

FINANCIAL INSTRUMENTS - LECTURE EXAMPLE

Loan notes are issued for \$1,000, redeemable in five years' time at \$1,250.
Interest at 5.9% per year is payable.

The total finance cost is the interest plus the redemption premium ($5 \times \$59 + \$250 = \$545$) and this amount must be spread over the five-year life of the loan. The relevant percentage to show a constant rate of return on this figure can be calculated to be 10% per year.

The following table shows the allocation over the five years:

Year	Balance at beginning of year	Income statement: Finance cost for year (10%)	Cash paid during year	Balance at end of year
1	1000	100	(59)	1041
2	1041	104	(59)	1086
3	1086	109	(59)	1136
4	1136	113	(59)	1190
5	1190	119	(59 + 1250)	—