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Mr. Shayne Kuhaneck
Acting Technical Director
Financial Accounting Standards Board
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File Reference No. 2019-730

Dear Mr. Kuhaneck:

RSM US LLP is pleased to provide feedback on the proposed Accounting Standards Update (ASU), *Debt – Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging – Contracts in Entity’s Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity*. We appreciate the efforts the Financial Accounting Standards Board is putting forth to improve the relevant accounting guidance given the complexity associated with the current guidance and its emphasis on form over substance. With the exception of the proposed amendments to the indexation guidance in Subtopic 815-40-15 (which we believe do not go far enough in reducing complexity nor in decreasing the emphasis on form over substance), we generally are supportive of what the Board is proposing. In this letter, we elaborate on these views through our responses to the specific questions raised in the proposed ASU, and we discuss other matters we would like to bring to your attention.

Responses to Questions for Respondents

Convertible Instruments

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 believe that by eliminating the separation models currently within Subtopic 470-20 and accounting for most convertible instruments as a single unit of account, the economic cost associated with granting a conversion option in lieu of a market rate of interest will not be recognized in the financial statements. However, given the reduction in complexity that would occur and feedback from the users of financial statements indicating they do not find the current separation models to be useful or relevant, we are supportive of this proposed simplification. With consideration given to the additional proposed disclosure requirements, we are not aware of any additional information that would be necessary in order to understand an entity’s financial position and performance.

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*

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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 proposed disclosure amendments generally provide decision-useful information; however, we believe it would be beneficial to permit fair value, terms and other information for similar convertible debt instruments to be disclosed in the aggregate (with disclosures of ranges of terms when terms differ) rather than individually when, due to the number of instruments outstanding, aggregation would avoid unnecessary repetition and promote a more clear, concise and meaningful disclosure.

As it relates to interim disclosures, we believe the requirement in Regulation S-X to disclose significant changes in capitalization, including significant new borrowings, since the end of the most recent fiscal year suffices such that it is not necessary to require any of the proposed disclosures to be included in interim financial statements. We acknowledge that private companies are not bound by Regulation S-X; however, most private companies do not prepare interim financial statements with a complete set of footnote disclosures.

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 the ability to disregard remote settlement features when performing the settlement analysis required by Subtopic 815-40-25 will be very impactful in reducing cost and complexity, as well as in reducing divergence in accounting treatments for instruments that are substantively the same. We believe "remote" is an operable threshold in this context, particularly because it is rare in practice for one of the conditions currently listed in paragraph 815-40-25-10 to result in cash settlement of an equity contract. However, we believe it would be beneficial to clarify whether the remote assessment should be based on the likelihood of the condition occurring as of the evaluation date (i.e., issuance or reassessment date) or over the life of the contract. We believe the Board's intent is that, on the evaluation date, one would consider whether the condition has a more than remote likelihood of occurring at any time during the life of the contract (as opposed to just considering whether as of the evaluation date the condition has a more than remote likelihood of occurring), but we believe it would be beneficial to clearly articulate the intended meaning.

For consistency purposes, we also strongly encourage the Board to make similar modifications to Topic 480 to indicate that when performing the analysis required by paragraph 480-10-25-8, contingent obligations that have a remote likelihood of occurring should be disregarded. We believe the concept of disregarding remote contingent obligations also is consistent with the underlying concept in paragraph 480-10-25-1 to disregard nonsubstantive or minimal features.

