The Association of Accountants and Financial Professionals in Business

October 21, 2019

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

Re: File Reference No. 2019-730, Proposed Accounting Standards Update *Debt ─ Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging ─ Contracts in Entity's Own Equity (Subtopic 815-40)*

Dear Mr. Kuhaneck:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on the Financial Accounting Standards Board's (FASB or Board) Proposed Accounting Standards Update *Debt ─ Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging ─ Contracts in Entity's Own Equity (Subtopic 815-40)* (Proposed ASU).

The IMA is a global association representing over 140,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The Committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

The Committee agrees with the Board's efforts to ease the application of the guidance on accounting for convertible debt arrangements and determining the classification of contracts in an entity's own equity. However, we do not support issuance of the Proposed ASU in its current form. Instead, we have proposed an alternative model related to the accounting for convertible debt that we describe below and that we discussed with the Board in September.

Relative to the proposed guidance regarding derivatives on an entity's own equity, we would generally prefer to retain the current model as we believe there is a principle underlying that model. If that is not an acceptable alternative to the Board, rather than requiring an assessment of the likelihood of a future event, we believe the Board should provide a list of events (such as an initial public offering, change in control, tax law changes, bankruptcy, or an acquisition) that would be assumed to be remote during the term of a derivative contract. Such an approach would significantly reduce complexity and would be operational and auditable. However, we believe a reporting entity should be required to periodically reassess the likelihood of an event and, if the event is probable, reclassify the equity derivative to a liability at its then current fair value and subsequently recognize changes in the fair value through earnings. Finally, we believe liability classification is the most economically consistent accounting when a reporting entity grants a counterparty to equity derivative rights higher than shareholder rights or is required to post collateral benefiting a counterparty.

We have other comments on the Proposed ASU that are detailed below. Our recommendations largely result from the following challenges that we have with the Board's proposal.

- The proposed guidance on accounting for convertible debt could result in reporting entities with significantly different credit profiles reporting similar amounts of interest expense because the reporting entity with an increased credit risk has provided investors with a conversion option, which could even be in-the-money. While the approach in the Proposed ASU to reporting convertible debt would give users the balance sheet information they prefer, it would distort information provided to users who are interested in a reporting entity's results of operations. We believe the approach in the Proposed ASU would obscure the economics associated with convertible debt arrangements by making all such arrangements look alike.
- The proposed guidance on classifying derivatives on an entity's own equity is not easily operable or auditable and thus would not eliminate complexity in assessing the classification of a derivative on an entity's own equity. As it relates to the operability and auditability of the proposed approach, we note that unlike with legal contingencies, there are not specialists with a practical basis to provide the reporting entity and its auditors with information about whether the occurrence of a provision requiring net cash settlement of a derivative on the entity's own equity is remote over the life of the contract. We believe the Board's approach may eliminate one aspect of complexity from the equity classification model, but the requirement to assess the probability of occurrence of a provision creates complexity that, in our view, is at least comparable to the complexity of the guidance the Board proposes to eliminate.
- The Board's proposed approach to derivatives on an entity's own equity would also delay the recognition of a liability (or an asset) when the likelihood of an event requiring (or permitting the counterparty to elect) net cash settlement well beyond the time that the occurrence of such an event is no longer remote, requiring the reporting entity to recognize the settlement (or adjustment) when the event occurs. We have difficulty reconciling that approach with the approach the Board took on recognizing credit losses on financial assets. We also note that the approach in Topic 450 would result in recognizing a liability sooner than would the Proposed ASU.
- We do not agree with amendments to the guidance in Subtopic 815-40 that explicitly permit a counterparty to a derivative on an entity's own equity to be in a position that is above that of a holder of the class of equity on which the derivative is written. We are aware of no practice issues associated with classifying a derivative on an entity's own equity when the reporting entity is required to provide collateral for the benefit of the counterparty because the guidance in Subtopic 815-40 is clear on the impact providing collateral (or rights that rank higher than shareholder rights) would have on classification. We believe requiring liability (or asset) classification in those cases is appropriate because the instrument does not have similar risk characteristics to an equity instrument because of those protections.

