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February 3, 2017

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

RE: Exposure Draft, *Distinguishing Liabilities from Equity (Topic 480): I. Accounting for Certain Financial Instruments with Down Round Features and II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception* (File Reference No. 2016-370)

Dear Technical Director:

We appreciate the opportunity to comment on the proposed ASU, *Distinguishing Liabilities from Equity (Topic 480): I. Accounting for Certain Financial Instruments with Down Round Features and II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception*.

Subject to our suggested clarifications about applying the guidance, we broadly support the proposed ASU's guidance for freestanding and embedded equity-linked instruments with down-round features. However, we believe that the Board should require more prominent financial statement disclosure of the existence and substance of down-round features before the period in which the feature is triggered. We also believe that replacing the indefinite deferral of the accounting requirements for mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests with a scope exception could enhance the understandability of the Codification for some Codification users.

This cover letter summarizes our key concerns and suggested clarifications. Appendix I comprises our responses to the Board's specific questions for respondents. Appendix II describes our other observations.

Interaction between the Proposed ASU and Current GAAP

As we understand the proposal, an entity may need to apply several other areas of the Codification to an equity-linked instrument with a down-round feature before it applies the proposed ASU's guidance. Therefore, we recommend that the Board include two flowcharts to help readers navigate the interaction between the proposed ASU's guidance and other GAAP. One flowchart would address

freestanding equity-linked financial instruments with down-round features (e.g., warrants). The other would address convertible preferred shares and convertible debt instruments with down-round features. We have included flowcharts in Appendices III and IV that we believe are consistent with the proposed guidance.

As indicated in the flowchart in Appendix IV, we understand that the guidance about beneficial conversion features would be a catch all for convertible instruments because a down-round feature by its nature would be considered a *contingent* beneficial conversion feature. We agree with this approach because neither the cash conversion nor the beneficial conversion feature guidance cause any of the issues that stakeholders find problematic about down-round features. As a consequence, based on our understanding, the proposed guidance in ASC 480-20 would apply to a very small subset of equity-linked instruments with down-round features, most commonly to freestanding warrants.

If our reading of the proposed ASU is correct, the Board should consider clarifying that if ASC 815, *Derivatives and Hedging*, or ASC 470-20 applies to a freestanding or embedded equity-linked instrument with a down-round feature, the proposed guidance in ASC 480-20 would never subsequently apply to the instrument. More specifically, triggering a down-round feature contained in convertible instruments accounted for under the cash conversion guidance or the beneficial conversion feature guidance in ASC 470-20 would not have an accounting consequence. We believe this would be the case even if the down-round feature reduced the conversion price to a level that is above the current share price. For example, assume a company with a current stock price of \$10 per share issues convertible debt containing a down-round feature at a current strike price of \$50. Assume also that the down-round feature could reduce the strike price to \$20. We believe that the proposed guidance in ASC 480-20 would never apply to the instrument because the down-round feature would constitute a contingent beneficial conversion feature and, therefore, the beneficial conversion feature guidance in ASC 470-20 would apply to that instrument. We agree with the decision not to apply the proposed guidance in ASC 480-20 because doing so would introduce unnecessary complexity by requiring the measurement guidance in the proposed ASU to be applied after the cash conversion or beneficial conversion feature guidance had been applied.

Instruments in the Scope of the Proposed Guidance in ASC 480-20

The proposed ASU indicates that financial instruments that are in the scope of the proposed guidance in ASC 480-20 may be classified as liabilities. Presumably, this refers to freestanding instruments because embedded features would be accounted for under ASC 815, the cash conversion guidance, or the beneficial conversion feature guidance.

It is unclear what type of freestanding financial instrument would be accounted for as a financial liability in its entirety under the proposed guidance in ASC 480-20. It would be helpful to clarify in the final ASU whether this proposed Subtopic is intended to address freestanding equity-linked instruments that do not meet the definition of a derivative and do not meet the conditions in ASC 815-40-15 (EITF 07-5), disregarding the down-round feature. For example, gross settled, private company warrants that become exercisable only if the S&P 500 Index increases 500 points, would be classified as a liability. However, as ASC 815-40-15 (EITF 07-5) does not include subsequent measurement guidance that the entity would ultimately use to recognize and measure the down-round feature, it would be helpful for the Board to clarify whether this subset of equity-linked instruments would be

subject to the proposed guidance in ASC 480-20. In any event, the Board should consider providing examples of those instruments and an explanation of why they would be accounted for as liabilities.

