

Extinguishing financial liabilities with equity instruments

On 26 November 2009, the International Financial Reporting Interpretations Committee (IFRIC) issued IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* to provide guidance on accounting for these transactions. In this Supplement to IFRS outlook, we summarise IFRIC 19 and highlight the impact the interpretation may have on financial statements.

Background

Entities may renegotiate the terms of a financial liability and issue equity instruments to the creditor to fully, or partially, extinguish a financial liability. This is commonly referred to as a 'debt for equity' swap and has become more common as a result of the financial crisis. Significant diversity has arisen in the accounting for these transactions from the perspective of the issuer¹. Certain entities recognise the equity instruments issued at the carrying amount of the financial liability, while others recognise the equity instruments at the fair value of either the liability extinguished or the equity issued.

IAS 39 *Financial Instruments: Recognition and Measurement* specifically requires an entity to recognise the difference between the carrying amount of the financial liability extinguished and the consideration paid in profit or loss. However, questions arose as to whether equity instruments issued in return for extinguishing a liability are "consideration paid" and if so, how they should be measured.

Scope

IFRIC 19 does not apply to common control transactions in which the creditor or a related party of the creditor is also a shareholder, and the substance of the transaction is an equity contribution or distribution. It also excludes situations where a creditor is also a direct or indirect shareholder and is acting in its capacity as a shareholder.

In addition, IFRIC 19 does not apply to transactions where, in accordance with the original terms of the financial liability, the liability is extinguished by the issuance of equity instruments. An example of this type of transaction would be the conversion of a convertible bond instrument to shares of the issuing entity.

Summary

IFRIC 19 clarifies that equity instruments issued to a creditor to extinguish a financial liability are "consideration paid" in accordance with paragraph 41 of IAS 39. As a result, the financial liability is derecognised and the equity instruments issued are treated as consideration paid to extinguish that financial liability. The interpretation states that equity

¹ The interpretation does not address the accounting by the creditor.

instruments issued in a debt for equity swap should be measured at the fair value of the equity instruments issued, if this can be determined reliably. If the fair value of the equity instruments issued is not reliably determinable, the equity instruments should be measured by reference to the fair value of the financial liability² extinguished as of the date of extinguishment.

Any difference between the carrying amount of the financial liability that is extinguished and the fair value of the equity instruments issued is recognised immediately in profit or loss. The resulting gain or loss is disclosed separately on the statement of comprehensive income, or the separate income statement (if presented), or in the notes.

The same principle applies when there is partial extinguishment of the financial liability. In these situations, the issuer would have to determine whether part of the consideration paid relates to a modification of the part of the liability that remains outstanding. If so, the issuer would allocate the consideration paid between the portion of the liability extinguished and the portion of the liability that remains outstanding.

The interpretation also requires an assessment of the terms of the remaining liability to determine whether they are substantially different from those of the original liability, applying the approach set out in IAS 39 paragraph 40. Any consideration allocated to the remaining liability would form part of this assessment. If the terms of the retained liability are substantially different, the entity accounts for the transaction, in accordance with IAS 39, as an extinguishment of the entire original financial liability, the recognition of a new liability (at fair value) and the issue of equity instruments, together with any resulting gain or loss in profit or loss.

Effective date and transitional provisions

The interpretation is effective for annual periods beginning on or after 1 July 2010. Early application is permitted.

If application of the interpretation results in a change in accounting policy, it would be applied retrospectively from the beginning of the earliest comparative period presented.

The IFRIC decided that there is no need to analyse modifications that occurred earlier than the beginning of the earliest comparative period presented, as application to earlier periods would only result in reclassification of amounts within equity.

Business Impact

In many recent cases, modifications will result in gains. This is because the fair value of the equity instruments issued would often be less than the carrying amount of the financial liabilities (measured at amortised cost) which are extinguished due to the global economic slowdown.

Determining the fair value of the equity instruments issued, or the fair value of the financial liabilities extinguished, if necessary, would be straightforward in circumstances where the equity instruments (or financial liability) are traded on a liquid exchange. However, this is more challenging when these instruments are privately held or are not actively traded. As the interpretation is to be applied retrospectively, establishing fair values in the past may be more difficult.

If an exchange involves a partial extinguishment of the financial liability and a modification of the terms of the financial liability retained, the approach set out in the interpretation may be difficult to apply. The interpretation does not state how to determine the part of the consideration paid that relates to the modification, or what proportion of the original liability should be compared with the new liability, to determine if the terms are substantially different. In making this determination, the entity would consider all relevant facts and circumstances.

Retrospective application, albeit only for the comparative period, would result in a reclassification of amounts within equity. This reclassification within equity may affect entities that operate in jurisdictions that have specific rules as to which elements of equity may be distributed.

As these transactions often occur within group structures, and therefore are likely to be out of scope, an entity would still need to develop (or retain) an accounting policy for these intra-group transactions.

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² The interpretation indicates that paragraph 49 of IAS 39 is not applied for this purpose. Paragraph 49 of IAS 39 states that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. The IFRIC noted that the demand feature of the liability does not have any substance, i.e., the liability is no longer payable on demand, once it is determined that the liability will be extinguished. Therefore, paragraph 49 of IAS 39 is not applicable.