FASB Emerging Issues Task Force

Issue No. 09-1

Title: Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance

Document: Issue Summary No. 1, Supplement No. 1*

Date prepared: May 26, 2009

FASB Staff: Homant (ext. 359)/Malcolm (ext. 231)

EITF Liaison: Robert Uhl

Date previously discussed: March 19, 2009

Previously distributed EITF materials: Issue Summary No. 1, dated March 2, 2009

References:

FASB Statement No. 5, *Accounting for Contingencies* (Statement 5)

FASB Statement No. 123 (revised 2004), *Share-Based Payments* (Statement 123R)

FASB Statement No. 128, *Earnings per Share* (Statement 128)

FASB Statement No. 129, *Disclosure of Information about Capital Structure* (Statement 129)

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement 133)

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (Statement 150)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (Statement 154)

FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (Interpretation 39)

FASB Staff Position APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (FSP APB 14-1)

*** The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants* (Opinion 14)

EITF Issue No. 85-1, "Classifying Notes Received for Capital Stock" (Issue 85-1)

EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" (Issue 96-18)

EITF Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments" (Issue 96-19)

EITF Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios" (Issue 98-5)

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" (Issue 00-19)

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments (Issue 00-27)

EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" (Issue 07-5)

Background

1. At the March 19, 2009 EITF meeting, the Task Force reached consensuses-for-exposure on this Issue and directed the staff to pursue the issuance of a draft abstract for public comment. A draft abstract for this Issue was posted to the website on April 7, 2009, with a comment period that ended on May 5, 2009. No formal comment letters were received on the draft abstract, but several informal comments were received by the staff. At the June 18, 2009 EITF meeting, the Task Force will have the opportunity to consider those informal comments as it redeliberates the consensuses-for-exposure. The Task Force will then be asked whether it agrees with the staff recommendations for the proposed changes to the draft abstract and for the amendments to the FASB Accounting Standards Codification (the Codification), which are attached as Appendixes 09-1A and 09-1B, respectively, and whether it would like to affirm its consensuses-for-exposure (as amended) on this Issue as a final consensus.

Accounting Issues

Issue 1: Whether the Task Force agrees with the staff's proposed changes to the draft abstract as it relates to the measurement and recognition of an expense related to counterparty default.

2. The staff received one comment asking for clarification on the accounting required by an entity for which the loaned shares are not returned in accordance with the share lending arrangement, nor does the entity receive cash equal to the then fair value of the shares. The staff believes that the entity that issued the own-share lending arrangement should be required to recognize an expense equal to the fair value of the shares, net of any anticipated recoveries, on the date it is probable the shares will not be returned. Subsequent revisions of the estimated amount of the recoveries would be accounted for in accordance with Statement 5.

3. If the Task Force agrees with the staff's view, the draft abstract (paragraph 8) and the Amendments to the FASB Accounting Standards Codification (Section **470-20-35-22**), which are included as Appendixes 09-1A and 09-1B, will be amended as follows (added text is underscored):

Subsequent Measurement

If it becomes probable[1] that the counterparty to a share lending arrangement will default, the issuer of the share lending arrangement shall recognize an expense equal to the then fair value of the unreturned shares, net of the fair value of probable recoveries, with an offset to additional paid in capital. Subsequent revisions to the estimated amount of the recoveries should be accounted for in accordance with Statement 5.

Issue 2: Whether the Task Force agrees with the proposed changes to the draft abstract and to the Amendments to the FASB Accounting Standards Codification.

4. The staff received two comments asking for clarification of when the loaned shares should be included in the basic and diluted earnings per share. The draft abstract stated that the loaned shares are excluded from basic and diluted earnings per share unless default of the share lending arrangement occurs, at which time the loaned shares would be included in the common and diluted earnings-per-share calculation. The staff believes that the loaned shares should be included in the basic and diluted earnings per share when it is probable that the shares will not be returned. These comments have been reflected in the draft abstract and the Amendments to the FASB Accounting Standards Codification, which are included as Appendixes 09-1A and 09-1B.

5. The staff received one comment asking for clarification if the two-class method of computing earnings per share was required by the Issue. The staff believes that it is not necessary to provide earnings per share for the shares subject to the share-lending agreement. However, if the dividends on the loaned shares do *not* revert back to the entity, the staff believes that the amounts attributable to the shares subject to the share-lending arrangement should be deducted in computing income available to common shareholders. This is consistent with the treatment of a physically-settled forward contract pursuant to paragraph 25 of Statement 150, which notes that the treatment is consistent with the "two-class" method set forth in paragraph 61 of Statement 128. This comment has been reflected in the marked draft abstract and the Amendments to the FASB Accounting Standards Codification, which are included as Appendixes 09-1A and 091B.

