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February 6, 2017

Via email to director@fasb.org

Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
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Re: Distinguishing Liabilities from Equity (Topic 480): I. Accounting for Certain Financial Instruments with Down Round Features; II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with Scope Exception (File Reference No. 2016-370)

Dear Ms. Cosper:

We are pleased to provide comments on the Board's proposal to amend the accounting for certain financial instruments with down round features. We believe the amendments will reduce the current reporting burden and income statement volatility resulting from down round features that are commonly included in certain financial instruments issued to raise capital.

As expressed in our recent letter to the Board regarding its future technical agenda,[1] we also believe a new, cohesive accounting framework for debt and equity is needed to resolve the challenges of navigating today's patchwork of individual (and often conflicting) standards. Such a project will likely take years to complete. In that context, we support this narrow amendment as an interim measure and continue to encourage the Board to overhaul the debt and equity guidance in a separate project. We note the Board commonly uses a phased approach in standard setting and see no reason why a short-term and long-term project can't be pursued in tandem.

However, we believe the scope of the proposal as it relates to liability-classified instruments should be clarified in the final amendments. Currently, down round features embedded in convertible debt or convertible preferred stock are within the scope of the guidance on beneficial conversion features when other GAAP does not apply, such as when a conversion feature is not bifurcated. This is consistent with the Board's observations in the basis for conclusions. Further, freestanding instruments that are not within the scope of ASC 480 and that do not meet the definition of a derivative, but which are classified as liabilities for other reasons are carried at fair value through earnings each period. Consequently, it is not clear which, if any, liability-classified instruments will actually be within the scope of the final amendments. Rather, the proposed guidance for recognizing the effect of a down round feature when it is triggered appears primarily intended for freestanding equity-classified instruments, such as warrants. If so, it appears unnecessary for the

[1] Refer to our comment letter dated October 17, 2016 related to File Reference No. 2016-290, Agenda Consultation.

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Board to finalize the proposed guidance for liabilities in the ED. Nevertheless, if it is finalized, the final ASU should clarify which liabilities are within scope, perhaps with an implementation example.

We elaborate on this point and several other aspects of the ED in our responses to the Board's specific questions in the Appendix to this letter.

Separately, we agree with the proposal to provide a scope exception instead of an indefinite deferral for certain mandatorily redeemable financial instruments and noncontrolling interests. This will make the Codification more legible and user-friendly.

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We would be pleased to discuss our comments with the FASB staff. Please direct questions to Adam Brown at (214) 665-0673 or Gautam Goswami at (312) 616-4631.

Very truly yours,

BDO USA, LLP

Appendix

Question 1: Do you agree that when classifying certain financial instruments with down round features, the down round feature should be excluded from the assessment of whether an instrument is indexed to an entity's own stock (in accordance with the guidance in Subtopic 815-40)? If not, please explain why and suggest alternatives.

We agree with the proposal to exclude a down round feature from the indexation assessment of certain financial instruments. This approach provides a practical solution to the reporting complexities and potential income statement volatility associated with such instruments.

We believe that the lack of a cohesive accounting framework contributes significantly to the challenges that preparers and auditors face using today's patchwork of individual standards. Indeed, errors related to accounting for debt and equity have been the single most frequent cause of restatements for the past decade, according to a recent study by Audit Analytics.[2] Therefore, while we support the proposal, we note it comes at a cost. Creating a new Subtopic 480-20 adds another layer of navigation and accounting complexity to an already complex analysis, which the Board acknowledged in BC22.[3] As indicated in our cover letter, this interim step does not alleviate the need for a broader project.

Paragraph BC18 indicates a primary reason for the proposal is that current guidance requires an instrument with a down round feature to be carried at fair value, even though an increase in share price will not cause that feature to be triggered. We observe that similar arguments may apply to other situations in which a contractual feature that never operates in practice nevertheless requires the instrument to be carried at fair value through earnings each period. For instance, warrants may fall within the scope of ASC 480-10 or embedded features may be accounted for separately under ASC 815 due to the remote potential of cash settlement, for instance because the reporting entity lacks a sufficient number of authorized shares to settle the contract, despite the fact that actual cash settlement rarely occurs. Scenarios of this nature—remote or uneconomic outcomes and presumptions that determine the accounting—reinforce the necessity for a comprehensive framework for debt and equity.[4]

Lastly, we recommend revising the proposed definition of a "Down Round Feature" to include a formula-driven adjustment in an equity-linked instrument that simultaneously reduces the strike price and increases the number of shares to be issued. The language in BC26 should be incorporated in the final definition, as follows:

> **Down Round Feature** A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the current strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the current strike price of the issued financial instrument. <u>A down round feature may reduce the strike</u>

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[2] *2015 Financial Restatements, a Fifteen Year Comparison* issued April 2016.

[3] "The Board acknowledges that integrating a separate model for financial instruments with down round features with existing guidance on equity-linked financial instruments potentially increases complexity in navigating and applying GAAP in this area."

[4] In the short term, they may also represent other areas for targeted improvements, similar to this proposal.

