

# DEBT FOR EQUITY SWAPS

## IFRS Factsheet

*Practical help in a complex world*

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### Debt for Equity Swaps

This factsheet explains how to account for 'debt for equity swaps' in accordance with IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*. These requirements will usually result in a profit (or, less commonly, a loss) when debt is renegotiated on terms which provide for an issue of equity instruments. In addition, the factsheet considers the impact of company law for UK companies extinguishing debt with equity.

### Key regulations for this factsheet

This factsheet includes links and references to key regulations. There's a summary of the links, and guidance on how to use them, on page 2.

### Section 1

#### Overview 1

### Section 2

#### Links to regulations 2

### Section 3

#### Scope of IFRIC 19 3

### Section 4

#### Accounting required by IFRIC 19 4

### Section 5

#### UK legal issues 6

### Further information

#### Faculty resources and contact details 9

## Section 1

### Overview

#### Accounting requirements

IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* addresses the accounting requirements for entities that issue equity instruments to extinguish all or part of a financial liability. These transactions are often referred to as 'debt for equity swaps'. Such transactions are more common when the borrower is in financial difficulties and the lender agrees to forgive amounts due in return for receiving equity in the borrower, but IFRIC 19 is not limited to such situations.

#### Legal requirements for UK companies

UK companies will also need to consider the legal requirements when a company effectively issues shares at a premium and, therefore, the amount that must be transferred to the share premium account.

UK entities applying FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* should refer to the faculty's FRS 102 factsheet *Debt for Equity Swaps*.

## Section 2

# Links to regulations

### Using the links and margin notes in this document

The margin notes in this factsheet identify relevant sections of standards and other regulations – these sections cannot be considered in isolation when applying them in practice.

You might find it useful to download relevant section(s) of the standard(s) so that you can refer to them when using this document.

### Make sure that you use the right version of the regulations or standards

Standards and regulations are often updated and amended, and may have transitional provisions. It is important to use the right version, and to make sure that it applies to the relevant time period. The standards below are linked to the faculty's standards tracker which shows when standards were amended, and when amendments come into effect. Links are then provided to the version of the standard relevant to specific time periods. To use the links in the standards tracker it is strongly recommended that you are first logged into the Financial Reporting Faculty, and also logged into [eIFRS](#).

#### Standards

Key regulations for this factsheet - IFRSs

[IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments](#)

[IAS 32 Financial Instruments: Presentation](#)

[IAS 39 Financial Instruments: Recognition and Measurement](#)

[IFRS 9 Financial Instruments](#)

Key regulations for this factsheet – UK legislation

[TECH 02/17BL: Guidance on realised and distributable profits under the Companies Act 2006](#)

### Section 3

## Scope of IFRIC 19

The interpretation addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments (as defined by IAS 32 *Financial Instruments: Presentation*) to the creditor to extinguish all or part of the financial liability. The interpretation provides guidance on the accounting treatment to be applied by the issuer of the equity instruments (ie, the borrower). It does not address the accounting by the creditor (ie, the lender).

IFRIC 19.2

The interpretation does not apply to transactions in which a financial liability is extinguished by issuing equity instruments in accordance with the original terms of the financial liability. For example, it does not apply to the conversion of convertible debt which was accounted for as a compound instrument and is converted on the originally agreed terms. The interpretation addresses transactions when there is a renegotiation of the original terms which provide for the issue of equity instruments.

IFRIC 19.3(c)

The interpretation also does not apply to transactions in which the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect shareholder. In reaching this decision, the Interpretations Committee noted that determining whether the issue of equity instruments in such situations is considered a transaction with an owner in its capacity as an owner would be a matter of judgement depending on the particular facts and circumstances.

IFRIC 19.3(a)  
IFRIC 19.BC7

Similarly, the interpretation does not apply when the creditor and the entity are under common control both before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity. The Interpretations Committee acknowledged that the allocation of consideration between the extinguishment of all or part of a financial liability and the equity contribution or distribution components may not always be reliably measurable.

