Project **Annual Improvements Process**

Topic **IAS32/39 – debt to equity swap in a restructuring**

Introduction

Objective of this paper

1. The objective of this paper is to document the staff's analysis and ask the Board for a decision on whether to include the issue in the Annual Improvements project. As such, this paper:
   (a) provides background information on this issue;
   (b) analyses the alternatives and provides the staff's view;
   (c) makes a staff recommendation on the proposed amendments;
   (d) provides preliminary agenda criteria assessment for the IFRIC;
   (e) assesses the issue against the Annual Improvements criteria; and
   (f) asks the Board whether they agree with the staff recommendation.

Background

2. In June 2009, the IFRIC received a request to add to the IFRIC agenda an issue with respect to the application of IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 32 *Financial Instruments: Presentation* in the case when an entity issues its own equity instruments in settlement of debt (so called "debt to equity swap") in a restructuring. This issue will be discussed at the IFRIC meeting in July.

3. In a debt restructuring an entity may negotiate the extinguishment of a financial liability in exchange for issuing equity instruments to the creditor. The question arises whether the entity should account for the exchange by:

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) **(View 1)** recognising the equity instruments at fair value and recording a gain/loss in profit or loss equal to the difference between this fair value and the carrying amount of the extinguished liability, or

(b) **(View 2)** recording the equity instruments issued at the carrying amount of the extinguished liability with no gain/loss on extinguishment being recognised

4. The staff notes that lenders have the following options to cope with loans to entities in financial difficulty:

(a) Sell the loans in the market and collect money

(b) Change the terms of the loan (eg. extension of maturity, free interest payment)

(c) Debt to equity swap (this issue)

5. The debt to equity swap is agreed between the lenders and the entity in financial difficulty in order to reduce the burden of the debt instruments. The entity is legally released from its obligation to pay cash to the lenders. The lenders accept the swap because they expect the capital gain in the future. For example, entity A issued a 10 year debt instrument for its par amount of CU 100. Some years later, entity A was in financial difficulty. Entity A and its lenders agreed to the extinguishment of the financial liability in exchange for issuing equity instruments to the lenders. The fair value of the equity shares issued in exchange was CU 60. Under View 1, the equity is recorded at its fair value of CU60 and a gain of CU 40 is recorded in profit or loss on the extinguishment of the existing debt. Under View 2, the equity is recorded at the carrying amount of the debt of CU100. No gain or loss is recognised on the extinguishment of the existing debt.

6. The full text of the agenda request has been included as Appendix A.

7. US GAAP (SFAS 15) *Accounting by Debtors and Creditors for Troubled Debt Restructuring*s states that "a debtor should record an equity interest in the debtor granted to a creditor to settle a payable in a troubled debt restructuring at its fair value, and the difference between that fair value and the carrying amount of the payable settled should be recognized as a gain in measuring net income (paragraph 96)". Paragraph 92 indicates that "fair value" in this context

normally means the fair value of the liability satisfied or the fair value of the equity interest granted, whichever is the more clearly evident.

Staff Analysis

Guidance on debt to equity swap in IFRSs

8. IFRSs do not have any specific guidance on accounting for a debt to equity swap.

9. IFRS does not provide the requirements on the initial recognition and measurement of equity shares other than in respect of

    (a) *Splitting compound instruments* (IAS 32.31 and 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) *The cost of equity transactions and own equity instruments ("treasury shares") acquired and reissued or cancelled* (IAS 32.33): If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity;

    (c) *Equity instruments issued in share-based payment transactions* (IFRS 2.10-23): For equity-settled share-based payment transactions, the entity shall measure 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 shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

10. The Board decided in its meeting in June 2009 in the *Financial Instruments with characteristics of equity* project that an entity's own equity instruments should be initially measured at their **transaction prices** (see Appendix B). The Board clarified that the transaction price of an equity instrument is the **fair value of the**

consideration received for issuing the instrument at the date the instrument is issued. If an equity instrument is issued because of the exercise of an option, the transaction price includes both the exercise price and the fair value of the option (paragraph B8). The exercise price plus the fair value of the option would exceed the trading price of the share on any date before the date the option expires (paragraph B9).

