July 21, 2017

Russell G Golden, Chairman
Susan M Cosper, Technical Director
FASB
401 Meritt 7
PO Box 5116
Norwalk, CT 06856-5116

Via Email to director@fasb.org

Re: Research Project, Distinguishing Liabilities from Equity

Dear Mr. Golden and Ms. Cosper:

Grant Thornton LLP supports the Board’s decision to undertake a research project on Distinguishing Liabilities from Equity and we strongly encourage the Board to undertake a broad scope project that resolves the fundamental issues in this area. This subject has challenged the Board for many years, resulting in a half-finished project with numerous changes directed at narrow scope issues. As we noted in our comment letter on the FASB’s August 2016 Invitation to Comment, Amda Consultation, as presently written, the guidance in this area is a collection of rules issued over the years that are extremely complex to follow, costly to apply, and that result in very different accounting for economically similar instruments.

We would like the Board to consider a model that is based on Statement of Financial Accounting Concepts (SFAC) No. 6, Elements of Financial Statements, which defines liabilities as “… arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.” Additionally, the model would incorporate changes to the guidance on calculating both basic and diluted earnings per share, as more fully discussed within this letter.

The existing accounting framework for determining classification of financial instruments that have both liability and equity characteristics considers (a) whether settlement requires the transfer of cash or other assets, or, (b) whether settlement in an entity’s own shares represents...
an equity-like ownership relationship between the investor and the reporting entity. Whether settlement in an entity's own shares represents an equity like ownership relationship has never been addressed within the conceptual framework.

Determining whether settlement of a financial instrument requires the transfer of cash or other assets or an entity's own shares is complicated by situations in which settlement is not unilaterally within control of the reporting entity. If settlement of a financial instrument in an entity's own shares is not unilaterally within the reporting entity's control, the financial instrument is classified as a liability and measured at fair value each reporting period even if it is unlikely that the entity will ultimately settle the financial instrument by transferring cash or other assets. However, a reporting entity that issues the same financial instrument but has the unilateral ability to settle the instrument in its own shares classifies the financial instrument as equity and will not re-measure the financial instrument, leading to vastly different accounting for similar financial instruments.

**Proposed model**

We believe liability or equity classification for an instrument that is indexed to or potentially settled in an entity's own shares should be wholly dependent on whether a reporting entity has a present obligation to transfer cash or other assets. We believe that the issue of whether settlement in an entity's own shares represents an equity-like ownership relationship between the investor and the reporting entity is important to equity investors and is best addressed by amending the earnings per share guidance. The model discussed here results in subsequent measurement through earnings for instruments that require settlement in cash or other assets. For instruments that allow reporting entities to settle in shares, basic or diluted earnings per share would be calculated so that either measurement would be the same whether the instruments are liability or equity classified. This model would require earnings per share guidance to be based on a fair value model rather than an intrinsic value model. In other words, earnings per share would reflect the change in an instrument's fair value during the reporting period rather than just the change in intrinsic value captured under the treasury stock method of computing diluted earnings per share.

This model would significantly reduce classification complexity while benefiting users, whether they be equity investors or debt investors. Although the model would increase measurement complexity, it would do so only for entities that report earnings per share.

**Present obligation to transfer cash or other assets**

We believe that an instrument should be equity classified if (1) the holder has the present right to settle the instrument, (2) the issuer controls whether settlement, subject to the holder's present right, is made in shares or in cash or other assets, and (3) it is not probable that a contingent event will occur that could require the issuer to settle the instrument in cash or other assets. An instrument should be liability classified if (1) the holder has a present right to settle the instrument and the issuer cannot control whether settlement is made in shares or in cash or other assets, or (2) the holder lacks a present right to settle the instrument but, if the
instrument requires settlement in the future, it is probable that the issuer will not control whether settlement is made in shares or in cash or other assets. Refer to the flowchart in the appendix to this letter.

The following examples illustrate the application of this model:

- A reporting entity’s obligation to issue shares would be a liability if the holder has a present right to receive more than the current number of authorized and unissued shares. However, a reporting entity’s obligation to issue shares at a future date would be equity unless it is probable that there will not be sufficient authorized and unissued shares at the settlement date.

- A reporting entity’s obligation to deliver registered shares would be a liability if the holder has a present right to receive registered shares and the reporting entity does not have the ability to deliver registered shares at the reporting date. This would be the case if the reporting entity has written an option that is currently exercisable and in the money. However, a written option that is not currently exercisable or is currently exercisable but not in the money would be equity unless it is probable that the reporting entity will be unable to deliver registered shares.

