ILLINOIS CPA SOCIETY™

October 14, 2019

Technical Director
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

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The Accounting Principles Committee of the Illinois CPA Society ("Committee") appreciates the opportunity to provide its perspective on the Financial Accounting Standards Board's ("FASB" or the "Board") Proposed Accounting Standards Update ("ASU"), *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity (Subtopic 470-20 and 815-40) ("Update")*. The Committee is a voluntary group of CPAs from public practice, industry and education. Our comments represent the collective views of the Committee members and not the individual views of the members or the organizations with which they are affiliated. The organization and operating procedures of the Committee are outlined in Appendix A to this letter.

We agree that simplification of the debt and equity accounting models in US GAAP is necessary. However, under the proposed model, economically very different convertible instruments will be presented similarly in companies' financial statement. We believe the accounting model should differentiate the economics of the underlying convertible instrument and not limit the identification of the features of these convertible instruments to the disclosures. Some complexity in the model is necessary, and provides benefit worth the cost, to reflect the differences in the economics of the convertible instruments under consideration in this Update.

The Committee had differing views on the proposed amendments to the guidance in Subtopic 815-40.

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We appreciate the opportunity to provide our comments and observations on the Update and would be pleased to discuss them with the Board members or the FASB staff at your convenience.

Sincerely,
Brian Kot, CPA
Chair, Accounting Principles Committee

William Keirse, CPA
Vice Chair, Accounting Principles Committee

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.*

Response: We do not agree with the proposed guidance that accounts for convertible instruments as a single unit of account except in circumstances in which the conversion feature is required to be bifurcated. We believe that the conversion options in convertible instruments that are not required to be bifurcated should be recognized and accounted for. We do not believe that the increased disclosures required for convertible instruments by ASC 470-20-50-1A through 1I and ASC 505-10-50-12 through 18 provide adequate transparency for differentiating the economics underlying these instruments.

We do believe that all convertible instruments, in which the conversion features are not required to be bifurcated, should be accounted for by a single method in which the embedded equity conversion feature is measured at fair value at issuance, and recommend that companies:

> Calculate the difference between fair value and proceeds. Accrete the difference over the life of the convertible instrument to expense or dividend and to APIC. This alternative is based on the Stock Compensation model in ASC 718, and is familiar to preparers, users, and auditors.

We observe that convertible instruments are sometimes issued at a premium for the reason that investors purchase convertible instruments at a lower stated interest rate than nonconvertible instruments. If the model proposed in the Update for instruments with conversion features that do not require bifurcation is adopted, we suggest that the FASB prohibit companies from recognizing income by amortizing premiums and require companies to report losses when settling convertible instruments at more than carrying amount.

We note that developing a consistent accounting model for equity options issued in financings is not a simple task. We support developing a single model that provides consistent accounting for all equity options. The following accounting guidance for equity options would be inconsistent with the proposed model as the fair value, relative fair value, or change in the fair value of these equity features is recognized:

1. Down round model – ASU 2017-11 recognizes the difference in fair value the moment before and the moment after the down round, and the difference is reported through expense or dividend.
2. Inducement model – ASC 470-20 recognizes the fair value of the incremental equity offered as an inducement for conversion as an expense or dividend.
3. Bifurcated conversion option – the cost is expensed through recognition of a discount that for debt is amortized to interest over the life of the debt. If the host instrument is equity with a set maturity date, the charge is taken to dividends over the life of the debt.
4. Bifurcated conversion option that subsequently becomes equity classified – the cost is expensed through recognition of a discount that is amortized to interest over the life of the debt. At the point the conversion option becomes equity classified, it is marked to market through the P&L one last time, and then recorded in equity. The discount created at issuance continues to be amortized. The situation is the same for convertible preferred stock with a set maturity date and a bifurcated conversion option, except the charge is recorded to dividends.
5. Convertible instruments that are modified rather than extinguished – any increase in the fair value of the conversion option is recognized in equity and increases the amount of the discount. The discount is amortized to interest expense or dividends over the life of the modified debt or modified convertible stock.
6. Convertible instruments issued with warrants – the discount created by the warrant (either fair value if the warrant is a liability or relative fair value if the warrant is equity) is amortized to expense or dividend over the life of the instrument.