We address these issues, and our proposed alternatives, further below.

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Accounting for Convertible Debt

We agree with the Board's view that improvements to the guidance on accounting for convertible debt are needed and we believe reducing the number of models under which those instruments could be accounted represents significant progress. However, we do not support the approach in the Proposed ASU because it results in interest expense that does not reflect the economics of the arrangement. Just as equity instruments issued to employees, nonemployee providers of goods or services, and customers are given accounting recognition under U.S. GAAP, we believe it is appropriate that the cost of equity options embedded in a borrowing from a lender be reflected in the issuer's financial statements as well.

To address that issue, and consistent with our discussions with the Board at our meeting on September 5, 2019, we believe the Board should require reporting entities to recognize interest expense on convertible debt at a rate consistent with the rate the entity would incur on nonconvertible debt. Under our proposed approach, at issuance the reporting entity would recognize the debt at the proceeds received and would estimate its nonconvertible debt borrowing rate. The reporting entity would recognize the difference between that estimated borrowing rate and the effective rate on the convertible debt in each period the instrument remains outstanding. The nonconvertible debt borrowing rate estimated at issuance would be used throughout the life of the instrument and would not be reassessed in subsequent periods. The difference between interest expense at the estimated rate on nonconvertible debt and the effective rate on the convertible debt issued by the reporting entity would be recognized as additional paid-in capital over the term of the debt instrument, consistent with how issuers account for equity instruments issued to employees and nonemployee service providers. Recognizing the debt at the proceeds received would provide users with the information on the statement of financial condition they have told the Board they want, while recognizing interest expense at a level consistent with the reporting entity's creditworthiness.

Preparer members of the Committee who have issued convertible debt subject to the Cash Conversion subsections of Subtopic 470-20 noted that they were provided with multiple financing alternatives to evaluate, which included nonconvertible debt. Additionally, those entities were able to obtain information about interest rates on non-convertible debt issued by comparable reporting entities from their underwriters. Other entities would be able to consider information such as their own existing borrowing arrangements, borrowing rates of companies with similar credit quality, and input from commercial bankers, investment bankers, or venture capital investors to estimate their nonconvertible debt borrowing rate upon issuance. Alternatively, in the absence of other sources of information to estimate their nonconvertible debt borrowing rate, we believe it would be acceptable for entities to value the embedded conversion feature using an option-pricing model and use that value as an estimate of the additional interest cost to be recognized over the term of the instrument. Given that entities generally may need to estimate their incremental borrowing rates when they enter into a lease, we do not believe that it would be incrementally difficult for those entities to estimate their nonconvertible debt borrowing rate when they issue a convertible debt instrument, which would likely occur far less frequently than leasing arrangements. Accordingly, we believe the benefits of enhanced comparability and improved representational faithfulness provided by recognizing interest cost at a rate that reflects the economics of the convertible debt instrument outweighs the costs reporting entities may incur to estimate their borrowing rate for a nonconvertible debt instrument. Further, requiring companies to do so will avoid abuses that could otherwise result, such as issuing convertible debt at a premium because of an in-the money conversion feature that allows the reporting entity to recognize interest income from amortizing the premium.

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We also disagree with the requirement to provide the disclosures in paragraphs 470-20-50 1D and 1F of the Proposed Update in financial statements of interim periods. As we have noted in prior comment letters to the Board, we believe disclosures in interim periods should only be required if there have been material changes from the disclosures included in the annual financial statements.

Derivatives on an Entity's Own Equity

While the Committee agrees with the Board's objective of reducing complexity regarding the classification of derivatives on an entity's own equity, we do not believe the Proposed Update achieves that objective. In proposing that reporting entities assess the probability of a future event occurring, we believe the Board is trading one complex approach for another. As discussed previously, we are concerned about the lack of a framework for assessing whether the occurrence of an event that would trigger a net cash settlement of a derivative on an entity's own shares, particularly given the length of some of those arrangements. Is it practicable for an entity to conclude that an event is remote when the contract has a term of 10 years? What information should a reporting entity consider in concluding that the likelihood of an event is remote? We think most companies will struggle to conclude that the likelihood of an event occurring during a 10-year contract term is remote and to develop internal control procedures to assess that remoteness. Further, we suspect auditors will have difficulty identifying sufficient competent evidential matter to independently test such an assessment.