- A reporting entity’s obligation to issue shares that is conditional on shareholder approval would be a liability if the holder has a present right to receive shares and the reporting entity has not obtained the shareholder approval at the reporting date. However, a reporting entity’s obligation to obtain shareholder approval prior to the exercise or settlement date would be equity unless it is probable that the reporting entity will be unable to obtain shareholder approval prior to exercise or settlement.

- A reporting entity’s obligation with respect to an instrument that the holder has the present right to settle and for which the entity controls the form of settlement (shares or cash) that, in the event of a change in control, would allow the holder to control the form of settlement (for example, shares or cash with an equivalent value) would be equity unless it is probable that there will be a change in control. Likewise, a reporting entity’s similar obligation with respect to an instrument for which the reporting entity presently controls the form of settlement that, in the event of an IPO, would allow the holder to control the form of settlement would be equity unless it is probable that there will be an IPO.

- A reporting entity’s obligation with respect to an instrument that the holder does not have the present right to settle, and that would require the reporting entity to issue shares or an equivalent amount of cash at the holder’s option only in the event of a change in control would be a liability. Likewise, a reporting entity’s similar obligation to issue shares or an equivalent amount of cash at the holder’s option only in the event of an IPO would be a liability.
**Subsequent measurement**

Instruments classified as liabilities under this framework would be subsequently measured based on the following model:

- Subsequent measurement at amortized cost if the settlement amount is fixed or is determinable by reference to an interest rate index.

- Subsequent measurement at the amount that would be paid if settlement occurred at the reporting date if the settlement amount is determinable by reference to an internal index.

- All other liability classified instruments would be subsequently measured at fair value.

Equity classified instruments would not be subsequently remeasured, although earnings available to common shareholders and calculations of earnings per share would be adjusted based on the following model to capture the value transfer between the existing shareholders and the financial instrument counterparties, as well as both the dilutive and antidilutive effect:

- Equity classified instruments that require settlement in a variable number of shares based on a fixed amount or an amount that is determinable by reference to an interest rate index would be subsequently measured at amortized cost for purposes of determining earnings available to common shareholders and calculating basic earnings per share.

- Equity classified instruments that require settlement in a variable number of shares based on an internal index would be subsequently measured based on the fair value of the number of shares that would be issued if settlement occurred at the reporting date for purposes of determining earnings available to common shareholders and calculating basic earnings per share.

- Other equity classified instruments that require settlement in shares would be subsequently measured at fair value for purposes of determining earnings available to common shareholders and calculating basic earnings per share.

- Equity classified options and contingent obligations to issue shares would be subsequently measured at fair value for purposes of adjusting the numerator in the calculation of diluted earnings per share. The denominator would not be adjusted, similar to the current method for options that require or presume cash settlement.

Based on this model, equity classified instruments that will require settlement in shares, such as written forwards and preferred shares that automatically convert into a variable number of common shares with a fixed monetary value, would be reflected in equity at historical cost but would be subsequently remeasured for purposes of adjusting income available to common shareholders in the basic earnings per share calculation. Other equity classified instruments that
might require settlement in shares, such as written options and contingently convertible preferred shares, would also be reflected in equity at historical cost but would not affect basic earnings per share. Rather, since such instruments might or might not affect the reporting entity’s common shareholders, the effect of changes in their fair values is reflected in diluted earnings per share.

The following examples illustrate the application of these concepts:

- An instrument issued by the reporting entity for $8 that could require redemption in five years for $10 at the option of the holder would be classified as a liability and subsequently measured at amortized cost. An equity classified instrument issued for $8 that could require settlement in five years for a variable number of shares with a value of $10 at the option of the holder would be subsequently measured at amortized cost solely for purposes of determining earnings available to common shareholders and calculating basic earnings per share. The monetary settlement value is the same for these two instruments even though the first is settled in cash and the second is settled in shares. The impact on earnings available to common shareholders and basic earnings per share under this proposed model would be the same for these two instruments.

- An instrument issued by the reporting entity for $10 that requires cash redemption in one year based on the price of one share of stock would be classified as a liability and subsequently measured at fair value. An equity classified instrument issued for $10 that requires settlement in one year for one share of stock would be subsequently measured at fair value solely for purposes of determining earnings available to common shareholders and calculating basic earnings per share. The monetary settlement value is the same for these two instruments even though the first is settled in cash and the second is settled in shares. The impact on earnings available to common shareholders and basic earnings per share under this proposed model would be the same for these two instruments.