[1] As defined in Statement 5.

6. The staff received one minor editorial comment regarding the referencing to specific other applicable literature. This comment has been reflected in the draft abstract and the Amendments to the FASB Accounting Standards Codification, which are included as Appendixes 09-1A and 09-1B, respectively.

Appendix 09-1A

EITF ABSTRACTS (DRAFT[*])

Issue No. 09-1

Title: Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance

Dates Discussed: March 19, 2009; ~~[~~June ~~17–~~18, 2009~~]~~

References: FASB Statement No. 128, *Earnings per Share*

FASB Statement No. 129, *Disclosure of Information about Capital Structure*

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

FASB Statement No. 154, *Accounting Changes and Error Corrections*

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"

EITF Issue No. 00-27, "Application of Issue No. 98-5 to Certain Convertible Instruments

EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock"

Objective

1. **The objective of this Issue is to clarify how an entity should account for an own-share lending arrangement that is entered into in contemplation of a convertible debt offering.**

All paragraphs in this Issue have equal authority. **Paragraphs in bold set out the main principles.**

[*] ~~**This draft abstract is being exposed for a public comment period that will end on May 5, 2009.**~~

Background

2. An entity for which the cost to an investment banking firm (investment bank) or third-party investors (investors) of borrowing its shares is prohibitive (for example, due to a lack of liquidity or extensive open short positions in the shares) may enter into share lending arrangements that are executed separately but in connection with a convertible debt offering. Although the convertible debt instrument is ultimately sold to investors, the share lending arrangement is an agreement between the entity (share lender) and an investment bank (share borrower) and is intended to facilitate the ability of the investors to hedge the conversion option in the entity's convertible debt.

3. The terms of a share lending arrangement require the entity to issue shares (loaned shares) to the investment bank in exchange for a nominal loan processing fee. Although the loaned shares are legally outstanding, the nominal loan processing fee is typically equal to the par value of the common stock, which is significantly less than the fair value of the loaned shares or the share lending arrangement. Generally, upon maturity or conversion of the convertible debt, the investment bank is required to return the loaned shares to the entity for no additional consideration.

4. Other terms of a share lending arrangement require the investment bank to reimburse the entity for any dividends paid on the loaned shares. Typically, the arrangement precludes the investment bank from voting on any matters submitted to a vote of the entity's shareholders to the extent the investment bank is the owner of the shares.

Scope

5. **This Issue applies to a share lending arrangement on an entity's own shares when executed in contemplation of a convertible debt offering or other financing.**

<u>**Glossary**</u>

<u>**Probable**</u>

<u>The future event or events are likely to occur.</u>

<u>Measurement</u>

6. **At the date of issuance, a share lending arrangement entered into on an entity's own shares in contemplation of a convertible debt offering or other financing is required to be measured at fair value and recognized as a debt issuance cost in the financial statements of the entity. The debt issuance cost is amortized under the effective interest method over the life of the financing arrangement as interest cost.**

7. The share lending arrangement should be considered in conjunction with other applicable generally accepted accounting principles ~~(for example, Statement 150 and Issue 00-19)~~ in determining the classification of the share lending arrangement in the financial statements of the entity.

<u>Subsequent Measurement</u>

8. <u>If it becomes **probable** that the counterparty to a share lending arrangement will default, the issuer of the share lending arrangement shall recognize an expense equal to the then fair value of the unreturned shares, net of the fair value of probable recoveries, with an offset to additional paid in capital.</u> Subsequent revisions to the estimated amount of the recoveries should be accounted for in accordance with Statement 5.

Other Presentation Matters

9. The loaned shares are excluded from basic and diluted earnings per share unless default of the share lending arrangement <u>is probable of occurring</u> ~~occurs~~, at which time the loaned shares would be included in the common and diluted earnings-per-share calculation.

10. <u>If dividends on the loaned shares do *not* revert back to the entity,</u> any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to the loaned shares shall be deducted in computing income available to common shareholders<u>, consistent with the "two-class method" of computing earnings-per-share set forth in paragraph 61 of Statement 128</u>.

Disclosure

11. The following disclosures are required by entities that enter into a share lending arrangement on their own shares in contemplation of a convertible debt offering or other financing. The

disclosures must be made on an annual basis in any period in which a share lending arrangement is outstanding.

