Accounting for Equity Instruments in a Shares-for-Debt Transaction

Extract, IFRS® Discussion Group Report on the Meeting – September 19, 2023

Background

Financial liabilities are most commonly extinguished by repayment with cash. In certain transactions (such as private placements), financial liabilities may instead be extinguished through the issuance of common shares or a combination of common shares and share purchase warrants. Shares-for-debt transactions with shareholder-creditors continue to be observed in public markets in Canada. In the present interest rate environment, more of these transactions could be contemplated where financial liabilities are extinguished other than by cash repayment.

The Group discussed matters related to the accounting for equity instruments in a shares-for-debt transaction. This included the factors an entity might consider when determining whether a shareholder-creditor is acting in the capacity of a shareholder, the accounting for equity instruments issued, and the recognition of any resulting extinguishment differences.

Current guidance

IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* provides guidance when a debtor and creditor renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. IFRIC 19 addresses the measurement of any difference between the carrying amount of a financial liability (or part of a financial liability) extinguished and the consideration paid. It also requires that this difference be recognized in profit or loss (paragraph 9 of IFRIC 19).

IFRIC 19 does not apply in situations when the creditor is also a direct or indirect shareholder, and it is determined that the creditor is acting in its capacity as a shareholder (paragraph 3(a) of IFRIC 19). Paragraph BC7 of the Basis for Conclusions for IFRIC 19 states that determining whether the issuance of equity instruments to extinguish a financial liability is considered a transaction with an owner in its capacity as an owner would be a matter of judgment depending on the facts and circumstances.

In providing guidance for transactions accounted for as changes in equity during the period, paragraph 109 of IAS 1 *Presentation of Financial Statements* includes transactions with owners in their capacity as owners.

In summary, IFRS Accounting Standards provide guidance on shares-for-debt transactions when the shareholder-creditor *is not* acting as a shareholder. However, judgment is required when the shareholder-creditor *is* acting as a shareholder. Judgment is required in areas such as determining whether the shareholder-creditor is acting as a shareholder, and in measuring the shares-for-debt transaction in that case. When the shareholder-creditor is acting in the capacity of a shareholder in

the shares-for-debt transaction, the difference between the carrying amount of the extinguished debt and the equity instruments issued may be recognized within equity. For example:

- If the equity instruments issued to extinguish the debt are recognized at the fair value of the equity instruments issued, then the difference between that and the carrying amount of the liability would be recognized in equity.
- If the equity instruments issued are recognized at the carrying amount of the financial liability, then there is no extinguishment difference.

Issue 1: What factors might the entity consider when determining whether a shareholder-creditor is acting in the capacity of a shareholder?

Analysis

The following are examples of factors an entity might consider:

(a) Comparison of the terms of the transaction with shares-for-debt transactions completed with non-shareholder-creditors

Stock exchanges in Canada have listing policies that specify terms such as the quantity and the deemed price of instruments to be issued in a private placement.

- When a shares-for-debt transaction is completed with a tranche of creditors under identical terms regardless of the nature of the creditor (shareholder or non-shareholder), this may indicate that any shareholder-creditor is acting in the capacity of a creditor.
- When a shares-for-debt transaction is completed with one tranche of non-shareholder-creditors under certain terms and another tranche of shareholder-creditors under different terms (e.g., trading prices over different trading periods), this may indicate that the shareholder-creditor is acting in the capacity of a shareholder.

(b) Other transactions with or relationships to the entity

In addition to holding debt instruments and common shares, a shareholder-creditor may have engaged in other transactions or relationships with the entity, such as:

- holding trade payables or convertible instruments;
- agreeing to waive significant interest and/or penalties on the debt instruments;
- agreeing to amendments to repayment or maturity dates for the debt instruments; or
- acting as a guarantor for other liabilities of the entity.

The magnitude of these transactions or relationships may be relevant to determining the shareholder-creditor's capacity in the shares-for-debt transaction.

Note that these other transactions may also be outside the scope of IFRIC 19 if the shareholder-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.

