IFRIC

International Financial Reporting Interpretations Committee

IFRIC DRAFT INTERPRETATION D25

Extinguishing Financial Liabilities with Equity Instruments

Comments to be received by 5 October 2009

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INVITATION TO COMMENT

The International Accounting Standards Board's International Financial Reporting Interpretations Committee (IFRIC) invites comments on any aspect of this draft Interpretation *Extinguishing Financial Liabilities with Equity Instruments*. Comments are most helpful if they indicate the specific paragraph to which they relate, contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing so as to be received no later than 5 October 2009.

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IFRIC ***International Financial Reporting Interpretations Committee***

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IFRIC [DRAFT] INTERPRETATION D25

Extinguishing Financial Liabilities with Equity Instruments

IFRIC [draft] Interpretation X *Extinguishing Financial Liabilities with Equity Instruments* ([draft] IFRIC X) is set out in paragraphs 1–10 and the Appendix. [Draft] IFRIC X is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in paragraphs 2 and 7–17 of the *Preface to International Financial Reporting Standards*.

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References

- *Framework for the Preparation and Presentation of Financial Statements*
- IFRS 2 *Share-based Payment*
- IFRS 3 *Business Combinations* (as revised in 2008)
- IAS 1 *Presentation of Financial Statements*
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 32 *Financial Instruments: Presentation*
- IAS 39 *Financial Instruments: Recognition and Measurement*

Background

1 A debtor and creditor may renegotiate the terms of a financial liability with the result that the liability is fully or partially extinguished by the debtor issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'. The IFRIC has received requests for guidance on the accounting for such transactions.

Scope

2 The [draft] Interpretation addresses only the accounting by an entity that renegotiates the terms of a financial liability and issues equity instruments to the creditor to extinguish the liability fully or partially. It does not address the accounting by the creditor.

Issues

3 This [draft] Interpretation addresses the following issues:

(a) Are an entity's equity instruments 'consideration paid' in accordance with IAS 39 paragraph 41?

(b) How should an entity initially measure the equity instruments issued to extinguish a financial liability?

(c) How should an entity account for any difference between the carrying amount of the financial liability extinguished and the initial measurement amount of the equity instruments issued?

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Consensus

4 The issue of an entity's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with IAS 39 paragraph 41. An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when it is extinguished in accordance with IAS 39 paragraph 39.

5 An entity shall initially measure equity instruments issued to a creditor to extinguish all or part of a financial liability at the fair value of the equity instruments issued or the fair value of the liability extinguished, whichever is more reliably determinable.

6 An entity shall recognise in profit or loss the difference between the carrying amount of the financial liability (or part of the financial liability) extinguished and the initial measurement amount of the equity instruments issued in accordance with IAS 39 paragraph 41.

7 If only part of the financial liability is extinguished by the issue of equity instruments, the entity also assesses the terms of the financial liability that remains outstanding to determine whether they are substantially different from those of the original financial liability. If the terms of the financial liability that remains outstanding are substantially different from those of the original financial liability, the entity shall account for the modification as the extinguishment of the original financial liability and the recognition of a new financial liability in accordance with IAS 39 paragraph 40.

8 An entity shall disclose a gain or loss recognised in accordance with paragraph 6 or 7 as a separate line item in the statement of comprehensive income and the separate income statement (if presented) or in the notes.

Effective date and transition

9 An entity shall apply this [draft] Interpretation for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies this [draft] Interpretation for a period beginning before [date to be inserted after exposure], it shall disclose that fact.

10 An entity shall apply a change in accounting policy in accordance with IAS 8 from the beginning of the earliest comparative period presented.

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Appendix
Amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards*

The amendment in this Appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies this [draft] Interpretation for an earlier period, these amendments shall be applied for that earlier period.

A heading and paragraph D25 are added to Appendix D.

Extinguishing financial liabilities with equity instruments

D25 A first-time adopter may apply the transitional provisions in IFRIC X.

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft Interpretation.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

BC2 The IFRIC received a request for guidance on the application of IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 32 *Financial Instruments: Presentation* when an entity issues its own equity instruments to extinguish all or part of a financial liability. The question is how the entity should recognise the equity instruments issued.