> An entity is required to disclose (a) a description of any outstanding share lending arrangements on an entity's own stock and all significant terms of the share lending arrangement including the number of shares, the term, the circumstances under which cash settlement would be required, and any requirements for the counterparty to provide collateral, (b) the entity's reason for entering into the share lending arrangement, (c) the fair value of the outstanding loaned shares as of the balance sheet date, (d) the treatment of the share lending arrangement for the purposes of calculating earnings per share, (e) the unamortized amount and classification of the debt issuance costs associated with the share lending arrangement at the balance sheet date, and (f) the amount of interest cost recognized relating to the amortization of the debt issuance cost associated with the share lending arrangement for the reporting period.

12. Disclosures required by Statement 129 are applicable to entities that enter into a share lending arrangement on their own shares in contemplation of a convertible debt offering or other financing.

Transition

13. This Issue is effective for fiscal years beginning on or after December 15, 2009, and interim periods within those fiscal years. Early adoption is not permitted. This Issue requires retrospective application for all arrangements outstanding as of the beginning of the fiscal year in which this Issue is initially applied.

14. The transition disclosures in paragraphs 17 and 18 of Statement 154 shall be provided.

The provisions of this Issue need not be applied to immaterial items.

Appendix 09-1B

AMENDMENTS TO THE *FASB ACCOUNTING STANDARDS CODIFICATION*™

Introduction

A1. This appendix outlines how this proposed Issue would affect the FASB Accounting Standards Codification™.

A2. This proposed Issue would amend and add additional guidance to Subtopic 470-20, Debt – Debt with Conversion and Other Options.

Amendments to the Codification

~~[Added text is underlined and deleted text is struck out.]~~

A3. Amend paragraph **470-20-05-1**, with a link to transition paragraph 470-20-65-3, as follows:

470-20-05-1 This Subtopic provides accounting and reporting guidance for debt (and certain preferred stock) with specific conversion features and other options as follows:

a. Debt instruments with detachable warrants
b. Convertible securities—general
c. Beneficial conversion features
d. Interest forfeiture
e. Induced conversions
f. Conversion upon issuer's exercise of call option
g. Convertible instruments issued to nonemployees for goods and services~~services.~~
h. Own-share lending arrangement issued in contemplation of convertible debt issuance.

A4. Add paragraphs **470-20-05-14~~3~~ through 05-16~~5~~** and preceding heading, with a link to transition paragraph 470-20-65-3~~1~~, as follows:

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

470-20-05-14~~3~~ An entity for which the cost to an investment banking firm (investment bank) or third-party investors (investors) of borrowing its shares is prohibitive (for example, due to a lack of liquidity or extensive open short positions in the shares) may enter into share-lending arrangements that are executed separately but in connection with a convertible debt offering. Although the convertible debt instrument is ultimately sold to investors, the share-lending arrangement is an agreement between the entity (share lender) and an investment bank (share borrower) and is intended to facilitate the ability of the investors to hedge the conversion option in the entity's convertible debt.

470-20-05-15~~4~~ The terms of a share-lending arrangement require the entity to issue shares (loaned shares) to the investment bank in exchange for a nominal loan processing fee. Although the loaned shares are legally outstanding, the nominal loan processing fee is typically equal to the par value of the common stock, which is significantly less than the fair value of the loaned shares or the share-lending arrangement. Generally, upon maturity or conversion of the convertible debt, the investment bank is required to return the loaned shares to the entity for no additional consideration.

470-20-05-16~~5~~ Other terms of a share-lending arrangement require the investment bank to reimburse the entity for any dividends paid on the loaned shares. Typically, the arrangement precludes the investment bank from voting on any matters submitted to a vote of the entity's shareholders to the extent the investment bank is the owner of the shares.

A5. Amend paragraph **470-20-15-2**, with a link to transition paragraph 470-20-65-~~1~~3, as follows:

> Transactions

470-20-15-2 The guidance in this Subtopic applies to all debt instruments. The guidance on beneficial conversion features and conversion features that reset applies also to convertible preferred stock. The guidance in the General Subsections does not apply to those instruments within the scope of the Cash Conversion Subsections. The guidance on own-share lending arrangements applies to a share-lending arrangement on an entity's own shares when executed in contemplation of a convertible debt offering or other financing.

A6. Insert the following Master Glossary term in Section **470-20-20**, with a link to transition paragraph 470-20-65-3, as follows:

Probable

The future event or events are likely to occur.

A7. Amend paragraph **470-20-25-1**, with a link to transition paragraph 470-20-65-3, as *follows*:

> Overall

25-1 The guidance in this Section shall be considered after consideration of the guidance in the Fair Value Options Subsections of Subtopic 825-10 and the guidance in Subtopic 815-15 on bifurcation of embedded derivatives, as applicable. The guidance in this Section is organized as follows:

a. Debt instruments with detachable warrants

b. Beneficial conversion features

c. Conversion features that reset

d. Conversion features that are not beneficial

e. Convertible instruments issued to nonemployees for goods and services

f. Own-share lending arrangements issued in contemplation of convertible debt issuance.

