

XX October 2009

International Financial Reporting Interpretations Committee
30 Cannon Street
London
EC4M 6XH
United Kingdom

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 29 September 2009

Dear Madam/Sir

IFRIC D25 *Extinguishing Financial Liabilities with Equity Instruments*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the IFRIC Draft Interpretation D25 *Extinguishing Financial Liabilities with Equity Instruments* ("IFRIC D25"). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issue.

- 1 IFRIC D25 provides guidance on how an issuer of debt should account for a debt for equity swap; in other words, when a debtor and creditor renegotiate the terms of a financial liability with the result that the liability is fully or partially extinguished by the debtor issuing equity instruments to the creditor. EFRAG agrees that existing IFRS lack sufficient guidance on such transactions and that as a result there is diversity in practice. We support the IFRIC in its efforts to develop interpretive guidance on such transactions.

Summary of IFRIC D25

- 2 IFRIC D25 proposes that:
 - (a) if a debtor issues equity instruments to a creditor to extinguish all or part of a financial liability, the issue of equity instruments is the consideration paid for the purposes of IFRS (IAS 39 paragraph 41);
 - (b) the equity instruments issued shall be measured at the fair value of the financial liability settled or the fair value of the equity instruments issued, whichever is more reliably measurable;
 - (c) any gain or loss resulting from the transaction (being the difference between the carrying amount of the extinguished part of the financial liability (or the extinguished financial liability) and the amount of the equity instruments issued to extinguish that part of the financial liability (or that financial liability)) shall be presented as a separate line item in either the statement of comprehensive income or the separate income statement (if presented) or

the notes;

- (d) if only part of the financial liability is extinguished by the issue of equity instruments, the terms of the financial liability that remains outstanding shall be assessed to determine whether they have been changed substantially. Under existing IFRS, an entity is required to account for a substantial change in the terms as an extinguishment of the original liability and the recognition of a new liability; and
- (e) entities should apply this interpretation retrospectively from the earliest comparative period presented.

EFrag's overall view

- 3 We broadly agree with the draft consensus, with one exception. It is proposed that the equity instruments issued shall be measured at the fair value of the financial liability settled or the fair value of the equity instruments issued, whichever is more reliably measurable. We can accept such an approach, because it is pragmatic, will resolve many difficulties in practice, and is consistent with the approach adopted in IFRS 2 Share-based Payments.
- 4 However, we think that theoretically, in order to be consistent with the Framework (specifically paragraph 49 (c) which defines equity as the residual interest in the net assets), the equity instruments issued should be measured at the fair value of the financial liability extinguished. Furthermore, we are concerned that some might view IFRIC D25's proposed approach as involving a choice as to the measurement basis to be used, which we do not believe is the IFRIC's intention. For those reasons, we think the guidance would be improved were the wording of paragraph 5 redrafted along the following lines:

"An entity shall initially measure equity instruments issued to a creditor to extinguish all or part of a financial liability at the fair value of the liability extinguished, whichever is more reliably determinable unless this value cannot be reliably measured in which case the equity instruments shall be measured at their fair value."

Two detailed concerns

- 5 Having said that, we do have two detailed—but nevertheless important—concerns regarding the proposals.
 - (a) We are concerned about the implications that paragraph 49 of IAS 39 *Financial Instruments: Recognition and Measurement* might have for the proposed approach. (Paragraph 49 states that "the fair value of a financial liability with a demand feature (e.g. 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".) Debt for equity swaps often take place when the issuer is in financial difficulty. At such times, the issuer has often breached its debt covenants, which often has the effect of making financial liabilities repayable on demand. As such, paragraph 49 could be relevant in determining the fair value of the financial liabilities extinguished. We think it would be helpful if the final Interpretation could make it clear whether paragraph 49 is intended to be applied in such circumstances.

- (b) We are concerned about the treatment of some common control transactions where the relative ownership of debt and equity remains the same before and after the conversion and the possible cost/benefit implications of this draft interpretation on such transactions, especially where the reporting entity is a wholly-owned subsidiary and its debt is not actively traded. In such circumstances we wonder whether the benefits arising from the implementation of the proposed interpretation will exceed the costs involved. It is not clear from IFRIC D25 whether the IFRIC has considered such transactions when developing the draft guidance, but we think a scope exclusion similar to that in IFRIC 17 *Distributions of Non-cash Assets to Owners* might be appropriate unless guidance that will simplify the valuation process in such circumstances is provided.

Some comments on the Basis for Conclusions

6 We also have some drafting suggestions relating primarily to the Basis for Conclusions:

- (a) We note that paragraph BC16 states that “renegotiating a financial liability to permit it to be extinguished by the issue of equity instruments is always a substantial modification of the terms of the financial liability.” In our view this is guidance, and should be included in the consensus part of the Interpretation rather than the Basis for Conclusions. The positioning of guidance of this kind is particularly important in the EU because the Basis for Conclusions is not part of the material that is considered for endorsement.
- (b) We note that paragraph BC10 describes debt for equity transactions in two very different ways, whereas paragraph BC16 refers only to one of those descriptions (the second one). We think this does not contribute to a coherent basis for conclusion. We believe that these paragraphs require further attention. Therefore, we suggest either that the first description is omitted from paragraph BC10 or that text along the following lines is added at the end of paragraph BC 16:

“Similarly, the first transactional analysis in BC10 will result in the extinguishment of the liability with the same effect on profit or loss.”
- (c) We found it confusing that paragraph BC14 seems to be claiming that IFRS 2 and IFRS 3 apply the same principles when in fact they are different, and potentially conflicting principles (either the residual approach that translates to measuring the equity instruments at the fair value of the financial liability or measuring the instruments at the fair value of the equity at the date of issuance). We believe that these paragraphs require further attention in order to coherently present the IFRIC's basis for conclusion.

If you would like further clarification of the points raised in this letter, please contact Marius Van Reenen or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman