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October 7, 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

Dear Mr. Kuhaneck:

Mind the GAAP, LLC and Wipfli LLP appreciate the opportunity to comment 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): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity* (hereafter referred to as the "Exposure Draft") .

We strongly support the Board's efforts to reduce the complexity in applying the current accounting guidelines in ASC 470, *Debt*, and ASC 815, *Derivatives and Hedging*. The current accounting rules for debt and equity financings can be arduous for preparers to apply given the volume of requirements, the variety of accounting methods, and the number of exceptions found within the guidance. In addition, the outcomes of applying the current rules can be difficult for users to comprehend and may even be counterintuitive in certain circumstances.

Therefore, we generally favor the amendments proposed in the Exposure Draft. Appendix A contains our responses (as well as additional observations and suggestions) to the Questions for Respondents posed by the Board in the Exposure Draft.

However, we are concerned with the operability of applying a "remote likelihood of occurrence" threshold to evaluate (i) potential adjustments that could affect whether the indexation guidance in ASC 815-40-15 is met, or (ii) whether certain contingent events could require net cash settlement under ASC 815-40-25. In addition, notwithstanding the views set out in paragraphs BC34-BC35 of the Exposure

Draft, we strongly believe that one of the most challenging current practice issues involves the identification of stock-settled debt, as well as accounting for instruments that contain both traditional conversion features and non-predominant stock-settlement alternatives. We do not believe that the introduction of new paragraph ASC 470-20-15-2C, or the amendment to paragraph ASC 470-20-25-14, will alleviate this practice issue. Therefore, we request that as part of this current simplification initiative, the Board also amend the current accounting guidelines in this area. Our specific proposals are outlined in more detail below.

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While we appreciate the Board's desire to simplify the application of the guidance in ASC 815-40, we believe preparers and auditors of financial statements will find it difficult to determine whether the exercise of a settlement feature is remote and therefore disregarded for purposes of classifying a contract in an entity's own equity (for both indexation and settlement).

The issuance of a convertible instrument represents the culmination of good faith bargaining process between an issuer and investors. Presumably, all of the provisions included in the underlying financing agreement – including those related to various settlement alternatives – were negotiated and agreed by both parties. When different types of settlement provisions are included in a contract, it would seem that at least one party, if not both parties, believe that the each of the various alternatives have a "reasonably possible" chance of being exercised or triggered. The Accounting Standards Codification Master Glossary defines reasonably possible as "the chance of the future event or events occurring is *more than remote* but less than likely" [emphasis added]. Therefore, by definition, we believe it will be difficult to conclude that any settlement alternatives included in a contract are remote, thereby failing to achieve the objective of simplifying the application of the indexation guidance in ASC 815-40.

It is also unclear to us whether, under the Exposure Draft, each potential settlement alternative should be evaluated individually for "remoteness" or if the determination should be based on an aggregate likelihood assessment. For example, assume a particular instrument has 20 different settlement alternatives that would impact its strike price or the number of shares used to calculate the settlement amount. Further assume that each alternative has an equal 2.5% likelihood of occurring. Evaluated individually, each alternative would be considered to have a remote likelihood of occurrence. However, in aggregate, there is a 50% chance – i.e., a more than remote possibility – that one of these settlement alternatives would impact an instrument's strike price or the number of shares used to calculate the settlement amount.

In response to these concerns, we suggest the Board abandon the proposals in the Exposure Draft around introducing a "remote threshold" into the indexation and equity-classification assessments. Instead, we recommend that the Board pursue one of four possible alternative approaches.

The first approach acknowledges that the current guidance in ASC 815-40 – particularly around indexation – is extremely difficult to apply. Moreover, there are a number of exceptions to the "fixed-for-fixed" principle, which further increases complexity. Thus, our strong recommendation would to revamp the existing indexation guidance in ASC 815-40 itself, rather than add yet another exception (for remote alternatives) in having to apply this guidance. While we acknowledge the overhaul of the existing guidance would be a significant task, the existence of the many exceptions to the current indexation model may be indicative of weaknesses in the current guidance.