11. *Near final draft - International Financial Reporting Standard (IFRS) for Small and Medium-sized Entities* (SMEs) in May 2009 states for the original issue of shares or other equity instruments:

> "22.8 An entity shall measure the equity instruments *at the fair value of the cash or other resources received or receivable*, net of direct costs of issuing the equity instruments….(*emphasis added*)."

12. The submission indicates that IFRSs are unclear on the following issues:

    (a) Whether issuing equity instruments is one form of consideration for the liability (ie a non-cash exchange transaction) in accordance with IAS 39 paragraph 41:

    > "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, shall be recognised in profit or loss."(emphasis added)

    (b) Whether initial measurement of equity in the context of a debt to equity swap is the fair value of equity shares or the carrying amount of the liability. Another possible measurement basis would be the fair value of the liability.

Issue	View 1	View 2
(a)	IAS 39.41 requires the difference between the carrying amount of a liability (or part of a liability) extinguished and the consideration paid, including non-cash assets transferred or liabilities assumed, to be recognised in profit or loss. Issuing equity instruments is	IAS 39.41 is not considered to be determinative as it refers to recording a gain or loss by reference to "the consideration paid, including non-cash assets transferred or liabilities assumed." However own equity instruments are arguably not "consideration paid" as they are neither non-cash assets nor liabilities.

	one form of consideration.	
(b)	The measurement of consideration should follow the principles usually applied in IFRS for substantive non-cash transactions, i.e. the equity instruments should be measured at fair value at the date of the restructuring.	Even if the term "consideration paid" is extended to equity instruments issued, IAS 39 does not specify how that element of consideration would be measured. IAS 32.33 states that no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.

Firms' publications

13. The staff notes that four large firms address this issue in their publications. Two firms support View 1. "When the classification of an instrument changes from a financial liability to equity, in our view, this represents the extinguishment of a financial liability and the issue of equity instruments and the resulting gain or loss on the extinguishment of the liability should be recognised in profit or loss." "This approach is consistent with the rationale that the restructuring could be seen as a "shortcut" for issuing shares to the lender and using the consideration received to repay the debt."

14. Others accept both View 1 and View 2. "As the standard does not specifically deal with the above issue (ie a debt to equity swap), we believe either approach is acceptable, provided it is used on a consistent basis."

The staff's view

15. The staff notes that Appendix B states that 'Measurement of newly issued equity instruments at the transaction price is a long-standing practice.' However, the staff does not believe that in all cases current practice results in the recognition of the *fair value* of the consideration received at the date the equity instruments

are issued. In particular, the accounting described in paragraph 10 is not current practice for accounting for the issue of shares on the exercise of options.

16. In the staff's experience, 'transaction price' is interpreted as 'total *proceeds* received'. Thus, on exercise of options, the newly issued equity would be measured at the sum of the premium received on the issuance of the options and the strike price paid on exercise. This is also implied by IFRS 2. IFRS 2.45(b) requires the disclosure of weighted average *exercise prices* of share options exercised during the period and IFRS 2.45(c) requires disclosure of the weighted average *share price* at the date of exercise. This disclosure is included to allow users to determine the intrinsic value of the options at the date of exercise. It would be unnecessary if that amount were reflected in the statement of changes in equity because the shares were recognised at their fair value on the date of issue. In the staff's view, this line of thinking supports View 2. That is, in the debt to equity swap, the total proceeds the entity received for the equity instruments was the carrying amount of the liability.

17. However, in the staff's opinion, in a debt to equity swap in a restructuring, the new shares issued should be measured at **the fair value of the liability** extinguished. The difference between the carrying amount of the financial liability extinguished and its fair value (which is equal to the initial measurement of the new shares) should be recognised in profit or loss.

18. The staff's opinion is supported by:

    (a) General principle of IFRS that equity is a residual and should be measured by the changes in assets and liabilities (stated in the *Framework* and IFRS2);

    (b) Consistency with IFRIC 17.

19. Firstly, the staff notes that the *Framework* and IFRS 2.BC62 states:

> "Equity is the residual interest in the assets of the enterprise after deducting all of its liabilities … The amount at which equity is shown in the balance sheet is dependent upon the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise … (paragraphs 49 and 67)"

20. The staff also notes that IFRS 2.BC63-65 states:

> The accounting equation that corresponds to this definition of equity is: assets minus liabilities equals equity." "Equity is a residual interest, dependent on the measurement of assets and liabilities. Therefore, accounting focuses on recording changes in the left side of the equation (assets minus liabilities, or net assets), rather than the right side. Changes in equity arise from changes in net assets (emphasis added)". "Hence, the Board concluded that, when accounting for an equity-settled share-based payment transaction, the primary accounting objective is to account for the goods or services received as consideration for the issue of equity instruments. Therefore, equity-settled share-based payment transactions should be accounted for in the same way as other issues of equity instruments, by recognising the consideration received (the change in net assets), and a corresponding increase in equity (emphasis added)".

