

Liabilities and equity (Lecture A767 – 9.15 minutes)

FRS 102, Section 22 *Liabilities and Equity* outlines the requirements in classifying financial instruments as either a financial liability (i.e. debt) or equity. It also deals with the issue of ‘compound financial instruments’ (see 4.3 below) which are defined in the Glossary to FRS 102 as:

*A financial instrument that, from the issuer’s perspective, contains both a **liability** and an **equity** element.*

FRS 102 Glossary
**compound
financial
instrument**

There are a couple of other definitions which are important when dealing with FRS 102 as follows:

Financial liability

Any **liability** that is:

- (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.*

FRS 102
Glossary
**financial
liability**

Equity

*The residual interest in the **assets** of the entity after deducting all its **liabilities**.*

FRS 102 Glossary
equity

In a lot of cases, debt will be treated as a liability in the balance sheet, but this is not always the case. The overriding principle in Section 22 is that where the issuer (i.e. the borrower) does not have an unconditional right to avoid the settlement in cash, or by way of another financial asset, and the contract does not, in substance, evidence a residual interest in the net assets of the issuer (the lender) after deducting all of its liabilities, the financial instrument is classified as a financial liability.

So what does this mean in layman’s terms? Effectively, where a borrower has an obligation to part with cash or other assets in either complying with the terms of the financial instrument, such as paying the lender interest; or by way of redemption at

some point in the future, the contract is a financial liability. So whenever there is a contractual obligation on the part of the borrower to pay cash or settle an obligation by parting with another asset, a liability is recognised.

Example

Roby Ltd issues 7,000 £1 preference shares and the owners of the preference shares are entitled to receive a 5% dividend each year.

The preference shares contain an obligation to deliver cash to the owners and hence are recognised as a financial liability, they are not recognised as equity despite the name being 'preference **shares**'. The 5% coupon payments are recognised as interest expense in the company's profit and loss account each year.

A financial instrument is classified as equity when it fails to meet the definition of a financial liability (i.e. there is no obligation to deliver cash or other financial assets to another entity). The key requirement is to consider whether there is an unconditional ability to avoid delivering cash or other assets.

Example

Ratchford Ltd wishes to raise finance to help finance its expansion plans. The bank has agreed to finance some of the working capital requirements, but it requires the shareholders to invest further into the business to demonstrate their commitment to the company. Two individuals subscribe to ordinary shares in the company. Dividends on the ordinary shares are paid at the entity's discretion and there is an option whereby the company can redeem equity shares for cash.

The existence of the option which allows the company the option to redeem equity shares for cash does not, in itself, mean the ordinary shares should be classified as a financial liability; nor does the fact that the company may pay future dividends on the ordinary shares. This is because the issuer retains an unconditional right to avoid delivering cash or another financial asset and hence the ordinary shares are recognised in equity. A contractual obligation to deliver cash or another financial asset would only arise at the point when the issuer exercises its right to redeem the shares.

1.1 Equity instruments issued prior to payment being received

FRS 102 does not generally allow offsetting (especially not in the balance sheet). There are limited exceptions to this rule for certain transactions.

When share capital has been issued but not paid for, a debtor balance must be recorded to comply with the requirements of company law. This is notably different than the provisions in *IFRS for SMEs* which would require the debit balance to be offset against equity.

Example

On 29 December 2021, a company issued 5,000 ordinary £1 shares to a long-standing employee at par. Payment for these shares was received on 5 January 2022 and the company is preparing its financial statements for the year-ended 31 December 2021.

In the financial statements to 31 December 2021, the £5,000 share issue will be recorded in the books of the company as:

	£
Dr Called up share capital not paid	5,000
Cr Share capital	5,000

Being share issue on 29 December 2021

1.2 Equity instruments subscribed for but not issued

FRS 102, paragraph 22.7(c) says that when equity instruments have been subscribed for but not issued (or called up), and the entity has not received the cash or other resources to pay for the shares, no increase in equity is recognised.

1.3 Convertible debt

Convertible debt or similar compound financial instruments are dealt with in FRS 102 at paragraphs 22.13 to 22.15. There is also an appendix to Section 22 providing an example of the issuer's accounting for convertible debt.

