Project	**D25 *Extinguishing Financial Liabilities with Equity Instruments***
Topic	**Comment letter analysis**

Purpose of this paper

1. The purpose of this paper is to provide a comment letter analysis on the proposals in D25 *Extinguishing Financial Liabilities with Equity Instruments* and to set out the staff recommendations for the next steps that the IFRIC should take on this project.

2. This paper focuses on responses to the following three issues addressed in D25:

   (a) Are an entity's equity instruments 'consideration paid' in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* (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?

3. The paper also discusses other significant comments raised by respondents in their comment letters.

Background information

4. In August 2009, the IFRIC published for public comment the draft Interpretation D25 *Extinguishing Financial Liabilities with Equity Instruments* (D25). In response to the proposals in D25, the IFRIC received 33 comment letters.

5. D25 proposes guidance for an entity that renegotiates the terms of a financial liability and issues its own equity instruments to the creditor to fully or partially extinguish the liability. These transactions are sometimes referred to as '**debt for equity swaps**'.

6. Divergence has arisen in practice, with some entities recording a gain or a loss on these transactions, based on the fair value of either the equity instrument issued (FV of equity) or the financial liability extinguished (FV of the liability). Other entities recognise no gain or loss on these transactions, with the equity instruments issued being recorded at the carrying amount of the financial liability extinguished.

Staff analysis

General comments

7. Almost all of the respondents supported the IFRIC's efforts to provide interpretative guidance on debt for equity swaps, noting the existence of diversity in practice. A minority did express concerns as to whether it was appropriate to address this issue in an Interpretation rather than as part of the Board's broader projects on Financial Instruments.

8. Most agreed with the consensus that issuance of an entity's equity instruments is 'consideration paid', and that the extinguishment should be determined at fair value, with any difference between the carrying value of the financial liability and its fair value at extinguishment being recognised as profit or loss.

9. However, the majority of those supporting these proposals expressed concerns about some aspects of the consensus, particularly the requirement to measure debt for equity swaps at the FV of equity or FV of the liability, whichever is more reliably determinable. Many proposed that a **preferred measurement basis** should be determined to avoid an 'accounting choice' developing in practice.

10. Many respondents were also concerned with the proposed guidance for situations where only part of the financial liability is extinguished. A range of suggestions for addressing this issue of **partial extinguishment** were proposed.

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

11. None of the respondents disagreed with the proposal in paragraph 4 of D25 that the issuance of an entity's equity instruments to extinguish all of part of a financial liability is '**consideration paid**'.

12. Many respondents considered that this proposal was consistent not only with IAS 39, but also with the principle of IFRS 2 *Share-based Payment* and guidance in IFRS 3 *Business Combinations*.

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

13. Only a minority of respondents agreed with the proposals in paragraph 5 of D25. They noted that the 'more reliably determined' approach to determining whether measurement should be based on the FV of equity or the FV of the liability is a reasonable and practical approach to measurement.

14. The majority of respondents nevertheless expressed concerns with this approach, noting that:

    (a) *'there will be no robust basis for deciding which measurement is more reliably determinable. D25's proposal will then create operational difficulties and may amount to a de facto accounting policy choice.'*
    (CL 11 Grant Thornton)

(b) *'in order for the entity to conclude that one fair value is "more reliably determinable" than the other, the entity would have to determine both the fair value of the equity instruments issued and that of the financial liability.'* (CL 13 MASB)

(c) *'there would be difficulty in applying the requirements in the situation where fair value of the financial liability and the equity instrument are either equally reliable or equally unreliable.'* (CL 7 KASB)

15. These respondents proposed an alternative measurement approach by which a **preferred measurement basis** is identified, with the alternative fair value measure used only in situations where this preferred measurement basis is not reliably determinable.

16. However, there were mixed views as to whether this preferred measurement basis should be the FV of equity or FV of the liability.

Fair value of equity issued as the preferred measurement basis

17. Some respondents considered that the **FV of equity** should be the preferred measurement basis. These respondents considered that:

(a) this is consistent with the notion that the issue of an entity's equity instrument is '*consideration paid*'. (CL 11 Grant Thornton)

(b) this is consistent with '*principles usually applied in substantive non-cash transactions*', (CL 15 KPMG), '*in particular, in IFRS 3, equity instruments issued in a business combination*'. (CL 27 Mazars)

(c) '*the equity they* [the creditors] *are being offered is worth more to them than the debt they currently hold. Accordingly, valuing the equity instruments at the same amount as the debt would mean that the equity is undervalued and the gain that is recognised is too high*'. (CL 28 ICAEW)

18. Some of those supporting this view also noted that the FV of equity may often be reliably determinable, noting the current Board proposals to eliminate the fair value exception in paragraph 46 (c) of IAS 39 for certain equity instruments.