BC3 The IFRIC noted that lenders manage loans to entities in financial difficulty in a variety of ways including one or more of the following:

(a) selling the loans in the market to other investors/lenders;

(b) renegotiating the terms of the loan (eg extension of the maturity date or lower interest payments); or

(c) accepting the debtor's equity instruments in full or partial settlement of the liability (sometimes referred to as a 'debt for equity swap').

BC4 The IFRIC was informed that there was diversity in practice in how entities measure the equity instruments issued. Some recognise the equity instruments at the carrying amount of the financial liability and do not recognise any gain or loss in profit or loss. Others recognise the equity instruments at the fair value of either the liability or the equity instruments issued and recognise any difference between that amount and the carrying amount of the financial liability in profit or loss.

Scope

BC5 The IFRIC concluded that this proposed Interpretation should address only the accounting by the entity that renegotiates the terms of a financial liability with the creditor and issues equity instruments to the creditor to fully or partially extinguish the financial liability. It does not address the accounting by the creditor because other IFRSs already set out the relevant requirements.

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BC6 The IFRIC considered whether to provide guidance on situations in which the creditor is also a shareholder. However, the IFRIC concluded that determining whether the issue of equity instruments to extinguish such a financial liability is a transaction with an owner in its capacity as an owner would be a matter of judgement depending on the facts and circumstances. Consequently, the IFRIC concluded that the proposed Interpretation should not address such transactions.

Are an entity's equity instruments 'consideration paid'?

BC7 The IFRIC noted that IFRSs do not contain any specific guidance on accounting for the issue of equity instruments. IAS 39 paragraph 41 requires an entity to recognise in profit or loss the difference between the carrying amount of the financial liability extinguished and the consideration paid. That paragraph describes 'consideration paid' as including non-cash assets transferred or liabilities assumed but does not specifically mention equity instruments issued. Consequently, some are of the view that equity instruments are not included in 'consideration paid'.

BC8 Holders of this view believe that, because IFRSs are generally silent on how to measure equity instruments on initial recognition (see paragraphs BC12 and BC13), a variety of practices has developed. One such practice is to recognise the equity instruments issued at the carrying amount of the financial liability extinguished.

BC9 However, the IFRIC observed that both IFRS 2 *Share-based Payment* and IFRS 3 *Business Combinations* make it clear that equity instruments are used as consideration to acquire goods and services as well as to obtain control of businesses.

BC10 The IFRIC also observed that the issue of equity instruments to extinguish a financial liability could be analysed as consisting of two transactions — first, the issue of new equity instruments to the creditor for cash and second, the creditor accepting payment of that amount of cash to extinguish the financial liability. In an alternative two-transaction analysis, the first transaction could be considered to be the renegotiation of the financial liability that leads to the extinguishment of the original liability and the recognition of the new renegotiated liability in accordance with IAS 39 paragraph 40. In this analysis the second transaction would be the conversion of the new liability into equity in accordance with its terms.

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BC11 As a result of its analysis, the IFRIC concluded that the equity instruments issued to extinguish a financial liability are 'consideration paid' in accordance with IAS 39 paragraph 41.

How should the equity instruments be measured?

BC12 The IFRIC observed that although IFRSs do not contain a general principle for the initial recognition and measurement of equity instruments, guidance on specific transactions exists, including:

(a) *initial recognition of compound instruments* (IAS 32). The amount allocated to the equity component is the residual after deducting the fair value of the financial liability component from the fair value of the entire compound instrument.

(b) *cost of equity transactions and own equity instruments ('treasury shares') acquired and reissued or cancelled* (IAS 32). No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. These are transactions with an entity's owners in their capacity as owners.

(c) *equity instruments issued in share-based payment transactions* (IFRS 2). For equity-settled share-based payment transactions, the entity measures the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received (eg transactions with employees), the entity measures their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

(d) *consideration transferred in business combinations* (IFRS 3). The total consideration transferred in a business combination is measured at fair value. It includes the acquisition-date fair values of any equity interests issued by the acquirer.