A second possible approach, admittedly, takes the exact opposite position (and for this reason, is not our favored pathway). Under this approach, we would suggest modifying the existing indexation guidance model to include *additional exceptions* to the principle. Specifically, a settlement alternative would be considered indexed to the company's own stock if (a) settlement would be "fixed-for-fixed" or (b) the only factors that would cause variability in either the number of shares issued or exercise price upon settlement would be related to:

- Standard antidilution provisions
- Down round features
- Future financings
- Initial public offerings ("IPO")
- A change in control

A third possible approach involves retaining the probability assessment for each settlement alternative as discussed in the Exposure Draft. However, we would propose changing the threshold from remote to "more likely than not". That is, issuers would not have to consider the indexation guidance unless it is more likely than not that a particular settlement alternative would result in an adjustment to the exercise price or number of shares issued on settlement. A similar, conforming change could also be made when evaluating equity classification. Specifically, the last sentence of ASC 815-40-25-7 could be revised to read: "The occurrence of a contingent event that could result in net cash settlement is not considered in the analysis of whether a contract is equity-classified unless that event is more likely than not to occur."

The final approach would involve simply eliminating the indexation guidance altogether. The Board could further evaluate whether the elimination of this guidance would apply to all entities, or only to those entities that are not public business entities.

In sum, we believe that there are better, more operational alternatives than requiring entities to identify, and then exclude, "remote" settlement features in determining the classification of a contract in an entity's own equity (for both indexation and settlement). We would urge the Board to instead explore one or more of our aforementioned alternatives.

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We also strongly encourage the Board to expand the scope of this project to address current practice issues in the accounting for stock-settled debt.

Both Mind the GAAP and Wipfli are seeing a proliferation of financings that call for mandatory or optional variable share settlements contingent upon completing a qualifying financing or IPO. Some examples include Simple Agreements for Future Equity ("SAFEs") and convertible bridge loans issued by private companies to investors prior to an anticipated IPO. Sometimes, the shares issued at settlement will be from an existing class of equity. In other cases, the shares will originate from a future, yet-to-be issued class of equity that will be created as part of a qualified financing. Usually, the number of shares issued upon settlement is based on a price that is at a discount to the price of the equity instrument issued in the qualifying financing or IPO.

Our understanding is that issuers currently undertake the following process in accounting for these types of financings:

- First, the issuer must evaluate the most predominant settlement alterative. Making this determination can involve significant judgment, especially since many recent financings call for multiple ways in which the financing can be settled (for instance, depending on whether the company first concludes a qualified offering, completes an IPO, has a change in control, or experiences an event of default).

- After determining the predominant settlement alternative, the issuer will then assess whether the entire instrument falls within the scope of ASC 480-10-25-14(a) – i.e., accounted for as stock-settled debt. In practice, it can be difficult to distinguish stock-settled debt from convertible debt, as indicated in BC34 of the Exposure Draft.

- Next, the issuer must evaluate the accounting for the following embedded features:
    a. "Traditional" conversion features, which involves a complex process of identifying whether the feature requires bifurcation as a derivative, a cash conversion feature, or a beneficial conversion feature.
    b. Non-predominant settlement features, including contract provisions that may be labeled as conversion rights. In our experience, many issuers – especially private companies – are surprised to learn that these features are deemed to be settlement features rather than conversion rights. The distinction is important. Often, private companies will <u>not</u> bifurcate a traditional conversion feature as an embedded derivative because a similar contract, issued on a standalone basis, would not meet the net settlement conditions in paragraphs 99-139 of ASC 815-10-15 (and thus fail the criteria for bifurcation under ASC 815-15-25-1(c)). However, private companies frequently <u>do</u> have to separately account for a "deemed" settlement feature as an embedded derivative. This is because most major accounting firms believe that variable share settlement features result in net settlement under paragraphs 107-109 of ASC 815-10-15, whereas these paragraphs are not relevant for conversion features. Moreover, deemed settlement features typically will not meet the indexation guidance in ASC 815-40 – we believe this would hold true even if a remote probability threshold was introduced, as contemplated in the Exposure Draft. Therefore, the issuer is typically disqualified from applying the derivative scope exception in ASC 815-10-15-74(a) to the deemed settlement feature.

