

**Financial Accounting and Reporting Section
of the American Accounting Association**

Financial Reporting Policy Committee

**Response to the FASB Exposure Draft:
Accounting for Convertible Instruments and Contracts in an Entity's Own Equity
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Introduction

The Financial Accounting and Reporting Section (FARS) of the American Accounting Association (AAA) charges the Financial Reporting Policy Committee (the Committee) to evaluate selected official standard-setting releases (e.g., invitations to comment, discussion papers, exposure drafts, and accounting standard updates) related to financial accounting and reporting, and to provide timely, substantive, and constructive written feedback that is grounded in relevant academic research. We are pleased to provide feedback on the Exposure Draft, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. The comments in this letter reflect the views of the individuals on the Committee and do not represent an official position of either FARS or the AAA.

The Exposure Draft sets out seventeen questions for respondents. Our goal in providing comments is to do so on the basis of relevant academic literature. Thus, we have limited our comments to those questions for which there is relevant research. In our view, these are Questions 1-3, Question 7, Question 9, and Questions 10-12. We were unable to identify research that was directly relevant to the other questions in the Exposure Draft.

Questions and Comments

***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 are not aware of any academic research that addresses the costs or benefits of bifurcating convertible instruments. Thus, we do not offer a comment on the first question.

Regarding the second question, we believe accounting for convertible instruments as a single unit of account is unlikely to result in a loss of information, so long as sufficient disclosures about the instruments' terms and features are provided. This conclusion is based on academic

research that suggests that the classification of hybrid financial instruments is not of primary importance to experienced users of financial statements (whom we view as most likely to be interested in such instruments). Specifically, a number of archival studies examine market reactions to specific hybrid or compound securities (Kimmel and Warfield 1995; Cheng et al. 2003, Terando et al. 2007). These studies support the conclusion that market participants condition their assessments of such instruments on their features. More recently, Clor-Proell et al. (2016) conduct an experiment with experienced finance professionals. They find that these experienced users rely primarily on disclosed features of a hybrid financial instrument in making credit-related judgments, rather than on the instrument's classification as a liability or as equity.¹

Question 2: *Do the disclosure amendments in this proposed Update for convertible debt instruments in paragraphs 470-20-50-1A through 50-11 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 the disclosure amendments do provide decision-useful information. A consistent theme in the research on financial instruments with characteristics of both liabilities and equity is that standard setters should consider disclosure to be as important as classification, and perhaps even more important. This is evident in the studies noted in our comment on Question 1 above, and we commend the emphasis on disclosure in the proposed Update.

With respect to whether disclosures should be provided for every annual or interim period, we believe that all proposed disclosures should, to the extent practical, be provided for every period in which statements of financial position and performance are presented. This conclusion is based on the evidence that these disclosures provide decision-useful information. However, as noted by Fargher et al. (2019), academic research generally does not speak to the cost-benefit tradeoff of providing information about features, and we do not offer a comment about the costs of providing these disclosures.

Regarding whether other disclosures should be provided for convertible instruments, the proposed disclosures appear quite comprehensive. However, as noted in our response to Question 1, academic research suggests that terms and features of financial instruments—rather than their classification—are of primary importance to experienced users of financial statements. Consistent with this, we do not believe disclosure requirements should generally depend on whether instruments are classified as liabilities or equity. Therefore, we would support adding a fair value disclosure requirement for equity-classified instruments to the amendments in 505-10-

¹ In an earlier experimental study, Hopkins (1996) found that buy-side analysts' valuation judgments differed in a predictable way when a security with characteristics of both debt and equity was classified as a liability or as equity. There are multiple possibilities for the apparent differences between the conclusions reached by Hopkins (1996) and Clor-Proell et al. (2016), including both the passage of time and the different nature of the dependent measures in the two studies (valuation in Hopkins (1996) versus creditworthiness in Clor-Proell et al. (2016)). Nevertheless, we consider it likely that experienced users understand the significant variation in the features of financial instruments. Hybrid and compound financial instruments may not have been well-understood in the mid-1990s, even by experienced users. However, the subsequent proliferation of such instruments, paired with a lack of clarity about classification, has likely made experienced users aware of the need to examine the features of financial instruments.

