KPMG LLP
345 Park Avenue
New York, N.Y. 10154-0102

Telephone +1 212 758 9700
Fax +1 212 758 9819
Internet www.us.kpmg.com

October 8, 2019

Mr. Shayne Kuhaneck
Acting Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Proposed Accounting Standards Update, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity* (File Reference No. 2019-730)

Dear Mr. Kuhaneck:

We appreciate the opportunity to comment on the proposed ASU, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. We support the Board's objective to reduce complexity in accounting standards while maintaining or improving the usefulness of the information provided to financial statement users.

We generally believe that the proposals would reduce complexity, consistent with the Board's objectives in undertaking this project.

Accounting for convertible debt

We agree that the existing accounting for convertible debt is complex and that eliminating three of the five existing accounting models would reduce that complexity. However, we believe one of the primary goals of financial reporting – to provide a consistent framework through which financial statement users can make meaningful comparisons – would be impeded if convertible debt instruments and debt instruments with no conversion features are both accounted for as plain debt instruments under the same accounting model. We believe that accounting for convertible instruments as a single unit of account without, at a minimum, requiring disclosures about the value of the conversion feature, likely would not reflect the substantive economics of the arrangements in the financial statements. Our detailed recommendations are in our response to Question 1 in Appendix I.

Derivatives scope exception for contracts in an entity's own equity

We generally support disregarding remote settlement features for purposes of classifying contracts in an entity's own equity and believe this will reduce form-over-substance accounting conclusions. However, the introduction of a qualitative remote threshold will add initial and ongoing implementation costs. We agree with the Board's observation, as discussed in its proposals to simplify the balance sheet classification of debt, that the operability of evidence provided by management expectations is lower than the operability of more objective evidence.[1]

[1] Paragraph BC19 of Proposed Accounting Standards Update (Revised) – Debt (Topic 470): Simplifying the classification of debt in a classified balance sheet (current versus noncurrent)

As a result, we suggest that the Board alternatively permit entities to disregard settlement features in a contract when their value is insignificant in relation to the value of the contract as a whole.

We encourage the Board to add guidance on factors that an entity should consider in performing its qualitative assessment of the remote threshold, and to begin outreach with audit standard setters so that they can contemporaneously develop guidance on audit evidence that would be considered sufficient and reliable to support a qualitative assessment.

Finally, we are concerned that the Board's proposal that an entity apply the remote threshold at contract inception and reexamine it only when a reassessment event occurs may not provide a sufficiently timely financial reporting response to changes in circumstances. We recommend that the Board require an annual reassessment of the derivatives scope exception using the remote threshold. Our detailed recommendations are in our responses to Questions 3 and 7 in Appendix I.

Earnings per share

We support the Board's objective to improve the consistency of EPS calculations. In our response to Question 12 in Appendix I, we have identified other areas of the EPS guidance that we believe the Board could consider for improvement in a separate project.

Our responses to the Questions for Respondents are in Appendix I. Our additional recommendations are in Appendix II.

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If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com, Mahesh Narayanasami at (212) 954-7355 or maheshnarayanasami@kpmg.com, or Patrick Garguilo at (212) 954-2852 or pgarguilo@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP

Appendix I – Responses to Questions for Respondents

Question 1: Should convertible instruments be accounted for as a single unit of account, except in circumstances in which the conversion features are required to be bifurcated by guidance in Topic 815? Please explain why or why not. Under this simplification, would any specific information about convertible instruments be missing in order to understand an entity's financial position and financial performance? If so, please explain what information would be missing and how that information is used.

We agree that the accounting for convertible debt under current GAAP is complex and the proposal to eliminate three of the five existing models would reduce complexity. The proposed amendments retain two accounting models for convertible debt: a single unit of account approach under Subtopic 470-20, and a bifurcation approach with a debt host and a conversion feature that is bifurcated and accounted for as a derivative under Topic 815. Under these two accounting models, economically similar instruments may be accounted for differently because the conversion option may be bifurcated as an embedded derivative in one case (when it does not meet the equity scope exception under Topic 815), but not in another (either because it does not meet the definition of a derivative, or because it meets the equity scope exception under Topic 815). When the conversion option is bifurcated as an embedded derivative, the interest expense recognized is higher than the coupon interest that is recognized when the conversion option is not bifurcated because of the debt discount that is created by the bifurcation. Similarly, the proposed disclosure requirements are different. For example, fair value, gains and losses on changes in fair value, and other quantitative and qualitative disclosures are required under Topic 815 for a bifurcated conversion feature, but not for a conversion feature that is accounted for as a single unit of account as part of the debt.

