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October 26, 2022

Ms. Hillary Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7

PO Box 5116
Norwalk, CT 06856-5116

Via Email to director@fasb.org

Re: Agenda request – Clarifying the scope and application of ASC 480 with respect to legal form debt instruments

Dear Ms. Salo:

Grant Thornton LLP appreciates the opportunity to submit an agenda request to the FASB for a project to clarify the scope of ASC 480 and potentially the application of ASC 480-10-25-14 and 35-5 to certain debt instruments.

Specifically, we request that the FASB, or the Emerging Issues Task Force (EITF), consider undertaking a project to clarify whether financial instruments that are debt in legal form are within the scope of ASC 480, *Distinguishing Liabilities from Equity*. If it is determined that legal form debt instruments are within the scope of ASC 480, then we believe that the project should also clarify the application of ASC 480-10-25-14 to debt instruments that may be settled by the issuer transferring to the creditor a variable number of the issuer's shares with a total fixed monetary value (referred to throughout this agenda request as "share-settled debt").

We are submitting this request because (1) the issue appears to be pervasive, (2) diversity in practice exists regarding whether share-settled debt should be evaluated under ASC 480 and (3) it is not clear to us how to apply ASC 480-10-25-14 and 35-5 to share-settled debt if it is evaluated under ASC 480.

In recent years we have seen an increase in share-settled debt issuances, often by early stage companies, to finance operations between equity offerings (so called "bridge loans"). In our experience, this type of financing is common in start-up and early stage companies across various industries.



Although applying ASC 480 to a legal form debt instrument would not impact its presentation on the statement of financial position as a liability, it is important to address this issue because the subsequent measurement guidance in ASC 480 may differ from guidance that is applied to non-share-settled debt instruments. ASC 480-10-35-5 requires issuers to subsequently measure instruments within the scope of ASC 480, other than mandatorily redeemable financial instruments and certain physically settled forward purchase contracts, at fair value, unless another Codification Subtopic specifies a different measurement attribute. For certain share-settled debt instruments, it is unclear whether another Subtopic, such as ASC 835-30, *Interest: Imputation of Interest*, specifies a relevant measurement attribute.

Scope of ASC 480

We believe it is unclear whether legal form debt instruments are within the scope of ASC 480.

Some practitioners believe that legal form debt instruments are not, under any circumstance, within the scope of ASC 480. It is our understanding that this view is primarily based on the objective of FASB Statement 150 (the primary source of the guidance in ASC 480), which was to address (1) stakeholder concerns about “issuers’ classification in the statement of financial position of certain financial instruments that have characteristics of both liabilities and equity but that have been presented either entirely as equity or between the liabilities section and the equity section of the statement of financial position,” and (2) questions about “the classification of certain financial instruments that embody obligations to issue equity shares,” including certain obligations that are “setttable by delivery of the issuer’s equity shares but not indexed to the issuer’s shares that may have been classified as equity.”¹

In addition, we note that ASC 480-10-05-1 includes the following sentence (emphasis added):

The Codification contains separate Topics for liabilities and equity, **including a separate Topic for debt.**

Some practitioners believe that the reference to “a separate Topic for debt” indicates that the guidance in ASC 480 does not apply to financial instruments that are debt in legal form.

¹ From the “Summary” section of Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*



Since there has been no confusion in practice about whether legal form debt should be presented as a liability on the statement of financial position, and since FASB Statement 150 was issued to deal with instruments that previously had been presented as equity despite having characteristics of liabilities, some practitioners believe that it was not the Board's intent for FASB Statement 150 (and therefore ASC 480) to address the accounting for legal form debt instruments. Accordingly, they believe that legal form debt instruments should not be evaluated under ASC 480.

Other practitioners note that, regardless of the Board's intent when issuing FASB Statement 150, ASC 480 applies to "any freestanding financial instrument," according to ASC 480-10-15-3. A debt instrument, as a contract that both imposes on one entity (the debtor) a contractual obligation to deliver cash to a second entity (the creditor) and conveys to that second entity a contractual right to receive cash from the first entity, meets the definition of a "financial instrument." Therefore, these practitioners believe that a legal form debt instrument, as a financial instrument, must be evaluated under the guidance in ASC 480-10-25 to determine whether it is subject to the initial and subsequent measurement guidance in ASC 480.

