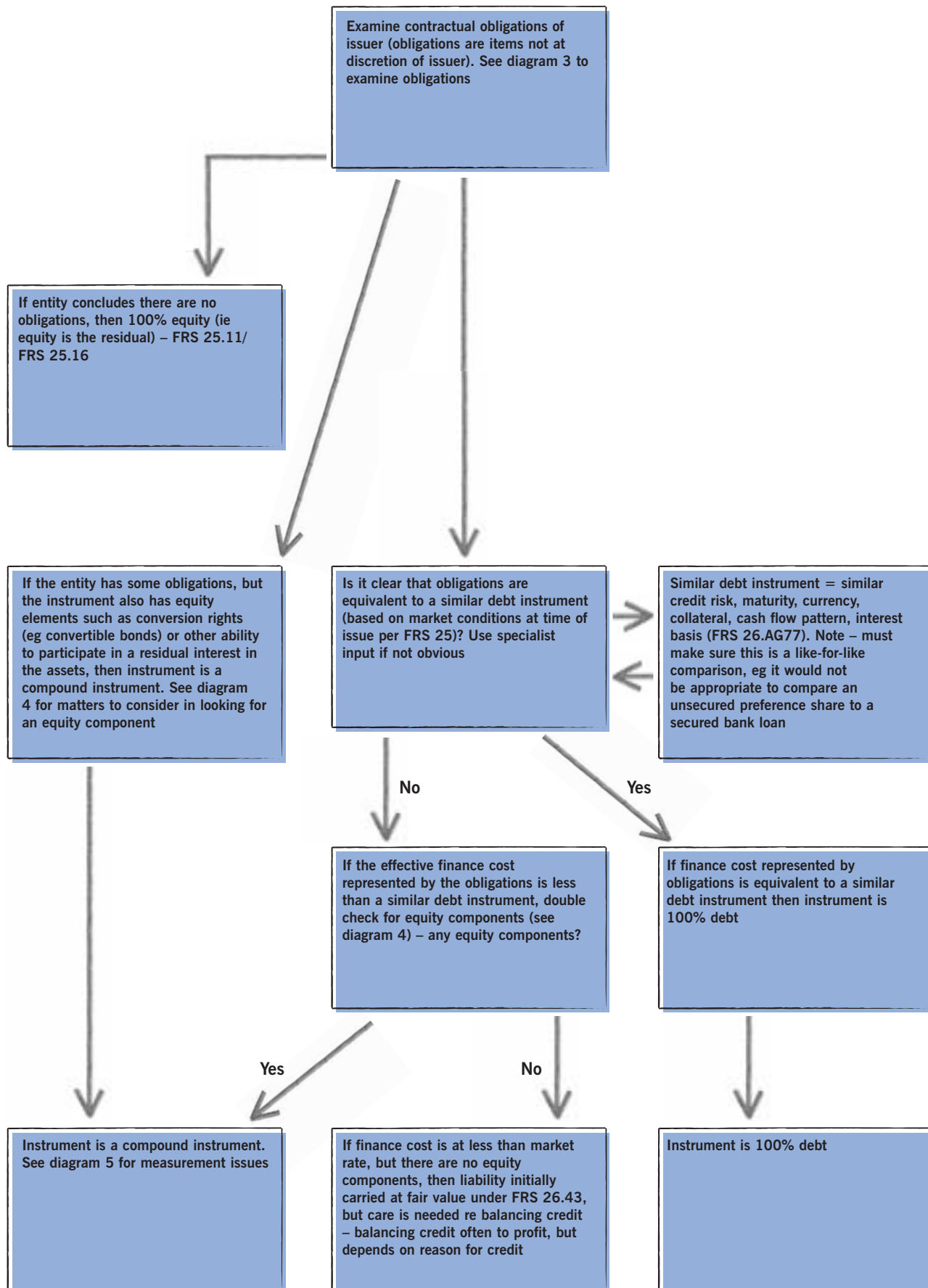


Diagram 2A – classification process (FRS 25 with FRS 4 and FRS 26 not applying)