Fair value of liability extinguished as the preferred measurement basis

19. Other respondents considered that the **FV of the liability** should be the preferred measurement basis. These respondents considered that:

    (a) paragraph 49 (c) of the Framework defines equity as the residual interest. As such, in debt for equity swaps the equity should be measured at the fair value of the liability extinguished. (CL 6 OIC, CL 8 ACCA, CL 31 EFRAG)

    (b) this approach is consistent with '*the requirements in IFRS 2 Share-based Payment paragraph 10 under which the entity measures the goods or services received and the corresponding increase in equity, directly at the fair value of the goods and services received, unless that fair value cannot be estimated reliably'* and paragraph 12 of IAS 18 *Revenue* which requires measurement based on the '*fair value of goods or services received*'. (CL 10 AASB)

    (c) this reflects paragraph 31 of IAS 32 *Financial Instruments: Presentation* which *'gives priority to the measurement of the liability component in a compound financial instrument'*. (CL 18 NASB)

Other measurement matters

20. A number of respondents also requested clarification about the interaction with paragraph 49 of IAS 39 which states that 'the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid'.

21. These respondents identified in the case of debt for equity swaps where the FV of the liability is 'more reliably determinable', and was measured in accordance

with paragraph 49 of IAS 39, no gain or loss would be recognised in profit and loss on extinguishment.

22. Many of these respondents proposed that the final Interpretation should state that paragraph 49 of IAS 39 is not applicable when measuring the FV of the liability in applying D25.

23. Some respondents also requested that the final Interpretation clarify the **measurement date**. Most proposed that this measurement date should be consistent with the date of the debt restructuring agreement or, where the number of shares to be issued varies, the date that the exchanged amounts become fixed.

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?

24. All respondents agreed with the proposal in paragraph 6 of D25 that profit or loss should be recognised on the difference between the carrying amount of the liability extinguished and the initial measurement of the issued equity instruments.

25. However, many respondents commented on the proposals in paragraph 7 relating to partial extinguishment.

26. Specific concerns were raised that in a partial extinguishment situation the consensus indicates that consideration would be allocated entirely to the part of the financial liability that was extinguished. As a result, no consideration would be allocated to any modification of the remaining part of the financial liability.

27. Respondents considered that in this situation *'the issue of equity instruments is consideration for both the so-called "partial extinguishment" of the financial liability and the modification of the portion of the liability that remains outstanding'*. (CL 15 KPMG)

28. Respondents suggested that in addition to acknowledging this point, the final Interpretation could address partial extinguishments in the following ways:

    (a) ‘*Because we believe a debt restructuring is negotiated as a whole between the lenders and the entity, we think it should also be analysed as a whole to faithfully represent the substance of the transaction …*’ (CL 27 Mazars)

    (b) ‘*If the fair value of the liability is used to calculate the amount of gain or loss’* paragraph 13 A of IFRS 2 *‘will still require the fair value of the equity instruments issued to be used to determine if there is any additional "compensation" for "unidentifiable goods or services" that should be expensed.*’ (CL 26 PwC)

    (c) *‘Clarify, in a partial extinguishment, the notion of “substantial modification”’.* (CL 27 Mazars)

29. One respondent (CL 15 KPMG) simply proposed that paragraph 7 should be excluded from the consensus, on the basis that further guidance on partial extinguishments should be outside of the scope of the Interpretation.

Other presentation and disclosure matters

30. A small number of respondents mentioned the **disclosure** requirements in paragraph 8 of D25. Specifically, they questioned whether it was appropriate to introduce new disclosure requirements, given the Board’s wider deliberations on Derecognition (CL 12 DTT) and the guidance relating to disclosures of material transactions in IAS 1 Presentation of Financial Statements. (CL 32 FAR SRS)

Staff recommendations

General

31. The staff noted that most respondents to D25 supported the IFRIC's proposals to issue guidance on debt for equity swaps. Consequently, the staff recommends that the IFRIC should continue deliberating D25 and address some of the concerns expressed by respondents on the proposals.

Question 1: Next steps
Does the IFRIC agree with the staff's recommendation that IFRIC should continue to deliberate this issue?

Scope

32. In addition to responses to the specific issues addressed in D25, certain respondents requested clarification of the scope in the final Interpretation.

33. These comments included proposals for:

    (a) a '*specific scope out provision in respect of conversion of convertible bonds*'. (CL 17 Larsen & Toubro)

    (b) a '*scope exclusion similar to that in IFRIC 17 Distributions of Non-cash Assets to Owners*' (CL 30 EFRAG) for common control transactions.

    (c) clarification as to whether the scope '*is intended to include the issuance of treasury shares*'. (CL 3 AIC)

34. In response to these comments, the staff recommends that the scope in paragraph 2 should clarify the IFRIC's intent that D25 does not apply to those debt for equity swaps where conversion terms are included in the initial contract of the liability extinguished. The staff also recommends that the scope be clarified to exclude the common control transactions identified in BC6.

Question 2: Scope
Does the IFRIC agree with the staff's recommendation that the scope of D25 should be clarified to reflect paragraph 34?

Measurement of the equity instruments issued

35. The staff believes that, consistent with the proposals in D25, the issuance of an entity's equity instruments to extinguish all or part of a financial liability reflects 'consideration paid'.