IFRIC 19.3(b)  
IFRIC 19.BC8

In other words, for practical purposes, intra-group transactions are outside the scope of the interpretation. Other accounting policies may be acceptable but the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (or, when adopted, IFRS 9 *Financial Instruments*<sup>1</sup>) must still be met.

<sup>1</sup> IFRS 9 is effective for accounting periods beginning on or after 1 January 2018.

## Section 4

### Accounting required by IFRIC 19

Paragraph 3.3.3 of IFRS 9 deals with derecognition of a financial liability (or paragraph 41 of IAS 39, for entities that have not yet adopted IFRS 9). It requires the difference between the carrying amount of a financial liability (or part thereof) extinguished and the consideration paid (including any non-cash assets transferred or liabilities assumed) to be recognised in profit or loss. It does not specifically mention equity instruments issued. Consequently, prior to the issue of IFRIC 19, some held the view that equity instruments were not 'consideration paid' for this purpose and there was diversity of practice. IFRS 9.3.3.3

IFRIC 19 confirmed that 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 paragraph 3.3.3 of IFRS 9 (or in accordance with paragraph 41 of IAS 39, for entities that have not yet adopted IFRS 9). IFRIC 19.5

Having resolved this uncertainty, the Interpretations Committee then addressed how to measure the 'consideration paid'. It concluded that this should be the fair value of the equity instruments issued, unless that fair value cannot be reliably measured. IFRIC 19.6

If the fair value of the equity instruments issued cannot be reliably measured, the consideration paid is measured to reflect the fair value of the liability extinguished. When the liability includes a demand feature (eg, a demand deposit) IFRIC 19 specifies that paragraph 47 of IFRS 13 is not applied when measuring the fair value of the liability. Paragraph 47 of IFRS 13 specifies that in other cases the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. IFRIC 19.7

If only part of the financial liability is extinguished, it becomes necessary to determine whether some of the consideration paid relates to a modification of the terms of the liability that remains outstanding. When this is the case, the consideration paid is allocated between the part of the liability extinguished and the part of the liability that remains outstanding. All relevant facts and circumstances relating to the transaction are considered in making the allocation. IFRIC 19.8

The difference between the carrying amount of the liability (or part thereof) extinguished and the consideration paid in this respect is recognised in profit or loss in accordance with paragraph 3.3.3 of IFRS 9 (or paragraph 41 of IAS 39). When the debt for equity swap has been prompted by financial difficulties of the borrower, this almost invariably results in a profit rather than a loss because the fair value of distressed debt (and hence the fair value of the shares issued in settlement) will typically be less than its carrying value. But in other circumstances, either outcome is possible. The equity instruments issued are measured at the date the financial liability (or part thereof) is extinguished. IFRIC 19.9

As described above, sometimes it will be necessary to allocate the consideration paid (ie, the fair value of the shares issued) between an amount relating to the extinguishment of part of the liability and an amount relating to a modification of the remaining liability. Whether there is any such modification depends on the particular facts of each case. When part of the consideration is allocated to the modification of a remaining liability, it forms part of the assessment of whether the terms of the remaining liability have been substantially modified for the purposes of paragraph 3.3.2 of IFRS 9. In such circumstances IFRS 9 requires that such an exchange is accounted for as an extinguishment of the original financial liability and recognition of a new financial liability. (For entities that have not yet adopted IFRS 9, the reference is instead to paragraph 40 of IAS 39.) IFRIC 19.10

Any gain or loss recognised in accordance with paragraph 3.3.3 of IFRS 9 (or paragraph 41 of IAS 39) is disclosed as a separate line item in the income statement or in the notes to the financial statements. IFRIC 19.11

### Practical tip: what this means in practice

The issuing of equity instruments to extinguish a financial liability can be seen as consisting of two separate transactions. The entity could first issue equity instruments to the creditor for cash consideration. The creditor could then agree to accept the same amount of cash as settlement of the full amount of the liability. The accounting treatment should be the same whether the financial liability is exchanged for equity instruments or equity instruments are issued for cash which is then used to extinguish the liability.