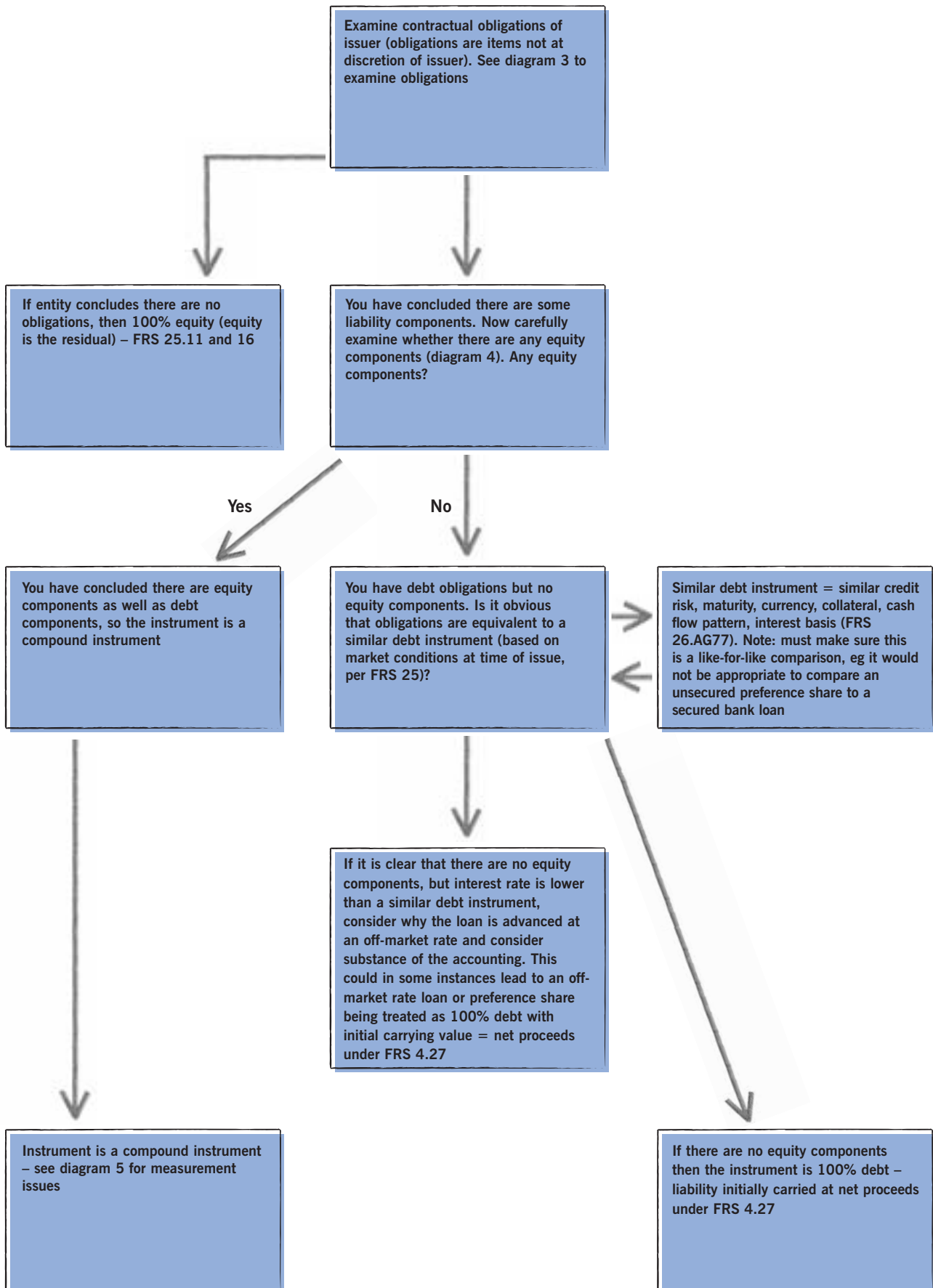




Diagram 3 – determine obligations of issuer

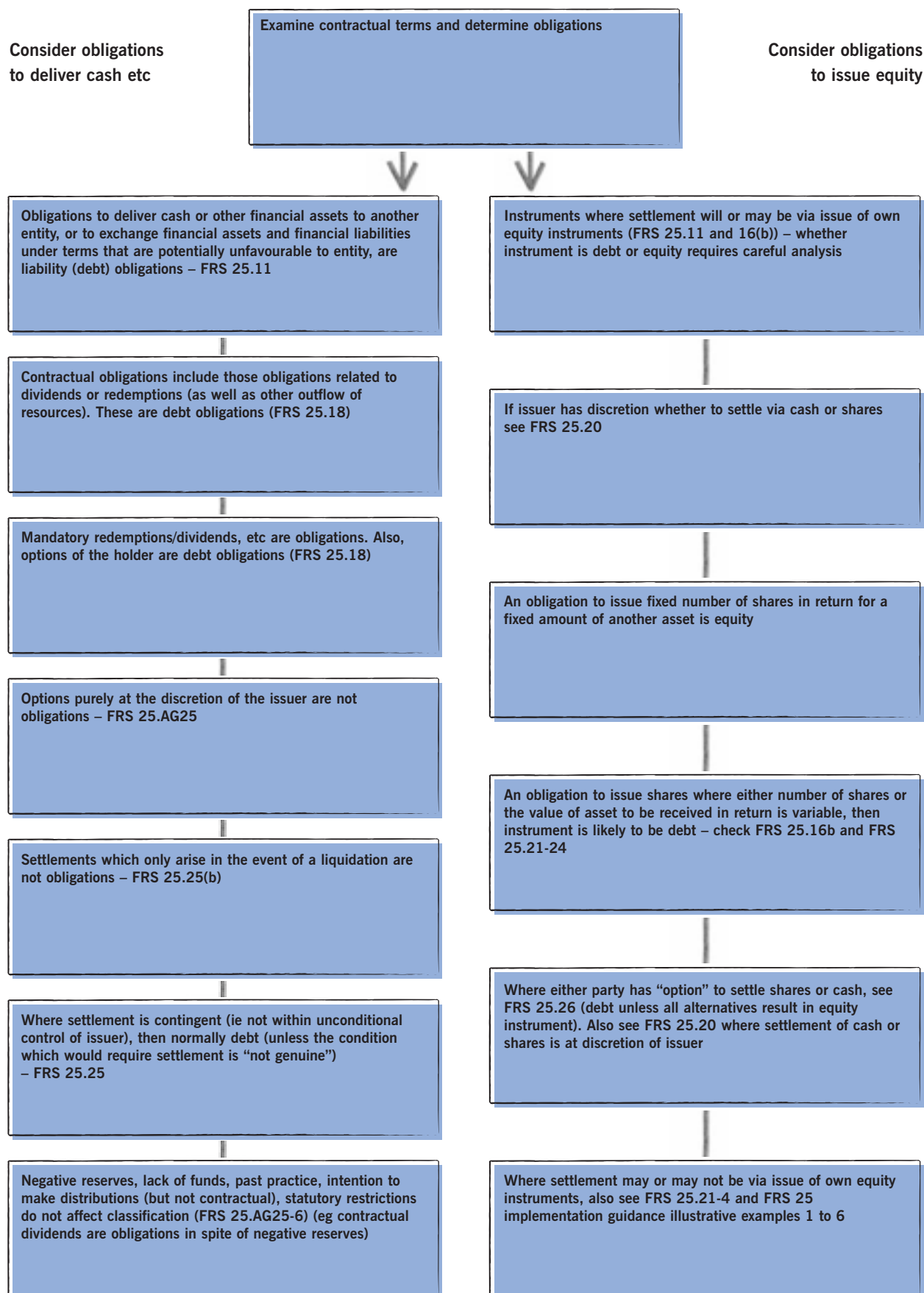