Definition of a Down-round Feature

The definition of a down-round feature in the proposed ASU uses the term *current strike price*. We understand this to mean the currently-stated strike price. The Board should consider replacing the phrase *current strike price* with *currently-stated strike price* or *stated strike price* to avoid confusion.

Additional Analysis under ASC 815 may be Needed

Many entities have determined that a freestanding or embedded equity-linked financial instrument requires derivative accounting because of the existence of a down-round feature. These same instruments will need to be analyzed under other aspects of ASC 815, which may not have been fully analyzed since the down-round feature caused the instrument to be a derivative under ASC 815. Although we do not disagree with that outcome, the Board may want to consider highlighting this outcome in the Basis for Conclusions and/or Summary of the ASU.

Amortization of Adjustments to Liabilities Measured Under 480-20

Paragraph 480-20-35-3 of the proposed ASU is unclear about whether the interest rate used for amortizing the carrying amount of a financial liability that is measured under the proposed guidance in ASC 480-20 should ever be revised. This may be important for subsequent accounting measurements for modifications of the instrument and the 10% cash flow test. The Board should consider clarifying this guidance.

Disclosure Requirements

While we agree that the disclosure requirements in the proposed ASU that relate to only down-round features that have been triggered will be very helpful to financial statement users, we believe that an additional requirement to disclose the existence of down-round features and their substantive terms when the instrument is entered into (i.e., before the feature is triggered) would provide additional useful information to financial statement users.

Implementation Guidance Examples

In addition to our suggested flowcharts in Appendices III and IV, in view of the complexity in current GAAP related to the accounting for equity-linked financial instruments, it may be helpful to provide illustrative examples of the accounting for convertible preferred shares and convertible debt with down-round features. It would be particularly helpful for these examples to show how to navigate the Codification when analyzing these instruments as illustrated in our flowcharts, and illustrate that these instruments would not be subject to the proposed guidance in ASC 480-20.

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Effect on EPS

The proposed ASU does not indicate whether the new guidance will affect EPS. We suggest that the Board consider explaining, and possibly providing examples of, the effect on EPS of triggering a down-round feature.

If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com; Patrick Garguilo at (212) 954-2852 or pgarguilo@kpmg.com; or Paul Munter (212) 909-5567 or pmunter@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP



Appendix I - Responses to Questions for Respondents

Question 1

Do you agree that when classifying certain financial instruments with down round features, the down round feature should be excluded from the assessment of whether an instrument is indexed to an entity's own stock (in accordance with the guidance in Subtopic 815-40)? If not, please explain why and suggest alternatives.

Yes. Subject to our suggested clarifications for applying the proposed guidance, excluding the down-round feature from the assessment of whether an instrument is indexed to an entity's own stock would generally be more representationally faithful of the economics of certain freestanding and embedded equity-linked instruments in the reporting entity's financial statements. However, the Board should consider reminding entities that previously determined that derivative accounting applied to an instrument solely because of the existence of a down-round feature that they will also need to analyze the instrument under other aspects of ASC 815 or the cash conversion or beneficial conversion feature guidance.

Question 2

Do you agree that for certain financial instruments with down round features, the effect of the down round feature should be recognized when it is triggered and that the approach for recognition should follow the classification (liability or equity) of the instrument? If not, please explain why and suggest alternatives.

We believe that recognizing the effect of the down-round feature only when it is triggered results in more useful information than derivative accounting because it more closely aligns the financial reporting for financial instruments with down-round features with their economic substance. In addition, we believe that after the feature is triggered, the subsequent accounting should follow the classification of the instrument. However, the proposed guidance in ASC 480-20 would apply to a very small subset of equity-linked instruments with down-round features, most commonly to freestanding warrants.

We believe that consistent with current practice, a warrant or conversion option with a down-round feature that will be measured at fair value should be valued using a Monte Carlo or similar valuation model rather than a Black-Scholes-Merton model. We do not believe that ignoring the existence of the down-round feature for classification purposes should change the valuation approach. If the Board agrees that the proposed guidance is not intended to affect the valuation approach of an equity-linked instrument that contains a down-round feature, the Board should clarify the proposal.

