

December 18, 2020

Ms. Hillary Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

By email: director@fasb.org

Re: File Reference No. 2020-800, Exposure Draft, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40)*

Dear Ms. Salo,

The International Swaps and Derivatives Association’s (ISDA)¹ Accounting Policy Committee appreciates the opportunity to comment on the Financial Accounting Standards Board’s (FASB) Exposure Draft, Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity’s Own Equity (Subtopic 815-40), on an Issuer’s Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Forwards and Options (the Exposure Draft). Collectively, the Committee members have substantial professional and practical expertise addressing accounting policy issues related to financial instruments. This letter provides our organization’s overall views on the Exposure Draft and our responses to the questions for respondents included within the Exposure Draft.

Overview

ISDA supports the FASB’s objectives in the Exposure Draft to clarify and reduce diversity in an issuer’s accounting for modifications or exchanges of freestanding equity-classified forwards and options (including warrants) that remain equity classified after modification or exchange.

As discussed below in our responses to the FASB’s questions, we have included additional comments and proposed refinements for the FASB’s consideration.

¹ Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 925 member institutions from 75 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

Please find below the Committee's responses to the questions for respondents.

Responses to FASB's Questions for Respondents

Question 1—Do you agree that the amendments in this proposed Update should apply to freestanding equity-classified forwards and options that remain equity classified after modification or exchange and are not within the scope of Topic 718 or accounted for as derivatives under Topic 815? Why or why not?

We agree that the amendments in this proposed Update should apply to freestanding equity-classified forwards and options that remain equity classified after modification or exchange and are not within the scope of Topic 718 or accounted for as derivatives under Topic 815. The Committee believes this will reduce diversity in practice for these types of modifications.

Question 2— Do you agree that an issuer should recognize the effect of a modification or an exchange of a freestanding equity-classified forward or option on the basis of the substance of the transaction as described in paragraph 815-40-35-17? Why or why not?

We agree that an issuer should recognize the effect of a modification of a freestanding equity-classified forward or option on the basis of the substance of the transaction. However, we do not believe the implementation guidance in paragraphs 815-40-55-49 through 55-51 provides financial statement preparers with enough clarity on which terms need to be emphasized when determining the substance of the transaction.

The issuer is providing additional value to the holder of the option either through a reduction in the exercise price or an extension of the option term, under Case A and Case B respectively. The key difference between the two cases appears to be that in Case A, the modification is executed to induce the exercise of the outstanding warrants. However, a similar argument could be made that the issuer is seeking to induce exercise of the warrants in Case B by increasing the likelihood of exercise through the extended time.

If the determining factor for concluding that the modification relates to a financing transaction is whether the modification is made to induce an imminent conversion, this should be clarified in the examples. Based on the comments above, please see our proposed edits to Case A below:

815-40-55-50 Entity A reduces the exercise price of the warrants that are significantly in-the-money prior to modification to \$9 per share for a 60-day period to induce exercise of the outstanding warrants. Entity A determines that the warrants remain equity classified in accordance with this Subtopic after the modification. Entity A considers the guidance in paragraph 815-40-35-15 and determines that the circumstances of the warrant modification indicate that the modification is executed in contemplation of an equity offering (that is, to induce the imminent exercise of the outstanding warrants and raise equity capital). Entity A concludes that the incremental fair value of the outstanding warrants is an incremental cost directly attributable to a proposed equity offering. Entity A recognizes the incremental fair value of the outstanding warrants as an equity issuance cost in accordance with paragraph 815-40-35-17(a). At the date on which the modification is executed by Entity A and the warrant holder,

Entity A recognizes deferred costs of an offering (calculated in accordance with paragraph 815-40-35-16) to be charged against the gross proceeds of the offering. See paragraphs 815-40-50-5 and 505-10-50-3 for disclosure guidance.

Further, we suggest the FASB provide additional background information and context in Case B on how Entity A determined that the criteria in paragraph 815-40-35-17(a) through (c) are not met to help entities apply the principles in the Exposure Draft.

Question 3— For modifications or exchanges of freestanding equity-classified forwards and options that are within the scope of the proposed amendments, an issuer would not recognize the effect of a modification or an exchange that results in a reduction in the fair value of that instrument (similar to the share-based payment model in Topic 718). Do you agree with that accounting? Why or why not?

We do not object to the issuer only recognizing the effect of modifications or exchanges when such modifications result in an increase in the fair value of the instrument. However, we suggest that the guidance explicitly state that modifications resulting in a reduction in the fair value of the instrument receive no accounting recognition.

To provide this clarification, we believe the following should be added to the end of paragraph 815-40-35-16: “The effect of a modification or an exchange that results in the reduction in value of the instrument shall not be recognized.”

Additionally, as currently drafted, only increases in value of a freestanding equity-classified forward or option held by a creditor are included in the 10 percent test; however, as noted in 470-50-40-10(a) and 40-10(b), changes in fair value of equity-related features are considered regardless of the direction (e.g., (a) discusses only a change, and (b) contemplates both the addition or elimination of a conversion feature). As such, we proposed the following edit to ensure consistency:

470-50-40-12A If a modification or an exchange of a freestanding equity-classified forward or option held by a creditor is a part of or directly related to a modification or an exchange of an existing debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)), a change ~~an increase~~ in the fair value of the freestanding equity-classified forward or option held by the creditor, calculated in accordance with paragraph 815-40-35-16, shall be included in the application of the 10 percent cash flow test described in paragraph 470-50-40-10.