> price of a warrant or option to the current issuance price, with the amount of the reduction limited by a floor, or the down round feature may reduce the strike price of a warrant or option on the basis of a formula that considers a ratio of shares outstanding before and after an issuance, resulting in a price that is at a discount to the original exercise price but above the new issuance price of the shares. A **standard antidilution provision** is not considered a down round feature.

This clarification is important for two reasons. First, it acknowledges that the population of down round features is broader than those that merely reduce an instrument's strike price to the reporting entity's most recently issued instruments, e.g., reducing a strike price from $10 to $8. That is, it includes more sophisticated down round adjustments effected through a formula, which are common in practice. Second, it also confirms that an increase in the number of shares does not necessarily result in the feature being considered a "standard antidilution provision" which is excluded from the scope of the ED. Without the edits we propose, the only element of the proposed definition that contemplates a change in the number of shares would be in the reference to standard antidilution provisions. If the proposed definition isn't clarified, some constituents may interpret it to mean that any adjustment designed to maintain an instrument's value other than a simple reduction of the strike price (e.g., from $10 to $8) is not eligible for the relief that this ED is intended to provide. That unintended outcome could maintain much of the income statement volatility that exists today.

We also note that a standard antidilution provision is defined to be an equity restructuring event, which is a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend. As such, it is unclear whether two of the triggering events in Example 17 of paragraph 815-40-55-42 (an indexation example) are affected by the amendments. Paragraph 55-42(a) and (b) contain items that would fall within the definition of an equity restructuring event, i.e., nonreciprocal stock dividends, stock splits, etc. However, items (c) and (d) in paragraph 55-42 refer to issuances and repurchases of stock at off-market prices. They represent two-way transactions (a transfer of shares in exchange for cash with a counterparty) but the off-market pricing might be construed as a "nonreciprocal" element in an otherwise reciprocal transaction. Therefore, we suggest confirming in the final amendments that the feature in Example 17 is considered to represent an antidilution provision, which is excluded from the ED, assuming that is the Board's intent.

Question 2: Do you agree that for certain financial instruments with down round features, the effect of the down round feature should be recognized when it is triggered and that the approach for recognition should follow the classification (liability or equity) of the instrument? If not, please explain why and suggest alternatives.

We agree with recognizing the effect of a down round feature when it is triggered. However, we recommend revising or deleting the following discussion in the basis for conclusions.

BC27 states "Under current GAAP, some instruments with down round features are not required to be measured at fair value because those instruments do not meet the definition of a derivative (for example, a private-company warrant that is gross share settled). As a result, down round features in certain financial instruments that had no accounting effect previously would be required to be recognized and measured when the down round feature is triggered under the proposed model."

Under current GAAP, we note the scope of the indexation guidance in ASC 815-40 is not limited to instruments that meet the definition of a derivative. Specifically, paragraph 815-40-15-1 states freestanding financial instruments that are not derivatives are within the scope of the indexation guidance. If a physically-settled warrant issued by a private company is not indexed to the company's stock because of its down round feature, equity classification is precluded and the instrument would be accounted for as liability (815-40-15-8A). Although that indexation guidance does not specify a subsequent measurement attribute, practice has evolved to measure those instruments at fair value through earnings.[5] We suggest that the Board correct or delete the statement in BC27 to avoid unintended consequences. Further, the Board may wish to clarify the subsequent measurement guidance for instruments that are not indexed to the company's stock under ASC 815-40-15. In this context, we note the subsequent measurement guidance in ASC 815-40-35-4 only addresses contracts classified as liabilities under ASC 815-40-25. This could be addressed through a modest amendment to paragraph 35-4, as follows: "All contracts classified as assets or liabilities under <u>Section 815-40-15 or</u> Section 815-40-25 shall be measured subsequently at fair value…."

Question 3: The proposed amendments in paragraphs 480-20-30-1 through 30-2 describe how to measure the effect of the down round trigger. Do you agree with that approach? If not, please explain why and suggest alternatives.

If an instrument with a down round feature is not required to be carried at fair value through earnings each period, we believe that an intrinsic value measurement at the date of the triggering event for equity-classified instruments more clearly depicts the price protection an investor obtains at that time.

Nevertheless, if the Board adopts the "before and after" measurement approach in the ED, we believe it would be operational for the instruments to which it will apply, such as equity-classified warrants (see our comments regarding liabilities). We recommend describing the measurement approach as "fair value-based"[6] rather than a true fair value under ASC 820 in paragraph 480-20-30-2. This is because the down round feature is not contemplated in the fair value of the hypothetical financial instruments used to measure the effect of the adjustment. That is, the fair value measurement doesn't actually reflect a key attribute of the instrument in question. This is supported by paragraph BC44, in which the Board observed that the disclosure requirements in Topic 820 would not apply to the down round feature because the value of the effect of that feature is determined on the basis of the fair values of other instruments. We suggest elevating this basis to the main amendments.