21. Based on the general principle noted in the above paragraphs, measurement of the equity should focus on the left side of the equation (ie. assets minus liabilities). Therefore, in the staff's view, equity measurement in a debt to equity swap should be the fair value of the **liability** settled rather than the fair value of the equity itself.

22. The staff also notes that, for equity-settled share-based payment transactions, IFRS 2.10 require the entity to measure the goods or services received, and the corresponding increase in equity, directly, at **the fair value** of the goods or services **received.** Therefore, in the staff's view, equity measurement in a debt to equity swap should be **the fair value** of liability settled rather than the carrying value of liability.

23. Secondly, the staff notes that IFRIC 17 *Distributions of Non-cash Assets to Owners* applies to non-reciprocal distributions of non-cash assets by an entity to its owners acting in their capacity as owners. IFRIC 17 clarifies that an entity shall measure a liability to distribute non-cash assets as a dividend to its owners at the fair value of the assets to be distributed. IFRIC 17 also clarifies that when an entity settles the dividend payable, it shall recognise the difference, if any, between the carrying amount of the assets distributed and the carrying amount of the dividend payable in profit or loss.

24. IFRIC 17 BC50 states:

> "…when an entity distributes its assets to its owners, it loses the future economic benefit associated with the assets distributed and derecognises those assets. Such a consequence is, in general, similar to that of a disposal of an asset. IFRSs (eg IAS 16, IAS 38, IAS 39 and IFRS 5) require an entity to recognise in profit or loss any gain or loss arising from the derecognition of an asset. IFRSs also require such a gain or loss to be recognised when the asset is derecognised. As mentioned in paragraph BC42, the Framework requires an entity to consider the effect of a transaction from the perspective of an entity for which the financial statements are prepared. For these reasons, the IFRIC concluded that the credit balance and gains or losses on derecognition of an asset should be accounted for in the same way".

25. Similarly, in a debt to equity swap in a restructuring, it could be considered that the proceeds of new equity shares are paid by the lenders and the lenders then accept the proceeds in full settlement of the liability. The proceeds represent the **fair value of the liability** because that is the amount for which a liability is settled between knowledgeable willing parties. IAS 39 requires an entity to recognise in profit or loss any gain or loss arising from the derecognition of a liability.

Question 1 for the Board
Does the Board agree with the staff's analysis in paragraphs 15-25?

Agenda criteria assessment for the IFRIC

26. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *Is the issue widespread and practical?*
    Yes. In the staff's view, the issue could arise in many jurisdictions and is likely to be more frequent in the current environment.

    (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
    Yes. Although in the staff's view, the issue could be solved by current IFRSs it is clear that the standards are being applied differently in practice. .

    (c) Would financial reporting be improved through elimination of the diversity?

Yes. These are often material transactions and consistency is important.

(d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?
No. The issue seems to be too narrow to develop an interpretation. Alternatively, it could be considered to be too broad as it would be developing a measurement standard for equity that does not currently exist.

(e) If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process.)
Yes in the light of current market conditions. However, even if the IFRIC added the issue to the agenda, the fastest timing for the project would be at least one year plus a possible effective date of three months after the publication (ie second half of 2010). On this basis, development of an interpretation would not provide a short-term solution as expected by the submitter even if there is a pressing need for guidance in the light of current market conditions. The issue is within the scope of the project on Financial Instruments with Characteristics of Equity. The IASB is expecting to release an Exposure Draft in the fourth quarter of this year. The final standard is expected to be completed by the date agreed in MoU with the FASB (2011).

Annual Improvements criteria assessment

27. The staff does not believe that the issue meets the IFRIC's agenda criteria even though we conclude that it could result in diversity in practice. We believe that the most effective way to resolve it is for the Board to amend IAS 39 through the annual improvements project. We believe that this issue meets the annual improvements criteria of being a non-urgent but necessary amendment to IFRSs.

