[DRAFT] INTERPRETATION D25

Extinguishing Financial Liabilities with Equity Instruments

*Comments to be received by **1 September 2009***

INVITATION TO COMMENT

The Accounting Standards Council ("ASC") 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 **1 September 2009** preferably by email to: MOF_Feedback_ASC@mof.gov.sg or addressed to:

Accounting Standards Council
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100 High Street #10-01
The Treasury
Singapore 179434

[DRAFT] INTERPRETATION D25

Extinguishing Financial Liabilities with Equity Instruments

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

References

- *Framework for the Preparation and Presentation of Financial Statements*
- FRS 102 *Share-based Payment*
- FRS 103 *Business Combinations* (as revised in 2008)
- FRS 1 *Presentation of Financial Statements*
- FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- FRS 32 *Financial Instruments: Presentation*
- FRS 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'. Requests had been received 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 FRS 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?

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 FRS 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 FRS 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 FRS 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 FRS 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 FRS 8 from the beginning of the earliest comparative period presented.

Appendix
Amendment to FRS 101 *First-time Adoption of 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 INT FRS X.

Basis for Conclusions

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

Introduction

BC1 This Basis for Conclusions summarises the considerations in reaching the consensus.

BC2 A request for guidance was received on the application of FRS 39 *Financial Instruments: Recognition and Measurement* and FRS 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 It was 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 Information was received 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 It was 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 FRSs already set out the relevant requirements.

BC6 It was considered whether to provide guidance on situations in which the creditor is also a shareholder. However, it was 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, it was concluded that the proposed Interpretation should not address such transactions.

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

BC7 It was noted that FRSs do not contain any specific guidance on accounting for the issue of equity instruments. FRS 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 FRSs 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, it was observed that both FRS 102 *Share-based Payment* and FRS 103 *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 It was 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 FRS 39 paragraph 40. In this analysis the second transaction would be the conversion of the new liability into equity in accordance with its terms.

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

How should the equity instruments be measured?

BC12 It was observed that although FRSs 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* (FRS 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* (FRS 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* (FRS 102). 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* (FRS 103). 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 It was noted that the general principle of FRSs is that equity is a residual and should be measured initially by reference to changes in assets and liabilities (the *Framework* and FRS 102). FRS 102 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. FRS 103 is clear that when an entity's equity instruments are part of consideration transferred, they are measured at fair value.

BC14 It was decided that the same principles should apply when equity instruments are issued to extinguish financial liabilities. However, the concern was 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, it was 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 FRS 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 It was 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 entity's own equity instruments. Paragraph 40 of FRS 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, it was noted that, in accordance with FRS 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, it was 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 the conclusions set out in paragraphs BC10, BC14 and BC17, it was 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 It was 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, it was 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 It was 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 FRSs, 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)

(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. (FRS 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. (FRS 107 paragraph 20)

Transition

BC21 It was decided that the proposed Interpretation should be applied retrospectively even though it was acknowledged that determining fair values retrospectively may be problematic. It was noted that FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides guidance on circumstances in which retrospective application might be impracticable. It was 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, it was 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.