A8~~6~~. Add paragraphs **470-20-25-21 and 25-22** and preceding heading, with a link to transition paragraph 470-20-65-~~1~~3, as follows:

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

470-20-25-21 At the date of issuance, a share-lending arrangement entered into on an entity's own shares in contemplation of a convertible debt offering or other financing is required to be measured at fair value (in accordance with Topic 820) and recognized as a debt issuance cost (in accordance with paragraph 835-30-45-3) in the financial statements of the entity.

470-20-25-22 The share-lending arrangement should be considered in conjunction with the guidance in Subtopic 815-40 and Topic 505 ~~other applicable generally accepted accounting principles (for example Topic 480)~~in determining the classification of the share-lending arrangement in the financial statements of the entity.

A9~~7~~. Add paragraph **470-20-30-~~27~~32** and preceding heading, with a link to transition paragraph 470-20-65-~~1~~3, as follows:

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

470-20-30-27 At the date of issuance, a share-lending arrangement entered into on an entity's own shares in contemplation of a convertible debt offering or other financing is required to be measured at fair value in accordance with Topic 820.

A10~~8~~. Add paragraph **470-20-35-21 and 35-22** and preceding heading, with a link to transition paragraph 470-20-65-3~~1~~, as follows:

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

470-20-35-21 The debt issuance cost associated with a share-lending arrangement shall be amortized under the effective interest method over the life of the financing arrangement as interest cost.

470-20-35-22 If it becomes **probable** that the counterparty to a share lending arrangement will default, the issuer of the share lending arrangement shall recognize an expense equal to the then fair value of the unreturned shares, net of the fair value of probable recoveries, with an offset to additional paid in capital. Subsequent revisions to the estimated amount of the recoveries should be accounted for in accordance with Subtopic 450-20.

A11~~9~~. Add paragraph **470-20-45-4~~3~~** and preceding heading, with a link to transition paragraph 470-20-65-3~~1~~, as follows:

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

470-20-45-4~~3~~ The loaned shares are excluded from the basic and diluted earnings per share unless default of the share-lending arrangement ~~occurs~~is probable of occurring, at which time the loaned shares would be included in the common and diluted earnings-per-share calculation. If dividends on the loaned shares do *not* revert back to the entity ~~A~~any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to the loaned shares shall be deducted in computing income available to common shareholders, consistent with the "two-class" method set forth in paragraph 260-10-45-60B.

A12~~0~~. Add paragraphs **470-20-50-7~~3~~ and 50-8~~4~~** and preceding heading, with a link to transition paragraph 470-20-65-3~~1~~, as follows:

> Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance

470-20-50-7~~3~~ The following disclosures are required by entities that enter into a share-lending arrangement on their own shares in contemplation of a convertible debt offering or other financing. The disclosures must be made on an annual basis in any period in which a share-lending arrangement is outstanding.

a. A description of any outstanding share-lending arrangements on an entity's own stock and all significant terms of the share-lending arrangement including the number of shares, the term, the circumstances under which cash settlement would be required, and any requirements for the counterparty to provide collateral

b. The entity's reason for entering into the share-lending arrangement

c. The fair value of the outstanding loaned shares as of the balance sheet date

d. The treatment of the share-lending arrangement for the purposes of calculating earnings per share

e. The unamortized amount and classification of the debt issuance costs associated with the share-lending arrangement at the balance sheet date

f. The amount of interest cost recognized relating to the amortization of the debt issuance cost associated with the share-lending arrangement for the reporting period.

470-20-50-84 Disclosures required by Topic 505 are applicable to entities that enter into a share-lending arrangement on their own shares in contemplation of a convertible debt offering or other financing.

A13~~1~~. Add paragraph **470-20-65-3~~1~~** and preceding heading, as follows:

> Transition and Effective Date Related to EITF Issue No. 09-1, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance"

470-20-65-3~~1~~ The following represents the transition and effective date information related to EITF Issue No. 09-1, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance."

a. The pending content that links to this paragraph is effective for fiscal years beginning on or after December 15, 2009, and interim periods within those fiscal years.

b. Early adoption is not permitted.

c. In the fiscal year that this pending content is initially applied, retrospective application for all arrangements outstanding as of the beginning of the fiscal year is required.

d. The transition disclosures required in paragraphs 250-10-50-1 through 50-3 shall be provided.