28. Accordingly the staff recommends that the Board amend IAS 39 as a part of Annual Improvement project. The proposed wording for amendment is set out in Appendix C.

Question 3 for the Board
1. Does the Board agree that the issue should be added to Annual Improvements project? 2. Does the Board have any comments on the proposed wording for the amendment to IAS 39 in Appendix C?

Appendix A – IFRIC potential Agenda Item Request

IFRIC Potential Agenda Item Request

This letter describes an issue that we believe should be added to the IFRIC's agenda. We have included a summary of the issue, possible views and an assessment of the issue against the IFRIC criteria.

The issue

Application of IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 32 *Financial Instruments: Presentation* in case of issuance of own equity instruments in settlement of debt

In a debt restructuring an entity may negotiate the extinguishment of a financial liability in exchange for issuing equity instruments to the creditor. The question arises whether the entity should account for the exchange by:

1) recognising the equity instruments at fair value and recording a gain/loss in profit or loss equal to the difference between this fair value and the carrying amount of the extinguished liability, or
2) recording the equity instruments issued at the carrying amount of the extinguished liability with no gain/loss on extinguishment being recognised.

View 1

View 1 can be supported by the following arguments:

- IAS 39.41 requires that the difference between the carrying amount of a liability (or part of a liability) extinguished and the consideration paid, including non-cash assets transferred or liabilities assumed, is recognised in profit or loss. Issuing equity instruments is one form of consideration. This rationale is for example applied in IFRS 3 *Business Combinations* (see IFRS 3.37). The measurement of consideration should follow the principles usually applied in IFRS for substantive non-cash transactions, i.e. the equity instruments should be measured at fair value at the date of the restructuring. Therefore a gain or loss is recognised for the difference between the fair value of the instruments issued and the carrying amount of the liability.
- IAS 32.AG35 indicates that amending the terms of a compound instrument to induce early conversion by offering a more favourable conversion ratio is a form of "paying … additional consideration in the event of conversion" and requires the incremental fair value arising to be recognised as a loss in profit or loss. The different guidance in IAS 32.AG32 noted below regarding the conversion of a compound instrument at maturity is not relevant since it addresses only the exercise of a pre-existing equity feature and not a new agreement to deliver equity instruments.
- This view is further supported by IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*. IFRIC 2 in example 3 in paragraph A10

demonstrates a transfer of a share from financial liabilities to equity arising from a change in the governing charter. In the example, since the share is carried at fair value and, presumably because of this, there is no gain or loss recognised on the transfer. The interpretation specifically states: "*In this example* [italics added] the entity does not recognise a gain or loss on the transfer."

View 2

View 2 can be supported by the following arguments:

- IFRSs do not have any specific measurement rules related to equity. Equity instruments are outside the scope of IAS 39, including the requirement to measure initially at fair value plus transaction costs. Rather, IAS 32.33 states that no gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. In addition, IAS 32.AG32 states that, on conversion of a convertible instrument at maturity, an entity derecognises the liability component and recognises it as equity with no gain or loss on conversion.
- IAS 39.41 is not considered to be determinative as it refers to recording a gain or loss by reference to "the consideration paid, including non-cash assets transferred or liabilities assumed." However own equity instruments are arguably not "consideration paid" as they are neither non-cash assets nor liabilities. Also, even if the term "consideration paid" is extended to equity instruments issued, IAS 39 does not specify how that element of consideration would be measured.
- Therefore, the carrying amount of the financial liability should be transferred to equity.

Current practice

Current practice may be mixed as entities might consider applying either of the possible analyses outlined above. The published views of the large networks of accounting firms are mixed and therefore we believe that both current and future diversity in practice is likely.

Reasons for the IFRIC to address the issue

(a) We understand that the issue may be widespread in practice. Given current economic conditions, debt restructurings of this type may occur increasingly frequently as highly indebted entities become financially stressed or are unable to arrange replacement debt financing.
(b) The possible interpretations outlined above may produce significantly divergent results. We are aware that both interpretations are applied in practice.
(c) Financial reporting would be improved if the transactions described were accounted for on a consistent basis. The earnings and reported capital structures of entities are not comparable if the transactions are accounted for differently.
(d) The issue is capable of interpretation within the confines of IFRSs and the *Framework for the Preparation and Presentation of Financial Statements.*

(e) The IASB has projects on *Derecognition* and on the replacement of IAS 39. These projects are not expected to resolve this issue (for example, ED/2009/3 *Derecognition* proposes only to replace IAS 39.40 and .41 with similar wording). The IASB also has a project on *Financial Instruments with Characteristics of Equity* which is aimed at replacing IAS 32. This project is not planned to result in the issuance of a new standard to replace IAS 32 until 2011 and it is unclear whether this issue will be addressed.
In the light of current market conditions, we believe there is a more pressing need for the IFRIC to address the issue in the short-term, even if the issue will otherwise be addressed in one of the aforementioned projects.