(c) History of transactions and any previous relationships with the entity

The nature of past transactions or relationships between the shareholder-creditor and the entity may indicate that the shareholder-creditor is presently acting as more than a lender. If there were no past transactions or relationships and no other determining facts and circumstances, the sole matter of the existence of a shareholder-creditor relationship may not preclude an entity from applying IFRIC 19.

(d) Involvement in the entity's decision-making

The extent of the shareholder-creditor's involvement in the entity's operations, decision-making processes, or governance structures may provide indications as to the shareholder-creditor's capacity in the shares-for-debt transaction. For example, a shares-for-debt tranche may include a creditor who is a director-shareholder and a creditor who is a management entity shareholder. Consider the following scenarios:

- The debt with the director-shareholder was originally a loan advanced in cash. The loan terms have subsequently been extended or modified over multiple fiscal periods for the entity to maintain or improve ongoing financial flexibility. This may indicate shareholder capacity.
- The debt with the management entity shareholder was an unpaid invoice for management services provided in the immediately preceding period. This may indicate creditor capacity.

(e) Size of ownership interest

Under Canadian securities legislation, shareholders that own or control 10 per cent or more of an issuer's securities are required to submit insider reports. The ownership interest must be disclosed therein. The ownership percentage held by the shareholder-creditor, particularly if it is at or above an insider level, could indicate influence over the entity. That level of influence may not be present in a creditor-only relationship.

(f) Duration of ownership interest

When a shareholder-creditor holds its equity interest in the entity for a longer period, that might indicate a strategic intention (net asset growth) typical of a shareholder over a profit intention (yield) typical of a creditor.

(g) Business rationale

When the shareholder-creditor's reasons for accepting equity instruments as settlement of the financial liability are known and determined to be strategic (e.g., to influence the entity's operations or direction), this may indicate the shareholder-creditor is acting in a shareholder

capacity. When the shareholder-creditor instead seeks or announces an immediate exit of their equity position following the shares-for-debt transaction, this may indicate the shareholder-creditor is acting in a creditor capacity.

(h) Objective of the counterparty

Stand-alone arm's length transactions between lenders and borrowers occur at fair value. That is, the lender would not be compelled to complete a transaction that does not maximize their return. A lender will seek to maximize their return even when they are willing to accept alternatives to cash as repayment of debt (such as when the debtor is under duress). In contrast, shareholders do not necessarily transact at fair value. When information is available as to arm's length extinguishment terms for the subject debt that are more favourable to the creditor, that may indicate the shareholder-creditor is acting in a shareholder capacity. That is, a shareholder-creditor acting in a shareholder capacity may be willing to accept less-favourable terms than a party acting in a creditor capacity.

(i) Participation in shareholder meetings

The extent of the shareholder-creditor's participation in shareholder meetings could provide context as to the shareholder-creditor's capacity in a shares-for-debt transaction. Context could also be provided based on how the shareholder-creditor exercises their voting rights in matters such as significant transactions.

Fact Pattern 1

- Entity A is a medium-sized technology company listed on a Canadian stock exchange.
- Entity A has a diverse group of creditors, including both institutional and individual lenders.
- One creditor, Debt Ventures Inc. (DVI), also holds a 4.9 per cent equity interest in Entity A.
- DVI has a significant loan with a maturity date that was extended once and is now about to mature.
- Entity A has encountered financial difficulty and is unable to repay the loan in cash on the amended maturity date. Entity A and DVI enter into an agreement to settle the loan by the issuance of Entity A's common shares.
- The loan terms are similar to loans Entity A has entered into with creditors when there is no equity position.
- DVI has not been involved in the day-to-day decision-making of Entity A. DVI does not have a representative on the board of directors nor any executive influence within Entity A.