Question 3

The proposed amendments in paragraphs 480-20-30-1 through 30-2 describe how to measure the effect of the down round trigger. Do you agree with that approach? If not, please explain why and suggest alternatives.

We generally support the approach to measuring the effect of the down-round feature as proposed in paragraphs 480-20-30-1 through 30-2. However, it is unclear whether the interest rate used for amortizing the carrying amount of a financial liability that is measured under the proposed guidance in ASC 480-20 should ever be revised.

Question 4

Do you agree that for certain financial instruments with down round features that have been triggered during the reporting period, an entity should disclose the fact that the feature has been triggered, the value of the effect of the down round being triggered, and the financial statement line item in which that effect has been recorded? If not, please explain why and suggest alternatives.

Yes. We generally support the proposed disclosure requirements. However, an additional requirement to disclose the existence of down-round features and their substantive terms when the instrument is entered into (i.e., before the feature is triggered) would provide additional useful information to financial statement users.

Question 5

Do you agree that entities should apply the proposed guidance to outstanding instruments as of the effective date of the change, with no adjustments to prior periods presented, with the cumulative effect of the change recognized as an adjustment of the opening balance of retained earnings in the fiscal year or interim period of adoption? If not, please explain why and suggest alternatives.

We generally support the proposed transition provisions. However, the ASU should provide explicit guidance and examples to assist preparers with the transition. For example, consider a conversion feature that was previously separated from its host contract and accounted for as a derivative. Based on the proposed transition guidance, it appears that all of the previous derivative accounting would need to be unwound, and a cumulative effect of the change in accounting would have to be calculated as if the entire instrument had always been accounted for under the proposed ASU using the original terms of the instrument. If this is not the Board's intent, the ASU should clarify how to calculate the transition adjustment.

Question 6

How much time would be necessary to adopt the amendments in this proposed Update? Should early adoption be permitted? Would the amount of time needed to apply the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities?

We believe preparers are best able to comment on the effective date and the time that would be necessary to adopt the proposed ASU.



Appendix II – Other Observations

Scope

The scope section of the proposal indicates that the proposed model would apply to instruments for which the down-round feature does not currently affect classification and measurement under current GAAP. The Board should consider explicitly stating that the scope includes convertible instruments to which the guidance on derivative accounting, cash conversion or beneficial conversion, and gross-settled private company warrants that fail the criteria in ASC 815-40-15 (EITF 07-5) features apply.

Codification References

The paragraph immediately after 480-20-15-3(d) is labeled 480-20-15-3(b) in the proposed ASU. It should be 480-20-15-3(e).

Accounting for Registration Payment Arrangements

The accounting in proposed paragraph 480-20-25-3 is inconsistent with the conclusion in FSP EITF 00-19-2 related to registered shares (ASC 450-20 approach used with amounts always recognized in earnings).

The Board should consider explaining in the Basis for Conclusions the rationale for accounting for down-round features that are triggered under proposed paragraph 480-20-25-3 differently from payments for registration rights, particularly in view of the fact that both were motivated, at least partially, by the Board's efforts to simplify the accounting.

“Carrying Value” vs. “Carrying Amount”

The proposed ASU uses the term *carrying value*, which is not a defined term in GAAP. The Board should consider replacing this term with *carrying amount*,” which is a defined term.

Example 1 of the Implementation Guidance

This example presumes equity classification of the warrant (i.e., it concludes that the effect of the down-round feature should be recognized in equity). However, the example does not indicate that the warrant meets all of the conditions in ASC 815-40-15 (EITF 07-5) and ASC 815-40-25 (EITF 00-19). The Board should consider clarifying that the warrant meets all of the other conditions for equity classification.

