



3979 Freedom Circle, Suite 700  
Santa Clara, CA 95054

P: (650) 300 5101  
F: (650) 396 8071

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

File Reference No. 2016-370

Dear Ms. Cospers:

Connor Group, Inc. is pleased to provide our comments on the FASB's Exposure Draft, *Distinguishing Liabilities from Equity—Accounting for Certain Financial Instruments with Down Round Features* (Topic 480). Connor Group was founded in 2005 and is a technical accounting advisory firm built of Big 4 alumni and industry executives. We currently have over 150 accounting professionals and over 500 clients, and specialize in helping our clients solve complex technical accounting issues under both U.S. GAAP and IFRS. Our clients represent industries such as technology, software, internet, cloud services, life sciences and manufacturing, amongst others. Many of our clients are emerging growth mid-cap or small-cap public entities, companies aspiring to become public in the near future, or high-growth private companies.

We have included below our responses to Part 1, Questions 1 and 2 that the Board posed in the "Questions for Respondents" in the Exposure Draft. We have no comments on and support Part 2 of the Exposure Draft.

### **Comments on Questions 1 and 2 for Respondents**

**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.

**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 do not support Part 1 of the proposed Exposure Draft for several reasons, including

- We do not believe it has a conceptual basis that is consistent with other aspects of the equity/liability framework
- We do not believe it would simplify the accounting analysis
- We do not believe it would help reduce the number of restatements



- The Exposure Draft could impact the outcome of negotiations between investors and companies, and lead to proliferation of down round protection features, which will raise the importance of accounting guidance in this area
- It could result in dramatically different accounting answers for instruments with only slight changes in terms
- As drafted, we believe it has certain unintended consequences and oversights

We discuss the details of our concerns regarding the Exposure Draft below.

- *We do not believe the Exposure Draft has a conceptual basis that is consistent with other aspects of equity/liability framework*

Providing a scope exception for down-round features is inconsistent with the concepts underlying the equity/liability framework. We appreciate the concern that the remeasurement of the host instrument or of the bifurcated derivative feature goes in the opposite direction from the “true” value of the down round protection feature, which results in an outcome not reflecting the economic reality of the feature. However, there are other methods of addressing this issue. For example, we have become aware of a proposal in the Institute of Management Accountants’ comment letter to bifurcate the down round protection feature as a separate unit of account that would be remeasured at fair value when it is present. We believe this approach would be preferred to the one in the Exposure Draft. We also note that there are other features that are economically similar to the down round protection feature in that they protect the holder when the value of their investment is reduced. For example, some of our clients issued warrants that have a contingent repayment provision based on the Black Scholes value of the warrants that is determined using the higher of the stock prices before or after a merger of the entity is announced or closed. This feature protects the warrant holder against decline in the stock value, but would not meet the narrow definition of the down round feature as proposed in the Exposure Draft. One could hypothesize that most of the indexation guidance included in the original EITF 07-5 serves to address features that protect investors against reduction in the value of their investment. Thus, it does not appear appropriate to address one specific feature and ignore others.

- *We do not believe the Exposure Draft would simplify the accounting analysis*

We agree with the Board’s overarching goal to simplify application complexity and reduce costs for the accounting for financial instruments with characteristics of both debt and equity. However, we do not believe that this Exposure Draft would accomplish that goal. We believe the Exposure Draft would add to the maze of accounting scope considerations that are very hard to follow. As part of the comment letter process, we have interacted with numerous professionals within and outside Connor Group who are very familiar and experienced in the equity/liability topic. Nevertheless, even those experienced professionals find it very difficult to navigate through the scope provisions of the Exposure Draft. Specifically, people struggle to establish what guidance would apply to (a) convertible debt with down round features, (b) convertible debt with cash conversion features and down round features, (c) preferred stock with down round features, equity or mezzanine classified, and (d) options and warrants with down round features. We note that several audit firms have prepared expansive flowcharts to assist practitioners, which show the ordering and application of rules in this complex area. This Exposure Draft will not remove anything from those flowcharts, and conversely, will necessitate additional steps in the analysis which inherently is likely to cause additional complexity and potential for errors. This would be further exacerbated because different treatment would result for instruments with just small feature variations, as further discussed below.



- *We do not believe the Exposure Draft would help reduce the number of restatements*

In our experience, restatements are not typically caused because companies fail to remeasure features they have identified for bifurcation that are required to be carried at fair value. They result because companies do not properly navigate the existing framework, or do not understand the significance of various features, and therefore fail to identify that they require bifurcation, or otherwise change the accounting for the instrument issued. Because the Exposure Draft will make the debt/equity analysis framework more complex, we expect companies would still be making mistakes, and consequently, the number of restatements may not be significantly reduced.

We also believe that from a practical perspective, it is relatively easier for entities to miss recording an accounting adjustment that is only required upon a trigger (such as a change in conversion rate) than an adjustment that is required in every period, such as a remeasurement to fair value. Thus, we expect any reduction in the number of restatements occurring under the Exposure Draft may be offset by an increase in restatements from overlooking the accounting entry upon a down round occurrence. Alternatively, Companies might erroneously apply down round adjustments when not required because, for example, the instrument in question has a contingent beneficial conversion feature and, thus, would be scoped out of ASC 480-20. That is because there is a fine line between instruments in the scope of ASC 480-20 and out of scope, as discussed below.