As it relates to the proposed modifications to the indexation guidance, we believe a more fundamentally sound approach would be one that is similar to the *predominantly derived from stock price* approach discussed in the basis for conclusions and the approach required by paragraph 480-10-25-14 when the number of shares with which a contract will be settled is variable. While the proposed amendments would give consideration to the likelihood of an adjustment being triggered, no consideration is given to the significance of the potential adjustments (i.e., whether overall they cause the settlement value to not be correlated with the underlying stock) such that economically similar instruments would continue to be accounted for differently. Given the intent to retain the existing guidance in paragraph 480-10-25-14, an ideal approach would be to adapt this methodology to address not only variability in the number of shares but also the strike price such that the current

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rules-based guidance in Subtopic 815-40-15 could be eliminated. We encourage the Board to give further consideration to whether such an approach could be made understandable and operable through examples applying the principle to common variability in equity contracts, using both a qualitative approach and simplistic quantitative analysis (e.g., scenario analysis using a simple Black-Scholes approach to demonstrate the impact that a change in term due to the adjustments is likely to have on the fair value of the contract).

In the event the conclusion remains that such an approach is not operable, we are supportive of the proposed amendment to add a remote threshold to the indexation guidance, given that it is illogical for the balance sheet classification of an instrument to be driven by a feature that has a remote likelihood of occurrence. We do not believe the proposed modifications to the indexation guidance will significantly reduce the complexity associated with the analysis or restatement risk. Therefore, in the event the indexation guidance in Subtopic 815-40-15 is retained (with or without the proposed modifications), we believe the most effective way to reduce complexity and restatement risk is to publicly disclose views on its application to scenarios that are currently challenging. At any given time, there typically are a small number of common scenarios for which divergent views exist that create the complexity and uncertainty. We are aware that the approach typically taken to alleviate this uncertainty and complexity is for firms to have individual discussions with the FASB staff. We believe it would promote consistent application and would level the playing field if those views were made publicly available through incorporation in the guidance, discussion in the basis for conclusions or otherwise. The examples in Subtopic 815-40-55 have made the current indexation guidance understandable and operable; therefore, it seems that if the rules-based indexation guidance in Subtopic 815-40-15 is retained, keeping it updated to address current common practice issues will keep it operable. Examples of common practice issues in applying the current indexation guidance are included in the *Related matters for consideration* discussion that follows.

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 are highly supportive of the decision to remove this requirement from the classification guidance, given the extensive time and effort that often is needed to analyze agreements associated with registered offerings to determine whether the company could be forced to cash settle an instrument as a result of securities laws or the contract requiring settlement in registered shares. This time and effort does not appear to be justified given that we are unaware of any company being forced to net cash settle an equity contract as a result of not being able to deliver registered 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.*

In practice, we have not seen the posting of collateral result in the cash settlement of an equity-linked contract, so we agree that this requirement should not affect the classification of a contract. Additionally, it can be a time-consuming process to address this requirement, given the need to carefully evaluate collateral arrangements issued in conjunction with convertible or other debt to determine whether the collateral protection extends to the conversion option or to warrants that may have been issued with the debt instrument.

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 that this requirement should not affect the classification of a contract because the existence of rights ranking higher than a shareholder of the stock underlying a contract generally does not

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translate into a potential requirement to cash settle the contract. (If the right was a right to cash settlement, that would continue to be addressed through paragraph 815-40-25-4.)

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.*

While we recognize there are merits to limiting reassessment to the occurrence of a reassessment event, we believe it would be preferable to retain the current requirement to reassess the classification on an ongoing basis. We believe annual reassessment would suffice (i.e., rather than requiring reassessment for every reporting period). We have observed in practice that many entities tend to issue numerous instruments at various times using the same or very similar form. In the absence of a requirement to reassess annually or at each reporting period end, the same instrument issued at different dates could be accounted for differently solely because of a different conclusion reached on the likelihood of an adjustment being triggered or cash settlement being required at the different issuance dates. We believe the reassessment should focus on whether there was a significant change in facts and circumstances that would require reclassification.

If the Board moves forward with the proposal to only require reassessment upon the occurrence of a reassessment event, we believe the list of reassessment events in paragraph 815-40-35-8 should be expanded to include when a contract is modified. In other words, consistent with practice today, we believe that if a contract is modified to remove a problematic provision, the entity should be permitted to reclassify the instrument to equity. Similarly, if a problematic provision is added to an equity-classified instrument, that instrument should be reclassified to an asset or liability at the time of the modification. Additionally, if the Board moves forward with the proposal to only require reassessment upon the occurrence of a reassessment event, we encourage the addition of a requirement for an equity contract to be reclassified to a liability if cash settlement becomes probable.

