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IFRIC clarifies accounting for debt for equity swaps

On 26 November 2009 the International Financial Reporting Interpretations Committee (IFRIC) issued IFRIC Interpretation 19 *Extinguishing Financial Liabilities with Equity Instruments* ("the Interpretation"). The Interpretation addresses divergent accounting by entities issuing equity instruments in order to extinguish all or part of a financial liability (often referred to as "debt for equity swaps").

Background and scope

A borrower may enter into an agreement with a lender to issue equity instruments to the lender in order to extinguish a financial liability owed to the lender. This is particularly common when the borrower is in financial difficulty. The IFRIC noted that there was diversity in practice in accounting for these transactions. Some measure the equity instruments issued at the carrying amount of the financial liability derecognised and do not recognise any gain or loss on extinguishment of the liability in profit or loss. Others recognise the equity instruments at the fair value of either the liability extinguished or of the equity instruments issued, and recognise any difference between this amount and the carrying amount of the liability in profit or loss. The Interpretation eliminates this diversity.

The Interpretation addresses only the accounting by the entity which issues equity instruments in order to extinguish, in full or in part, a financial liability. It does not address the accounting by the lender. In addition, the Interpretation is not to be applied in situations where:

- the lender is also a direct or indirect shareholder and is acting in its capacity as direct or indirect shareholder;
- the lender and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution from, or contribution to, the entity; or
- extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability.

Issues

IAS 39.41 states that 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, should be recognised in profit or loss. The Interpretation addresses the following issues:

- whether the issue of equity instruments meets the definition of 'consideration paid' in accordance with IAS 39.41;
- how an entity should initially measure the equity instruments issued to extinguish such a financial liability; and
- how an entity should account for any difference between the carrying amount of a financial liability extinguished and the initial measurement of equity instruments issued.

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Consensus

The IFRIC concluded that the issue of equity instruments to extinguish all or part of a financial liability constitutes consideration paid in accordance with IAS 39.41. The IFRIC observed that the issue of equity instruments to extinguish financial liabilities can be seen as consisting of two transactions: first, the issue of equity instruments for cash and second, acceptance by the creditor of that amount of cash to extinguish the financial liability.

An entity should measure the equity instruments issued as extinguishment of the financial liability at their fair value on the date of extinguishment of the liability, unless that fair value is not reliably measurable. In this case the equity instruments should be measured to reflect the fair value of the liability extinguished.

If only part of a financial liability is extinguished through the issue of equity instruments, the entity should assess whether some of the consideration paid represents a modification of the portion of the liability which remains outstanding. If it is determined that part of the consideration paid relates to a modification of the outstanding liability, the entity should apportion the consideration between that portion which has been extinguished and that which remains outstanding.

Any difference between the carrying amount of the liability (or the part of the liability) extinguished and the fair value of equity instruments issued is recognised in profit or loss. When consideration is partly allocated to the portion of a liability which remains outstanding, the part allocated to this portion forms part of the assessment as to whether there has been an extinguishment or a modification of that portion of the liability. If the remaining liability has been substantially modified, the entity should account for the modification as the extinguishment of the original liability and the recognition of a new liability as required by IAS 39.40.

The following three scenarios illustrate this Interpretation:

Scenario 1
An entity issues equity instruments with fair value of CU100 million to extinguish the whole of a liability. The carrying amount of the liability on the date of extinguishment is CU90 million.

Accounting entries would be as follows
(all figures in CU million):

DR Financial liability	90
DR Profit and loss	10
CR Equity	100

To derecognise the financial liability, record the equity instruments issued at fair value as at the date of issue and recognise the difference in profit and loss.

Scenario 2
An entity issues equity instruments with fair value of CU55 million. At the date of issue, the entity has a financial liability with carrying amount of CU100m. The entity determines that the issue of equity instruments extinguishes a portion of the financial liability with carrying amount of CU40 million. The issue of equity instruments does not modify in any way the terms of the obligation relating to the portion of the liability which remains outstanding, whose carrying amount is CU60 million (i.e. CU100m-CU40m).

Accounting entries would be as follows
(all figures in CU million):

DR Financial liability	40
DR Profit and loss	15
CR Equity	55

To derecognise the portion of the financial liability which is extinguished, record the equity instruments issued at fair value as at the date of extinguishment of that portion and recognise the difference in profit and loss. There is no modification to the remaining portion of the liability of CU60 million hence this portion of the liability is not adjusted or derecognised.

Scenario 3
An entity issues equity instruments with fair value of CU52 million. At the date of issue, the entity has a financial liability with carrying amount of CU100m. The entity determines that the issue of equity instruments extinguishes a portion of the financial liability with carrying amount of CU40 million.

The remaining liability of carrying amount CU60 million (i.e. CU100m-CU40m) remains outstanding, however the lender agrees to change the contractual cash flows of this portion of the liability.

The entity determines that, of the issue of equity instruments of fair value CU52 million, CU50 million relates to the extinguishment of the portion of the liability extinguished and the remaining CU2 million is in substance a fee for the change in terms of the portion of the liability which remains outstanding.

The entity assesses the new terms and determines that they are not substantially different from the previous terms as defined in IAS 39.AG62. Therefore, the entity adjusts the effective interest rate of the portion of the liability which remains outstanding to the rate which discounts
new expected future cashflows to the new carrying amount of the financial liability. The fee incurred by the entity (i.e. the portion of equity instruments issued with fair value of CU2 million) adjusts the carrying amount of the liability, and is amortised over the remaining term of the adjusted liability in accordance with IAS 39.AG62.

Accounting entries would be as follows (all figures in CU million):

DR Financial liability	40
DR Profit and loss	10
CR Equity	50

To derecognise the portion of the financial liability which is extinguished, record the equity instruments issued at fair value as at the date of extinguishment and recognise the difference in profit and loss.

DR Financial liability	2
CR Equity	2

To adjust the carrying amount of the remaining financial liability on modification in accordance with IAS 39.AG62, and record the equity instruments issued at fair value at the date of modification. The effective interest rate of this remaining portion of the liability is recalculated to give the rate which discounts the new expected future cash flows to the new carrying amount of this portion of the liability.

The gain or loss recognised in profit or loss as a result of extinguishing a liability by the issue of equity instruments should be presented as a separate line item, in profit or loss or in the notes.

Effective date and transition

The Interpretation is effective for annual periods beginning on or after 1 July 2010, with earlier application permitted. Where adoption of the Interpretation results in a change in accounting policy, that change should be applied from the beginning of the earliest comparative period presented in the year of adoption, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. An entity is not required to restate the accounting for debt for equity swaps which occurred before the beginning of the earliest comparative period.

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