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Comment Letter No. 17

Ms. Susan M. Cospers
Technical Director
File Reference No. 2016-370
Financial Accounting Standards Board
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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 Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception*

Dear Ms. Cospers:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (Proposed Update) issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's objective to reduce the cost and complexity of accounting for certain financial instruments (freestanding or embedded) with down round features. Today's accounting often requires issuing entities to account for these instruments (or embedded features) at fair value. We believe that the Proposed Update would reduce the number of equity-linked financial instruments (or embedded features) with down round features that are required to be accounted for at fair value, thereby reducing measurement complexity.

However, we believe the FASB should clarify how the guidance would apply to convertible instruments with down round features that are also subject to the contingent beneficial conversion feature (BCF) guidance in Accounting Standards Codification (ASC) 470-20. We believe there could be confusion about whether a convertible instrument with an adjustment provision that could lead to the recognition of a contingent BCF would be in the scope of the proposed recognition and measurement guidance for down round features (i.e., ASC 480-20). We do not believe convertible instruments with down round features should be in the scope of ASC 480-20 because applying both that guidance and the contingent BCF guidance in ASC 470-20 would be too complex. We discuss this issue further in Appendix B, which includes other observations and recommendations.

Appendix A provides our responses to the questions posed in the Proposed Update.



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

Very truly yours,

Ernst & Young LLP

Appendix A – Responses to questions raised in the Proposed Update

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 proposed approach that would exclude a down round feature from the assessment of whether an instrument (or embedded feature) that contains such a feature is indexed to an entity's own stock. Excluding down round features from the assessment will result in fewer freestanding equity-linked financial instruments being classified as liabilities and fewer embedded features being bifurcated and accounted for as derivatives under ASC 815, *Derivatives and Hedging*. The current guidance that requires a down round feature to be considered in the assessment introduces needless complexity because, in many cases, it leads to the instrument (or embedded feature) being measured at fair value solely because of the down round feature.

In addition, we note that the proposed definition of a down round feature does not specify what is an acceptable reduction in the strike price of an issued financial instrument. This could permit a reduction in the strike price that is indexed to something unrelated to the price of the newly issued shares or the strike price of a newly issued equity-linked financial instrument. Therefore, we propose the following addition to the proposed definition (additions are underlined):

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. A down round feature reduces the current strike price of the issued financial instrument to (1) the issuance price of the newly issued shares or the strike price of the newly issued equity-linked financial instrument, with or without a floor or (2) a price based on (1) above, but that also considers the ratio of shares outstanding before and after an issuance. A standard antidilution provision is not considered a down round feature.

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 requiring entities to recognize the value of a down round feature when it is triggered. In addition, we generally support requiring entities to recognize the effect of a down round feature as either a reduction in retained earnings or a charge to net income, based on the balance sheet classification of the instrument (i.e., equity or a liability) that includes the feature.

Subsequent Measurement and Derecognition

The Proposed Update also would provide subsequent measurement and derecognition guidance for down round features. Specifically, proposed paragraph 480-20-35-3 would require an entity to “subsequently amortize the adjustment of the carrying amount of the liability-classified instrument arising from recognition of the value of the effect of the down round feature using the effective interest method in accordance with Topic 835 on interest.”

However, certain liability-classified financial instruments with down round features do not have defined cash flows (e.g., warrants classified as a liability and measured at cost), and therefore, entities cannot apply the effective interest method to these instruments to amortize the basis adjustment to the carrying amount of the liability arising from the recognition of the value of the effect of a down round feature. We recommend that the Board consider excluding these types of liability-classified financial instruments with down round features from the subsequent measurement guidance or prescribe an alternative measurement model, such as straight-line amortization.

We question why the Board proposed different subsequent measurement and derecognition models for financial instruments classified as equity and those classified as liabilities. We note that the economics of the down round features are same, but, under the proposed guidance, entities could recognize different amounts in net income and in retained earnings for liability-classified instruments and equity-classified instruments, respectively.

For example, consider a convertible debt instrument with a carrying amount of \$1,000 and convertible preferred stock with a liquidation preference of \$1,000 that both have a down round feature that is triggered, resulting in a charge of \$50 in net income for the convertible debt and a reduction of \$50 in retained earnings for the convertible preferred stock. The carrying amount of the convertible debt instrument would increase to \$1,050 under proposed paragraph 480-20-25-3. However, the carrying amount of the convertible preferred stock would not be affected, and the effect of the down round feature would be recorded separately on the balance sheet as an increase in additional paid-in capital (APIC).

Moreover, if both instruments were immediately extinguished with \$1,000 in cash, a gain of \$50 would be recognized in net income for the extinguishment of convertible debt. Since the Proposed Update would preclude the derecognition of the amount in APIC arising from the recognition of the value of the effect of the down round feature, an equivalent increase in retained earnings would not be recognized for the extinguishment of the convertible preferred stock.

As we said in our cover letter and discussed in Appendix B, we do not believe convertible instruments with down round features should be in the scope of ASC 480-20, given the complexity that could arise from the interaction of that guidance and the contingent BCF guidance in ASC 470-20. However, if the Board decides to include them in the scope of ASC 480-20, we recommend that it consider making the subsequent measurement and derecognition models consistent for equity- and liability-classified instruments with down round features.

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.

We support the “without the down round” approach the Board proposed for measuring the value of the effect of a down round feature when it is triggered. We believe this approach would make measuring financial instruments with down round features at fair value less complex.

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

We agree with the proposed disclosure requirements in paragraphs 480-20-50-1 and 50-2.