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 the proposed disclosure amendments provide decision-useful information. Consideration should be given to requiring disclosure of remote features that were disregarded in the accounting analysis.

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 entities likely would incur significant costs in determining the fair value of equity contracts in those cases where the underlying shares are not actively traded, or other significant inputs are not observable. In our opinion, these costs likely would exceed the benefits associated with fair value disclosures for equity-classified instruments.

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EPS

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 believe that it is appropriate to calculate diluted EPS for all convertible instruments using the if-converted method for consistency purposes and that the proposed changes made to the method are 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.*

We agree with the proposed simplified approach requiring a presumption of share settlement (with no ability to rebut that presumption) when calculating diluted EPS for a contract that can be settled in either cash or shares (except certain liability-classified share-based payments).

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 it would be beneficial to further explore whether (a) changes are warranted to existing guidance to more accurately reflect the dilutive impact on EPS by considering the effect of antidilutive instruments, and (b) there are additional opportunities to reduce complexity in EPS calculations.

Transition and effective date

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 believe consideration should be given to permitting prospective application using the approach outlined in proposed paragraph 815-40-35-10 in light of the cost and complexity that may be involved in reallocating proceeds in transactions involving multiple financial instruments such as the issuance of debt with detachable warrants illustrated in paragraph BC117 of the proposed ASU. In this scenario, a private company likely would need to incur significant cost to determine the fair value of the debt at its issuance date to reallocate the proceeds based on relative fair value. This should be less of a burden for public companies, given they are required to disclose the fair value of financial instruments carried at amortized cost and therefore would have the necessary information to reallocate proceeds. We are in agreement with the proposed transition expedient, given the difficulty of retroactively assessing the likelihood of a feature occurring.

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 agree with the proposed transition provisions as they are a cost-effective solution that will not diminish the usefulness of the information provided to the users of financial statements.

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*

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entities be different from the amount of time needed by public business entities? Should early adoption be permitted? Please explain your response.

We suggest a two-bucket approach to effective dates, similar to that outlined in the proposed ASU, *Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*. Given the complexities involved with transition (as illustrated in paragraph BC117), we believe reporting entities in bucket one should have, at a minimum, a year from the issuance date of a final standard before being required to implement it and that entities in bucket two should be given an additional two years for implementation. Also, we are in favor of permitting early adoption.

Overall

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 believe consideration should be given to whether the proposed modified disclosures are too onerous and unnecessary for private companies. Additionally, in the event our suggestion to permit prospective application is not implemented for all entities, we encourage the Board to allow prospective application for private companies at a minimum.

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.*

There may be some unintended consequences associated with the elimination of the separation models in Topic 470-20 that resulted in portions of convertible debt being recognized in equity. This could happen, for example, when a convertible debt instrument is required to be remeasured at fair value subsequent to its issuance date for reasons such as a business combination or debt extinguishment. It is not uncommon for the fair value of the convertible debt instrument to be significantly greater than its face amount due to the conversion feature becoming "in the money" and therefore more valuable as the company's stock appreciated with the passage of time. With the proposed elimination of the separation models in Topic 470-20, and specifically paragraph 470-20-25-13, through which such fair value premiums generally were recognized as paid-in-capital, the unintended consequence may be that negative interest expense will be recognized on a convertible instrument when it is subsequently remeasured to a significantly higher fair value and the premium amortization more than offsets the contractual interest expense. The proposed solution may be to acknowledge that this could occur. The proposed new disclosure requirement in paragraph 470-20-50-1F would make this nuance transparent in the financial statements.