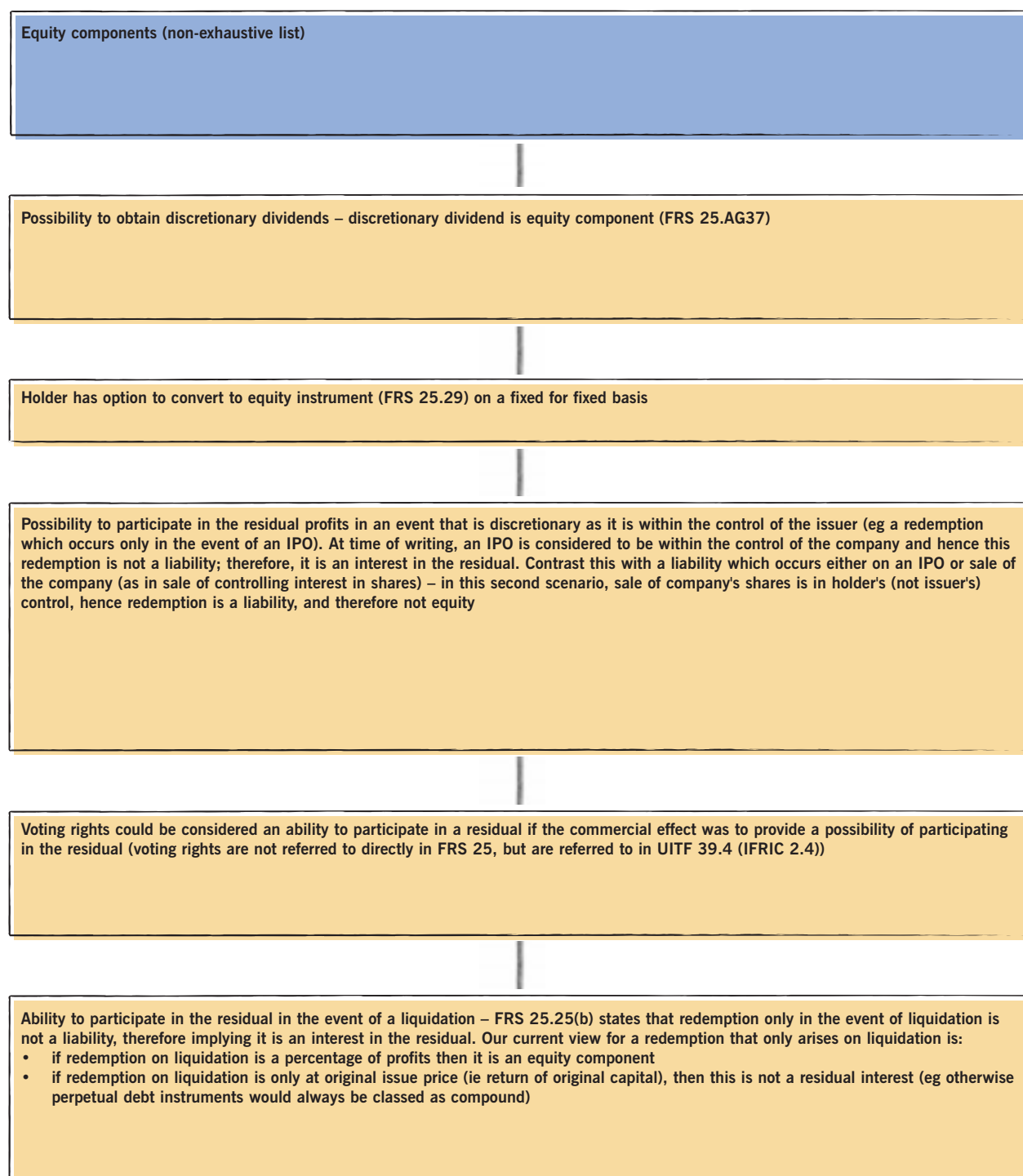


Diagram 4 – is there an equity component evidencing a residual interest?