Under the proposed amendments, economically dissimilar instruments would be accounted for in a similar manner. A convertible debt instrument, and a plain vanilla debt instrument without a conversion option would both be recognized as a single plain vanilla debt instrument measured at amortized cost under Subtopic 470-20. This accounting would ignore the conversion value provided to the holder of the convertible debt instrument because both the liability interest and the equity interest were issued in a single financial instrument rather than two financial instruments. However, if the two features were issued separately (e.g. if a debt instrument were issued with detachable warrants), entities would be required to account separately for both features.

Further, we note that in one circumstance under the proposed amendments the Board has, in effect, created a third accounting model where a portion of the value of a convertible debt instrument is recognized in equity and another portion as a liability. This circumstance would arise when a conversion feature was initially bifurcated and accounted for as a derivative liability and, on a reassessment event, subsequently reclassified to equity in accordance with paragraph 815-40-35-10.

We believe that accounting for similar instruments in a dissimilar manner, or accounting for dissimilar instruments in a similar manner impedes meaningful financial statement comparisons.

To address the possibility of form-over-substance conclusions under the proposed amendments the Board could consider two options:

1. adopt an accounting model similar to the cash conversion model under current US GAAP when the conversion option is not bifurcated and accounted for as a derivative. This would result in a convertible debt instrument being separated into a debt component (initially measured at fair value) and an equity component (initially measured at the residual value, i.e. proceeds of issuance less fair value of the debt component), or
2. provide disclosure about the value of the equity component given to the holder on issuance.

The first option would result in only two accounting models for convertible instruments where an entity would:

- recognize a debt component; and
- separate the conversion feature and recognize it either as equity, assuming it meets the equity scope exception under Topic 815, or as a bifurcated embedded derivative under Topic 815.

While we acknowledge that the Board considered users' feedback in deciding not to pursue an equity component separation approach, we believe that the fundamental principle underlying the separation approach for the cash conversion model under Subtopic 470-20 remains valid. It underscores the importance of reflecting the underlying economics of a convertible instrument, and is not considered complex to apply in practice. As discussed in the basis for conclusions of FSP APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement), an issuer of a convertible debt instrument that requires or permits partial cash settlement on conversion should recognize the same interest cost that it would have incurred had it issued a comparable debt instrument without the embedded conversion feature. The residual equity component thus reflects the interest cost 'paid' with the conversion option. The Board considered that approach to be less difficult to apply than alternative methods because the liability is measured at fair value of a similar liability (without the conversion feature) and the equity component is measured as the residual value rather than at fair value. It is also less complex to apply than the embedded derivative bifurcation model under Topic 815, which will continue to exist, because the bifurcation model requires more complex modeling to determine the fair value of the conversion option. We also note that the Board has stated its objective in amending Subtopic 815-40 is to reduce form-over-substance accounting conclusions so that economically similar contracts are accounted for consistently. We believe this rationale should apply for the amendments to the accounting for convertible instruments so that economically different instruments should not be accounted for under the same accounting model. The liability-first separation model also is consistent with the approach required by IAS 32, *Financial Instruments: Disclosure and Presentation*.

We do not believe that requiring disclosures about the terms of each instrument provides better and more comparable information than appropriately recognizing and measuring the substance of a transaction in the financial statements. However, based on stakeholder feedback, if the Board moves forward with its proposal to account for convertible debt under Subtopic 470-20 as a single debt instrument, it could consider requiring financial statement disclosure about the value of the conversion feature included in the convertible debt instrument at the time of issuance. Because disclosure of the fair value of the conversion option may require an entity to estimate inputs to and apply complex option pricing models (which may be operationally burdensome), the Board could consider instead requiring disclosure of the residual value attributable to the conversion feature similar to the residual value determined under the cash conversion model under current US GAAP. This would provide the same information to financial statement users – albeit through disclosure – as separately accounting for the conversion feature as equity.