Related matters for consideration

Common practice issues in applying the current indexation guidance

With the issuance of ASU 2017-11, paragraph 815-40-15-5D was added to Subtopic 815-40-15 to indicate that a down round feature should be excluded from the indexation considerations, and the definition of a down round feature was added to the Master Glossary. Questions have come up in practice related to whether down round protection triggered by increases or decreases in strike prices

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of other instruments (as opposed to being triggered by sales or issuances of new instruments as is contemplated in the definition of a down round) should be excluded from the indexation considerations. As background information, in addition to including a down round feature as defined in the Master Glossary, it is not uncommon for warrant and convertible instrument agreements to include a feature that will result in an adjustment to the strike price of the instrument if the strike price of another instrument drops below the strike price of the instrument in question, whether due to the contractual terms of the other instrument or modifications to its strike price put forth by the issuer. Other variations observed in practice include instruments that will have the strike price, number of shares and class of shares that can be purchased adjust or be determined based on the class of shares issued in the next qualified financing event and the price at which those shares are issued in that financing event. Questions and complexity arise in practice because, while such features are similar to, or substantially the same as, a down round, they do not meet a strict application of the definition.

Form over substance questions also frequently arise in the context of warrants issued with credit facilities, whereby the number of shares the holder can purchase under the warrant agreement is dependent upon future draws under the credit facility. A common arrangement is that, upon entering into a credit facility and making an initial drawdown, a single warrant agreement is issued that gives the lender the right to purchase 100,000 shares at a stated exercise price; however, in the event the company draws down the remaining available borrowings, an additional 100,000 shares can be purchased at the same stated exercise price. There are no substantive differences between this common arrangement and an arrangement structured as two separate warrant agreements (one to purchase 100,000 shares issued upon the initial draw on the credit facility and another one to purchase an additional 100,000 shares issued or exercisable upon the subsequent draw on the credit facility). When structured as two separate warrant agreements, the conclusion generally is reached that each agreement is indexed to the entity's shares because each agreement is to purchase a fixed number of shares at a fixed exercise price. There is divergence in practice and uncertainty as to the appropriate application of the guidance to the "common arrangement." Under one view, which focuses on form, the warrant agreement described as the common arrangement is viewed as not indexed to the entity's stock because the number of shares is not fixed and the variable (drawdowns on the facility) is not an input to an option pricing model. Given there are no substantive differences between the "common arrangement" and issuing two separate warrant agreements—each to purchase a fixed number of shares—under the alternate viewpoint that focuses on the substance, the single warrant agreement described under the common arrangement is viewed as indexed to the entity's own stock.

We understand that various firms have had conversations with the FASB Staff about these and similar recurring issues and believe it would be beneficial in reducing complexity and uncertainty and promoting consistent application if those views were made publicly available through incorporation in the guidance, discussion in the basis for conclusions or otherwise.

Recognition of the effects of a down round feature

We noted that the guidance in paragraph 260-10-25-1 requiring the effect of a down round to be recognized when triggered in an equity-classified freestanding instrument is retained in the proposed ASU and is extended to equity-classified preferred stock. As noted in paragraph BC45, recognition is not required when a down round is triggered in convertible debt instruments because Topic 825 requires fair value disclosures for convertible debt. We believe it would be preferable to be consistent in this regard (i.e., if recognition is given to a down round that is triggered in an equity-classified freestanding instrument or preferred stock, a triggered down round also should be recognized in

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convertible debt). We also question the logic behind maintaining the recognition provisions of paragraph 260-10-25-1 yet not requiring recognition when other adjustments are triggered, such as the strike price adjustment discussed in proposed paragraph 815-40-55-50B.

