



The Association of
Accountants and
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in Business

February 7, 2017

Ms. Susan M. Cospers, Technical Director
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

Re: **File Reference No. 2016-370**, Proposed Accounting Standards Update, *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 Companies and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception*

Dear Ms. Cospers:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on the Financial Accounting Standards Board's (FASB) Exposure Draft (ED) of the Proposed Accounting Standards Update, *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 Companies and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception* (Proposed ASU).

The IMA is a global association representing over 80,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy Activity, Areas of Advocacy, Financial Reporting Committee).

We agree with Part II of the Proposed ASU. Providing a scope exception for those financial instruments that were the subject of the indefinite deferral in FASB Staff Position No. 150-3 *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity"* will enhance Topic 480's readability. Even though the Board has not addressed the underlying issues that resulted in the need to provide the indefinite deferral, we do not believe constituents will be confused by the decision to provide the scope exception.



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We do not agree with Part I of the Proposed ASU. As stated in our comment letter on the Invitation to Comment, *Agenda Consultation*, before making any changes to the guidance on financial instruments with characteristics of liabilities and equity, we recommend that the Board first determine the root cause of restatements attributed to the accounting for those financial instruments. Unless the accounting for financial instruments with down round features is an area that has resulted in restatements, we do not believe the Board should make any changes. We believe the accounting for financial instruments containing down round features is well-understood (and has been since the issuance of EITF Issue No. 07-5 *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock*). We suspect that many restatements are due to other aspects of the accounting model for distinguishing liabilities from equity, including difficulties that arise from navigating through the applicable guidance to identify all of the relevant features of a financial instrument. We do not believe that ignoring a down round feature will change the difficulties reporting entities have with navigating their way through the applicable guidance.

Even if financial instruments with down round features were the cause of restatements, we disagree with the Board's proposed change. Down round provisions are important to investors as such provisions help mitigate exposure to losses. We understand that investors demand down round protection and that these provisions are frequently triggered. We do not believe it is appropriate to ignore a substantive term of an agreement, which is what the Board's proposed approach would do until the feature is triggered. If the Board believes that a down round feature should not result in classifying a freestanding or embedded option or forward as a liability in its entirety, we recommend separating the down round feature from the freestanding or embedded option or forward in cases when the feature would be the only reason that the freestanding or embedded option or forward would be classified as a liability. In those circumstances, the issuer would classify the down round feature as a liability and subsequently measure it at fair value with changes in fair value recognized in earnings. We recognize that our proposed approach is inconsistent with the prohibition in Subtopic 815-15 against separating a compound embedded derivative into its components. However, we believe that accounting would be consistent with the nature of the instrument and is preferable to ignoring a substantive feature of an agreement until that feature is triggered as proposed by the Board.

If the Board decides to proceed with finalizing the Proposed ASU as drafted, we have the following comments.

Scope

We are uncertain as to what convertible instruments with down round features would be within the scope of the Proposed ASU. New paragraph 3(e)(2) of ASC 480-20-15 states that the guidance does not apply to convertible instruments with a beneficial conversion feature or a contingent beneficial conversion feature within the scope of Subtopic 470-20. Paragraphs 22 and 23 of ASC 470-20-55, which the Proposed ASU would not amend, illustrate the accounting for a debt instrument containing a conversion feature that, at issuance, is not beneficial. The price of the conversion feature adjusts if the reporting entity subsequently issues common stock at a price lower than the market price on the date the convertible instrument was issued. Accordingly, it would appear that the Proposed ASU would not apply to a convertible instrument on which the conversion feature could reset to a price that would be lower than the issuance-date fair value or market price of the shares into which the instrument is convertible.



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However, paragraph 6 of the Proposed ASU amends Subtopic 470-20 to require a reporting entity to apply the guidance in the Proposed ASU to a convertible instrument with a down round provision when that provision is triggered. That proposed amendment seems inconsistent with the Scope and Scope Exceptions section, the example in Subtopic 470-20, and the discussion in paragraphs BC14(b) and (c), which indicate that the Board intended that the guidance on beneficial conversion features in Subtopic 470-20 would generally apply.