- DVI has not actively participated in shareholder meetings in the past. In addition, DVI has not exercised voting rights or shown interest in Entity A's governance.
- DVI's ownership interest of 4.9 per cent is not considered a significant equity interest. DVI does not have significant influence or control over Entity A's operations.
- DVI has held the loans for a relatively short time. The investment horizon aligns with similar creditors seeking financial returns.
- DVI initially issued the loan to Entity A with the expectation of receiving interest payments and the return of principal upon maturity. DVI has arranged with a third party for acquisition of the shares DVI received in the shares-for-debt agreement immediately following its completion.

Entity A concludes that DVI is acting in its capacity as a creditor seeking repayment of the loan.

Fact Pattern 2

- Risk Ventures Inc. (RVI) is a venture capital firm that invests in early-stage technology companies. One of their portfolio companies, Entity B, is a public entity experiencing financial difficulties.
- RVI is a significant shareholder with a 20 per cent equity interest in Entity B.
- RVI has also issued a loan to Entity B with a maturity date that has been extended once and is now about to mature. Entity B is unable to repay the loan in cash. Entity B and RVI enter into an agreement to settle the loan by the issuance of Entity B's common shares.
- RVI typically provides financing to its portfolio companies in the form of equity investments. This approach is consistent with their investment strategy.
- RVI has a representative on Entity B's board of directors and actively participates in strategic decision-making.
- RVI regularly attends and actively participates in Entity B's shareholder meetings. RVI exercises its voting rights and engages in discussions related to Entity B's direction and plans.
- RVI's 20 per cent equity interest in Entity B represents a significant investment in Entity B. This ownership interest gives RVI significant influence over Entity B's operations and strategic decisions.
- RVI has been a shareholder in Entity B since its early seed rounds and has maintained a long-term investment horizon. Its commitment to Entity B aligns with buy-and-hold shareholder expectations.
- RVI has a strong relationship with Entity B's management, characterized by its role as a strategic investor rather than a traditional creditor. RVI has provided loan guarantees to other creditors of Entity B.

- RVI's primary motivation is to support Entity B's growth and success. While RVI is concerned about the repayment of the loan, its actions are driven by a broader objective to ensure Entity B's viability.

Entity B concludes that RVI is acting in its capacity as a shareholder. This is because RVI's involvement and intentions go beyond the typical characteristics of a creditor.

Fact Pattern 3

- Entity C is a publicly traded technology company based in Canada. Entity C has a complex capital structure with traditional and hybrid debt instruments and common and preferred shares.
- One of Entity C's largest shareholder-creditors is Holdcredit Ventures Inc. (HVI). HVI holds a 20 per cent equity interest and has issued a term loan to Entity C comprising 20 per cent of Entity C's total term debt.
- The HVI term loan is due for repayment, and Entity C is facing financial challenges. Entity C and HVI enter into an agreement to settle the loan by the issuance of Entity C's common shares.
- HVI has engaged in a mix of financing transactions with Entity C. These include equity investments and debt instruments, which is not uncommon for HVI. However, HVI has also entered into traditional debt-only lending relationships with other non-technology companies in the past.
- HVI has a representative on Entity C's board of directors and participates in key decisions. HVI actively engages in strategic discussions, indicating a degree of influence.
- HVI occasionally attends shareholder meetings, and its participation is not consistent. HVI votes in some meetings but not in others.
- HVI's 20 per cent equity interest in Entity C gives them significant influence. HVI's term loan also represents a significant financial claim.
- HVI has been a shareholder in Entity C for a considerable period and maintains a long-term investment horizon with all its investees. The HVI term loan with Entity C had a slightly shorter duration than term debt issued to other investees.
- HVI's actions in this case are somewhat inconsistent with historical behaviour. HVI has previously acted as both a creditor and a shareholder, but its agreement to accept shares to extinguish the term loan rather than undertaking other repayment (or collection) action would be the first of its kind for HVI.
- Concurrent with the negotiations with HVI for a shares-for-debt settlement, Entity C engaged a prospective new lead banker to undertake a comprehensive review of its debt portfolio. This review indicated that there is no evidence that the terms agreed to with HVI are off-market.
- HVI has expressed concern about Entity C's financial health but also considers the long-term potential of Entity C.

