CONNOR
GROUP

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

October 14, 2019

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

File Reference No. 2019-730

RE: Exposure Draft – Debt – Debt with Conversion and Other Options (Topic 470-20) and Derivatives and Hedging – Contracts in Entity's Own Equity (Subtopic 815-40)

Dear Mr. Kuhaneck,

Connor Group, Inc. is pleased to provide our comments on the FASB's 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)*. Connor Group was found in 2005 and is a technical accounting advisory firm built of Big 4 alumni and industry executives. We currently have over 250 accounting professionals and over 600 clients and specialize in helping our clients solve complex technical accounting issues under both U.S. GAAP and IFRS. Our clients represent industries such as technology, software, internet, cloud services, life sciences and manufacturing, amongst others. Many of our clients are emerging growth mid-cap or small-cap public entities, companies aspiring to become public in the near future, or high growth private companies.

Accounting for convertible instruments

Overall, we support the Board's proposal to reduce complexity and improve comparability of financial reporting with accounting for convertible instruments. Based on our experience working with numerous public and private companies that issue convertible instruments, the current five-part accounting model guidance is complex, judgmental, and at times results in accounting conclusions that do not support the overall intent of the financing. Convertible instruments sometimes include clauses for contingent events that have relatively little value to both holder and issuer, but can drive accounting conclusions, specifically in the area of potential share adjustments. In addition, when conversion options need to be bifurcated and recorded separately (for example convertible debt with a cash conversion option), the resulting accounting conclusions are often not seen by management as useful, and cause an effect on the financial statements that may not be well understood by users (for example effective interest expense

CONNOR
GROUP

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

being very different from the coupon rate). The reduction of specific separation models coupled with robust disclosures would reduce complexity yet maintain the decision usefulness of information to users of the financial statements.

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

We generally support the Board's proposal to exclude contingent events which have an insignificant chance of occurring and/or carry little value from the derivative scope exception analysis. However, we do feel the term 'remote' is judgmental and is too low of a threshold. In our experience, remote is interpreted to be less than 5-10%, but this interpretation is subject to diversity and without a quantitative supporting analysis, will be difficult to operationalize. Further, in order to qualitatively support a 'remote' conclusion, entities would be required to prepare a robust memorandum including numerous judgments that will be subject to detailed auditor scrutiny due to increased audit risk. This will likely result in additional time and cost in the process, which is not in the spirit of the simplification goal outlined in this accounting standards update. While we believe contingent events that have an insignificant chance of occurring should not dictate accounting conclusions, we feel either providing more context around the meaning of 'remote' or increasing the threshold to events that are not likely to occur would be more appropriate. Alternatively, the underlying principle can also be formulated in terms of the value that the 'suspect' feature adds to the instrument. If substantially all of the value of the instrument is derived from its features other than the 'suspect' features, the principle can be defined to exclude those features from consideration.

In our minds, the threshold as currently proposed would be so low, or subject to such interpretation, that it would exclude many transactions that the proposed model is intended to cover, or put such a cost on the preparer that the resulting accounting benefit would not be worth the effort.

We also bring to the Board's attention our observation that many of the current errors that led to the issuance of the proposal result from lack of identification of 'suspect' features by either management and/or auditors. However, the proposal's requirement to assess the probability of an event implies that management first identifies 'suspect' features. Therefore, adding a probability assessment will not reduce the risk that 'suspect' features may be missed, and may in many instances increase, not reduce, the complexity of the accounting analysis. It will simply reduce the risk of restatement (i.e. that those features should have resulted in liability/fair value accounting) in the event the issue is identified and brought up later.

We have provided more detailed rationale in the responses to question below.