Note: this diagram is only relevant if it is established that there are some debt obligations (and so it is known that the instrument is not 100% equity). Where there is evidence of a residual interest as well as debt obligations then the instrument is a compound instrument. In broad terms, an ability to participate in the residual of the assets after deduction of liabilities is an equity instrument

(FRS 25.12). The following are possible equity components, but the list is not exhaustive. This is looking for any possibilities where the financial instrument could provide the holder with a return that has not already been taken account of as an obligation meeting the definition of a liability. This is an area of continuing debate and if you are in doubt you should seek advice.



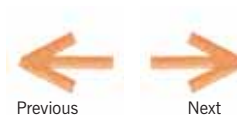


Diagram 5 – if a compound instrument, determine initial split between debt and equity (Note: this is done as at time of initial recognition and is not revised later as a result of changes in market conditions – FRS 25.AG30.)

The method below is prescribed by FRS 25.31, FRS 25.32 and FRS 25.AG31.)

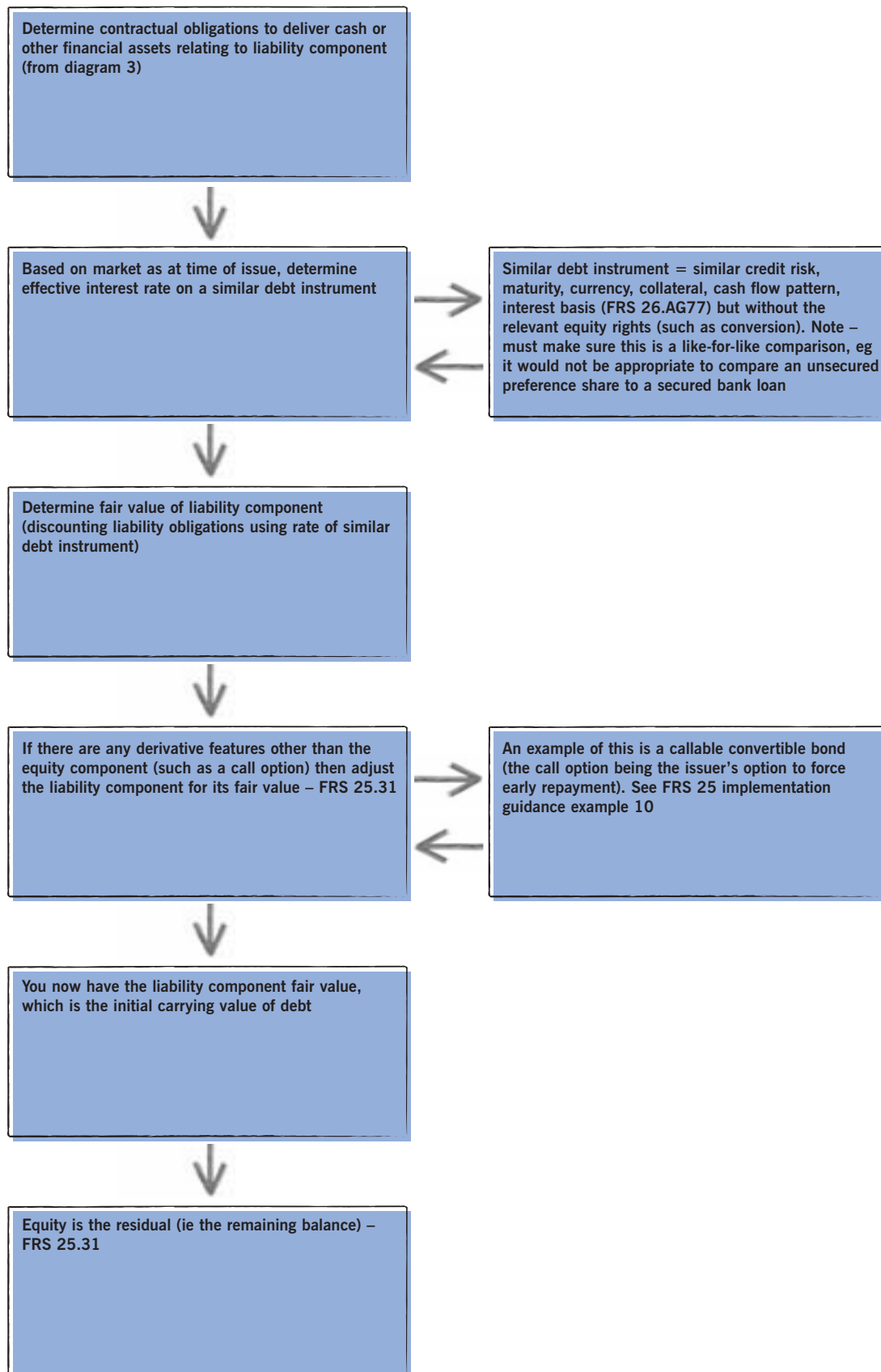
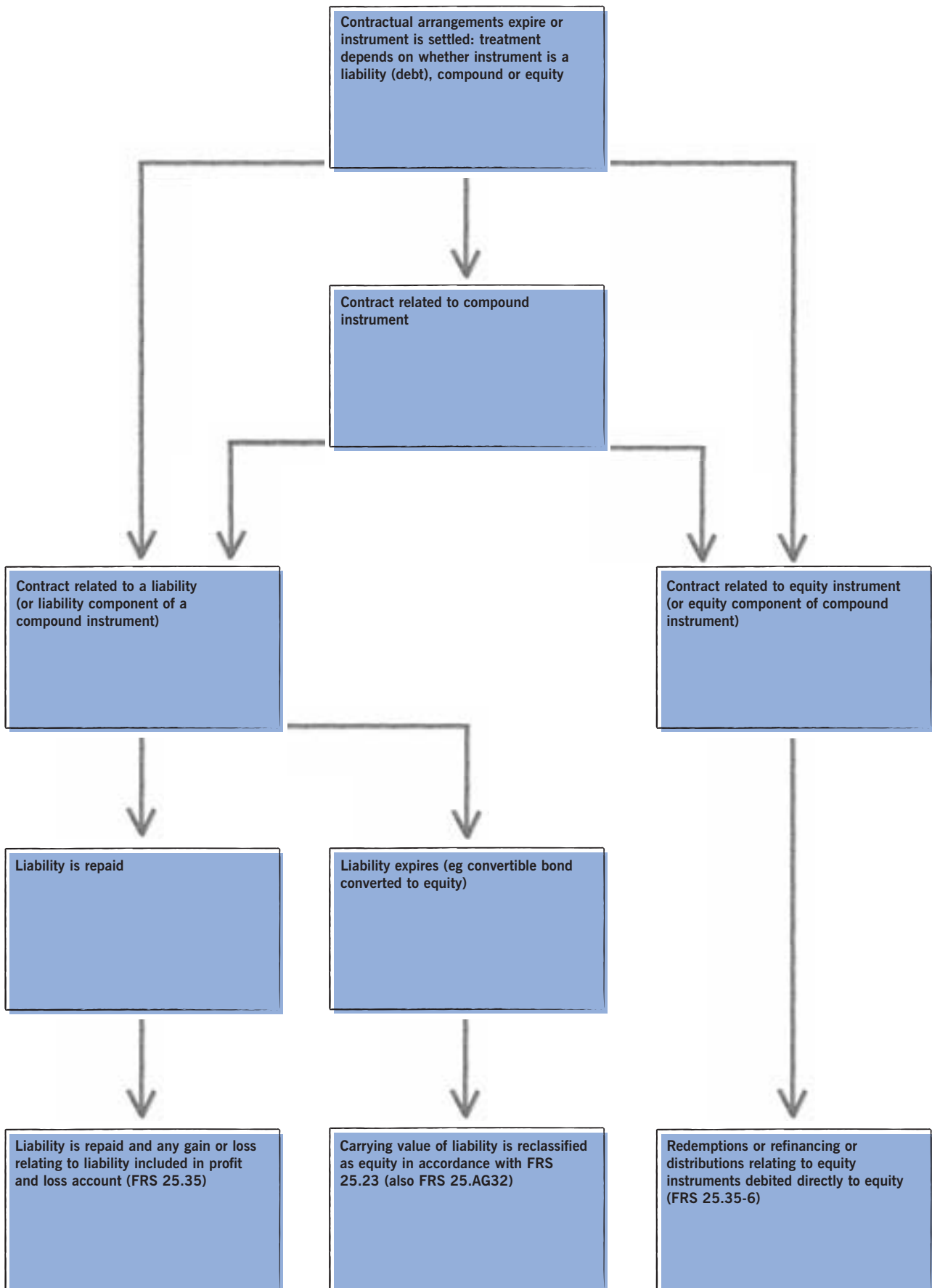
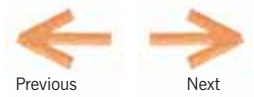