HVI's role is not readily categorized as solely that of a creditor or a shareholder because their history, involvement, and motivations reflect elements of both roles.

Facets that indicate acting in the capacity of a creditor include entering into debt-only lending relationships with other companies, and no evidence of arm's length terms that are more favourable. Facets that indicate acting in the capacity of a shareholder include participating in key decisions, engaging in strategic discussions, attending shareholder meetings, and voting.

The Group's Discussion

The Group agreed with the analysis of factors an entity might consider in determining whether a shareholder-creditor is acting in its capacity as a shareholder or creditor in a shares-for-debt transaction. The Group members noted that the analysis will involve judgment, and the factors discussed may not necessarily be found in the IFRS Accounting Standards. Rather, these factors may be useful considerations to help entities apply judgment in such situations.

Group members discussed the importance of understanding the economics of the transaction, such as how the negotiations are done and the entity's interactions with other shareholders and creditors. They also noted that the balance of factors is important (e.g., an insider-level ownership interest is not a bright line indicator), but that some factors may carry more weight than others. For example, several Group members commented that transacting at fair value as described in factor (h) would be a particularly strong indicator that a shareholder-creditor is acting in a creditor capacity. If that is known, they think other factors may be less relevant. One Group member also noted that fair value may not be known in some circumstances (e.g., in a cease trade scenario). In the absence of a precise fair value measure, judgment may be required, and it may become more important to consider other factors.

One Group member questioned the importance of factor (i), which suggests that participating in shareholder meetings and exercising voting rights could indicate a shareholder-creditor is acting in a shareholder capacity. For example, they thought if a shareholder-creditor is on the entity's board of directors and votes regularly, but there are not many items of significance to vote on, this may not indicate that the shareholder-creditor is acting in a shareholder capacity. Another Group member commented that judgment would need to be applied, including considering how the shareholder-creditor votes and exercises their rights and with what degree of influence.

A Group member commented that in assessing factor (g) on business rationale, they would consider the difference in value between the debt and shares. The magnitude and direction of this difference could help indicate the shareholder-creditor's intentions. The Group member thought this would become particularly important if the shares were categorized as a Level 1 fair value measurement in accordance with IFRS 13 *Fair Value Measurement*, as this would mean there is an active market for the shares. If there is an active market for the shares, it is more likely that the shareholder-creditor could immediately exit their equity position following the shares-for-debt transaction.

Group members also discussed incremental factors that an entity might consider, such as:

- *Extent and diversity of other creditors* – If the shareholder-creditor is the only party willing to lend, that could indicate they are acting in a shareholder capacity.
- *Magnitude of the debt* – A shareholder-creditor that holds significant debt may be compelled to act in ways that appear as if they are acting in a shareholder capacity. However, they may simply be trying to recover what little they can because recovering a small amount is better than recovering nothing.
- *Reasons for settling the debt through the issuance of equity instruments* – The transaction may be occurring for reasons other than financial difficulties of the entity, which could inform the assessment.
- *Nature of the equity instruments issued* – The equity instruments may not always be common shares. For example, they could be another type of share with different rights, which may be relevant to the assessment.

Group members also discussed the three fact patterns presented:

- On Fact Pattern 1, Group members generally thought that the shareholder-creditor was acting in a creditor capacity based on the facts presented. Nevertheless, one Group member noted that it is important to look at other factors, including the economics of the transaction and whether the shareholder-creditor's debt was extinguished at fair value. For example, they noted that the shareholder-creditor might have needed cash for their own purposes, and this transaction combined with the immediate sale of the shares to another party would have been an easy way to get that cash. The Group member noted that it may be relevant to look at any termination clauses that other creditors may have been subject to, and whether there would have been a discount if those creditors tried to cash in early.
- On Fact Pattern 2, Group members noted that it was unclear whether the shareholder-creditor was transacting at fair value. They thought this information was important to gather before making a conclusion.
- On Fact Pattern 3, some Group members thought the shareholder-creditor was acting in a creditor capacity. They noted that a strong indicator of this was that there was no evidence that the terms agreed to were off-market per the banker's review, meaning the transaction would have been at fair value. One Group member commented that the shareholder-creditor's 20 per cent equity interest, long-term investment and participation in board meetings may be indicators of acting in a shareholder capacity.

