COMPOUND FINANCIAL INSTRUMENTS

INSTRUMENTE FINANCIARE COMPUSE

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Abstract: *The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument in order to determine, whether it contains both a liability, as well as an equity component. Such components will be classified separately as financial liabilities, financial assets or equity instruments.*

Keywords: *financial instruments, equity, financial liabilities, option, bonds.*

INTRODUCTION

An entity recognizes separatly the components of a financial instrument that meets the following conditions:

a). it creates a financial liability of the entity and

b). it gives an option to the instruments holder to convert it into an equity instrument of the entity.

MATERIALS AND METHODS

From the entity's perspective, such an instrument comprises two components: a finacial liability and an equity instrument.

The issuer of such a financial instrument must represent the liability component and the equity component separatly in the balance sheet.

RESULTS AND DISCUSSIONS

The obligation of the issuer to make scheduled payments of the interest and the interest rate is a financial liability that exists as long as the instrument is not being converted. At initial recognition, the fair value of the liability component is the present value of future cash flows specified in the contract and brought up to date by the market interest rate applyed at that time to credit instruments of comparable status and which usually generates cash flows at the same dead-lines, but without the conversion option.

The equity instrument is an embedded option to convert the liability into equity of the issuer. The fair value of this option includes time value and intrinsec value, if this exists. This option has value at initial recognition, even when it is out of the money.

Upon conversion of a convertible instrument at maturity, the entity derecognizes the liability component and recognizes it as equity. The initial component of equity remains equity. There is no gain or loss on conversion at maturity.

When an entity converts into cash an instrument before maturity through an early repurchase in which the initial conversion privileges remain unchanged, the entity allocates the paid value and any transaction costs regarding the repurchase of liability or equity components of the instrument at transaction date.

Once the amount was allocated, any gain or loss is treated in accordance with the accounting principles applicable to that certain component, as follows:

a). the gain or loss related to the liability component is being recognized under profit or loss, and

b). the amount related to the equity component is being recognized under equity.

Regarding the evaluation of the compound financial instruments, the following methods can be used:

- allocation of the residual value to the component that is most difficult to be evaluated (equity instrument), as a difference between the total value of the instrument and the easiest component to be evaluated (the financial obligation – evaluated by up-dating future interest-flow and nominal value at a market interest rate for a similar bond, without equity instrument);

- evaluating the liability and equity components separately (at fair value or through option evaluation models) and adjusting these values proportionately, on a pro-rata basis, so that the component sum is equal to the instrument's total value. The most used model is „Blake -Scholes". There are no gains or losses arising from this evaluation.

In the traditional approach, the hybrid instrument is registered as a combination of liability instruments and equity instruments. The advanteges of convertible bonds for investors are related to participation on securities markets with fix return rates (interest rates) and the stock market, with the possibility of appreciation for the capital component of the instrument, lower protection provided by the fix revenue component, higher return rate than the joint stocks and priority towards preferential shares, in case of payment inability.

Example of separation of a compound financial instrument on intial recognition:

An entity issues 5.000 convertible bonds at the beginning of 2010. The bonds have a term of three years and are issued at a nominal value of 1.000 m.u. per bond, generating revenues of 5.000.000 m.u. The interest is being paid annually, at an annual nominal interest rate of 8%. Each bond is convertible at any time up to maturity into 230 ordinary shares. When issuing the bonds, the benchmark interest rate on the market for similar liabilities without conversion options is 9%. On issuance date, the market price for a common share is 2 m.u. Estimated dividends for a period of three years on the bond loan rise up to 0,13 m.u./share at the end of each year, and

the annual interest rate of a similar loan, with a maturity of three years and unencumbered by any risk is 10%.

The liability component is the first one to be evaluated, and the difference between the bond issue revenues and the fair value of the liability is attributable to the equity component.The present value of the liability component is being calculated by using a discount rate of 9%, the market interest rate for similar bonds without conversion rights:

Explanations	**m.u.**
Present value of the principal - 5.000.000 m.u., payable after three years	3.860.917 m.u.
Present value of the interest - 400.000 m.u. payable annually, for three years	901.578 m.u.
Total present value of the bond component (3.860.917 + 901.578)	4.762.495 m.u.
Equity component (5.000.000 - 4.762.495)	237.505 m.u.
Revenues from bond issue	5.000.000 m.u.

Therefore, the convertible bond issue will generate the following entry:

5.000.000 m.u. Bank/Debtors = Bond loans 4.762.495 m.u.
Equity accounts 237.505 m.u.

Evaluation of the equity components through the option evaluation methods allows to determine directly the fair value of the conversion option (not through deduction). These evaluation models are used by the financial institutions to evaluate daily transactions. The most commonly used model is the „Black-Scholes" based on calculating the potential favorable/unfavorable of the underlying asset price and the calculation of the report between the fair value option of the underlying asset and the prices present value when exercising the option. In this sense financial tables and other data sources are being used.

Returning to the example above, according to this technique we obtain the following results:

Explanations	m.u.
Fair value of the „liability" component	4.762.495 m.u.
Fair value of the „capital" component	213.068 m.u.
Total fair value of the compound instrument	4.975.563 m.u.
Diference to be distributed among components	24.437 m.u.
Total value of the compound instrument	5.000.000 m.u.

Therefore, the diference of 24.437 m.u. will be proportionally distributed to the two components, 95,72% x 24.437 = 23.391 m.u. for the "liability" component (the „liability" component will have a total value of *4.762.495 + 23.391 = 4.785.886.m.u.) and the rest of the „equity" component*, 1046 m.u. (the „equity" c*omponent will have a total valueof 213.068 + 1046 = 214.114 m.u.).* The accounting entry will be in this case:

5.000.000 m.u. Bank/Debtors = Bond loans 4.785.886 m.u.
Equity accounts 214.114 m.u.

CONCLUSIONS

For the issuer of the hybrid instrument the advanteges are: low cost with the interest, tax deduction for paid interests, reduction of liability procentage in the capital, when the bond is converible into common shares, and by issuing convertible bonds practically a forward sale of common stocks is being realised at a price superior to the market value, with the premium value.

The Standard requires separate presentation of the liability and equity components of a single financial instrument in the balance sheet of the entity.

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