### Example: debt for equity swap

Company A issues equity instruments with a fair value of £90m to a lender as extinguishment of the whole of its liability to the lender. The carrying amount of the liability, based on amortised cost, on the date of extinguishment is £100m.

The following entries would be recorded:

		£m	£m
Dr	Financial Liability	100	
Cr	Profit or loss		10
Cr	Equity		90

The entries required to share capital, share premium and other reserves will be governed by local legal requirements. The UK legal position is considered in section 5 of this factsheet.

## Section 5

### UK legal issues

UK companies extinguishing debt with equity will have to consider the impact of UK company law.

#### Share capital and share premium

In the UK, the amount to be credited to share capital and share premium on an issue of shares is a matter of law and does not depend on the accounting for the transaction. Any apparent conflict between the accounting treatment and legal analysis can be resolved by transfers between the components of equity.

When shares are issued, the amount to be credited to share premium is based on the value of the consideration received for the issue of the shares. When the consideration is the release from a liability, its value for this purpose is the liquidated sum which is usually the face value of the liability (ie, its redemption amount). This value may be different from both the carrying amount of the liability at the transaction date and its fair value (being the value credited to equity under IFRIC 19).

The effect of the distinction between the accounting and legal analysis is that a gain recognised under the requirements of IFRIC 19 is likely to be treated as capital for UK company law purposes and, as such, the overall effect is that the company's reserves available for distribution are not increased.

It is important to review the supporting documentation for any such transaction to establish the legal consideration for the issue of shares and it may be necessary to obtain legal advice in cases when this is unclear.

This is illustrated in the following examples.

#### Example: liability carried at face value

Company A borrowed £1,000,000 on 1 January 20X1 for a term of 10 years. Full repayment of the principal is due on maturity. There were no transaction costs. On 1 January 20X6, the lender agreed to release Company A from the obligation to repay the £1,000,000 in consideration for the issue of 100,000 ordinary shares with a nominal value of £1 each and a total fair value of £250,000. The carrying amount of the liability, based on amortised cost, on the date of extinguishment is £1,000,000. No interest was outstanding on the date of extinguishment and no penalty was payable for early termination. The liquidated sum (ie, the redemption amount) is equal to the face value of the liability of £1,000,000.

The accounting entries for this transaction in accordance with IFRIC 19 are as follows:

	£000	£000
Dr Financial Liability	1,000	
Cr Profit or loss (£1,000,000 - £250,000)		750
Cr Equity		250

The credit to equity of £250,000 is allocated as £100,000 to share capital (being the total nominal value of 100,000 £1 shares) and £150,000 to share premium.

The total share premium to be recognised is £900,000, being the difference between the nominal value of the shares issued (£100,000) and the face value of the liability from which the company has been released (£1,000,000).

The following entry is therefore required to ensure the correct balance on the share premium account:

	£000	£000
Dr Retained earnings	750	
Cr Share premium		750

Consequently, the debt restructuring has no net impact on retained earnings available for distribution.

### Example: impact of transaction costs

Company B borrowed £1,000,000 from a bank on 1 January 20X1 for a term of 10 years. Full repayment of the principal is due on maturity. Transaction costs of £100,000 were deducted from the carrying amount of the liability on initial recognition and included in the subsequent measurement of the liability using the effective interest method. On 1 January 20X6, the lender agreed to release Company B from the obligation to repay the £1,000,000 (which at that point had a carrying amount of £950,000) in consideration for the issue of 100,000 ordinary shares with a nominal value of £1 each and a total fair value of £250,000. No interest was outstanding on the date of extinguishment and no penalty was payable for early termination. The liquidated sum (ie, the redemption amount) is equal to the face value of the liability of £1,000,000.

The accounting entries for this transaction in accordance with IFRIC 19 are as follows:

	<b>£000</b>	<b>£000</b>
Dr Financial Liability	950	
Cr Profit or loss (£950,000 - £250,000)		700
Cr Equity		250

The credit to equity of £250,000 is allocated as £100,000 to share capital (being the total nominal value of 100,000 £1 shares) and £150,000 to share premium.