We think that either of these options would meet the objective of reducing complexity while providing useful information about the economics of the convertible instruments.

Question 2: Do the disclosure amendments in this proposed Update for convertible debt instruments in paragraphs 470-20-50-1A through 50-1I and for convertible preferred stock in paragraphs 505-10-50-12 through 50-18 provide decision-useful information? Should any of these disclosures be required for every annual and interim period for which a statement of financial position and a statement of financial performance are presented? Should any other disclosures for convertible instruments be required? Please explain why or why not.

We believe financial statement users are best positioned to comment on whether the proposed disclosure amendments for convertible instruments would provide decision-useful information. However, see our response to Question 1 about possible disclosure of the value of the conversion feature at issuance.

With respect to the proposed amendments to the disclosure requirements in paragraph 470-20-50-1C for contingently convertible instruments, we recommend that the Board provide guidance and examples to help reporting entities evaluate what type of information should be disclosed that may be helpful to financial statement users, given their varying needs.

Question 3: Should remote settlement features be disregarded for purposes of determining the classification of a contract in an entity's own equity (for both indexation and settlement)? Is remote an operable threshold? Please explain why or why not.

We agree that disregarding remote settlement features will likely reduce form-over-substance accounting conclusions. However, the proposals would lead to inconsistencies in how entities assess contractual features and conditions for classification purposes:

- some conditions and features do not have a threshold and do not affect classification, such as down round features in a contract (pursuant to ASU 2017-11);
- some conditions do not have a threshold and may affect classification, such as determining whether an entity has sufficient authorized and unissued shares to settle the contract (paragraph 815-40-25-10(b)), or whether the contract has an explicit share limit (paragraph 815-40-25-10(c)); and
- some conditions have a threshold and may affect classification, such as when considering an adjustment to the settlement amount (paragraph 815-40-15-7D), or if there is a required cash payment or top-off or make-whole payments (subparagraphs 815-40-25-10(d) and 25-10(e)).

We believe preparers are best positioned to comment on whether the remote threshold is operable. If a remote threshold is added to the existing derivatives scope exception analysis, we believe there will be initial and ongoing costs to analyze contracts and support/audit any conclusions about the likelihood of occurrence of an event or condition that requires net cash settlement. Given the subjective nature and uncertainty of assessing whether a condition or event has a remote likelihood of occurring, it may be at least as difficult and costly for some entities to develop processes and internal controls around a qualitative analysis as it would be to undertake a quantitative fair value analysis. It may be more efficient for some entities to calculate the fair value of the contract with and without the settlement features to determine whether the features are insignificant to the fair value of the instrument as a whole and thus may be disregarded for purposes of determining the classification of the instrument. We recommend that the Board add guidance in Subtopic 815-40 to permit entities to perform such a quantitative analysis as an alternative to performing a qualitative analysis about whether conditions or events have a remote likelihood of occurring. Often the remote assessment will require entities to evaluate events or circumstances beyond their control, that are far into the future, or for which they do not have a history or precedence. We encourage the Board to add guidance on factors that an entity should consider in performing its qualitative assessment of the remote threshold, and to begin outreach with audit standard setters so that they can develop guidance on audit evidence that would be considered sufficient and reliable to support a qualitative assessment.

Because an entity would apply the remote threshold at contract inception and reexamine it only when a reassessment event occurs, we are concerned that there may be an undue level of pressure on the initial classification assessment with a bias toward equity classification. Reconsideration of initial classification based solely on reassessment events also increases the likelihood that the financial reporting response to changes in circumstances may not be timely. For these reasons, we recommend an annual reassessment of the derivatives scope exception. See our response to Question 7 for further discussion.

Question 4: Should a requirement to settle a contract in registered shares not affect the classification of a contract in the entity's own equity? Please explain why or why not.