We assume that the Board intended that a convertible instrument with a down round feature that could result in a reset of the conversion price to a price below the issuance-date fair value or market price of the shares into which the instrument is convertible would be within the scope of Subtopic 470-20 and that new Subtopic 480-20 would apply to a convertible instrument with a down round feature that could result in a reset of the conversion price, but not to a price lower than the issuance-date fair value or market price of the shares into which the instrument is convertible. If our assumption is correct, we believe the Board should clarify both the proposed scope guidance in new paragraph 3(e)(2) of ASC 480-20-15 and the amendment of Subtopic 470-20 to indicate what instruments are within the scope of the Proposed ASU. We believe it would be helpful if the Board would provide examples of convertible instruments with down round features that would be included in (and excluded from) the scope of the Proposed ASU.

In addition, we note that because of the narrow definition of a down round feature, features that function in a similar manner but that are triggered by an event other than the issuance of shares, equity derivatives, or a convertible instrument by the reporting entity will continue to result in accounting for a freestanding financial instrument or embedded conversion option that requires separate accounting from the host contract as a liability, with changes in fair value recognized in profit or loss. For example, we are aware of warrants to purchase common stock of a reporting entity that permit settlement at the fair value of the warrant if the reporting entity is acquired. The fair value of the warrant is determined using the higher of the stock price on the closing date, the day after the merger was announced, or the day before the merger was announced. This pricing mechanism protects the holder against a decrease in the share price upon the merger announcement. Therefore, it is similar economically to a down round feature, as defined in the Proposed ASU, but because it is not triggered by the reporting entity selling shares at a lower price or issuing an equity-linked financial instrument with a lower strike price, it would presumably be excluded from the scope of the Proposed ASU. That feature may be the only reason for classifying the warrant as a liability. If the Board believes that features similar to those found in a down round provision should not result in classifying a financial instrument as a liability, we would encourage the Board to consider whether it needs to broaden the definition of a down round feature to capture economically similar arrangements.

Recognition

New paragraph 3(a) of ASC 480-20-25 indicates that, when a down round feature is triggered on a financial instrument classified within equity, a reporting entity should charge the incremental increase in fair value to retained earnings with a credit to additional paid-in capital. We believe the Board should revise that guidance to indicate that a reporting entity should account for the incremental increase in the fair value of the financial instrument as a dividend. If a reporting entity does not have sufficient retained



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earnings, it may be prohibited from recognizing the effects of the feature as a charge to retained earnings.

Disclosure

The Proposed ASU provides disclosures that a reporting entity should make when a down round feature has been triggered. However, the Proposed ASU does not require a reporting entity to disclose, in financial statements for periods preceding the feature being triggered, that it has issued financial instruments that contain down round features, the terms of those down round features, and the fact that the reporting entity will not recognize the effects of the feature until the feature is triggered. We believe that existing disclosures of the existence and terms of down round features under paragraph 3 of ASC 505-10-50 tend to be minimal. We believe a reporting entity should disclose the existence and terms of the down round provisions and that it will not recognize the effects of the protection provided to the investor until the feature is triggered. When it is probable that the feature will be triggered subsequent to the end of the reporting period (because the reporting entity is in the process of raising funds at the balance sheet date and its share price has declined below the pricing of one or more prior rounds of fundraising), we believe a reporting entity should also disclose the potential effect on the financial statements.

Transition

The Proposed ASU indicates that a reporting entity should apply the guidance by means of a cumulative-effect adjustment. Does the Board intend that financial instruments with down round provisions be recorded at the carrying amount that would have resulted had the guidance in the Proposed ASU been effective for all periods in which the financial instrument was outstanding? If so, that could be a complicated exercise since a down round feature could have been triggered on more than one occasion. That would require a reporting entity to compute the incremental increase in the fair value of the financial instrument or embedded feature each time the feature was triggered, and could potentially affect financial instruments for which, under current guidance, the down round feature did not result in classifying an embedded feature as a liability. If that was not the Board's intent, we believe it should clarify the measurement objective of the transition guidance.

We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Sincerely,

A handwritten signature in blue ink that reads "N. Schroeder".

Nancy J. Schroeder, CPA
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