Diagram 6 – what happens when instrument is settled in accordance with original terms?

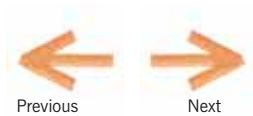
(Note – in addition, ensure that related transaction costs are dealt with in accordance with FRS 25.35.)

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Appendix 2 – FRS 25 – illustrative example of obligation to pay percentage of profits as dividend

Contents



Background

A Ltd on 1 January X0 issues A ordinary shares for £1 million in cash (at par). Their terms, as expressed in the articles, are as follows:

- the company is contracted to pay an annual dividend of 10% of profit before tax for any annual period that it makes a profit
- in addition, the company may declare a further discretionary dividend to the ordinary shareholders
- the shares are contractually required to be redeemed for £1 million cash on 31 December X9.

The obligation to pay 10% of profits as a dividend and the obligation to redeem meet the definition of a financial liability in accordance with FRS 25 (FRS 25.11 and various other supporting paragraphs including FRS 25.25). The additional discretionary dividends clause meets the definition

of an equity component, as it allows the holder to participate in the residual and so meets the definition of an equity instrument in accordance with FRS 25 (and also as clarified in FRS 25.AG37). So, the instrument contains both a liability component and an equity component and as such is a compound instrument.

Assessment of liability on inception

As the liabilities are a component of a compound instrument, at inception FRS 25.31 requires the liability component to be initially carried at fair value. In this case, fair value of the liability would be determined based on the net present value of the estimated future dividend obligations (that is, the 10% of profit dividend) and redemptions. Any expected discretionary dividends are not taken account of in this, as these are part of the equity component.

Due to the requirements of FRS 25.31 applying to all UK GAAP entities (irrespective of whether or not FRS 26 is being applied), this analysis is consistent between UK GAAP and IFRS.