Question 4—Are the proposed amendments operable, including for situations in which the substance of the transaction includes multiple elements (for example, debt financing and equity financing)? If not, what changes do you recommend and why?

Yes, we believe the proposed amendments are broadly complete and operable with respect to the proposed amendments when our proposed edits are considered.

We understand there is diversity in practice regarding the extent to which amendments are considered to extinguish derivative instruments subject to ASC 815 (i.e., deemed to be the termination of the “old” instrument and the execution of a “new” instrument). GAAP does not currently describe how

this analysis is performed, with some viewing a change to any term as representing an extinguishment, while others focus only on changes to terms that are significant or critical to the instrument. As currently drafted, the guidance is more aligned with the former, which may be overly restrictive and administratively burdensome – for example, it may have the effect of requiring an entity to perform multiple fair value analyses when only minor or insignificant changes occur.

There is precedence for this in GAAP today in Topic 480, where the guidance states that any nonsubstantive or minimal features shall be disregarded. Topic 480 also indicates that judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

Based on our comments above, please see our proposed edits to allow for judgment to be applied in these cases:

470-50-40-12A If a significant modification or an exchange of a freestanding equity-classified forward or option held by a creditor is a part of or directly related to a modification or an exchange of an existing debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)), ~~a change an increase~~ in the fair value of the freestanding equity-classified forward or option held by the creditor, calculated in accordance with paragraph 815-40-35-16, shall be included in the application of the 10 percent cash flow test described in paragraph 470-50-40-10. Judgment, based on consideration of all the terms of the modification or exchange and other relevant facts and circumstances, is necessary to distinguish significant modifications or exchanges from insignificant modifications or exchanges.

815-40-35-16 An entity shall treat a significant modification of the critical terms or conditions or an exchange of a freestanding equity-classified forward or option as an exchange of the original instrument for a new instrument. In substance, the entity repurchases the original instrument by issuing a new instrument. The effect of a modification or an exchange shall be measured as the excess, if any, of the fair value of the modified or exchanged instrument over the fair value of the original instrument immediately before it is modified or exchanged. In a multiple-element transaction, the total effect of the modification or exchange shall be allocated to the respective elements in the transaction.

Additionally, ASC 815-40-25-16 indicates that in multiple-element transactions, the total effect of the modification or exchange shall be allocated to the respective elements in the transaction. The guidance does not provide clarity on the basis with which to determine the amount to allocate to each element, such as the relative fair value (which is required for debt instruments with detachable warrants under ASC 470-20-25-2). If the guidance is intended to require the relative fair value method or another method, we believe this should be stated in the guidance.

Conversely, if the intention of the Board was to provide flexibility in how the allocation should be determined in multiple-element arrangements, and not to require a specific method for allocation, we suggest that the Basis for Conclusions should be explicit that other existing GAAP should be applied.

Question 5— For modifications or exchanges of freestanding equity-classified forwards and options that represent compensation for goods or services, are the proposed amendments in paragraph 815-40-35-18 and to Topic 718 necessary to clarify that those transactions are within the scope of Topic 718?

Yes, we believe the proposed amendments in paragraph 815-40-35-18 and Topic 718 are helpful to prevent any diversity in practice around the treatment of modifications that represent compensation for goods and services.

Question 6— Do you agree that an issuer should recognize the effect of a modification or an exchange of a freestanding equity-classified forward or option as a dividend when the substance of the transaction is not related to a financing, compensation for goods or services, or exchange transactions addressed by other Topics? Why or why not?

Yes, we agree with the view that the issuer should recognize the effect of a modification or an exchange of a freestanding equity-classified forward or option as a dividend when the substance of the transaction is not related to a financing, compensation for goods or services, or exchange transactions addressed by other Topics. Given the transaction continues to be equity-classified, we believe that the increase in fair value is best reflected as a dividend when the other criteria discussed above are not met. We note that this is consistent with practice for equity-classified preferred shares that are not extinguishments, where the application of the share-based payment model for modifications results in a deemed dividend.

Question 7— Do you agree with the transition provisions, including early adoption in an interim period as of the beginning of the fiscal year that includes that interim period? If not, what changes do you recommend and why?

We agree with the proposed transition guidance and proposed timing of adoption of the Accounting Standards Update.

Question 8— How much time would be necessary to adopt the proposed amendments? Would the amount of time needed to apply the proposed amendments by entities other than public business entities and public business entities that do not meet the definition of a Securities and Exchange Commission (SEC) filer be different from the amount of time needed by public business entities that meet the SEC filer definition?

The proposed amendments provide companies with the flexibility to apply the amendments (1) retrospectively to all prior periods with a cumulative catch-up adjustment recorded as of the beginning of the earliest period presented or (2) prospectively to modifications or exchanges occurring on or after the effective date. As a result, we believe the proposed amendments should be effective for the fiscal year after the final publication of the Accounting Standards Update. Because of the option to apply the guidance prospectively, we do not believe there is a difference in the amount of time needed for entities other than public business entities.

Closing

We hope you find ISDA's comments and responses informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter please do not hesitate to contact the undersigned.

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