

Financial Accounting Standards Board
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Dear FASB Board Members:

Thank you for tackling the project of simplifying areas of accounting. As both an issuer and user of financial statements for public and private companies, it is encouraging to see glimmers of hope to cut through the fog of frustration created by unnecessarily complex requirements in certain areas of accounting. I applaud this effort and am grateful for the strides already taken in areas like streamlining the accounting for extraordinary items, unified treatment of debt issuance costs as a debt discount, and other guidance that is emerging.

I've had the misfortune of living through other areas of accounting that are unnecessarily complex, often counter-intuitive, and where simplification would greatly benefit users and issuers of financial statements. I've outlined some areas below where I believe simplifications could be made relatively easily, and whose changes would make meaningful strides forward in providing users financial information that is more comprehensible, and allow issuers to focus on providing the right information that is important to financial statement users. Thank you for your consideration of these thoughts.

1. Mezzanine treatment of certain preferred stock transactions

Problem: Preferred stock is often issued with liquidation rights that may require a company to repay the investment in the event of a merger or acquisition ahead of common stockholders. Additionally, these preferred stockholders generally have voting rights, which causes an acquisition to not be entirely under the control of the company. This results in exclusion of the preferred stock from stockholders' equity, and instead classified between equity and liabilities (mezzanine). The exclusion from equity causes users of the financial statements to wonder why the company shows negative total stockholders' equity when the shareholders have put in capital. The concept of "permanent equity" does not outweigh the confusion mezzanine treatment creates. This by itself is a minor nuisance, but it has far reaching impacts which will be discussed later.

Solution: A suggestion to improve this is to include such preferred stock within equity until such time as it is "probable" that repayment will take place under the liquidation preference provisions. At that time, the company would reclass the equity into a liability equal to the amount the company expects to repay (the liquidation preference amount). If the liquidation preference is greater than the amount of equity contributed (like a 2x liquidation preference), then the company has incurred a cost of doing business and a loss should be recorded. But until then, the intent of the preferred stock investment is a capital investment in the company and should be classified as stockholders' equity. Presentation as something else is confusing. The accounting rule that equity must be "permanent" is not helpful. Instead, capturing what is probable each reporting period leads to better information for the users. If it's

probable the preferred stock is going to remain invested in the company, then it's equity. If it's probable the preferred stock is going to be repaid, then it's a liability. Footnotes can capture the nuances of ownership rights and liquidation preferences effectively. The gain or loss associated with a reclassification between equity and liability could be a line item in the income statement, or be charged through other comprehensive income.

2. Warrants in Preferred Stock

Problem: The mezzanine discussion above is a perfect segue to a very unnecessarily complex area of accounting surrounding preferred stock warrants. The preferred stock discussed above is treated as mezzanine, but a warrant in that preferred stock is treated as a liability – regardless of how remote the chances are that cash repayment will occur on these warrants. That already causes a lot of confusion, but what's worse is that the warrant liability is then re-measured to fair value each reporting period, which often leads to dramatic, meaningless, and counter-intuitive swings in the company's income statement. As an issuer of financial statements, this is a huge time consuming effort and it's costly. Then after going through all that cost and effort, the users of the financial statements (even sophisticated users) are confused by it, often leading the company to provide non-GAAP measures to back out these charges so the users can see the "real" performance of the company. Compounding that frustration, the fair value is determined based on highly subjective assumptions which are a nightmare for the company and the auditor, and the PCAOB's playground when reviewed with hindsight.

Current warrant liability accounting creates a situation where a company's decrease in value leads to a reduction in the warrant liability, which creates negative expense (a gain). At the extreme, this could cause a faltering company to show net income in its worse period! No wonder users are so frustrated with the current state of accounting – the company's best income statement is in the period it is about to go bankrupt. This is as counter-intuitive as it can possibly get. Please consider this proposed solution to fix this huge problem.

Solution: Accounting should align the economics of the transaction with the financial statement reporting. At issuance, the warrants are most likely expected to be exercised into shares of preferred stock, which means such warrants are equity (or mezzanine if not convinced to get rid of such a category). They do not fall under liability treatment under FAS 5, or any other conventional definition of a liability. Warrants are not liabilities until a fact pattern emerges which make cash settlement probable. At that time, the warrants are moved out of equity and into liabilities. The liability would be recorded at their fair value at that time, which incidentally is not a Black-Scholes or similar estimate, but rather the intrinsic value of the warrant (the difference between the expected cash outlay and the exercise proceeds) since these factors would likely be known at the time of liability reclassification. A gain or loss would be recorded in the period the warrant changes classification.