Issue 2: In situations when the shareholder-creditor is acting in its capacity as a shareholder, what is the accounting for equity instruments issued and for recognizing any resulting extinguishment differences?

Consideration paid in shares-for-debt transactions may consist of common shares only, or it may consist of equity units (common shares and common share purchase warrants).[1] Relevant considerations may be noted from discussions at the Group meeting on November 29, 2016, on the settlement of a shareholder loan. Circumstances where consideration is paid in the form of equity-classified units are illustrated below.

Fact Pattern

- A creditor has agreed to lend $5 million to Entity Y. The creditor is also a shareholder of Entity Y.
- Subsequently, Entity Y and the shareholder-creditor enter into another agreement to settle the entire loan with the issuance of equity-classified units of Entity Y. These consist of one common share and one common share purchase warrant exercisable for a period of two years.
- At the date of extinguishment:
    - The carrying amount of the loan is $3.5 million.
    - The fair value of the common shares at their quoted price is $3.5 million.
    - The fair value of the share purchase warrants using an option pricing model is $500,000.
    - There is no concurrent financing of units issued for cash proceeds.
- Entity Y has determined that the shareholder-creditor is acting in its capacity as a shareholder in the shares-for-debt transaction.
- Entity Y applies the guidance in paragraph 109 of IAS 1, where transactions with owners in their capacity as owners are equity transactions and are not recognized in profit or loss for the period.

View 2A – Entity Y measures the equity instruments issued at fair value, and the difference between the carrying amount of the financial liability and the fair value of the equity instruments is recognized in equity

Proponents of this view think:

- Entity Y would remove the financial liability at the carrying amount of $3.5 million from its statement of financial position when it is extinguished in accordance with paragraph 3.3.1 of IFRS 9.

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[1] For the purposes of this discussion, it is assumed that the common share purchase warrants are classified as equity in accordance with IAS 32 *Financial Instruments: Presentation*. If they were not, there may be additional considerations.

- The equity instruments issued would be measured at their fair value of $4 million.
- This would result in a difference of $500,000 between the carrying amount of the financial liability and the fair value of the consideration paid. This would be recognized in Entity Y's equity at the date of extinguishment.

View 2B – Entity Y measures the equity instruments issued at the carrying amount of the financial liability extinguished, resulting in no difference

Proponents of this view think that:

- The equity instruments issued would be measured at the carrying amount of the financial liability of $3.5 million.
- Entity Y would remove the financial liability at the carrying amount of $3.5 million from its statement of financial position when it is extinguished in accordance with paragraph 3.3.1 of IFRS 9.
- This would result in no difference.

View 2C – An accounting policy choice exists

Proponents of this view note that the IFRS Accounting Standards do not specially consider this transaction. They think the standards allow for judgment depending on the facts and circumstances, and thus that Entity Y has an accounting policy choice.

The Group's Discussion

Several Group members agreed with View 2C. Two Group members highlighted that the Basis for Conclusions on IFRIC 19 notes that the IFRS Accounting Standards do not contain specific guidance on the initial measurement of an entity's issued equity-classified instruments. As such, they think either View 2A or 2B would be possible.

One Group member agreed with View 2B. They thought it may not be appropriate to increase equity as in View 2A given the level of measurement uncertainty inherent in the valuation of share purchase warrants. The fair value of the shares may also not be observable in some situations (e.g., if the company is private).

Overall, the Group's discussion raised awareness of how an entity accounts for equity instruments in a shares-for-debt transaction, including factors an entity may consider in determining whether a shareholder-creditor is acting in a shareholder or creditor capacity in such a transaction. No further actions were recommended to the AcSB.