The net present value requires the cash flows to be discounted using the rate of a similar debt instrument. A similar debt instrument is one of similar collateral, maturity, currency and credit risk. Therefore, the similar debt instrument in this case is what a lender would give for an unsecured 10-year term loan where the timing of interest payments is dependent on profits. The risk profile is therefore similar to what a venture capitalist would typically look for in a traditional equity investment (using equity here in the traditional sense as opposed to its FRS 25 definition). For this illustration it is assumed a similar debt instrument would have required a return of 25%.



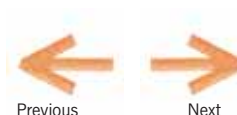
The net present value on inception is calculated at £412,005 as follows:

Date (31 Dec)	Projected profits £	Projected dividend obligation at 10% of profit £	Projected redemption obligation £	Total cash flows £	Discount factor (denominator) £	Net present value £
X0	400,000	40,000		40,000	1.2500	32,000
X1	600,000	60,000		60,000	1.5625	38,400
X2	800,000	80,000		80,000	1.9531	40,960
X3	1,000,000	100,000		100,000	2.4414	40,960
X4	1,100,000	110,000		110,000	3.0518	36,045
X5	1,200,000	120,000		120,000	3.8147	31,457
X6	1,300,000	130,000		130,000	4.7684	27,263
X7	1,350,000	135,000		135,000	5.9605	22,649
X8	1,400,000	140,000		140,000	7.4506	18,791
X9	1,500,000	150,000	1,000,000	1,150,000	9.3132	123,480
						412,005

Therefore on 1 January X0 the entry is

Dr Cash	£1 million
Cr financial liability (shares classed as)	£412,005
Cr equity – share capital	£587,995

The obligation to pay 10% of profits as a dividend and the obligation to redeem meet the definition of a financial liability in accordance with FRS 25 (FRS 25.11 and various other supporting paragraphs including FRS 25.25).



How does the liability move if profits stay as originally projected?

Year ended (Dec)	Opening liability £	Finance cost in year at 25% (in p&l) £	Cash flows £	Closing liability £
X0	412,005	103,001	(40,000)	475,006
X1	475,006	118,752	(60,000)	533,758
X2	533,758	133,440	(80,000)	587,198
X3	587,198	146,800	(100,000)	633,998
X4	633,998	158,500	(110,000)	682,498
X5	682,498	170,625	(120,000)	733,123
X6	733,123	183,281	(130,000)	786,404
X7	786,404	196,601	(135,000)	848,005
X8	848,005	212,001	(140,000)	920,006
X9	920,006	229,994	(1,150,000)	0

The above illustration shows how the liability would move over time, coming back to zero at the end of the period after redemption. But profit estimations (and so dividend flow in relation to the liability) will inevitably vary from projections. So, the next question to consider is how these changes affect the liability.

Now let's move forward in time to 31 December X0

In the original projection, the profits before tax had been projected at £400,000 for X0, resulting in a dividend obligation of £40,000. In fact, the company in X0 only made profits of £200,000, resulting in a mandatory dividend based on the contractual obligations of £20,000. The company did however pay a further discretionary dividend of £10,000. In addition, the company has now revised its profit forecasts and now foresees lower profits than were originally projected. So how do we account for this change?



Year ended 31 Dec	Original projected profits £	Original dividend obligation £	Revised estimated profits (X0 actual) £	Revised dividend obligation £
X0	400,000	40,000	200,000	20,000
X1	600,000	60,000	500,000	50,000
X2	800,000	80,000	700,000	70,000
X3	1,000,000	100,000	900,000	90,000
X4	1,100,000	110,000	1,000,000	100,000
X5	1,200,000	120,000	1,050,000	105,000
X6	1,300,000	130,000	1,100,000	110,000
X7	1,350,000	135,000	1,150,000	115,000
X8	1,400,000	140,000	1,200,000	120,000
X9	1,500,000	150,000	1,250,000	125,000

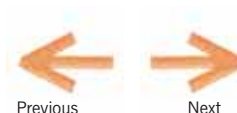
Discretionary dividend of £10,000

Firstly, the £10,000 discretionary dividend is accounted for separately as an equity instrument transaction in accordance with FRS 25.35. Providing it is paid before the year-end (or otherwise meets FRS 21 criteria), the entry is Dr equity £10,000 Cr Bank £10,000.

Accounting in liability component

When a company is within IFRS or FRS 26, the method is mandated by FRS 26.AG8. This is illustrated below as the FRS 26.AG8 method.





The company can apply a traditional interpretation of FRS 4 by altering the effective interest rate as time progresses.

When a company is within FRS 4, in our view there is a choice:

- The company can apply a traditional interpretation of FRS 4 by altering the effective interest rate as time progresses. This is seen as the method consistent with the more traditional FRS 4 approach. The traditional FRS 4.31 method results in a smoother finance charge with the effect of changes in estimations accumulated within the liability and amortised as time progresses to profit and loss in accordance with alterations to the effective interest rate
- However, it is also seen as acceptable to apply the FRS 26.AG8 method, even when applying FRS 4 (this is because FRS 26.AG8 lends itself naturally towards a situation where an item is carried initially at fair value and where the fair value is based on estimated future cash flows). The FRS 26.AG8 method has practical advantages, particularly when implementing FRS 25 for the first time in instruments dated some time ago (for example the traditional FRS 4 method would mean looking at the revised profit projections at each and every balance sheet date since the time the instrument was issued).