In summary, we believe that the application of current accounting requirements for SAFEs, convertible bridge loans, and similar financings is extremely burdensome for preparers (especially private companies) and confusing for users of the financial statement. We therefore request that the FASB expand the scope of this project to address the complexities found in the current literature around debt with share settlement provisions. Specifically, we recommend treating all variable share settlement features as traditional conversion features. Doing so would result in the elimination of the following steps from current practice:

a. Distinguishing features within a contract as conversion or settlement features
b. For deemed settlement features, determining which (if any) feature is predominant
c. Applying ASC 480 to an instrument containing a predominant deemed variable share settlement feature
d. Assessing other variable share settlement features as though they were redemption features, including applying paragraphs 107-109 of ASC 815-10-15 to evaluate whether the feature is net settled.

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Again, we thank you for your considerable efforts in trying to simplify this difficult area of U.S. GAAP. We strongly support the vast majority of the proposals in the Exposure Draft, but would ask that you further consider our two previously described areas of concern. If you have any questions regarding the contents of this letter, please contact Scott Ehrlich, President of Mind the GAAP, at (773) 732-0654 or Zachary Mayer, Partner at Wipfli, at (608) 270-2909.

Sincerely,

Mind the GAAP

Mind the GAAP, LLC

Wipfli LLP

Wipfli LLP

Appendix A

Questions for Respondents

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.

Yes, we agree with accounting for convertible instruments as a single unit of account, except when the conversion feature must be bifurcated under ASC 815. Eliminating three of the current accounting models in ASC 470-20 (cash conversion, BCF, and substantial premium) will reduce cost and complexity for preparers and potentially lessen confusion experienced by financial investors whose focus is on the dilutive effects of convertible instruments and on an issuer's future cash flows. As discussed in our responses that follow, users of financial statements would benefit from the changes in the calculation of EPS (moving away from treasury stock method to the "if converted" method) and having profit and loss information on interest expense aligned with actual cash expenditures (instead of an imputed figure that can be confusing to investors, analysts, and lenders that model future cash flows).

Based on the proposals in the Exposure Draft, we cannot think of any specific information about convertible instruments that would be missing in order to understand an entity's financial position and performance.

Question 2: Do the disclosure amendments in this proposed Update for convertible debt instruments in paragraphs 470-20-50-1A through 50-1I and for convertible preferred stock in paragraphs 505-10-50-12 through 50-18 provide decision-useful information? Should any of these disclosures be required for every 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.

In the list of examples in 470-20-50-1B, we suggest explicitly identifying the following: "a description of any redemption rights (puts or calls), including contingencies that affect whether those rights can be currently exercised". Also, we recommend changing the header for paragraphs 12-18 under ASC 505-10-50 from "Convertible Preferred Stock" to "Convertible Preferred Equity Interests" (or something similar), to indicate that these disclosures would apply to noncorporate entities, like LLCs. We suggest similarly changing "preferred stock" to "preferred equity interests" throughout these paragraphs. In addition, paragraphs 470-20-50-1C and 505-10-50-14(b) should clarify that the disclosures listed apply only to public companies. We also suggest including (1) "a description of any redemption rights (puts or calls), including contingencies that affect whether those rights can be currently exercised" within the list of examples under 505-10-50-13, and (2) the identical example shown in ASC 470-20-50-1I ("the purchase of call options that are expected to substantially offset changes in the fair value or the dilutive effect of the conversion option") in ASC 505-10-50-18.