Instruments with Down-round Features Not Measured at Fair Value Under Current GAAP

Paragraph BC27 of the proposed ASU discusses instruments with down-round features that are not required to be measured at fair value because they do not meet the definition of a derivative. Private-company warrants that are gross share settled are given as an example of those instruments. We believe those instruments would be a liability under ASC 815-40-15 (EITF 07-5). There is no subsequent measurement guidance in GAAP for those instruments. The Board should consider

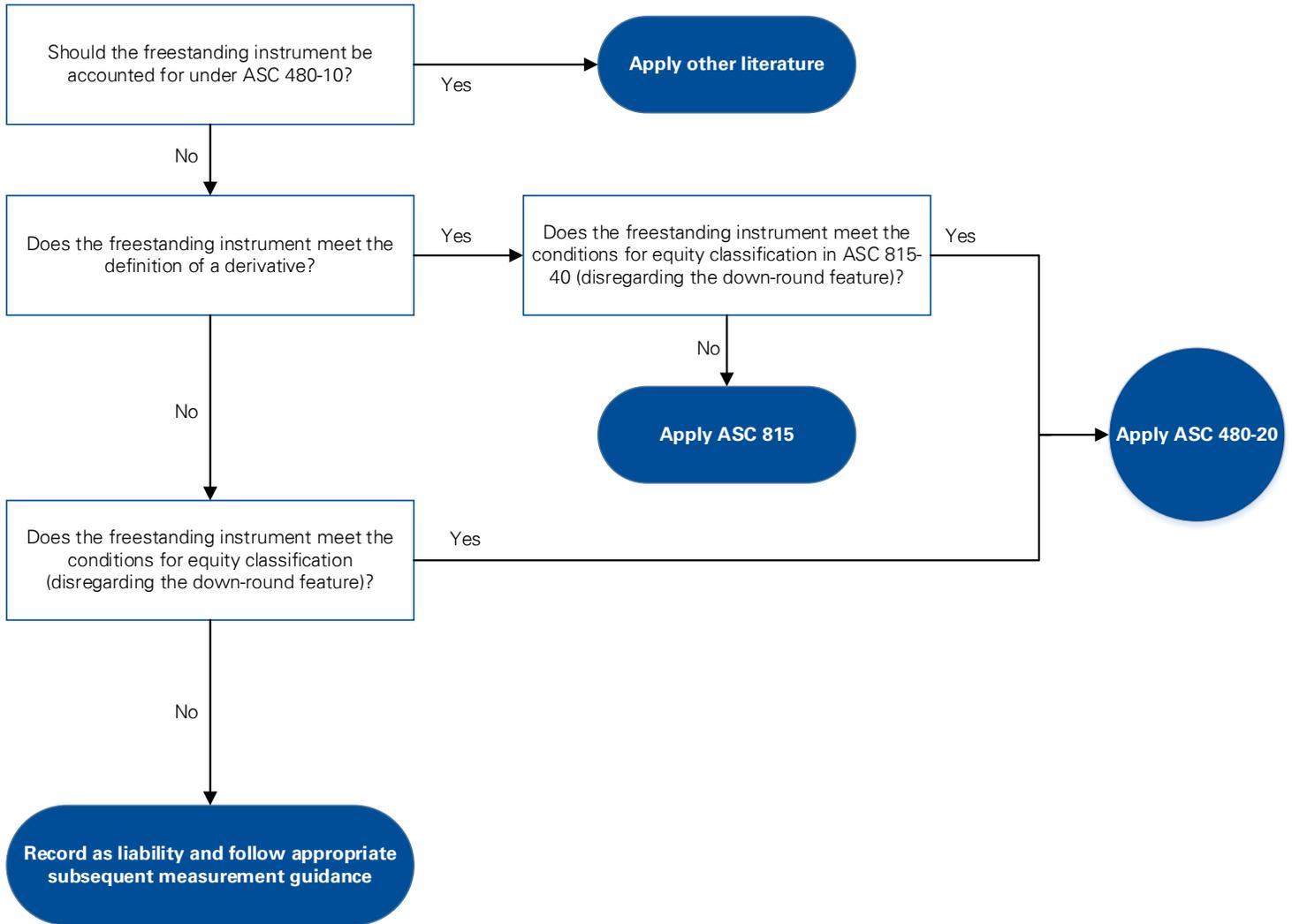
clarifying whether these instruments would be accounted for under the proposed guidance in ASC 480-20.

Part II – Certain Paragraphs Deleted by the Proposed ASU

It is not clear why the proposal would delete paragraphs 480-10-55-8 and 55-9. The Board should consider whether these paragraphs should be retained.