CONNOR
GROUP

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

<u>Section 1: Convertible Instruments</u>

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

We agree with accounting for convertible instruments as a single unit of account, except in circumstances in which the conversion features are required to be bifurcated under Topic 815. Under current GAAP, there are five different steps/models to follow when accounting for convertible debt instruments. Features included within an instrument offering, such as interest rate, premium, fees paid to lenders (debt discount), conversion features, additional interest, contingencies, etc. can vary depending on the economics an entity is trying to achieve through such offering. These features can also result in varying accounting treatments under current GAAP which can lead to costly, time consuming and complex accounting analysis by financial statement preparers. Additionally, the resulting accounting conclusions are not always best aligned with what a financial statement user may consider decision-useful information. For example, non-cash interest expense, which results from the bifurcation of a cash conversion feature or beneficial conversion feature, may not be considered valuable to users as it does not represent the true cost of borrowing and results in unnecessary complexity to the financial statements. Additionally, entities that issue convertible debt with a substantial premium record this premium in equity (providing other conditions of the model are not met). However, a premium isn't always indicative of a capital contribution, and depending on the instruments' ultimate settlement, the instrument itself may not end up being converted into equity. There also may be other facts and circumstances around the economics of the transaction which are not necessarily captured by the accounting model, but are important to the understanding of the nature of the transaction and therefore disclosed.

If the Board were to move forward with this simplification, we believe that removal of three of the steps under the current model in isolation could result in missing information in order to understand an entity's financial position or financial performance. While we concur that cash conversion features, beneficial conversion features, and substantial premiums should not be separately bifurcated, we believe that robust discloses would be critical to provide users with the relevant information about the economics of the transaction and potential settlement impacts.

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

CONNOR GROUP

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

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.

Yes, we believe the disclosure amendments in this proposed update for convertible instruments provide decision-useful information. We believe these disclosures should be required for every annual period for which a statement of financial position and statement of financial performance are presented. We believe that these disclosures should be included at an interim period to the extent that facts and circumstances have changed since the prior reporting period (i.e. new issuance or change in key information such as conversion rate).

Section 2: Derivatives Scope Exception for Contracts in an Entity's Own Equity

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.

Yes, we believe that settlement features which have an insignificant chance of occurring should be disregarded for purposes of determining the classification of a contract in an entity's own equity. Removing these settlement features would result in more substance-based accounting conclusions for non-remote settlement features.

However, we do not believe the use of the word 'remote' is operable. In ASC 450-20 'remote' is defined as "the chance of the future event or events occurring is slight." The vagueness of the definition will likely result in varying opinions of how to apply a remote threshold. Management will be required to develop internal controls and qualitative and potential quantitative estimation processes for determining how the term remote is applied in determining the classification of a contract.

As remote is a low threshold, we also feel that this may exclude a number of transactions which this simplification guidance would be targeted at. At inception, entities may not know if a specific provision has a remote (e.g. less than 5-10%) chance of occurring, but they can more confidently assert if the event is likely to occur. In addition, based on the economics and negotiations of the transactions, issuers and holders of convertible instruments generally have knowledge of how an instrument and its features were designed to operate and ultimately what the likely method of settlement is. While management's intent should of course not be the driving factor behind the accounting conclusion for convertible instruments, in our experience the intent when entering into the instrument has been closely aligned with the economics.

Lastly, using a remote threshold presents a challenge from an audit perspective. As this threshold generally may not be supportable through a quantitative analysis, auditors will have to audit management's judgments and representations at a detailed level sufficient to be comfortable

CONNOR
G R O U P

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

that a potential contingency falls below this 'remote' threshold. This will add time and cost into the process due to the enhanced audit risk and may result in conservative conclusions which would then negate the benefits the proposed update is intended to provide.

If the Board decides to make 'remote' the threshold for determining classification, we suggest providing a more detailed description of the threshold to avoid misuse. For example, in Topic 470, a substantial premium is typically understood as a premium greater than 10%. In topic 740, more likely than not is defined as greater than 50%. We believe applying a specific percentage threshold, or additional context would help alleviate the disparity in accounting conclusions reached. Alternatively, the guidance could also be structured to have settlement features that individually or in the aggregate do not substantially change the instrument's fair value excluded from the accounting analysis. As noted, the term "substantial" is often understood to mean more than 10%. Thus, under this approach, features with fair value of over 10% of the instrument's fair value would not impact the accounting.