The transaction costs do not affect the amount that must be credited to share premium (£900,000), being the difference between the nominal value of the shares issued (£100,000) and the face value of the liability from which Company B has been released (£1,000,000).

The following entry is therefore required to ensure the correct balance on the share premium account.

	<b>£000</b>	<b>£000</b>
Dr Retained earnings	750	
Cr Share premium		750

Consequently, there is a net debit of £50,000 to retained earnings (being the £700,000 gain recognised under IFRIC 19 less the £750,000 transfer to share premium) which represents the transaction costs not yet recognised in profit or loss under the effective interest method. This debit is a realised loss and reduces profits available for distribution (as it would have done over the remaining term of the debt in the absence of the renegotiation).

### Example: liability issued at a discount

Company C issued debt with a redemption value of £1,000,000 on 1 January 20X1 for a term of 10 years. Full repayment of the principal is due on maturity. The debt was issued at a discount, with Company C receiving £900,000 on issue. There were no transaction costs. The £100,000 discount was included in the subsequent measurement of the liability using the effective interest method. On 1 January 20X6, the lender agreed to release Company C from the obligation to repay the liability (which at that point had a carrying amount, based on amortised cost, of £950,000) in consideration for the issue of 100,000 ordinary shares with a nominal value of £1 each and a total fair value of £250,000. No interest was outstanding on the date of extinguishment and no penalty was payable for early termination.

The accounting entries for this transaction in accordance with IFRIC 19 are the same as in the previous example. The legal analysis may, however, be different.

It is important to establish, as a matter of law rather than financial reporting practice, the amount of the liability from which the company is being released.

If this amount is the full redemption amount of £1,000,000, the additional amount to be credited to share premium is £750,000 (as in the previous example).

If, however, the terms of the debt provide that the redemption amount accrues on a daily basis over the ten-year life of the debt (for example, to calculate the amount payable on early redemption) and therefore the liability from which Company C is released is £950,000, the required entries are as follows:

- the credit to equity of £250,000 is allocated as £100,000 to share capital (being the total nominal value of 100,000 £1 shares) and £150,000 to share premium; and
- the total share premium to be recognised is £850,000 (being the difference between the nominal value of the shares issued (£100,000) and the liability from which the company has been released (£950,000)).

The following entry is therefore required to ensure the correct balance on the share premium account:

	<b>£000</b>	<b>£000</b>
Dr Retained earnings	700	
Cr Share premium		700

Consequently, the debt restructuring has no net impact on retained earnings available for distribution.



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### **Contacts and further help**

#### **Factsheets for faculty members**

This factsheet is part of a series designed to provide practical help for Financial Reporting Faculty members in exercising their professional judgement.

The faculty cannot offer interpretations of standards or give views on the application of standards to particular companies or transactions.

#### **The faculty's standards trackers**

To check for current standards and recent amendments go to the faculty's standards trackers at: [icaew.com/frfstandardstracker](https://icaew.com/frfstandardstracker).

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Topics covered by other factsheets include:

- 2017 IFRS Accounts
- Introducing IFRS 9 Financial Instruments
- UK Distributable Profits

A complete list of factsheets can be found here:

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#### **Factsheet comments and suggestions**

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#### **Faculty resources [icaew.com/frf](https://icaew.com/frf)**

Resources published by the Financial Reporting Faculty may be found at [icaew.com/frf](https://icaew.com/frf). Resources include online access to the faculty's publications, webinar recordings and other guidance such as FAQs and the standards trackers. Faculty members also have full access to the IASB's eIFRs resource, including full texts of the standards.

#### **The Financial Reporting Faculty**

The faculty aims to help members keep up to date with the implications of new standards, regulations and practice in financial reporting.

Our international community of financial reporting professionals also contribute to the ICAEW's work in influencing the development of financial reporting concepts, standards and regulation.

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