7. Equity granted to a customer – the fair value of the equity is recognized as a reduction of revenue.
8. Equity granted to an employee or nonemployee for goods or services – the cost of the stock is expensed under ASC 718.

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.*

Response: We believe that the proposed incremental disclosures will provide users with useful information regarding terms and features of convertible instruments. As noted above, we do not believe the disclosures are an adequate substitute for accounting for the economic features of convertible debt discussed in our answer to Question 1. We recommend requiring full disclosures (470-20-50-1A through 50-1I and 505-10-50-12 through 50-18) on an annual basis; and requiring only disclosure of changes in events or accounting (e.g., reassessment) in interim periods.

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.*

Response: The accounting model for debt and equity is complex. The addition of a remote threshold adds the challenge of assessing the probability of an event to an already complex model. To the benefit of the Update's simpler model we must add the cost of determining, documenting, and defending the probability of an event.

We believe the remote threshold would be less challenging to implement and more operational if the Board provided implementation guidance in the form of factors, indicators, and/or examples about how to assess whether an event is remote of occurrence. We note that it can be challenging for both preparers and auditors to assess the probability of events occurring that are outside the company's control, such as initial public offerings. Also, many smaller public and private companies perform limited, if any, forecasting. Larger companies that do forecast generally limit detailed forecasting to two to three years. When an instrument is long term and a company's forecast is limited to less than three years, applying the remote threshold to events occurring beyond the forecasted period is challenging if not impossible.

We note that the Board has addressed simplification of 470-20 and 815-40. However, many of the warrants that we see are liabilities under ASC 480-10-25-8 because the warrants could be settled in cash upon a conditional event. We note that warrants that are liabilities under the scope of ASC 480-10-25-8 exceed the number of warrants that are liabilities under the scope of ASC 815-40-15 and 25. We suggest that if the Board finalizes the Update, it extends the application of the remote threshold to 480-10-25-8.

Further we observe that the SEC does not allow issuers to disregard remote settlement features (see ASC 480-10-S99-3A). Issuers with equity that is conditionally redeemable, even under remote circumstances, are required to classify that equity in the mezzanine section of the balance sheet. The proposal does not address the inconsistency that will occur between issuer and non-issuer reporting and accounting resulting from ASC 480-10-S99-3A.

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.*

Cashless exercise of financial instruments issued in a registered offering generally results in instruments that are exempt from registration. Gross settlement of financial instruments issued in a registered offering would not be exempt from registration, and settlement would not be allowed when the issuer has no effective registration statement. Contracts that do not restrict exercise to cashless exercise when there is no effective registration statement currently require liability classification. Since there is no economic difference between cashless exercise and gross settlement of financial instruments, we agree that the requirement to settle in registered shares should not affect classification.

We have found that the question of whether a contract can be settled in unregistered shares is often difficult to answer. Our experience is that the legal and accounting communities approach the question from different viewpoints that are difficult and expensive to resolve. The change proposed in the Update would eliminate argument and the associated cost. We also encourage the FASB staff to direct this issue to the SEC staff as the SEC staff will need to provide support before this Update is effective for issuers, particularly given the existence of an oft-referenced SEC staff speech on this topic.

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.*

Response: Some members of the Committee agree that such a requirement should not affect classification. Those members have significant experience with financial instruments and have not seen a convertible instrument for which the embedded conversion option required collateral in the time we have been practicing. Those members who believe a requirement to post collateral also have significant experience with financial instruments and observe that the reason derivatives on an entity's own shares do not include such a provision is because including such a provision would result in classifying the derivative as a liability. Those members believe that is an appropriate outcome because the counterparty is placed in a better position than investors holding the shares underlying the derivative.

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.*

Response: Some members of the Committee agree such a requirement should not affect classification. Those members have not seen this in practice, and different classes of equity often include different rights. Those members of the Committee who believe providing the counterparty with rights greater than the rights of shareholders should have an accounting consequence in terms of classification observe that the reason derivatives on an entity's own shares do not include such a provision is because including such a provision would result in classifying the derivative as a liability. Those members believe that is an appropriate outcome because the counterparty is placed in a better position than investors holding the shares underlying the derivative.