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

We agree that the requirement to settle a contract in registered shares should not affect the classification of a contract in an entity's own equity. Current GAAP assumes that a settlement which is not permitted in unregistered shares would ultimately result in cash settlement, although this is not always the case. Currently, in order to support the conclusion that an entity may settle a contract in unregistered shares, entities involve legal counsel which adds additional time and cost into the process. These conversations are often between i) management (including many times an outside technical accounting advisor), ii) legal counsel, iii) auditors, and iv) the auditor's technical accounting specialists, and involve discussing the accounting literature and bridging that with the legal interpretation, which are sometimes in conflict and need to be worked through.

Further, as the settlement guidance does not provide room to consider the likelihood of settlement, accounting conclusions reached may be inconsistent with the economics. If the criterion in ASC 815-40-25-10(a) is not removed as a result of this proposed accounting standards update, we recommend that an entity be able to assess the likelihood of settlement in unregistered shares or using cash, consistent with the likelihood threshold defined.

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.

Yes, we agree that a requirement to post collateral should not affect the classification of a contract in an entity's own equity. We believe this requirement is not related to determining the settlement method of the contract as collateral posting is not indicative of an ultimate cash settlement of the instrument. In addition, while equity holders would not be expected to hold

CONNOR GROUP
3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

collateral, we are not aware of any transactions where investors asked for or were interested in holding collateral.

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.

Yes, we agree that the hierarchy of a counterparty's rights or shareholder rights should not affect the classification of a contract in an entity's own equity. We believe this requirement is not related to determining the settlement method of the contract in either cash or shares. Rights of convertible instrument holders compared to those of shareholders are important to understand the overall economics of the transaction and should be disclosed, however, these rights should not in and of themselves result in a recognition and measurement accounting conclusion.

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.

Yes, we believe the proposed amendments about reassessment of the derivatives scope exception are operable. The reassessment events described in ASC 815-40-35-8 are not onerous and if these events occur, the underlying economics of the instrument may change which should warrant a revisit of the previous accounting conclusions. Lastly, the additional costs of monitoring the reassessment events would be offset by cost savings of not having to do a full reassessment each period. Entities will need to implement controls and procedures in order to identify when the three reassessment events have occurred. Alternatively, requiring reassessment at every balance sheet date could also be meaningful if a different probability threshold is applied. For example, a reassessment could be required if settlement using a specific feature that triggers classification as a liability becomes probable.

In addition to those defined in ASC 815-40-35-8, we believe the Board should include issuances of similar instruments as a reassessment event. For example, using the same facts and circumstances as outlined in the proposed example 22 in ASC 815-40-55-49A and 49B, on January 1, 20X1, Entity A issues Warrant X and determined the likelihood of not achieving revenues of at least $500 million by December 31, 20X4 is remote. Therefore, Entity A determined that Warrant X will settle in shares, qualifies for the scope exception and is equity classified. On January 1, 20X4, Entity A then issues Warrant Y with similar terms specifying a reduction in the strike price upon a reaching a revenue target of $500 million by December 31, 20X7. At the issuance date of Warrant Y, Entity A determined that the likelihood of not achieving this revenue target was greater than remote. Therefore, Warrant Y would not qualify for the scope exception and is liability classified.

CONNOR
GROUP

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

Though the terms vary, and Entity A may still be able to conclude that equity classification of Warrant X remains appropriate on January 1, 20X4, we believe the entity should be required to reassess the derivative scope exception. This will ensure consistent accounting treatment by an entity upon issuances of similar instruments.

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 agree that the addition of disclosure amendments for contracts in an entity's own equity in paragraph 815-40-50-5(f) through 5(g) will provide decision-useful information. Including information about either changes in terms which may change conversion or exercised prices or the number of shares used to calculate the settlement amount (excluding antidilution provisions) or actual changes in these items provides additional clarity regarding the potential settlement impact as well as the overall structure of the instrument.

We do not believe any other disclosures for contracts in an entity's own equity are required.

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?