50-12 through 50-18 that mirror the requirement in 470-20-50-1D(c) for debt-classified instruments.

We offer one additional comment on this issue. A large body of research on footnote disclosure versus recognition suggests that footnote disclosure is unlikely to be a complete substitute for clear presentation on the balance sheet (e.g., Aboody 1996; Barth et al. 2003; Ahmed et al. 2006; Frederickson et al. 2006). Thus, we concur with the assessment of Ryan et al. (2001), who note that, when practical, presentation on the face of the balance sheet is preferable to footnote disclosure as a means for communicating effectively to users. Presentation could include, for example, disaggregation of various types of financial instruments classified as liabilities and equity, listing of such instruments in order of priority in liquidation, and brief, parenthetical disclosure of other features (such as conversion features). Such information, clearly presented on the face of the balance sheet, would benefit many users in that it would make clear the existence of instruments within each classification that differ in their terms and features.

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 believe that 'remote' is an operable threshold in that this threshold has been applied in other areas of the Codification, such as in the disclosure of contingent liabilities. However, we also believe that, even if this threshold is operable, it is not ideal given the academic findings concerning verbal probability phrases.²

Prior research that has examined the interpretation of verbal probability phrases, such as remote, reasonably possible, and probable, has found that financial statement users apply a lower probability threshold to the term 'remote' than do managers. For example, whereas financial analysts considered events with a probability lower than 15% to be remote, managers considered events with a probability lower than 20% to be remote (Aharony and Dotan 2004). This gap suggests that the introduction of a remote threshold will result in more instruments being classified as equity than users would expect.

Further complicating this issue, the evidence indicates that managers' interpretation of verbal probability phrases may be influenced by their incentives. In a tax setting, Cuccia et al. (1995) found that tax practitioners used the latitude in a verbal probability phrase to achieve their desired reporting outcome. Thus, there is a concern that the introduction of a remote threshold will allow preparers to interpret the available evidence in a manner that is consistent with their preferred classification (presumably as equity, rather than as a liability).

Finally, there are reasons to suspect that auditors may be unable to effectively mitigate managers' opportunistic reporting in this setting. First, prior research has found that there can be variation in auditors' interpretation of the term 'remote' (Amer et al. 1994; Jambalvo and Wilner 1985). In some research, auditors have considered events with a probability lower than 9% to be remote (Reimers 1992); in other research auditors have considered events with a

² See Botosan et al. (2005) and Skaife et al. (2007) for reviews of the academic literature concerning verbal probability phrases in the context of SFAS 5 and SFAS 109, respectively.

probability lower than 23% to be remote (Jiambalvo and Wilner 1985). Given the level of disagreement among auditors about the probability associated with the term ‘remote,’ it is unlikely that there will be consistent application/oversight of this proposed change to the codification. More broadly, when accounting guidance is less precise (such as when it includes verbal probability phrases), it can become more difficult for auditors to adjust preparers’ reporting choices because they cannot prove that the reporting choice is incorrect (see Nelson 2003 and Libby et al. 2015 for reviews).

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 that the proposed amendments to the reassessment guidance, in which reassessment only occurs in the presence of a reassessment event, are operable in that the reassessment events described in paragraph 815-40-35-8 can be objectively determined. However, we also believe that the introduction of objective reassessment events is problematic.