The core to this simplification is that if the instrument is likely to lead to ownership in the company, then it is equity. If the instrument is likely to result in cash repayment, then it's a liability. Also, the instruments must be allowed to move out of equity and into liabilities when and if facts and circumstances make it appropriate. Remeasurement of the value of the instrument occurs at that time since the facts and circumstances around it have changed.

This proposed treatment follows the economics of the transactions and financial statement users will understand the financial statements to a much greater extent. Footnotes and the management's discussion and analysis (MD&A) can have a much more meaningful discussion around the financial results for the period since they will coincide with the company's events and the economics behind what

is driving the financial statement line items. This would be a huge improvement over the current endless pages of footnotes and discussion in the MD&A about meaningless fair value assumptions that are too complex for almost all financial users to understand or care about, and why they are driving earnings volatility that should be ignored when considering the performance of the company.

Example of proposed accounting:

Year 1 – issue preferred stock and warrants. The proceeds are split between the preferred shares and the warrants based on their relative fair values (Black-Scholes or similar for the warrants). Both amounts are included in equity at the time of issuance, assuming both are expected to result in issuance of shares (ownership) of the company and not cash repayment. No remeasurement in values occurs until a change in circumstances make it appropriate to do so.

Year 5 – it becomes probable that the company is going to be acquired. The preferred stock and warrant will either take advantage of liquidation preferences and be redeemed for cash, or they will participate *pari passu* on an *as-if* converted to common basis. If *pari passu* then there are no accounting implications since they participate just like any other shareholder and therefore should remain in equity. If cash payment under liquidation preferences is probable though, the equity associated with the preferred stock and / or the warrants is moved to a liability at their new fair value. This new fair value is the difference between the equity value on the balance sheet (from the time of original issuance in year 1), and the amount the company expects to pay out, net of any exercise proceeds in the case of the warrants. A gain or loss will result and should be remeasured each reporting period thereafter to capture changes in acquisition value assumptions. Present value concepts could be incorporated in the liability value if the time to M&A is expected to be significant.

This accounting follows the economics of the transaction, it is intuitive, and it leads to meaningful discussions in the footnotes and MD&A about the company's economic position and future plans.

3. Debt issued with features (like conversion rights or warrants)

Problem: The accounting guidance around debt (i.e. financing transactions in general) is immense and complex. That is understandable given the creativity bankers have in coming up with financial instruments, which is all the more reason that the accounting response must be anchored in core concepts as opposed to a myriad of complex decision trees loaded with pitfalls and qualifiers. Accounting literature today considers if the features are detachable, embedded, indexed to its own stock, redeemable, convertible, a derivative... with each one leading down a path surrounded by accounting complexities. Issuers struggle to get this right and users can't figure out what's going on with all the pollution surrounding the accounting. The accounting for each of these qualifiers is rooted in a thread of logic, but it seems to be looking at the trees and needs to get back to a view of the forest so users can understand how the financial statements relate to the economics of the transaction.

Solution: At the core, these features are bundled to debt because the company can get a better interest rate (i.e. cash savings) compared to if the debt were issued as a simple note without the features. The accounting should reflect the value attributed to the stand alone debt instrument, and the value attributed to the other features. A company can almost always reasonably determine what the interest rate would be if a simple note were issued as opposed to a debt instrument with features. Discounting the instrument's cash amortization repayment using the interest rate applicable to a simple note results in the debt value. This will create a debt discount which is amortized to interest expense using the effective interest method. The result is the interest cost reflected on the income statement appropriately captures the stand alone debt instrument's cost to the company.

The other side of the debt discount (the credit) is either a liability or equity depending on the nature of the feature being issued with the debt. If it's a warrant or some other right that is expected to convert into shares or ownership of the company, then that is reflected in equity (with the ability to be moved to liability as already discussed earlier). If it's some sort of instrument that is likely to ultimately be repaid in cash, then it is a liability (to be recorded at the present value of the cash repayment amount and amortized to interest over its maturity value).