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 proposal to require entities to use a modified retrospective approach for existing financial instruments with a down round feature at the effective date. In addition, we have the following observations about the proposed transition guidance:

- ▶ Paragraph BC48 of the Basis for Conclusions says that a convertible instrument with a down round feature that has been bifurcated but that would not have been bifurcated had the Proposed Update been in effect when the convertible instrument was issued would be recombined at the date of adoption. Paragraph BC48 further states that “under the transition approach, when recombining the host contract and bifurcated conversion option, an entity would not establish that value as the carrying value as of the date of adoption without any reversal of prior gains and losses on the derivative component.”

This paragraph seems to indicate that the carrying amount of the recombined instrument as of the date of adoption would be the carrying amount of the recombined instrument based on a pro forma non-bifurcation as of the date the entity issued the convertible instrument and the subsequent accounting for the recombined instrument before the effective date. We observe that this proposed transition requirement would be inconsistent with the transition guidance in Accounting Standards Update (ASU) 2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity*, and with the transition framework established by the Derivatives Implementation Group in Statement 133 Implementation Issue K5, *Miscellaneous: Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues (DIG K5)*. Under the guidance in ASU 2014-16 and DIG K5, the carrying amount upon transition of the recombined instrument is the total carrying amount of the host contract and the fair value of the previously bifurcated embedded derivative as of the effective date.

Again, we do not believe that convertible instruments should be in the scope of ASC 480-20, given the complexity that could arise from the interaction of that guidance with the contingent BCF guidance in ASC 470-20. However, if the Board decides to include convertible instruments in the scope of ASC 480-20, we recommend that the Board consider making the proposed transition guidance on recombined instruments consistent with ASU 2014-16 and DIG K5, which provided a simplified approach to determine the carrying amount of the recombined instrument as of the effective date of the Proposed Update.

- ▶ It is not clear how the proposed transition guidance would be applied to an outstanding financial instrument that does not contain a down round feature as of the date of adoption because the feature was removed before the effective date. We recommend that the Board clarify the transition guidance to address this issue.

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 believe that early adoption should be permitted because the proposal would provide entities with relief from accounting for financial instruments or embedded features containing down round features at fair value through earnings. We do not believe the proposed guidance would be difficult to implement. Therefore, we do not believe private entities would need additional time to implement it.

Appendix B – Additional observations and recommendations

Interaction of existing contingent BCF guidance and the proposed model for financial instruments with down round features:

We do not believe convertible instruments with down round features should be in the scope of ASC 480-20 given the potential complexity stemming from the interaction of that guidance with the contingent BCF guidance in ASC 470-20. We believe there could be confusion about whether a convertible instrument with an adjustment provision that could result in the recognition of a contingent BCF would be in the scope of ASC 480-20. Specifically, the Board should consider the following:

- ▶ Paragraph 480-20-15-3 excludes from the scope of the Proposed Update convertible instruments that are “required to be separated” into liability and equity components, including convertible instruments with a BCF or a contingent BCF within the scope of ASC 470-20. Further, the proposed paragraph 470-20-25-14 states that “an entity shall recognize a convertible debt instrument with a conversion feature that is not beneficial that contains a down round feature in accordance with paragraph 470-20-25-12 and shall apply the guidance in Subtopic 480-20 when the down round feature is triggered.”

Both paragraphs seem to indicate that for a convertible instrument to be excluded from the scope of ASC 480-20, a BCF or a contingent BCF must be recognized. While convertible instruments are generally subject to the contingent BCF guidance, the issuer may not recognize a separate equity component if it is not “beneficial.”

The wording in these paragraphs does not appear to be consistent with the Board’s intent, as described in the following paragraphs of the Basis for Conclusions:

BC31. ... The Board observed that allowing the current beneficial conversion model to prevail avoids these complexities. Therefore, as a practical matter, the Board believes that convertible instruments with down round features generally will be subject to the guidance for contingent beneficial conversion features and not the proposed model for financial instruments with down round features.

BC32. ... Ultimately, in developing the model for financial instruments with down round features, the Board decided to maintain the objectives of the specialized accounting guidance for convertible instruments and views of the prior Boards.

- ▶ The derecognition guidance in paragraph 480-20-40-3 is specifically for convertible instruments. If the Board’s intent was to exclude convertible instruments from the scope of ASC 480-20 (as discussed in paragraphs BC31 and BC32), it is unclear why the proposed derecognition guidance for convertible instruments is needed.

We suggest that the Board eliminate any inconsistencies in the Proposed Update and clarify whether convertible instruments with down round features that are also subject to the contingent BCF guidance in ASC 470-20 would be in the scope of ASC 480-20.

Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception:

- ▶ Paragraphs 480-10-55-8 and 480-10-55-9 would be deleted and replaced by a scope exception for certain mandatorily redeemable noncontrolling interests. However, the trust-preferred securities illustration would not have any accounting conclusion after this change. We suggest that the Board add a paragraph to discuss the application of the scope exception to trust-preferred securities for this illustration.

Editorial comments:

- ▶ Bullet (b) on page 11 in paragraph 480-20-15-3 on “Convertible instruments that are required to be separated under the following guidance...” should be changed to “(e).”
- ▶ We suggest that the Board clarify in paragraph 480-20-25-3(a) that the value of the effect of the down round feature recognized, when triggered, should be analogous to dividends as a return to shareholders, and therefore, it would affect earnings per share.
- ▶ The following edit should be made to paragraph 480-20-55-1 to clarify that all other criteria in ASC 815-40 must be met to classify the warrants as equity:

“... The warrants are classified as equity by Entity A in accordance with the guidance in this Subtopic and all other criteria in Subtopic 815-40.”