Practitioners that believe ASC 480 applies to all freestanding financial instruments, including debt instruments, also note that recent amendments to the guidance in ASC 470-20 indicate that legal form debt instruments may be within the scope of ASC 480. This amended guidance includes the following paragraphs (emphasis added):

ASC 470-20-15-2C

The guidance in this Subtopic does not apply to a convertible debt instrument award issued to a grantee that is subject to the guidance in Topic 718 on stock compensation unless the instrument is modified as described in and no longer subject to the guidance in that Topic. The guidance in this Subtopic does not apply to **stock-settled debt that is subject to the guidance in Subtopic 480-10** on distinguishing liabilities from equity or other Subtopics (see paragraph 470-20-25-14), unless the stock-settled debt also contains a substantive conversion feature (as discussed in paragraphs 470-20-40-7 through 40-10) for which all relevant guidance in this Subtopic shall be considered in addition to the relevant guidance in other Subtopics.

ASC 470-20-25-14

If a **debt instrument** has a conversion option that continuously resets as the underlying stock price increases or decreases so as to provide a fixed value of common stock to the holder at any conversion date, **the instrument shall be considered stock-settled debt that is subject to the guidance in Subtopic 480-10** or other Subtopics (such as Subtopic 718-10, 815-15, or 825-10). Example 4 (see paragraph 470-20-55-18) illustrates application of the guidance in this paragraph.



In addition, the Basis for Conclusions in ASU 2020-06 (which codified the amendments noted in the two paragraphs presented above) includes the following (emphasis added):

Stock-settled debt

BC52. The Board received feedback from stakeholders indicating the existence of diversity in practice in distinguishing stock-settled debt from convertible debt when debt instruments can be converted to a variable number of shares. As a result, entities may mischaracterize and inappropriately account for those instruments. **The Board decided to clarify that a debt instrument that can be converted to a variable number of shares with an aggregate fair value equal to a fixed monetary amount should be considered stock-settled debt that is subject to the guidance in Subtopic 480-10 or other Subtopics, rather than a convertible debt instrument.**

However, if a stock-settled debt also contains a substantive conversion feature, relevant guidance in Subtopic 470-20 should be considered in addition to the relevant guidance in other Subtopics. The Board concluded that this clarification could, to a certain extent, alleviate the mischaracterization of stock-settled debt as a convertible debt instrument. Noting the various types of stock-settled debt in practice and the complexities in current accounting guidance, some comment letter respondents requested that the Board address those issues under this project. The Board acknowledges that some practice issues related to stock-settled debt may continue to exist, especially the issues related to different interpretations and applications of the guidance in Subtopic 480-10 and Topic 815 for certain instruments, which are beyond the scope of this project.

Application of ASC 480-10-25-14

We believe it is unclear how to apply the following guidance in ASC 480-10-25-14 to share-settled debt:

ASC 480-10-25-14

> Certain Obligations to Issue a Variable Number of Shares

A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

- a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)
- b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares)



- c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

See paragraph 480-10-55-21 for related implementation guidance.

In particular, we believe it is unclear how to consider the concepts of *obligation*, *conditionality*, and *predominance* when applying ASC 480-10-25-14 to a legal form debt instrument, as discussed below.

Obligation

The definition of "obligation" in ASC 480 is:

A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. Because Topic 480 relates only to financial instruments and not to contracts to provide services and other types of contracts, but includes duties or responsibilities to issue equity shares, this definition of obligation differs from the definition found in FASB Concepts Statement No. 6, Elements of Financial Statements, and is applicable only for items in the scope of that Topic.

Some practitioners believe that whether share-settled debt is within the scope of ASC 480-10-25-14 depends on whether the issuer is obligated to transfer a variable number of shares with a fixed monetary value to the creditor. Because issuers of share-settled debt are often required to settle the instrument by delivering a variable number of shares only upon completing a qualifying equity raise, and because whether a qualifying equity raise is undertaken is at the issuer's discretion, these practitioners believe that such instruments do not embody an *obligation* to deliver a variable number of shares within the scope of ASC 480-10-25-14.

Other practitioners note that ASC 480-10-25-14 applies to financial instruments that embody obligations that the issuer *may* settle by delivering a variable number of shares, and that most legal form debt instruments embody obligations to deliver assets (cash) to the creditor by a fixed maturity date. Many share-settled debt instruments specify a maturity date at which the issuer is required to settle the instrument in cash, provided that either a qualified equity raise has not occurred prior to that date or, in some cases, the holder has elected not to exercise a fixed price equity conversion option.