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.*

Response: We believe that companies should assess the accounting for any change in probability (e.g., an event becomes possible or probable). We believe this assessment should be performed every reporting period. We considered whether this assessment should be performed annually as currently we assess the impairment of goodwill and long-lived intangibles annually. We would find annual assessment acceptable but prefer interim reporting period reassessment. Without these assessments, big changes in financial instruments could occur that would only be captured in the disclosures.

We also believe that modification of a contract should be included as a reassessment condition.

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.*

Response: We agree with the proposed disclosure amendments.

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?*

Response: We do not support adding new fair value disclosure requirements for equity-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.*

Response: We agree that the if-converted method should be required to compute diluted EPS for all convertible instruments and believe that the revisions are operable. We suggest that the Board provide an example for a company with cash convertible instruments that can settle in cash or shares to illustrate EPS when the principal is not cash settled.

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.*

Response: We agree with eliminating the ability to rebut the presumption about share settlement.

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.*

Response: Some members of the Committee believe the Board should consider a project about the effect of antidilutive instruments on the diluted EPS calculation. While there are no practice issues in this area because the guidance in Topic 260 is clear that antidilutive instruments are excluded from the computation of diluted EPS, that mandated exclusion results in a diluted EPS that is not meaningful. We are aware of reporting entities that have issued convertible debt and then entered into an equity derivative transaction that effectively increases the conversion price. However, the diluted EPS calculation will be based on the lower conversion rate in the debt instrument while ignoring the instrument that will offset, or significantly reduce, the dilution from the debt instrument. Other members of the Committee do not believe that the Board should consider a project about the effect of antidilutive instruments on the diluted EPS calculation.

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.*

Response: We agree with the proposed transition guidance and transition expedient.

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.*

Response: We recommend the same transition requirements for all aspects of the EPS amendments.

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.*

Response: We believe one year would provide enough time for public business entities to implement the changes proposed in this exposure draft. We also recommend a delayed effective date for other entities of at least one year following the effective date. We recommend providing all companies with an option to early adopt the final amendments.

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?*

Response: We do not believe there are any additional considerations specific to private companies.

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.*

Response: We did not note any unintended consequences. We note that the Update provides simplification without a conceptual basis. We find accounting models with a conceptual basis easier to apply and explain.

APPENDIX A
ACCOUNTING PRINCIPLES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2019-2020

The Accounting Principles Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members appointed from industry, education and public accounting. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of accounting standards. The Committee's comments reflect solely the views of the Committee and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to fully study and discuss exposure documents proposing additions to or revisions of accounting standards. The Subcommittee ordinarily develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

Public Accounting Firms:	
Large: (national & regional)	
Ryan Brady, CPA	Grant Thornton LLP
Ashley Carboni, CPA	KPMG LLP
Michael Couillard, CPA	Baker Tilly Virchow Krause LLP
Matthew Denton, CPA	Sikich LLP
Jason Eaves, CPA	Crowe LLP
William Keirse, CPA (Vice Chair)	Ernst & Young LLP
Scott Lehman, CPA	Crowe LLP
Melissa Lynch, CPA	Plante Moran, PLLC
Reid Mitchell, CPA	Wipfli LLP
Jason Plourde, CPA	Grant Thornton LLP
Elizabeth Prossnitz, CPA	BDO USA LLP
Darshana Raigaga, CPA	BDO USA LLP
Medium: (more than 40 professionals)	
Almira Goethe, CPA	CDH, PC
Danielle Martin, CPA	Porte Brown LLC
Jeffery Watson, CPA	Miller Cooper & Company Ltd
Small: (less than 40 professionals)	
Peggy Brady, CPA	Selden Fox, Ltd.
Brian Kot, CPA (Chair)	Cray Kaiser Ltd CPAs
Educators:	
Mollie Adams, CPA	Bradley University
John Hepp, CPA	University of Illinois at Urbana-Champaign
Industry:	
Jeffrey Ellis, CPA	FTI Consulting, Inc.
Michael Maffei, CPA	GATX Corporation
Thomas Masterson, CPA	Medix
Matthew Mitzen, CPA	CNA Financial Corp.
Lisa Sezonov, CPA	Northern Trust
Richard Tarapchak, CPA	Reynolds Group Holdings
William Wang, CPA	MAT Holdings, Inc.
Daniel Wilfong, CPA	Sunset Transportation, Inc.

Staff Representative: Rafael Wiesenberg, CPA — Illinois CPA Society