As proposed, paragraphs 480-20-25-3 and 480-20-35-3 provide that an entity should debit earnings and credit the liability for the effect of a down round feature when triggered. An entity would subsequently amortize any down round-related adjustment of a liability-classified instrument using the effective interest method. While we agree with the logic if the instrument is ultimately redeemed because that would bring the liability to par, we question whether it reflects the economics if the instrument is converted or exercised into equity. The proposed accounting would reverse a portion of the initial measurement of the down round feature that has been amortized to

[5] This is consistent with the SEC staff's longstanding view on written options (e.g., as expressed in EITF 08-8).
[6] Topic 718 makes a similar distinction between ASC 820 and the "fair value-based" approach that applies to share-based payments (see 718-10-30-3).

the date of conversion/exercise of the instrument. For instance, if the instrument is converted or exercised into the underlying shares at maturity, the entire incremental value of a down round related adjustment would have been reversed through the amortization process. Alternatively, we recommend recognizing the credit associated with the down round entry in equity, with no subsequent impact on the future accretion of the liability.

Our comments in the preceding paragraph assume there are liability-classified instruments that will fall within the scope of the proposed guidance. However, as indicated in our cover letter, it is unclear which liability-classified instruments are within the scope of the proposal. We believe current GAAP will capture substantially all liability-classified instruments, leaving virtually none that will fall within the scope of this guidance.

Specifically, down round features embedded in convertible instruments would be within the scope of the BCF literature in ASC 470-20,[7] consistent with the Board's observations in BC14 and BC31. This is true regardless of whether the triggering event is an IPO or other financing. Further, freestanding instruments that are not within the scope of ASC 480 and that do not meet the definition of a derivative, but which are classified as liabilities for other reasons are carried at fair value through earnings (see comments above re: the subsequent measurement guidance in ASC 815-40). As such, the measurement guidance proposed in paragraph 480-20-30-1 appears to be primarily intended for freestanding equity-classified instruments, such as warrants. We believe this should be clarified in the final amendments. Consequently, it does not appear necessary for the Board to finalize the proposed guidance for liabilities in the ED. Nevertheless, if the Board issues final guidance for liabilities, it should clarify which liabilities are within scope, with an implementation example.

We observe that paragraph 480-20-25-3 specifies that retained earnings be reduced when a down round is triggered for an equity classified instrument. Considering that some entities may be in a deficit position, we instead recommend that the amendments indicate that the measurement be recognized similar to a deemed dividend.

Finally, we note there is currently no guidance for equity-classified warrant modifications in the Codification. We believe the measurement guidance proposed in paragraph 480-20-30-1 would be a reasonable analogy, and therefore do not understand why the Board proposes to prohibit this in in BC36, which states "The Board observed that it would not be appropriate to analogize to the measurement method in this proposed Update to instruments with features other than down round features within the scope of this proposed Update." Entities often account for the effect of a warrant modification by comparing the "pre-and post-modification" fair values based on an analogy to the literature for employee stock options. Since it would be difficult to distinguish whether pre- and post- modification analysis is based on an analogy to the ED or the stock compensation literature, it could result in an inadvertent change to current practice, potentially resulting in no accounting by some entities for warrant modifications even though incremental value may be provided to an investor. For these reasons, we recommend deleting the prohibition in BC36.

Question 4: Do you agree that for certain financial instruments with down round features that have been triggered during the reporting period, an entity should disclose the fact that the feature has been triggered, the value of the effect of the down round being triggered, and the

[7] For convertible instruments, we recommend coordinating with the SEC staff to clarify whether and how the final ASU interacts with the guidance for mezzanine instruments in ASC 480-10-S99.

financial statement line item in which that effect has been recorded? If not, please explain why and suggest alternatives.

We agree with the proposed disclosures.

Question 5: Do you agree that entities should apply the proposed guidance to outstanding instruments as of the effective date of the change, with no adjustments to prior periods presented, with the cumulative effect of the change recognized as an adjustment of the opening balance of retained earnings in the fiscal year or interim period of adoption? If not, please explain why and suggest alternatives.

We agree with the proposed transition approach. Additionally, we would not object if practitioners are provided an option to use a full retrospective approach. Applying a full retrospective approach to instruments outstanding as of the adoption date would not necessarily add significant cost and effort compared to the cumulative effect approach, although it would enhance consistency among periods. We note that the incremental transition disclosures in Topic 250 applicable to a retrospective method of adoption would mitigate concerns regarding the comparability of entities that use different transition methods.

Question 6: How much time would be necessary to adopt the amendments in this proposed Update? Should early adoption be permitted? Would the amount of time needed to apply the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities?

We recommend an adoption date that is no earlier than fiscal years beginning after December 15, 2019 for public business entities, given the pending transition to the new revenue standard and transition complexities some companies may face when adopting this ASU. For instance, some companies will need to prepare detailed beneficial conversion feature calculations, including the related deferred tax impact associated with convertible debt under ASC 740-10-55-51. We believe that an additional year should be provided to entities other than public business entities.

We also recommend allowing early adoption effective upon issuance of the final ASU.