Under the proposed guidance, a reassessment would only occur if there was (1) adjustment to the instrument’s strike price or the number of shares used to calculate the settlement amount, (2) expiration of a settlement feature, or (3) a change in the condition for equity classification about sufficient authorized and unissued shares. These objective, bright-line criteria create an opportunity for firms to avoid triggering a reassessment event, should they so desire, either through the structure of the contract (i.e., events (1) and (2)) (Nelson 2003), or through the authorization of additional shares (i.e., event (3)). Thus, under these criteria, managers may never have to engage in a reassessment and it is unlikely that an initial classification, once established, would change in subsequent periods.

We are in favor of pre-determined reassessment intervals even if a reassessment event has not occurred. Regardless of the frequency of the predetermined reassessment interval (i.e., annual or otherwise), we would not support the remote-likelihood threshold. As described in our response to Question 3, we view the use of verbal likelihood thresholds (remote or otherwise) as problematic because their interpretation can differ for users, managers, and auditors (Aharony and Dotan 2004; Amer et al. 1994; Jiambalvo and Wilner 1985; Reimers 1992), can be influenced by managers’ incentives (Cuccia et al. 1995), and can be difficult for auditors to adjust (e.g., Nelson 2003). As a result, the use of a remote threshold in periodic reassessments would be unlikely to change preferred, prior period classification decisions, and would allow persistent classifications that may be inconsistent with users’ expectations.

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?

As noted in our responses to Questions 1 and 2, academic research suggests that terms and features of financial instruments—rather than their classification—are of primary importance to experienced users of financial statements. Consistent with this, we do not believe disclosure requirements should generally depend on whether instruments are classified as liabilities or equity. Therefore, where practical, we support fair value disclosure requirements for equity-classified instruments that mirror those for liability-classified instruments.

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.*

The Financial Accounting Foundation’s post-implementation review (PIR) found that “Statement 128 [now Topic 260] is understandable, can be applied as intended, and enables information to be reported reliably.” (FAF 2016) This conclusion draws both on direct outreach to users as well as academic research (and we understand that the academic literature review is available to the Board). However, the PIR also notes that “entities with complex capital structures sometimes find it difficult to apply [Topic 260] because of the complexity of the financial instruments that they issue . . .”

Further, academic research has shown that diluted EPS information often under-reports the extent of dilution that can result from the potentially-dilutive securities (see, for example, Core et al. 2002). However, much of that research has focused on the use of the treasury stock method – particularly with respect to the dilutive effect of share-based payment arrangements. Research focusing on the effect of the if-converted method also finds under-reporting of dilution, but perhaps to a lesser extent and in a manner that is easier for users to process (Partridge 2019).

Therefore, on balance we believe that the use of the if-converted method for all convertible instruments has the potential to address the challenges identified in the PIR and, perhaps, to more closely represent the potential dilution from convertible instruments. Further, we believe that the guidance in paragraph 260-15-45-40(b) is understandable and operable, especially if the remainder of the proposal is adopted because the amount of recognized interest cost on such instruments would be less than under current US GAAP.

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.*

As noted in our response to Question 10, academic research generally concludes that the application of Topic 260 under-reports the dilutive effect of potentially-dilutive securities on diluted EPS. If the Board requires the assumption of share settlement, then this would generally result in a more dilutive outcome under Topic 260. On balance, this requirement could reduce the system-wide under-reporting of the dilutive effect of potentially-dilutive securities on diluted

EPS. However, it could also harm representational faithfulness for contracts that are likely to be settled in cash if those contracts are treated as though they will be settled in shares. Thus, although the Board's proposal could result in reduced under-reporting of potential dilutive effects, we would encourage the board to undertake a separate, broader project to better align the reporting for the effects of potentially-dilutive securities on diluted EPS with the actual dilutive outcome.

***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.*

Consistent with our observations with respect to the academic research described in response to Questions 10 and 11, we believe the Board should consider a broader project to better align the reporting for the effects of potentially-dilutive securities on diluted EPS with the actual dilutive outcome. However, we believe that this is a project the Board should consider holistically rather than as part of this project, which is aimed at making targeted improvements to the accounting for convertible instruments and the indexation and settlement requirements of Topic 815.

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