What is proposed here is not all that different from much of the current accounting guidance, other than it eliminates the many variations and nuances that can arise in applying current accounting literature. The core concept of recording the instruments as equity or a liability based on their expected outcome, and the ability to move between equity and liability as those expectations change, allow the simplification proposed here.

Example of proposed accounting: A company receives \$100 million in exchange for a note payable that is bundled with preferred stock warrants. The note has an 8% interest rate and is repayable over 5 years (amortization schedule is \$25 million per year). Without the warrants, the note would have had an interest rate of 15%.

The present value of the \$25 million per year amortization repayment schedule at the 15% simple note interest rate is \$84 million. The \$84 million is recorded on the balance sheet as debt, leading to a debt discount of \$16 million, which is the value of the warrants issued with the debt. Assuming the company is not currently entertaining a transaction that would likely cause cash repayment of the warrants, the \$16 million is classified as equity. If conditions later make the warrants likely to become cash settled, then the warrant would be remeasured to fair value and classified as a liability as discussed earlier. The debt discount is amortized to interest expense over the term of the note using the effective interest method, causing the income statement to reflect interest expense in an amount equal to the cost of the debt had it been a simple note.

This accounting follows the economics of the transaction by properly presenting the cost of the debt component and the value of the attached instruments (and classified appropriately based on their characteristics).

4. Leases in a build-to-suit situation

Problem: Under current accounting guidance, if a tenant leases a building, and has input into functional features during its retrofit, then the tenant is deemed to own the building and must put it on its balance sheet as an asset and liability at fair value. How the thin thread of accounting logic that leads to this conclusion became the guidance for accounting for these transactions is baffling at best. There's not a landlord around that would agree that a tenant has the rights and ownership of their building because they have input into some design features. An auditor I was talking to about this stated that she once saw the same building on twelve different balance sheets. What a great example of accounting that is completely confusing, counter-intuitive to the economics of the transaction, and frustrating. It's downright embarrassing to the profession when trying to explain and justify this type of accounting to an audit committee.

Solution: The ongoing lease accounting project will fix this, along with the other problem of inconsistent treatment of leases in general (some on the balance sheet, some off the balance sheet). I applaud the fix that is in the works, and ask to please keep the final version of this new accounting guidance simple.

If it's not simple such that users of the financial statements can understand it, it will merely be one more item that adds to the mess. Every new piece of guidance has the opportunity to improve accounting, or create additional confusion and frustration by users and issuers alike.

The lease liability should go on the balance sheet at the present value of the committed minimum lease payments. The debit goes to the asset being leased. Lease payments go to a reduction in the lease liability and interest expense. The asset is amortized over the lease period to operating expense. If there are additional lease payments (such as contingent lease payments) which create a difference from the committed minimum lease payments that the liability was recorded at, then those are charged as incurred to operating expense. Perhaps one nuance would be leases that have a large amount of their economics tied to contingent payments would be recorded at the amount deemed probable, with changes running through operating expense as incurred.

I see very little reason to make leases any more complex than this. This accounting follows the economics of the transaction, it is understandable for the financial statement users, and it should not create undue burden for the issuers. (Lessor accounting is a different topic – and one that does not impact that many users or issuers).

Final thoughts

The accounting profession is in desperate need of getting back to a place of providing solid, useful financial information that appropriately reflect the economics of transactions and the financial position of the company. Unfortunately, the profession has drifted into a place where issuers are spending their time figuring out amounts and disclosures that are so complex that they are meaningless to the users who struggle to understand what they are reading.

The SEC has long been asking companies to improve disclosures to allow users of financial statements to view the economics of transactions and the financial position of the company through the eyes of management. Providing introductions and executive summaries are nice, but unless the fundamental concepts behind the accounting is effective, such summaries can only have a minimal impact. The simplifications put forth in this memo align the accounting with the economics of the transactions, and improve the quality and relevance of the financial information for the users.

The accounting simplification project the FASB has embarked upon is a fantastic opportunity to improve the accounting profession. I welcome the opportunity to discuss any of these ideas in more detail, or assist in any way I can to advance our profession to a better place.

Thank you for your time and consideration of these ideas –



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