The essential difference is that the traditional FRS 4 method involves gradually altering the effective interest each year whereas the FRS 26.AG8 method involves a cleaner reassessment of the liability at each balance sheet date while maintaining the same original effective interest rate as established at inception. The FRS 26.AG8 method has the advantage of being a cleaner year-end calculation because the impacts of earlier (now out of date) estimations are not carried forward in the balance sheet. However, the FRS 26.AG8 method would result in greater profit volatility.

Traditional FRS 4 method

FRS 4.31 states: “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.”

The traditional FRS 4 method would be as follows:

- the liability starts the period at £412,005 (see above on inception)
- the finance cost (pre the FRS 4.31 adjustment) is the effective interest rate of 25% x the opening liability of £412,005 = £103,001
- as actual dividends in the current year were £20,000, compared to the originally projected £40,000 for that year, there is an immediate credit to

the profit and loss account of £20,000 (within finance costs)

- the closing liability at 31 December X0 is then £475,006 (being 412,005 + 103,001 – 20,000 (FRS 4.31 adjustment) – 20,000 (payment))
- the effective interest rate needs to be revised with effect from 1 January X1, so the rate will be such that the finance costs will be a constant rate on the carrying amount (and coming back to a nil

liability after the redemption).

In the example given, the effective interest rate is revised to 22.89% (this can be determined by an Excel IRR formula, but can also be determined via iteration).

Year ended (Dec)	Opening liability £	Finance cost in year (25% for X0, revised thereafter) £	FRS 4.31 adjust current £	Cash flows re dividend £	Redemption £	Closing liability £
X0	412,005	103,001	(20,000)	(20,000)		475,006
X1	475,006	108,731		(50,000)		533,737
X2	533,737	122,175		(70,000)		585,912
X3	585,912	134,118		(90,000)		630,030
X4	630,030	144,217		(100,000)		674,247
X5	674,247	154,338		(105,000)		723,585
X6	723,585	165,632		(110,000)		779,217
X7	779,217	178,366		(115,000)		842,583
X8	842,583	192,871		(120,000)		915,454
X9	915,454	209,546		(125,000)	(1,000,000)	0

FRS 26.AG8 method

FRS 26.AG8 says: “If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument’s original effective interest rate. The adjustment is recognised as income or expense in profit or loss.”

This means that under the AG8 method:

- the liability starts the period at £412,005 (see above on inception)
- the finance cost (pre the AG8 adjustment) is the effective interest rate of 25% x the opening liability of £412,005 = £103,001
- the £20,000 dividend (paid based on the liability related contractual obligations) reduces the liability
- prior to the AG8 adjustment, the liability is then £412,005 +103,001 - 20,000 = £495,006

- based on the revised estimated cash flows, at 31 December X0, the net present value using the same original effective interest rate (of 25%) is £430,327 (see below net present value calculation). Under AG8 this becomes the closing carrying amount at 31 December X0. The difference of £64,679 (being £430,327 - £495,006) is credited to the profit and loss account within finance costs
- the closing liability at 31 December X0 is then £430,327 and the effective interest rate remains at 25%.

The liability calculation at 31 December X0 (after the £20,000 contractual dividend payment) is as follows:

Date (31 Dec)	Length of time (years)	Revised projected dividend obligation at 10% of profit £	Projected redemption obligation £	Total cash flows of obligation £	Discount factor (denominator) £	Net present value £
X1	1	50,000		50,000	1.2500	40,000
X2	2	70,000		70,000	1.5625	44,800
X3	3	90,000		90,000	1.9531	46,080
X4	4	100,000		100,000	2.4414	40,960
X5	5	105,000		105,000	3.0518	34,406
X6	6	110,000		110,000	3.8147	28,836
X7	7	115,000		115,000	4.7684	24,117
X8	8	120,000		120,000	5.9605	20,133
X9	9	125,000	1,000,000	1,125,000	7.4506	150,995
So under AG8 this is the closing liability at 31/12/X0 (after payment of £20,000 actual dividend)						430,327
Liability pre-AG 8 Dr/Cr						495,006
AG8 adjustment (included in finance costs)						(64,679)

As at 31 December X0, the liability movement, and future (revised) projected liability movement can therefore be summarised as follows:

Year ended (Dec)	Opening liability £	Finance cost in year at 25% £	AG8 Finance cost adjustment £	Cash flows £	Closing liability £
X0	412,005	103,001	(64,679)	(20,000)	430,327
X1	430,327	107,582		(50,000)	487,909
X2	487,909	121,977		(70,000)	539,886
X3	539,886	134,972		(90,000)	584,858
X4	584,858	146,214		(100,000)	631,072
X5	631,072	157,768		(105,000)	683,840
X6	683,840	170,960		(110,000)	744,800
X7	744,800	186,200		(115,000)	816,000
X8	816,000	204,000		(120,000)	900,000
X9	900,000	225,000		(1,125,000)	0

In our view, there is a choice of two methods in the case above when in pre-FRS 26 UK GAAP. The FRS 26 (IAS 39).AG8 method is mandatory for entities that are in the scope of FRS 26 or IFRS. Some may regard such an instrument as a derivative under IAS 39, in which case it would be accounted for at fair value through profit or loss – this would give a similar impact provided credit risk and market rates of interest remained similar in the future.

The example above was in respect of a redeemable instrument – what about instruments which are non-redeemable and the dividend is payable in perpetuity?