36. However, the staff considers that a preferred measurement basis for these issued equity instruments should be identified to avoid the concerns noted in paragraph 14, specifically relating to an 'accounting policy choice' developing upon application of the final Interpretation.

37. The staff notes that, as highlighted in paragraphs 17 to 21, respondents had different views of what this preferred measurement basis should be, with a number of arguments put forward for the two alternatives.

38. The staff considers that **FV of equity** should be identified as the preferred measurement basis. The staff believes that this measurement basis:

    (a) is consistent with the consensus that the issue of an entity's equity instruments is 'consideration paid'; and

    (b) best reflects the consideration paid to extinguish the financial liability, which often includes a premium that the holder requires to enter into the debt for equity swap.

39. As a result, the FV of the liability should only be used to measure debt for equity swaps when the FV of equity is **not** reliably determinable, and, if it is used, it should not be measured in accordance with paragraph 49 of IAS 39.

40. The staff also considers that, because of respondent requests, the final Interpretation should clarify that debt for equity swaps should be measured at the transaction date.

41. This is consistent with paragraph AG 76 of IAS 39, which recognises that the transaction price is often the best evidence of fair value. Many of the views expressed in paragraph BC 341, and noted as valid conceptual arguments in paragraph BC 342 of IFRS 3, are also relevant in justifying this proposal to use a transaction, rather than the settlement, date for measurement purposes.

42. In making this recommendation, the staff notes that the scope of D25 is limited to the issuance of equity instruments as applied in paragraph 16 of IAS 32. As a result, the concerns raised in paragraph 23 in determining a measurement date when the number of shares to be issued is uncertain relate to a transaction that would be outside of the scope of the final Interpretation.

Question 3: Measurement of the equity instruments issued
Does the IFRIC agree with the staff's recommendation that: (a) a preferred measurement basis should be identified in the final Interpretation? (b) if a preferred measurement basis is identified, that it should be the fair value of the equity instruments issued? (c) that if a debt for equity swap is measured using the fair value of the financial liability extinguished, that it should not be measured in accordance with paragraph 49 of IAS 39? (d) this measurement should be applied at the transaction date?

Partial Extinguishment

43. The staff considers that additional clarification should be provided in the final Interpretation to address partial extinguishments.

44. The staff consider that this could be addressed by either:

    (a) **Alternative 1** - clarification that in a partial extinguishment situation, consideration paid may relate both to the financial liability that is extinguished **and** to the part of the financial liability that has been modified. No additional guidance would be provided on how this consideration should be allocated between the extinguished or remaining part of the financial liability to determine whether there has been a substantial modification; or;

    (b) **Alternative 2 –** requiring that the debt for equity swap in a partial extinguishment situation should be considered a single modification transaction to determine whether there has been a substantial modification to the whole of the original financial liability.

45. The staff recommends Alternative 1, noting that Alternative 2 might lead to the consensus being applied more broadly to other partial extinguishment situations that are outside the scope of D25.

46. The staff does not consider that the final Interpretation should provide additional guidance on how 'substantial modification' should be applied to debt for equity swaps. The staff believes that this is a request for application guidance that is outside of the scope of this Interpretation.

Question 4: Partial extinguishment
Does the IFRIC agree with the staff's recommendation that: (a) additional clarification should be provided relating to consideration in a partial extinguishment situation? (b) this additional clarification should reflect Alternative 1 in paragraph 44? (c) further application guidance on the determination of substantial modification should remain outside of the scope of the final Interpretation?

Presentation, disclosure, effective date and transition

47. The staff recommends that the requirement for profit or loss to be recognized on debt for equity swaps, and the disclosures requirements in D25, should remain unchanged in the final Interpretation.

48. A minority of respondents expressed concern about the requirement in paragraph 9 of D25 for the proposals to be applied retrospectively, identifying challenges that entities might encounter in determining fair values for prior transactions. Instead, these respondents propose implementation on a prospective basis.

49. Also, a small number of respondents considered that retrospective application, from a date prior to the beginning of the earliest comparative period, should be required **only** to the extent that entities can reliably determine the fair values in these prior periods.

50. Although the staff acknowledges both of these views, we consider that IFRIC appropriately considered these matters in BC 21. As a result the staff does not propose any amendments to the effective date and transition guidance in D25.

Question 5: Presentation, disclosure, effective date and transition
Does the IFRIC agree with the staff's recommendation that the presentation and disclosure guidance, and effective date and transition provisions in D25, should not be changed in the final Interpretation?

Appendix A – Demographic Information on the respondents

A1. A total of 33 comment letters were received on D25. Demographic information on the respondents is as follows:

	Africa	**Asia-Pacific**	**Europe**	**North America**	**International**	**Totals**
Accountancy Bodies	1	1	6	1	-	**9**
Accounting Firms	-	-	1	-	6	**7**
Preparers	-	2	1	-	-	**3**
Regulators	-	-	1	-	-	**1**
Standard Setters		3	6	1	-	**10**
Others	-	1	2	-	-	**3**
Totals	**1**	**7**	**17**	**2**	**6**	**33**