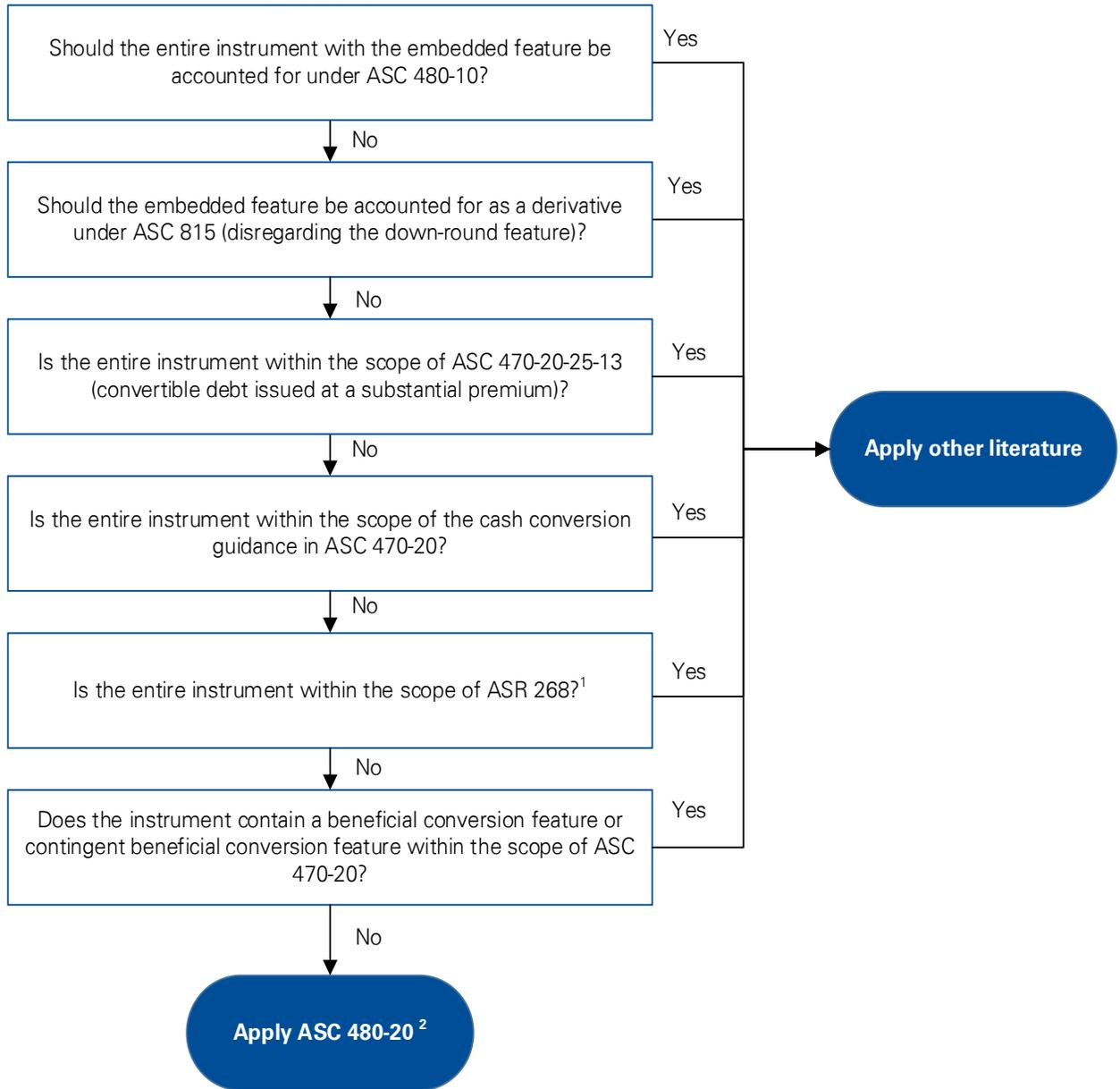


Appendix III - Freestanding Equity-linked Financial Instruments with Down-round Features





Appendix IV - Convertible Preferred Shares and Convertible Debt Instruments with Down-round Features



¹ The interaction of this ASU and ASR 268 should be determined, explained and coordinated with the SEC staff. For example, application of the literature to puttable, convertible preferred shares containing a down-round feature.

² We believe that this will apply to few if any financial instruments.