The traditional FRS 4 method relies on being able to set an effective interest rate such that the liability will

unwind to zero by the date of redemption. However, this is not feasible in the context of non-redeemable instruments, which pay the percentage of profit dividends in perpetuity. We suggest that in such cases the FRS 26.AG8 method should be used even for those entities in the scope of FRS 4. In the case of a non-redeemable, perpetual percentage of profits dividend, the following approach could be taken (assuming it is a compound instrument):

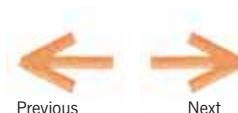
- As required by FRS 25.31, on inception the liability will be set by a net present value assessment of the expected dividends (based on projected profits) in perpetuity. In theory this involves looking at profits infinitely into the future, but in practice it can stop at the sooner of either the date on which

profits are projected to cease (where the entity's nature of business has a limited projected life) or when the impact of discount rates is such that incremental years do not add to the net present value

- In addition, at each balance date in the future, a revised FRS 26.AG8 calculation would be made and the liability restated (with the difference going to the profit and loss account).

Appendix 3 – FRS 25 – illustrative example of instrument redeemable on change of control

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Background

B Ltd is a profitable service company. Up to December X0, the managing director, Mr Alex owned the entire share capital (being 80,000 ordinary £1 shares originally issued many years ago at par). To take the business forward, Mr Alex is looking for the business to raise additional equity funding. On 1 January X1, it is agreed that Mr Roy, a former employee of the company, shall become a director and he subscribes for the following share capital:

- 500,000 preference shares at £2 each (totalling £1 million).

Extracts from the articles of association are such that the contractual obligations are as follows:

- share capital of 500,000 preference shares and 80,000 ordinary shares

- the holders of the preference shares are entitled to discretionary dividends *pari passu* with ordinary shareholders. This is an equity component
- the preference shares are redeemable at the amount originally subscribed on the earlier of change of control (re the ordinary shares) or liquidation
- the ordinary shares are equity (only discretionary dividends and no redemption obligations other than liquidation).

The company is under the scope of FRS 4 as opposed to FRS 26.

Analysis of classification under FRS 25

Under FRS 25, while the ordinary shares are equity, the preference

shares are compound. In particular, the following analysis applies to the preference shares:

- the obligation to redeem on liquidation is not a liability due to FRS 25.25
- however, the company cannot prevent its shareholders from selling its shares, so the requirement to redeem the preference shares in the event of change of control is a liability under FRS 25 (FRS 25.25 in particular)
- there is also a clear equity component relating to the discretionary dividends rights.

What are the entries on 1 January X1 re the preference shares issue?

Since this is a liability within a compound instrument, FRS 25 requires that the liability be recorded on inception at fair value, the liability being the net present value on paying the £1 million redemption proceeds on best estimate change of control date.

For instance, the best estimate change of control date might be assessed via probability analysis such as:

Date (31/12/XX)	Probability of change of control	Time (years)	Weighted average
X1	5%	1	0.050
X2	10%	2	0.200
X3	30%	3	0.900
X4	30%	4	1.200
X5	20%	5	1.000
X6	4%	6	0.240
X7	1%	7	0.070
	100%		3.660



In this calculation, the change of control best estimate has been calculated at 3.66 years.

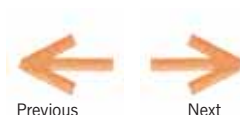
In terms of discount rates, a comparison might be based around some types of bank mezzanine finance (unsecured, non-convertible and redeemable around exit time). However, adjustments might be necessary for credit risk (as preference share capital ranks after unsecured legal debt) and taxation (as legal debt typically pays interest which is tax deductible by payer and taxable

income in the hands of recipient, whereas share capital pays its finance cost (in the form of dividends) on a post-tax basis). To an extent, these factors counteract each other. Assume a rate of 20% is chosen as a rate of a similar debt instrument.

The liability on 1 January X1 is therefore the net present value of paying £1 million in 3.66 years' time using a discount rate of 20%. This is £513,094 (£1 million divided by 1.20 to the power of 3.66).

The accounting entries on 1 January X1 are therefore:

Dr Bank	£1,000,000	
Cr Liability – preference shares		£513,094
Cr Share capital/share premium (equity)		£486,906



In practice, it is inevitable that the change of control date varies from the estimate.

In theory, if change of control occurred on exactly the originally estimated date (of 3.66 years from 1 January X1), the liability would move as follows:

Year	Opening liability £	Finance cost (at 20% annual rate) £	Redemption £	Closing liability £
X1	513,094	102,619		615,713
X2	615,712	123,142		738,854
X3	738,854	147,771		886,625
X4	886,625	113,375	(1,000,000)	0

Change in assumptions about the expected change of control date

In practice, it is inevitable that the change of control date varies from the estimate. Similarly to our percentage of profits example, we suggest that for those entities within the scope of FRS 4, there are two possible methods. These are:

- At each balance sheet date, as the change of control date best estimate changes, alter the liability based on the revised expected cash flow timing using the same original effective interest rate (the FRS 26.AG8 method), or
- After each balance sheet reporting date, alter the effective interest rate so that the liability comes back to zero after the revised expected change of control date redemption payment (ie traditional FRS 4 method)

When in IFRS or FRS 26, the FRS 26 (IAS 39).AG8 method is mandatory.

Contact us

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Further information

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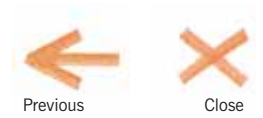
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