We agree with the Board's proposal to remove the condition that a contract must permit the entity to settle in unregistered shares to be classified as equity. However, we suggest that the Board clarify how this amendment would interact with the new remote threshold for settlement features. While the Board has proposed amending paragraph 815-40-25-10 so that conditions (d) and (e) - if remote of occurring - would not preclude equity classification, it is not clear how a contract that has a specific requirement to settle in registered shares would be assessed. For example, assume a contract specifies that an entity must settle in registered shares, failing which it must net cash settle the contract. It is not clear whether the entity would be required to analyze the likelihood of the contract settling in registered shares or cash, or whether the entity would ignore the contractual requirement to settle in registered shares, in determining whether the contract should be equity classified. The additional sentences in paragraphs 815-40-25-10(b) and 815-40-25-22 state that "federal securities law generally requires that transactions involving offerings of shares be registered, unless there is an available exemption. <u>For purposes of this Subtopic</u>, such requirements do not, by themselves, imply that an entity does not have the ability to deliver shares and, thus, do not preclude equity classification."

One interpretation of this language is that an entity would ignore the contractual requirement to settle in registered shares and not perform a likelihood assessment of this settlement feature. Another interpretation is that, because these sentences are specifically added in paragraphs 815-40-25-10(b) and 815-40-25-22, which deal with the condition of sufficient authorized and unissued shares, the likelihood of the contract settling in registered shares or cash should be assessed. We suggest the Board clarify its intent.

In addition, if the Board's intent is that the reference to federal securities law is relevant only to paragraphs 815-40-25-10(b) and 815-40-25-22, we suggest the Board clarify how it is relevant to the condition that an entity has sufficient authorized and unissued shares.

Question 5: Should a requirement to post collateral not affect the classification of a contract in an entity's own equity? Please explain why or why not.

We agree with the Board's proposal to remove the condition that a contract must have no requirement to post collateral to be equity-classified because that does not indicate how the contract will ultimately settle and therefore should not affect classification.

Question 6: Should the hierarchy of a counterparty's rights or shareholder rights not affect the classification of a contract in an entity's own equity? Please explain why or why not.

We agree with the Board's proposal to remove the shareholder rights condition because it is unrelated to whether the contract will ultimately be cash or share settled and therefore should not affect classification.

Question 7: Are the proposed amendments about reassessment of the derivatives scope exception operable? Should reassessment of the derivatives scope exception occur only upon a reassessment event (as defined in paragraph 815-40-35-8)? If not, should the reassessment be performed more frequently even if a reassessment event has not occurred, for example, on an annual basis? If performed annually, should the likelihood threshold be remote or should a different threshold be applied? Please explain your rationale for each of the answers provided.

We believe preparers are best positioned to comment on whether reassessment of the derivatives scope exception is operable.

As we noted in our response to Question 3, we believe an annual reassessment of the derivatives scope exception would reduce the pressure on the initial classification assessment and the impact of 'non-neutral accounting' noted in the basis for conclusions (BC129). Additionally, while we understand the desire for uniform classification throughout the life of a contract, we believe it is inconsistent with the principle underlying the remote threshold (i.e. reducing form-over-substance accounting conclusions) to continue to classify contracts based on their initial assessment when the likelihood of an adjustment to the settlement amount or a net cash settlement is no longer remote but a reassessment event as defined in paragraph 815-40-35-8 has not yet occurred.

To illustrate, assume an entity issues a contract that qualifies for the derivatives scope exception and classifies it as equity. The contract has some contingent net cash settlement provisions and the entity concludes that they are remote of occurring. In the following year, the entity enters into a similar contract with similar contingent net cash settlement provisions, but determines that at least one of the contingent events that could cause net cash settlement is more than remote of occurring and classifies this contract as a liability. The reverse scenario is also possible where an entity classifies a contract as a liability and subsequently issues an economically similar contract and classifies it as equity. In these examples, two similar contracts have dissimilar accounting because no reassessment event has occurred that would require reclassification. Additionally, under the proposed amendments certain relevant disclosures, such as fair value disclosures, that otherwise would be provided for liability classified items, would not be provided for instruments that continue to be classified as equity.