We believe these disclosures should be required for annual periods, as well as in any interim periods where new instruments are issued or existing instruments are modified.

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.

Please refer to our detailed response in the forepart of this letter. Overall, we believe that the addition of an exception for "remote" features would not be operational, and will simply add another layer of complexity to an exceedingly difficult area of U.S. GAAP. We would instead prefer that the FASB address the underlying root cause of the complexity, which lies in the application of the existing indexation guidance. Again, please see our suggestions earlier in this letter for possible approaches to reducing complexity to the guidance in ASC 815-40-15.

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 with the Board's proposal – settlement in registered versus unregistered shares should in no way affect the classification of a contract in the entity's own equity. Historically, this condition has been subject to serious disagreements between lawyers and accountants, as highlighted in BC74 of the Exposure Draft, or subverted by the inclusion of a statement in the financing arrangement precluding cash settlement in the event of the entity's inability to deliver registered shares. So, for both conceptual and pragmatic reasons, we agree with the Board's conclusion to remove this condition from the criteria for a contract to be equity-classified.

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.

We agree that a requirement to post collateral should not affect the classification of a contract in an entity's own equity for the same reasons outlined in BC77 of the Exposure Draft. Specifically, the nature of collateral is that it may be returned, meaning that the mere posting of collateral does not equate to cash settlement.

Question 6: Should the hierarchy of a counterparty's rights or shareholder rights not affect the classification of a contract in an entity's own equity? Please explain why or why not.

We actually believe that the hierarchy of a counterparty's rights <u>should</u> be considered in the classification of a contract in an entity's own equity. It seems inappropriate for a contract to be classified as equity when the counterparty to that contract has rights that are greater than that of an equity owner. Moreover, we do not believe that the existing requirements in paragraphs 31-34 of ASC 815-40-25 generally caused companies undue cost to analyze, nor did they typically cause a contract to fail the conditions for equity classification. Therefore, we would prefer to retain this requirement for equity classification.

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.

We believe the proposed amendments about reassessment of the derivatives scope exception to be operable and feel the proposal is a good solution to reduce complexity and cost while not affecting the quality of the financial results. We do not believe the reassessment should be performed more frequently – reassessment should be limited to the reassessment events described in the Exposure Draft.

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 feel the proposed disclosure amendments for contracts in an entity's own equity in paragraphs 815-40-50-5(f) through (g) will offer decision-useful information by providing additional transparency regarding potential changes in settlements and their impact on capital structure. However, the new language added to 815-40-50-5(d) may be inoperable because it may be impossible to calculate. For example, a company may issue a SAFE that contains an embedded conversion feature that allows for conversion into a new class of equity at the same time that new class of equity is issued, at a range of discounts based on the dollar value of the future capital raised. Specifically, assume that the discount would be (i) 10% if the total capital raised is less than $10 million, or (ii) 15% if the total capital raised is $10 million or more. We are uncertain that a preparer would be able to comply with the requirements outlined in paragraph (d) in this scenario due to the inherent uncertainties of the future value of the share-settlement feature and amount of the capital raised. We do not believe using an approach analogous to ASC 260-10-45-21A would be appropriate as that paragraph presumes the issued equity would be common shares which would not apply in this example since the shares issued would be an entirely new class of future equity that may or may not be convertible into common shares.

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 believe the introduction of new fair value disclosures for public business entities for equity-classified instruments would be burdensome, require complex valuations, and would not increase the usefulness of the information for users of the financial statements. We further note that the market prices of public companies imply an enterprise value of the company as a whole, and the existing disclosures in ASC 505-10-50 should allow an informed user of the financial statements to estimate the fair value of each class of equity security considering any waterfall distribution requirements set out in shareholder agreements.