Appendix B – Extract from the board paper in June 2009

The followings are extracts from the board paper in June 2009 on *Financial instruments with characteristics of equity* (Paper 9A paragraphs 21-31).

B1. We identified three potential alternatives for initial measurement of an entity's own equity instruments–fair value, transaction price, and current market trading price.

Fair Value

B2. It is inherently difficult for an entity to measure its own equity instruments at fair value as currently defined because ownership instruments are unique to the issuer. Liability instruments represent contracted payments that a third party with the same credit risk could undertake to provide without changing the level of risk to the holder. There may be no market for a particular liability instrument but at least in theory, a market transaction is possible if the creditor agrees to it. The same cannot be said for an entity's own equity instruments. Not even in theory can a third party step into the position of an issuer of ownership interests and maintain the same potential for risks and returns to the holder.

B3. When the IASB discussed the fair value of one's own equity in January 2009 (in a meeting on the fair value measurement project), the Board acknowledged the theoretical difficulty and identified a practical solution. The fair value to the holder of an equity instrument should be used as a proxy for the fair value to the issuer.

B4. The FASB has no explicit guidance on determining fair values of one's own equity instruments. Footnote 4 of FASB Statement No. 157, *Fair Value Measurements*, states that "the definition of fair value focuses on assets and liabilities because they are a primary subject of accounting measurement. However, the definition of fair value also should be applied to instruments measured at fair value that are classified in stockholders' equity." However, Statement 157 provides no further guidance on how to deal with the problems discussed in paragraph 22 of this paper. Therefore, if the Boards decide fair

value is the appropriate initial measurement attribute, the FASB will have to provide guidance on how to determine fair value.

B5. Even if the Boards can agree on what fair value means in the context of an equity instrument, initially measuring equity instruments at fair value could create Day 1 gains or losses if the transaction price and the fair value of a particular instrument differ. It would be difficult to explain why an entity should recognize a gain on issuance of its own shares in an arm's-length market transaction.

B6. Describing the measurement attribute as fair value and then providing a practical expedient like the IASB did in the fair value measurement project seems to "pollute" the definition of fair value and would likely to lead to confusion and inappropriate application of the expedient to other items by analogy. We strongly recommend against setting that precedent.

Transaction Price

B7. Measurement of newly issued equity instruments at the transaction price is a long-standing practice and avoids the potential difficulties of fair value measurement. The transaction price of an equity instrument is the fair value of the consideration received for issuing the instrument. If an equity instrument is issued because of the exercise of an option or other derivative, the transaction price includes both the exercise price and the fair value of the option.

B8. It should be noted that even if the transaction price of an equity instrument issued under the terms of an option includes the fair value of that option, the total may not equal the amount at which the instrument could have been issued in a market transaction on that same day. Of course, the intrinsic value of the option plus the exercise price of that option will always equal the trading price of the shares on the exercise date. However, the fair value of the option would include some time value if it were exercised at any time other than the expiration date. Therefore, the exercise price plus the fair value of the option would exceed the trading price of the share on that date.

Current market trading price

B9. A third alternative might be to use the current market issuance price (or trading price) of a newly issued equity instrument even if it is not actually issued at that price. That would avoid the difficulty of determining fair value to the issuer and also would avoid reporting shares issued pursuant to options at amounts greater than the trading price on the issuance dates.

B10. The downside of using the current market trading price would be for entities issuing shares for which there are no price quotes. For those entities, current trading price would be no more difficult to estimate than fair value. In fact, the current market trading price would be the same thing under the IASB's practical expedient of using the holder's price.

B11. The actual transaction price would normally be easier to determine than either the fair value or the current market trading price.

Appendix C – Proposed amendment to IAS39

[Appendix omitted from observer note]