BC13 The IFRIC noted that the general principle of IFRSs is that equity is a residual and should be measured initially by reference to changes in assets and liabilities (the *Framework* and IFRS 2). IFRS 2 is clear that when goods or services are received in return for the issue of equity instruments, the increase in equity is measured directly at the fair value of the goods or services received. IFRS 3 is clear that when an entity's equity instruments are part of consideration transferred, they are measured at fair value.

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BC14 The IFRIC decided that the same principles should apply when equity instruments are issued to extinguish financial liabilities. However, the IFRIC was concerned that entities might encounter practical difficulties in measuring the fair value of both the equity instruments issued and the financial liability, particularly when the entity is in financial difficulty. Therefore, the IFRIC decided that equity instruments issued to extinguish a financial liability should be measured initially at the fair value of the equity instruments issued or the fair value of the financial liability extinguished, whichever is more reliably determinable.

How should a difference between the carrying amount of the financial liability and the consideration paid be accounted for?

BC15 In accordance with IAS 39 paragraph 41, the entity should recognise a gain or loss in profit or loss for any difference between the carrying amount of the financial liability extinguished and the consideration paid. This requirement is consistent with the *Framework*'s discussion of income:

(a) Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or *decreases of liabilities that result in increases in equity*, other than those relating to contributions from equity participants. (paragraph 70(a)) (emphasis added)

(b) Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits … (paragraph 75)

(c) Income may also result from the settlement of liabilities. For example, an entity may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan. (paragraph 77)

Full extinguishment

BC16 The IFRIC noted that renegotiating a financial liability to permit it to be extinguished by the issue of equity instruments is always a substantial modification of the terms of the financial liability. As discussed in paragraph BC10, a transaction in which an entity issues equity instruments to extinguish a liability can be analysed as first consisting of a modification of the terms of the liability to permit settlement with the

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entity's own equity instruments. Paragraph 40 of IAS 39 requires a substantial modification of the terms of an existing financial liability to be accounted for as the extinguishment of the original financial liability and the recognition of a new financial liability. Any difference between the two is recognised in profit or loss.

BC17 Similarly, the IFRIC noted that, in accordance with IAS 32, when an entity amends the terms of a convertible instrument to induce early conversion, the entity recognises in profit or loss the fair value of any additional consideration paid to the holder. Thus, the IFRIC concluded that when an entity settles an instrument by issuing its own equity instruments and that settlement is not in accordance with the original terms of the contract, the entity should recognise a gain or loss in profit or loss.

BC18 As a result of its conclusions set out in paragraphs BC10, BC14 and BC17, the IFRIC decided that the entity should recognise a gain or loss in profit or loss equal to the difference between the carrying amount of the financial liability and either the fair value of the financial liability or the fair value of the equity instruments issued, whichever is more reliably determinable.

Partial extinguishment

BC19 The IFRIC also observed that the restructuring of a financial liability often involves both the partial extinguishment of the financial liability by the issue of equity instruments to the creditor and the modification of the terms of the financial liability that remains outstanding. Therefore, the IFRIC decided that the proposed Interpretation should apply equally to partial extinguishments. In the case of a partial extinguishment, the discussion in paragraphs BC16–BC18 applies to the part of the financial liability extinguished.

Presentation

BC20 The IFRIC decided that an entity should disclose the gain or loss on the extinguishment of the financial liability by the issue of equity instruments as a separate line item in profit or loss or in the notes. This requirement is consistent with the requirements in other IFRSs, for example:

(a) When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. (*Framework* paragraph 76)

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(b) An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance. (IAS 1 paragraph 85)

(c) An entity shall disclose net gains or net losses on financial liabilities either in the statement of comprehensive income or in the notes. (IFRS 7 paragraph 20)

Transition

BC21 The IFRIC decided that the proposed Interpretation should be applied retrospectively even though it acknowledged that determining fair values retrospectively may be problematic. The IFRIC noted that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides guidance on circumstances in which retrospective application might be impracticable. The IFRIC concluded that it was preferable to require entities that could apply the proposed Interpretation retrospectively to do so, rather than requiring all entities to apply it prospectively to future transactions. However, to simplify transition, the IFRIC also concluded that it should require retrospective application only from the beginning of the earliest comparative period presented because application to earlier periods would result only in a reclassification of amounts within equity.

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