We believe an annual evaluation of conditions or events that could cause net cash settlement, using the same remote threshold at every assessment, is more conducive to the goal of reducing form-over-substance accounting conclusions than the proposed reassessment approach.

Question 8: Do the proposed disclosure amendments for contracts in an entity's own equity in paragraph 815-40-50-5(f) through (g) provide decision-useful information? Please explain why or why not. Should any other disclosures for contracts in an entity's own equity be required? Please explain which disclosures should be required and why.

We believe financial statement users are best positioned to comment on whether the proposed disclosure amendments for contracts in an entity's own equity would provide decision-useful information.

Question 9: Under current guidance in Topic 825, fair value disclosures are required for financial instruments that are classified as liabilities but are not required for financial instruments that are classified as equity. Should new fair value disclosures be considered for public business entities for all equity-classified instruments, including those outside the scope of the proposed amendments (such as employee stock options)? If yes, how would you use that information? If yes, which equity-classified instruments should the disclosures be required for?

We believe financial statement users are best positioned to comment on whether the proposed fair value disclosures for financial instruments that are classified as equity would provide decision-useful information.

Question 10: Should diluted EPS for all convertible instruments be calculated using the if-converted method of diluted EPS? Is the revision to the if-converted method in paragraph 260-10-45-40(b) operable? Please explain why or why not.

We agree with the Board's decision to simplify the calculation of diluted EPS for convertible instruments by requiring the use of the if-converted method.

However, we believe the Board should clarify its rationale for deleting paragraph 260-10-55-11. Currently, convertible instruments that permit or require the payment of cash by the holder of the security at conversion are considered the equivalent of warrants, and diluted EPS is calculated using the treasury stock method for the proceeds assumed to be received, in addition to the if-converted method. If the Board's intent is that an entity should ignore any cash received on conversion of convertible debt instruments, it should consider clarifying this and explaining its rationale in the basis for conclusions.

We believe the proposed revision to the if-converted method in paragraph 260-10-45-40(b) is operable.

Question 11: For a contract that may be settled in either cash or shares (except for certain share-based payment arrangements that are classified as liabilities), should an entity presume (and not be allowed to overcome the presumption) share settlement when calculating diluted EPS? Please explain why or why not.

Yes. Presuming share settlement without the ability to overcome the presumption is consistent with the purpose of diluted EPS, which is to reflect the maximum possible dilution.

However, it is unclear how proposed paragraph 260-10-45-45 interacts with the guidance for contingently issuable shares. It refers to paragraph 260-10-55-8 if the election to settle in shares is contingent on the occurrence of a specified event or circumstance. Shares issuable contingent on the occurrence of a specified event or circumstance (‘condition’) are included in diluted EPS based on the guidance in paragraphs 260-10-45-48 through 45-54, which considers the status of the condition (satisfied or not satisfied) at the reporting date. It is unclear whether, under the proposed amendments, an entity would first apply the guidance in paragraphs 260-10-45-48 through 45-54 and then apply the guidance in paragraph 260-10-55-8.

We suggest that the Board clarify the guidance and its intent.

Question 12: Should the Board consider a project about the effect of antidilutive instruments on the diluted EPS calculation (for example, the effect of call options used to offset the potential dilution from convertible instruments)? Should any other EPS improvements be considered? If yes, please provide details.

We believe financial statement users are best positioned to comment on whether the Board should consider a project about the effect of antidilutive instruments on the diluted EPS calculation.

We believe there are various areas in which the Board could provide additional guidance in Topic 260. These include (1) guidance on calculating diluted EPS using the two-class method (such guidance appeared in a 2008 Exposure Draft for an amendment to Statement 128, but was not finalized and is still being applied in practice), and (2) clarifying the guidance on convertible instruments with both a market condition and variable conversion alternatives / conversion price adjustments. While a market condition is ignored for a convertible instrument, the Board could clarify how the market condition should be considered when it affects the conversion alternatives available or the conversion price.

Question 13: Should the proposed amendments that affect classification, recognition, and measurement be applied on a modified retrospective basis, with an option for full retrospective application? Do you agree with the Board's proposed transition expedient? Please explain why or why not.

