



DEBT FOR EQUITY SWAPS

FRS 102 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 FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. 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.

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Section 1

Introduction

When an entity issues an equity instrument to extinguish all or part of a financial liability this is often referred to as a 'debt for equity swap'. 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 the accounting requirements are not limited to such situations.

Amendments to FRS 102

Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Triennial review 2017 – Incremental Improvements and clarifications published in December 2017 include amendments which clarify the treatment of debt for equity swaps with shareholders and parties under common control. The amendments are effective for accounting periods beginning on or after 1 January 2019 with early application permitted provided that all of the amendments (with some limited exceptions) are applied at the same time.

This factsheet is based on the revised requirements.

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, an amount must be transferred to the share premium account.

Entities applying IFRSs should refer to the faculty's IFRS 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.

Standards and regulations

Key standards

[FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*](#)

Other regulations for this factsheet

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

[Amendments to FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland - Triennial review 2017 - Incremental Improvements and clarifications*](#)

Section 3

Overview

General requirements

The general requirements as described below are for all debt for equity swaps other than transactions with shareholders or parties under common control, or when the equity is issued to extinguish a financial liability (or part thereof) in accordance with the original terms. The exceptions to the general requirements are discussed further at the end of this section.

Derecognition of the debt instrument

When a financial liability (or part thereof) is extinguished, then Section 11 *Basic Financial Instruments* requires the liability to be derecognised. The difference between the carrying amount of the liability (or part thereof) and the consideration paid is recognised in profit or loss.

FRS 102.11.36&38

Measurement of equity instruments issued

When the entity issues equity instruments, Section 22 *Liabilities and Equity* generally requires the equity instruments to be measured at the fair value of the cash or other resources received or receivable, net of transaction costs.

FRS 102.22.8

Practical tip: what fair value to use

In a debt for equity swap no cash or other resources are received or receivable. Instead, what is 'received' is the extinguishment of the debt. FRS 102 does not specify whether to measure the transaction based on the fair value of the equity instruments issued or the fair value of the debt extinguished. In an arm's length transaction, the fair value of the equity instrument and the fair value of the financial liability should be the same. In practice, generally the more reliable measure should be used. However, the fair value of the liability and the carrying value of the liability may be different (see example below).

Other than in the circumstances described below, the gain or loss arising on the debt for equity swap will be the difference between the fair value of the equity instruments issued (or the debt extinguished) and the carrying value of the financial liability. This gain or loss will be recognised in profit or loss.

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.

Interaction with company law

When accounting for the debt for equity swap, it will be necessary to consider the requirements of company law, when relevant, as regards the amount of share premium, if any, to record. The UK legal position is considered in section 5 of this factsheet.

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 UK law. See section 5 of this factsheet.

Exceptions to the general requirement for measuring the issue of equity instruments

Transactions with shareholders and controlling parties

The general requirement to measure equity instruments at the fair value of the cash or other resources received or receivable does not apply to certain transactions when the creditor is also a direct or indirect shareholder, or when the creditor and the entity are under common control. In such cases, no gain or loss will be recognised in profit or loss. These transactions are considered further in section 4 of this factsheet.

FRS 102.22.8, 8A(a)-(b)

Financial liabilities extinguished in accordance with the original terms

The general requirement also 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. No gain or loss will be recognised in profit or loss. Such transactions are not considered further in this factsheet.

FRS 102.22.28A(c)

Practical tip: scope exclusions introduced by December 2017 amendments to FRS 102

The scope exclusions above were introduced as part of the *Amendments to FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland – Triennial review 2017 – Incremental Improvements and clarifications* issued in December 2017 (the 'Triennial review 2017 amendments'). The accounting for financial liabilities extinguished in accordance with the original terms has not been contentious and the amendments simply confirm existing practice. However, the accounting treatment for transactions with shareholders and parties under common control was less clear and there has been some divergence in practice. The amendments therefore help clarify and standardise the accounting treatment for such transactions.

The Triennial review 2017 amendments are effective for accounting periods beginning on or after 1 January 2019. The transitional requirements are that early application is permitted provided that all of the amendments (with some limited exceptions) are applied at the same time. This is considered further in section 4 of this factsheet.

Section 4

Common control and shareholder transactions

Scope exclusion from measurement requirements for equity instruments

As noted above, the general requirement in Section 22 is to measure equity instruments at the fair value of cash or other resources received or receivable, net of transaction costs.

FRS 102.22.8

However, this requirement (as amended by the Triennial review 2017 amendments) 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 existing shareholder.

FRS 102.22.8A(a)

Similarly, this requirement (as amended) does not apply when the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity.

FRS 102.22.8A(b)

No gain or loss will be recognised in profit or loss as a result of such transactions.

Accounting treatment

As no gain or loss is recognised in profit or loss, the recognised financial liability has, in effect, been settled by the issue of equity instruments for consideration equal to its carrying amount (ie, it is a quasi-conversion and should be treated like the conversion of convertible debt). Thus, the liability is eliminated and an equal and opposite amount is credited to equity.

Example: shareholder transaction

Company A is a wholly-owned UK subsidiary of Company B. Company A issues equity instruments with a fair value of £90m to Company B as extinguishment of the whole of its liability to its parent. 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	Equity		100

The entries required to share capital, share premium and other reserves will be governed by UK law (see section 5).

The fair value of the equity instruments issued is not relevant, as the general requirement to measure equity instruments at fair value does not apply to transactions in which a financial liability is extinguished (partially or in full) by the issue of equity instruments to an entity's owners.

Practical tip: change in accounting policy

Prior to the Triennial review 2017 amendments, FRS 102 was silent on the accounting for common control and shareholder transactions, and therefore diversity in accounting treatment developed in practice. If an entity changes its accounting policy to comply with the new requirements, this would need to be accounted for retrospectively. However, only amounts reported in profit or loss in the comparative period should require restatement. Compliance with UK company law (as discussed in section 5) should ensure that the amounts reported in opening and closing equity of the comparative period are already correctly stated.

Section 5

UK legal issues

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 FRS 102's general requirements).

CA 2006 s583

The effect of the distinction between the accounting and legal analysis is that a gain recognised under the requirements of FRS 102 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 from a bank 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 FRS 102 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 Company A 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, 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 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 FRS 102 are as follows:

	£000	£000
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.

	£000	£000
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 FRS 102 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 FRS 102 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:

	£000	£000
Dr Retained earnings	700	
Cr Share premium		700

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

Practical help in a complex world

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.

Factsheets

Topics covered by other FRS 102 factsheets include:

- An Introduction to FRS 102
- 2018 UK GAAP Accounts
- Financial Instruments

A complete list of factsheets can be found here:

icaew.com/frffactsheets

Factsheet comments and suggestions

To comment on factsheets, or to suggest topics that you'd like to see covered by factsheets, email us at frfac@icaew.com

Faculty resources icaew.com/frf

Resources published by the Financial Reporting Faculty may be found at 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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