Stock-settled debt

We believe further clarifications are necessary to clearly distinguish between stock-settled debt, which may be within the scope of Topic 480, and debt with a substantive conversion feature that would be within the scope of Subtopic 470-20. We noticed that an attempt was made to do this in proposed paragraph 470-20-15-2C, where references were made to paragraphs 470-20-25-14 (for an illustration of stock-settled debt) and to paragraphs 470-20-40-7 through 40-10 (for a discussion of substantive conversion features). Stock-settled debt is not defined in the master glossary. We believe the illustration at 470-20-25-14 and related example at 470-20-55-19 do not properly convey that stock-settled debt is not limited to instruments with conversion options that continuously reset to the current market price of the stock. Instruments currently prevalent in the market place are structured with automatic (or in some cases, optional) conversion into the class of shares issued in the next qualified financing event, with the number of shares determined based on the qualified financing price to result in a fixed amount of value. While larger accounting firms and certain others have made the connection between the instruments prevalent in the market place and the instruments described in Subtopic 470-20 as stock-settled debt, those reporting entities and practitioners who have not thus far made the connection likely will not unless stock-settled debt is defined in a broader, conceptual manner (i.e., to capture instruments for which the conversion price is based on the issuance price of the class of conversion shares at the date of conversion).

Additionally, it would be beneficial to clarify paragraph 470-20-15-2C to expand on what is meant by a “substantive conversion feature” when used in this context. As currently worded, one is instructed to look at paragraphs 470-20-40-7 to 40-10 for this determination. With consideration given to this guidance, conversion features with a conversion price that is based on the discounted fair value of the shares at the time of conversion or a discount to the qualified financing price could be deemed to be substantive. We believe it would be beneficial to modify paragraph 470-20-15-2C to clearly indicate that conversion features need to be analyzed to determine whether (a) they are designed to give the holder a fixed amount of value paid in shares, in which case, they should be evaluated as put features and consideration given to Subtopic 815-15, unless the entire instrument is viewed as stock-settled debt under ASC 480-10-25-14(a), or (b) they are designed such that the value the holder receives upon conversion is dependent upon the value of the underlying shares, in which case, they are within the scope of Subtopic 470-20 and should be evaluated as conversion options when considering Subtopic 815-15.

Clarify provisions related to allocation of proceeds

Paragraphs 470-20-25-2 and 470-20-30-1 indicate proceeds from the sale of a debt instrument issued with stock purchase warrants should be allocated to the two elements based on their relative fair values at the [time of issuance](#). Paragraph 470-20-25-2 also indicates that the portion of the proceeds allocated to the warrants should be accounted for as paid-in capital. These paragraphs are misleading and should be clarified to caveat that this treatment is relevant when the warrants meet the requirements to be classified in equity.

Guidance also should be added to address the allocation of proceeds to liability-classified warrants and other instruments that are subsequently measured at fair value (proceeds are first allocated to instruments that are subsequently measured at fair value equal to their issuance date fair value with any remaining proceeds allocated based on relative fair value to instruments that are not

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subsequently measured at fair value). Further, it would be beneficial to add guidance to Topic 505 to address the allocation of proceeds since preferred stock often is issued with warrants.

Clarification to derecognition provisions of subtopic 470-20

Paragraph 470-20-40-4 addresses the accounting for the contractual conversion of a convertible debt instrument and indicates that any unamortized premium, discount or issuance costs should be credited to the capital accounts to reflect the shares issued, and no gain or loss should be recognized. This paragraph should be clarified to indicate that it applies when the conversion option was not separately recognized as a derivative, given that the scope of Topic 470-20 applies to all debt instruments (including those for which the conversion option requires separation under Subtopic 815-15). Guidance also should be added to address the contractual conversion when the conversion option was separately recognized as a derivative (i.e., since the debt host contract is no longer viewed as convertible, extinguishment accounting applies, with gain or loss recognized for the difference between the fair value of the shares and the combined adjusted carrying amounts of the debt host contract and the conversion option derivative).

We appreciate this opportunity to provide feedback on the proposed ASU and would be pleased to respond to any questions the Board or its staff may have concerning our comments. Please direct any questions regarding this letter to Rick Day at 563.888.4017 or Faye Miller at 410.246.9194.

Sincerely,

RSM US LLP

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