We agree with the Board's proposal that the proposed amendments that affect classification, recognition, and measurement be applied on a modified retrospective basis, with an option for full retrospective application. We agree that the proposed transition expedient in paragraph 815-40-65-1(d) will help reporting entities apply the amendments in a cost-effective manner without having to go back to prior periods and analyze – without using the benefit of hindsight – whether each condition or feature had only a remote chance of net cash settlement.

Question 14: Should the proposed amendments to EPS be applied as of the initial date of adoption for the transition from treasury stock method to if-converted method and applied retrospectively for instruments that may be settled in cash or shares? Please explain why or why not.

We believe that both the transition from applying the treasury stock method to the if-converted method, and the transition for the proposed amendment regarding the cash settlement assertion should be applied in the same manner. The treasury stock method is often used for convertible debt instruments that may be settled in cash or shares, where cash settlement is asserted for the principal amount.

To illustrate, assume an entity issues two convertible debt instruments:

- one similar to that in paragraph 260-10-55-84 – the issuer must settle the principal amount in cash and the conversion premium in either cash or shares (Instrument C); and
- another for which the entity may settle the principal and/or conversion premium in any combination of cash or shares (Instrument X).

Currently, under paragraph 260-10-55-84, the entity includes Instrument C in diluted EPS using the treasury stock method. Similarly, if the entity asserts that the principal amount of Instrument X would be settled in cash (based on its stated policy and past practice), but the conversion premium would be settled in shares, then Instrument X resembles Instrument C, and the entity includes Instrument X in diluted EPS using the treasury stock method.

Under the Board's proposed transition approach, the entity would include Instrument X in diluted EPS using the if-converted method retrospectively for all periods presented (because of the change for instruments that may be settled in cash or shares), yet include Instrument C in diluted EPS using the treasury stock method for periods prior to the date of adoption. This is despite the fact that both Instruments C and X had previously, under existing guidance, been included in diluted EPS using the treasury stock method.

Question 15: How much time would be needed to implement the proposed amendments? Should the amount of time needed to implement the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities? Should early adoption be permitted? Please explain your response.

We believe that preparers are best positioned to comment on the time needed to implement the proposed amendments. We support early adoption for entities that have not yet adopted ASU 2017-11 so that they would not have to apply multiple transitions under two ASUs for the same instruments. Additionally, we believe early adoption should be permitted for all entities.

Question 16: The proposed amendments would affect all entities that issue convertible instruments and/or contracts in an entity's own equity. Are there any specific private company considerations, in the context of applying the Private Company Decision Making Framework, that the Board should be aware of?

We are not aware of any specific private company considerations in the context of applying the Private Company's Decision Making Framework that the Board should consider in finalizing this ASU.

Question 17: The proposed amendments would supersede various areas of guidance (such as the guidance on certain accounting models for convertible instruments). Do you expect that superseding that guidance will result in any unintended consequences? For example, is there guidance that is currently analogized in practice to account for transactions for which there is no explicit guidance under current GAAP? Please explain what those unintended consequences are and potential solutions, if applicable.

We are not aware of any potential unintended consequences of superseding various areas of guidance as a result of the proposed amendments.

Appendix II – Additional Recommendations

We have the following recommendations to enhance or clarify the proposals:

Reference	Recommendation	Rationale
470-20-55-1B	Consider adding guidance to clarify the meaning of the phrase 'the following reporting period'.	It is not clear whether the phrase 'the following reporting period' refers to the next interim reporting period (for those reporting interim financial information) or the next annual reporting period.
470-20-55-1B	If the Board's intent is that a probability assessment is required each reporting period, consider clarifying that it is a requirement for the purpose of disclosure although it is not required for accounting. If that is not the Board's intent, consider clarifying the nature of the ongoing assessment that may trigger the disclosure.	It is not clear if the guidance "...events or changes in circumstances that occur during the reporting period ....include those that indicate that, in the following reporting period, the conversion contingencies may be met or the conversion terms may be changed...." requires a probability assessment to determine if the criteria are met such that the disclosures in 470-20-50-1E(b) are triggered.