- A forward contract entered into by the reporting entity to sell one share of stock in one year for $10 that can be net cash settled by the holder would be classified as an asset or liability and subsequently measured at fair value. A forward contract to sell one share of stock in one year for $10 that requires physical settlement or net share settlement would be classified as equity and subsequently measured at fair value solely for purposes of determining earnings available to common shareholders and calculating basic earnings per share. For both the asset/liability classified contract and the equity classified contract the numerator in the calculation of basic earnings per share would be impacted by the change in fair value. The monetary settlement value is the same for these two instruments even though the first is settled in cash and the second is settled in shares. The impact on earnings available to common shareholders and basic earnings per share under this proposed model would be the same for these two instruments.
- A forward contract entered into by the reporting entity to purchase one share of stock in one year for $10 that requires physical settlement or net cash settlement would be classified as an asset or liability and subsequently measured at fair value. A forward contract to purchase one share of stock in one year for $10 that requires net share settlement would be classified as equity and subsequently measured at fair value solely for purposes of determining earnings available to common shareholders and calculating basic earnings per share. For both the asset liability classified contract and the equity classified contract the numerator in the calculation of basic earnings per share would be impacted by the change in fair value. The monetary settlement value is the same for these two instruments even though the first is settled in cash and the second is settled in shares. The impact on earnings available to common shareholders and basic earnings per share under this proposed model would be the same for these two instruments.

- An option written by the reporting entity allowing the holder to purchase one share of stock in one year for $10 (written call option) that can be net cash settled by the holder would be classified as a liability and subsequently measured at fair value. An option allowing the holder to purchase one share of stock in one year for $10 that requires physical settlement or net share settlement would be classified as equity and subsequently measured at fair value solely for the purposes adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments even though the first is settled in cash and the second is settled in shares. The impact on diluted earnings per share under this proposed model would be the same for these two instruments.

- An option written by the reporting entity allowing the holder to sell to the entity one share of stock in one year for $10 (written put option) that requires physical or net cash settlement would be classified as a liability and subsequently measured at fair value. An option issued by the reporting entity allowing the holder to sell to the entity one share of stock in one year for $10 that requires net share settlement would be classified as equity and subsequently measured at fair value solely for the purposes of adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments even though the first is settled in cash and the second is settled in shares. The impact on diluted earnings per share under this proposed model would be the same for these two instruments.

- An option purchased by the reporting entity allowing the entity to purchase one share of stock in one year for $10 (purchased call option) that requires net cash settlement would be classified as an asset and subsequently measured at fair value. An option purchased by the reporting entity allowing the entity to purchase one share of stock in one year for $10 that requires physical settlement or net share settlement would be classified as equity and subsequently measured at fair value solely for the purposes adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments even though the first is settled
in cash and the second is settled in shares. The impact on diluted earnings per share under this proposed model would be the same for these two instruments.

- An option purchased by the reporting entity allowing the entity to issue one share of stock to the holder in one year for $10 (purchased put option) that requires net cash settlement would be classified as an asset and subsequently measured at fair value. An option purchased by the reporting entity allowing the entity to issue one share of stock in one year for $10 that requires physical settlement or net share settlement would be classified as equity and subsequently measured at fair value solely for the purposes of adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments even though the first is settled in cash and the second is settled in shares. The impact on diluted earnings per share under this proposed model would be the same for these two instruments.

- An option written by the reporting entity allowing the holder to purchase one share of stock in one year for $10 that is conditional upon an IPO (written call option) and can be net cash settled by the holder would be classified as a liability and subsequently measured at fair value. An option allowing the holder to purchase one share of stock in one year for $10 that is conditional upon an IPO that requires physical settlement or net share settlement would be classified as equity and subsequently measured at fair value solely for the purposes of adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments even though the first is settled in cash and the second is settled in shares. The impact on diluted earnings per share under this proposed model would be the same for these two instruments.

**Compound instruments**

The classification of embedded features that are indexed to or potentially settled in an entity’s stock would be determined based on the same model applied to freestanding instruments. Liability classified instruments with embedded features that are liability classified would be subsequently measured at fair value. Liability classified instruments with embedded features that are equity classified would be subsequently measured at amortized cost, but would be measured at fair value for purposes of calculating earnings per share, consistent with the subsequent measurement model for freestanding equity contracts described above. Equity classified instruments with embedded features that are equity classified would be subsequently measured at fair value only for purposes of calculating earnings per share, consistent with the subsequent measurement model described above for freestanding equity contracts that are settled in shares based on the holder exercising an option or occurrence of a contingent event.