No, we do not believe that new fair value disclosures should be required for all equity-classified instruments as these disclosures are not currently required and adding them would result in additional cost to preparers. However, we defer further comment to financial statement users if this would provide decision useful information where the additional cost may be justified.

<u>Section 3: EPS</u>

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.

Yes, we agree with the decision to require the use of the if-converted method for the calculation of diluted EPS as this would simplify the analysis performed by an entity to determine which

CONNOR GROUP

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

method to use. Under current GAAP, EPS for entities with convertible debt instruments would be calculated using either the treasury method or if-converted method. The treasury method assumes that the entity will utilize proceeds from the exercise of the conversion to buy back common shares, which is not always practical. We believe the if-converted method creates a more uniform approach to calculating EPS for convertible instruments and is in line with the general economics of these instruments.

However, we do not agree with the use of the if-converted method for convertible debt where settlement of the conversion feature is required in cash (or to the extent it is required in cash). This is because settlement of such debt (or a portion of the debt) cannot result in issuance of additional shares.

We believe the proposed revision to the if-converted method in paragraph 260-10-45-40(b) is operable-, if the Board decides to require the if-converted method for all convertible instruments. Interest charges on convertible debt required to be paid in cash are easily identified. It should also be straightforward for an entity to determine if the convertible debt is required to be paid in cash.

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 believe that entities that have contracts that may be settled in either cash or shares should presume share settlement when calculating diluted EPS using the if-converted method. Per ASC 260-10-45-16, diluted EPS is calculated by adding the number of additional common shares that *would have been outstanding* if the maximum dilutive potential common shares had been issued. The most dilutive case scenario should be disclosed to the users, and as such, not being able to overcome the presumption of share settlement is consistent with this objective.

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 do not believe the Board should consider a project about the effect of antidilutive instruments on the diluted EPS calculation. We are not aware of any other EPS improvements that should be considered by the Board.

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

Section 4: 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 agree with the Board's decision to apply the amendments that affect classification, recognition, and measurement on a modified retrospective basis at the beginning of the fiscal year in which the pending content is adopted. We also agree with the proposed amendment to include an option to apply the pending content retrospectively for each prior reporting period presented.

We also agree with the transitional expedient that allows an entity to assess the likelihood of contingent events at the date of adoption. Assessment on the adoption date is a more practical approach than going to the issuance date and assessing each instrument and its features to determine the likelihood of contingent events 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 do not agree with the application approach to the proposed amendments to EPS. We believe that changes to the calculation of EPS should be applied consistently with the transition approach for accounting for convertible instruments and contracts in an entity's own equity. For an entity that elects the full retrospective approach, there should be adequate disclosures regarding the adoption to make it clear what the prospective changes in EPS relate to.

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

We believe that an entity that issues convertible instruments or contracts in an entity's own equity may need a significant amount of time to implement the proposed amendments. The entity would need time to become familiar with the new guidance, re-analyze the terms of the instrument under the guidance, and potentially update the accounting framework that was historically in place. The entity would also need to update its internal control environment to ensure that go-forward accounting requirements are reflected in the financial statements.

CONNOR
G R O U P

3979 Freedom Circle, Suite 700
Santa Clara, CA 95054
P: (650) 251 0074
F: (650) 396 8071

We believe that private companies should have an additional two years for implementation, consistent with the proposed accounting standards update on effective dates. Privately held entities, especially start-up companies, often have a significant number of convertible instrument arrangements and arrangements where settlement in cash or shares may be required. Having additional time to evaluate these instruments under the new standard while being able to leverage public company examples will be helpful for these entities to implement the proposed amendments with reduced incremental cost of the analysis.

We believe that early adoption should be permitted for all entities.

Section 5: 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 are not aware of any considerations that would specifically impact private companies that issue convertible instruments and/or contracts in an entity's own equity.

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

We are not aware of any potential unintended consequences that the proposed amendments would have on superseded areas of the guidance.

We would be pleased to respond to any questions the Board might have regarding our comments.

Sincerely,

Connor Group, Inc.

Accounting Standards and Professional Practice Group