Question 10: Should diluted EPS for all convertible instruments be calculated using the if-converted method of diluted EPS? Is the revision to the if-converted method in paragraph 260-10-45-40(b) operable? Please explain why or why not.

We agree with the proposal in the Exposure Draft for diluted EPS to be calculated using the if-converted method for all convertible instruments. However, we suggest integrating the explanation in BC102 into ASC 260-10-45-40(b)(1), as it is not inherently obvious why "For convertible debt for which the principal is required to be paid in cash, the interest charges shall not be added back to the numerator." We believe explaining why this requirement has been inserted into the guidance would be helpful for users, especially since the basis for conclusions is not codified as part of the authoritative guidance.

In general, we believe the revision to the if-converted method is operable, as the information to report the impact assuming the conversion of convertible instruments should be available to preparers. In the event the dilution calculation involves futures shares that have not yet been issued by the reporting date, we suggest public companies use the average price of its common stock during the reporting period as the basis for computing the incremental number of shares.

Question 11: For a contract that may be settled in either cash or shares (except for certain share-based payment arrangements that are classified as liabilities), should an entity presume (and not be allowed to overcome the presumption) share settlement when calculating diluted EPS? Please explain why or why not.

We agree with the Board's proposal. Our view is that the purpose of reporting diluted EPS is to reflect the potential dilution on conversion of convertible securities or the exercise of contracts to acquire additional shares. The if-converted method better achieves this objective. In contrast, the treasury stock method is inconsistent with this principle, as it presumes issuers will buy back shares in the marketplace with the proceeds from the equity contact. This is often an unrealistic presumption. If a company truly did execute such a buy-back, it should reflect the impact of their decision on EPS at the time the share repurchase (i.e., at the time the repurchase was executed and not beforehand).

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.

No. We do not believe that such a project would provide decision-useful information to users of financial statements, and would lead to added complexities and cost for issuers. We recognize that some companies will expend resources to minimize the impact of dilution. We believe that if companies enter into these transactions, they should be disclosed, but we do not believe it is necessary to create additional modifications to the EPS calculation as doing so would be inconsistent with the objectives of reporting diluted EPS, as discussed previously in Question 11.

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.

With respect to the proposed amendments that affect classification, recognition, and measurement, we agree with allowing entities the option to choose the method of adoption based on a company's preference.

As discussed previously, we do not support requiring practitioners to evaluate the likelihood of a settlement alternative occurring. Hence, we cannot comment on the Board's proposed transition expedient to assess the likelihood of contingent events in the indexation and settlement evaluations as of the adoption date rather than at contract inception.

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.

Yes, we agree 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 with retrospective application for instruments that may be settled in cash or shares. Consistent with stock splits and similar equity restructurings that are also reflected on a retrospective basis, it is important for EPS presentation be consistent and comparative across all periods presented.

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 suggest the proposed amendments be effective for the fiscal years beginning after December 15, 2020 for certain classes of public companies (e.g., large accelerated filers, accelerated filers, etc.) with a 1-year deferral for all other companies. We also believe that all entities should have the option to early adopt.

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?

Please refer to the body of this letter for further details. In particular, please consider our suggestions around:

a. The application of the indexation guidance. One of our suggested approaches, in lieu of adding a remote probability threshold, would be to exclude private companies from having to apply the guidance in ASC 815-40-15 altogether.
b. Debt with stock-settlement features. Please refer to the forepart of this letter for our detailed recommendations on how to simplify the accounting for these instruments.
c. EPS disclosures. As noted in our response to Question 2, we believe that certain EPS disclosures should be clarified to ensure private companies do not have to comply with these requirements.

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 do not believe superseding the existing guidance will result in any unintended consequences and think practitioners will welcome the elimination of ASC 470-20 on beneficial conversion features, cash conversion features, and debt issued with substantial premiums. With the proposed changes, users will actually receive better information that lends to decision making for forecasting future cash flows and the dilutive effects of these securities.