The following examples illustrate the application of these concepts for compound instruments:

- An instrument issued by the reporting entity for $10 that could require redemption in five years for $10 plus a 5% cumulative rate of return at the option of the holder and that also allows the holder to convert the instrument into one share of stock at any
time would be classified as a liability and subsequently measured at amortized cost. A perpetual equity instrument issued for $10 that has a 5% cumulative dividend and also allows the holder to convert the instrument into one share of stock at any time would be classified as equity and subsequently measured at amortized cost solely for purposes of determining earnings available to common shareholders and calculating basic earnings per share. Both instruments would be subsequently measured at fair value solely for the purposes of adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments. The impact on earnings available to common shareholders, basic earnings per share, and diluted earnings per share under this proposed model would be the same for these two instruments.

- An instrument issued by the reporting entity for $10 that is convertible into one share of stock and could require redemption in five years in cash at an amount equal to the greater of $10 plus a 5% cumulative rate of return or the value of one share of stock would be classified as a liability and subsequently measured at fair value. A perpetual equity instrument issued for $10 that has a 5% cumulative dividend and also allows the holder to convert the instrument into one share of stock at any time would be subsequently measured at amortized cost solely for purposes of determining earnings available to common shareholders and calculating basic earnings per share. The equity instrument would be subsequently measured at fair value solely for the purposes of adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments. The impact on diluted earnings per share under this proposed model would be the same for these two instruments.

- A debt instrument issued by the reporting entity for $10 that requires redemption in five years for $10 plus interest at 5% and provides the holder an option to put the debt at the value of one share of stock if there is an IPO would be classified as a liability and subsequently measured at fair value. A debt instrument issued by the reporting entity for $10 that requires redemption in five years for $10 plus interest at 5% and also allows the holder to convert into one share of stock if there is an IPO would be classified as a liability and measured at amortized cost. The entire instrument would be subsequently measured at fair value solely for purposes of adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments. The impact on diluted earnings per share under this proposed model would be the same for these two instruments.

- A debt instrument issued by the reporting entity for $10 that requires redemption in one year for $10 plus interest at 10% and provides the holder a put at 125% of par if the entity issues shares in a subsequent offering would result in an embedded put option initially and subsequently measured at fair value as a separate instrument, with the initial residual proceeds classified as a liability and measured at amortized cost. A debt instrument issued by the reporting entity for $10 that requires redemption in one year for $10 plus interest at 10% and allows the holder to convert into a subsequent share issuance at an 80% discount would be classified as a liability and measured at...
amortized cost. The entire instrument would be subsequently measured at fair value solely for purposes of adjusting the numerator in the calculation of diluted earnings per share. The monetary settlement value is the same for these two instruments; however, in this case the impact on diluted earnings per share under this proposed model would be similar but not identical for these two instruments.

**Costs and benefits**

We believe that this proposed model would greatly simplify classification of financial instruments with characteristics of debt and equity. The model would also vastly improve the usefulness of financial information by aligning the earnings per share impact of cash- and share-settled instruments when the monetary settlement value is the same. The underlying premise is that classification and measurement of cash-settled instruments is important to both debt and equity investors, while classification and measurement of share-settled instruments is important only to equity investors. The principal drawback to this model is that measurement complexity would increase for public companies that report earnings per share. However, we believe that this model provides far better earnings per share information than under the current model for earnings per share. This model best accommodates the fundamental conundrum of accounting for financial instruments with characteristics of liabilities and equity: it is possible to simplify either classification or measurement, but not both, under a single, broadly applicable accounting model.

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If you have any questions about this letter, or wish to further discuss our proposed model, please contact Mark Scopes, Partner, at 312-602-8780 or mark.scoles@us.gt.com.

Sincerely,

/s/ Grant Thornton LLP
Appendix

Classification flowchart

1. Instrument that could be settled in cash or stock
2. Does the holder have the present right to settle the instrument?
   - Yes: Proceed to step 3
   - No: Proceed to step 4
3. Can the issuer control whether the instrument is settled in shares or cash/assets?
   - Yes: Proceed to step 5
   - No: Proceed to step 6
4. If and when it is settled, is it probable that the issuer will not control whether the instrument is settled in shares or cash/assets?
   - Yes: Proceed to step 7
   - No: Proceed to step 8
5. Is it probable that the instrument will become settleable in cash/assets in the future?
   - Yes: Proceed to step 9
   - No: Proceed to step 10
6. Liability
7. Equity
8. Proceed to step 5
9. Proceed to step 7
10. Proceed to step 9