Convertible debt contains both a liability feature and an equity feature. Convertible bonds, for example, may require the issuer to pay fixed coupons (interest) and there is an option for the holder to convert some of the instrument (usually the capital element) into shares. The legal form of such instruments is that of debt, but its substance is of two instruments:

- (a) a financial liability to deliver cash by making interest payments or interest and capital payments as long as the bond is not converted; and
- (b) a call option which grants the holder the option to convert the bond into a fixed number of ordinary shares of the entity, thus meeting the definition of equity.

There is a two-stage process to initially recognising convertible debt:

- Stage 1. Determine the amount of the liability component as the fair value of a similar liability which does not contain the conversion option.
- Stage 2. Allocate the difference between the liability calculated in Stage 1 and the fair value of the proceeds received as equity.

It is important that the transaction is accounted for in this order because of the definition of equity which is the residual interest in the assets of the entity **after** deduction of liabilities.

Example – Convertible debt

On 1 April 2021, an 8% convertible bond was issued with a nominal value of £600,000. It is redeemable on 31 March 2025 at par, or it may be converted into equity shares. An equivalent loan note without the conversion option would have carried interest at 10%. Interest of £48,000 has already been paid and has been included within interest payable and similar expenses.

Present value rates are as follows:

End of year	8%	10%
1	0.926	0.909
2	0.857	0.826
3	0.794	0.751
4	0.735	0.683

The first stage involves calculating the amount that has to be recognised as a liability in the entity's financial statements, with the balance being recognised in equity. This is calculated as follows:

	8% interest (£600k x 8%)	10% factor	Present value
Year 1	48,000	0.909	43,632
Year 2	48,000	0.826	39,648
Year 3	48,000	0.751	36,048
Year 4	648,000	0.683	<u>442,584</u>
Liability amount			561,912
Proceeds			<u>(600,000)</u>
Equity			38,088

The journals to record the above are:

	£
Dr Cash at bank	600,000
Cr Loan (financial liability)	561,912
Cr Equity	8,088

The profit and loss account currently recognises year 1 interest of £48,000 being the coupon rate paid to the holder of the bond. An equivalent loan without the conversion option would carry interest at 10% which is the rate that the cash flows in the bond have been discounted at in the table above.

The present value of the debt portion is £561,912 and at 10%, interest would be £56,191. Therefore, additional interest of £8,191 (£56,191 less £48,000) will need to be recognised in the financial statements. The journals to account for the additional interest are:

Dr Interest payable and similar expenses	£8,191
Cr Loan payable	£8,191

FRS 102, para 22.14 says that the entity shall not revise the allocation in a subsequent period.

FRS 102.22.14

The liability portion of the debt will be subsequently measured at amortised cost using the amortised cost and effective interest method in Section 11 *Basic Financial Instruments*.

Example cont ...

The liability of £561,912 is accounted for under the amortised cost method as follows:

Opening balance	Cash flow	Interest 10%	Closing balance
£	£	£	£
561,912	(48,000)	56,191	570,103
570,103	(48,000)	57,010	579,113
579,113	(48,000)	57,911	589,024
589,024	(648,000)	58,976*	-

*=adjusted for rounding

On conversion, the liability portion is extinguished (as is the case in the example above) and equity is issued. The value of the equity recognised since initial inception will remain in equity, although it may be reallocated to another line item within equity.

1.4 Early redemption of a compound instrument

FRS 102, Section 22 is silent on the issue where a compound instrument is redeemed early (i.e. before the date it contractually matures). It would therefore be acceptable that when a compound instrument is redeemed early, the redemption amount plus any directly attributable transaction costs will need to be allocated between the liability and equity components on the date early redemption takes place. An acceptable method would be to allocate part of the redemption amount to the liability component based on the liability's fair value at the date of redemption, with any residual amount being allocated to the redemption of the equity component.

Where the redemption amount allocated to the liability exceeds the carrying amount of the liability component at the redemption date, a loss is recognised in profit and loss. Where the redemption amount is lower than the carrying amount of the liability, a gain is recognised in profit and loss.