- *The Exposure Draft could impact the outcome of negotiations between investors and companies, and lead to proliferation of down round protection features*

Today, many companies are able to “push back” in their negotiations with lenders (investors) regarding the down-round protection features because they argue that such features will trigger severe accounting consequences for them. We have advised a number of our clients in this regard and have seen down round protection features struck out of the final versions of the investment (loan) agreements. As a result, for example, down-round protection features currently are not frequent in regular convertible debt and cash-convertible debt. Conversely, they are frequent in preferred stock instruments where they have no practical implications. We are concerned that the proposed Exposure Draft, if adopted, would result in the increase in the number of instruments with down-round protection features, because companies will not be as motivated to push back on them in negotiations. This in turn will increase the relative importance of accounting guidance in this area, as down round protection features could raise in prominence.

- *The Exposure Draft could result in dramatically different accounting answers for instruments with only slight changes in terms*

As we understand the intricate provisions of the Exposure Draft, convertible preferred stock and convertible notes with down round protection features may fall into the scope of ASC 470-20 if the down round protection feature is also a contingent beneficial conversion feature, and ASC 480-20 if it is not. In practice, we expect that any down round protection feature would also be a contingent beneficial conversion feature unless it has a “floor” for adjustments that is at least equal to the fair value of the underlying stock on the issuance date. Thus, presence or absence of a “floor” would result in a change in the applicable accounting rules. Further, when the “floor” is present, a \$0.01 difference in the floor would result in a change in the applicable accounting rules.

For example, consider convertible notes with a conversion price of \$10.00 issued when the underlying stock fair value is \$6.00. If the conversion price can be adjusted down but only to \$6.00, the notes would fall in the scope of ASC 480-20. If the conversion price could be adjusted down to \$5.99, because it is now a contingent beneficial conversion feature, the notes are subject to ASC 470-20. Under ASC 480-20, if the down-round



protection is triggered, the cost recorded by the entity would reflect the impact of the entire reduction in the conversion price from \$10.00 to \$6.00, i.e., \$4.00. Under ASC 470-20, if the down round protection is triggered, the cost recorded by the entity would reflect the impact of the reduction in the conversion price below \$6.00, i.e. \$0.01. Thus, a significantly different financial statement impact would result for all of a \$0.01 change in the “floor” of the conversion price. We believe it is not helpful to introduce accounting rules that result in such outcomes. We also note that it is not infrequent for private companies to change their judgments in retrospect about the fair value of their underlying common stock. Such change, however, even if small, e.g., by \$0.01, could result in a change in the accounting rules applicable to the instruments with the down round feature, which results in significantly different impacts on the financial statements. This could make the implications of the proposed rules difficult for companies to make judgments about, and for auditors to audit. It also opens structuring opportunities for companies to avoid an undesirable accounting result.

- *As drafted, we believe the Exposure Draft has certain unintended consequences and oversights*

For convertible debt with cash conversion features, based on the proposed ASC 480-20-15-3.e.1, our understanding is that they are not in the scope of the proposed new Topic 480-20. Therefore, remeasurements addressed in the proposed ASC 480-20-25-3 will not apply to such conversion features. However, we question whether this is the intended outcome when a down round feature is triggered. Unlike debt with beneficial conversion features, there is no subsequent accounting provided for the bifurcated equity-classified feature in cash conversion instruments—likely because a down round feature would have caused derivative accounting under current accounting. In fact, ASC 470-20-35-17 explicitly prohibits remeasurement of an equity-classified conversion feature as long as it qualifies for equity classification. Thus, triggering down-round protection for convertible debt with cash conversion features would have no accounting consequences under the proposed Exposure Draft. We do not believe this is a reasonable outcome considering the principles that we understand underlie the Exposure Draft.

For a liability, triggering of a down round feature under the proposed ASC 480-20-25-3-b, would result in the liability increasing, which would then be reversed through amortization as reduced interest expense. In substance, this means that the total amount of interest expense on this instrument over its life will not change as a result of triggering the down-round protection feature; it will simply be accelerated. Also, increasing the carrying value of the liability may result in negative interest expense over the remainder of the debt term. We believe this may represent an unintended or an unreasonable outcome, because triggering the down-round protection should increase the cost of the instrument to the issuer due to a potentially higher number of equity shares the holder could receive. Thus, we believe the impact to trigger down-round protection features for liability-classified awards should be recorded as an increase in additional paid-in capital.

The Board also did not address how to treat the adjustments from down round features in calculating EPS. For example, should an adjustment to equity be treated as a dividend in basic EPS, or only be incorporated into the diluted EPS?



We support the Board undertaking a full project to establish a conceptual-based and relatively easy-to-apply Standard for liabilities and equity versus short-term fixes. In our view, the “band aid” approach should be discontinued. In fact, we believe that this Exposure Draft is a prime example of why the “band-aid” approach does not work: the existing framework is so complex and full of inconsistencies that, in our opinion, any attempts to fix it are bound to just add complexity, create new inconsistencies, and ultimately fail to accomplish their objectives.

Sincerely,

*Connor Group, Inc.*

Accounting Standards and Professional Practice group

- Aleks Zabreyko, Partner [aleks.zabreyko@connorgp.com](mailto:aleks.zabreyko@connorgp.com) (650) 353-7044
- Denis Kozhevnikov, Partner [denis.kozhevnikov@connorgp.com](mailto:denis.kozhevnikov@connorgp.com) (650) 521 3099
- Brooke Richards, Director [brooke.richards@connorgp.com](mailto:brooke.richards@connorgp.com) (203) 241 1421