Rather than requiring an assessment of the likelihood of a future event, we believe the Board should provide a list of events (such as an initial public offering, change in control, tax law changes, bankruptcy, or an acquisition) that would be assumed to be remote during the term of a derivative contract. Such an approach would reduce complexity and would be operational and auditable.

Whether the Board elects to simplify the application of the guidance in Subtopic 815-40 by providing a list of events that would be considered remote or decides to retain the guidance in the Proposed Update, we believe a reporting entity should be required to periodically reassess the likelihood of an event. We do not believe deferring the recognition of an adjustment until the adjustment has occurred (as provided under the Proposed Update paragraph 815-40-35 8(a)) serves users of financial statements.

We also disagree with the Board's decision to permit equity classification when a reporting entity grants a counterparty rights higher than shareholder rights or is required to post collateral benefiting the counterparty. Neither of those actions is consistent with the classification of the derivative in equity. We are not sure what issue with cost and complexity the Board is trying to resolve by deleting the guidance in paragraphs 10(f) and (g) of ASC 815-40-25 as neither provision is complex to apply in assessing the classification of the derivative. While permitting the counterparty to have rights higher than the rights of shareholders or to benefit from collateral posted by the issuer would likely reduce the cost of the transaction to the issuer, that does not seem to us a sufficient reason to permit a reporting entity to ignore those features in a contract.

Lastly, we disagree with the revision to the disclosure required by paragraph 5(d) of ASC 815-40-50. We believe the cost of compiling that data (particularly for features the reporting entity has concluded are remote of occurring) exceeds the potential benefit of the information provided to users. In circumstances where the adjustments are not limited, the range of the changes a reporting entity would be required to disclose could be significant. We do not believe disclosing such information would have any informational benefit and could be confusing if the events giving rise to the adjustments are not likely to occur.

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Earnings per Share

We recommend the Board add an example to Topic 260 to illustrate the earnings per share (EPS) impact of the Proposed Update. The example amended by the Proposed Update involves a convertible debt instrument where the reporting entity is required to settle the principal amount of the debt in cash. The Proposed Update does not change the outcome for that type of arrangement. We believe the Board should illustrate the computation of EPS for a convertible debt instrument where the reporting entity has the right, but not an obligation, to settle the principal amount of the debt in cash. That appears to be the transaction most impacted by the Board's conclusions on the EPS treatment, so it would be helpful to illustrate it.

Other Comments

The Proposed Update amends paragraph 7D of ASC 815-40-15 to allow a reporting entity to disregard a provision that would adjust the instrument's strike price or number of shares used to calculate the settlement amount if the likelihood of an adjustment occurring is remote. It was not clear if the remoteness assessment applies to the guidance in paragraph 7F of ASC 815-40-15, which indicates that a settlement amount affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares would not be considered indexed to the entity's own shares. We do not think the remoteness assessment should apply to the circumstances in paragraph 7F of ASC 815-40-15 and that the introduction of variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract should result in classifying the derivative as an asset or liability even if the adjustment is considered remote.

If the Board decides to retain the approach to assessing the likelihood of a future event, we believe it should reconsider the guidance on the impact of down-round features on the classification of a derivative on an entity's own shares. Paragraph 75A of ASC 815-10-15, which was added by ASU 2017-11, requires a reporting entity to exclude a down-round feature from its consideration of whether the equity derivative is indexed to the entity's own stock. That guidance would be inconsistent with the remoteness assessment the Board would require for other features that could affect the classification of the equity derivative. We believe the Board should require a consistent methodology for assessing the impact of certain features in a contract on the classification of that contract.

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We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Sincerely,

NSchroeder

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