These practitioners note that, upon settling share-settled debt in a variable number of shares (for example, upon completing a qualifying equity raise prior to the debt's maturity date), the issuer has extinguished (settled) its obligation to transfer assets to the creditor at the maturity date. Therefore, they believe that share-settled debt embodies an obligation that the issuer *may* settle by transferring a variable number of its shares to the holder, regardless of whether the issuer is *required* to settle the debt in shares in all circumstances.



Conditionality

ASC 480-10-25-14 applies to financial instruments other than outstanding shares that embody conditional obligations that the issuer must or may settle in a variable number of shares.

We believe it is unclear what constitutes a “conditional obligation” because ASC 480 neither defines the term “conditional” nor provides adequate illustrative guidance to clarify what constitutes a condition.

Some practitioners believe that a conditional obligation is an obligation triggered by the occurrence of an event outside the reporting entity’s control. Other practitioners look to other uses of “conditional” in the Codification, in particular, the term “conditional asset retirement obligation,” which is defined in the Codification Master Glossary as follows (emphasis added):

A legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are **conditional on a future event that may or may not be within the control of the entity**.

These practitioners believe that a condition may or may not be within the control of the issuer. Therefore, while an issuer might be able to avoid an obligation to transfer a variable number of shares that is conditional upon, for example, completing a qualifying equity raise (which the issuer could avoid by choosing not to undertake the process of issuing shares), the issuer nevertheless has a *conditional* obligation to transfer a variable number of shares. Accordingly, these practitioners believe that an instrument that embodies such a conditional obligation is within the scope of ASC 480-10-25-14.

We also note that use of “conditional” and “unconditional” as adjectives describing an obligation as defined in ASC 480 might be considered redundant, since an “obligation” encompasses “a conditional or unconditional duty or responsibility” to transfer assets. In other words, substituting this definition for the term “obligation,” ASC 480-10-25-14 applies to “a financial instrument other than an outstanding share that embodies a conditional [conditional or unconditional duty or responsibility to transfer assets or to issue equity shares] that the issuer must or may settle by issuing a variable number of its equity shares...”

Predominance

ASC 480-10-25-14 applies to instruments that embody obligations for which the monetary value is based solely or predominantly on (a) a fixed monetary amount, (b) variations in something other than the value of the issuer’s shares, or (c) variations inversely related to changes in the fair value of the issuer’s shares. We are aware of diversity in practice with respect to determining whether the monetary value of an obligation is based predominantly on one of those three factors.

Some practitioners believe that predominance should be assessed in a manner consistent with other areas of U.S. GAAP; that is, a potential settlement outcome is considered “predominant” if its occurrence is “more likely than not.”



Other practitioners believe that, within the context of ASC 480, predominance should be assessed using a higher threshold than “more likely than not.” This view is based on an understanding that, as originally proposed, the guidance in FASB Statement 150, which was codified in ASC 480-10-25-14(a), applied to instruments that embody obligations for which the monetary value is *solely* based on a fixed monetary amount known at inception. In the final version of FASB Statement 150, the Board decided to use the phrase “solely or predominantly” instead, in response to stakeholders’ concerns that the use of only the term “solely” might prompt entities to circumvent the guidance in ASC 480-10-25-14 by inserting a small amount of variability in the monetary value into an instrument that otherwise would be a liability under ASC 480.

These practitioners believe that since the term “predominantly” was used to prevent circumvention of the guidance in ASC 480 by adding minor provisions to an instrument, assessing “predominant” using a high threshold (for example, a 90 percent likelihood) is acceptable.

Application of ASC 480-10-35-5

We believe it is unclear how to apply the following guidance in ASC 480-10-35-5 to share-settled debt:

ASC 480-10-35-5

All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured subsequently at fair value with changes in fair value recognized in earnings, unless either this Subtopic or another Subtopic specifies another measurement attribute.

In particular, we believe it is unclear whether share-settled debt is within the scope of ASC 835-30.

ASC 835-30-15-2

The guidance in this Subtopic applies to receivables and payables that represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, whether or not there is any stated provision for interest, with certain exceptions noted below. Such receivables and payables are collectively referred to in this Subtopic as notes. Some examples are the following:

- a. Secured and unsecured notes
- b. Debentures
- c. Bonds
- d. Mortgage notes



- e. Equipment obligations
- f. Some accounts receivable and payable.

To illustrate various views, consider the following scenario: A borrower issues a two-year debt instrument in exchange for \$50 million with a 5 percent annual coupon. If the borrower completes an equity raise of at least \$100 million before the maturity date of the debt, then the debt automatically settles in a variable number of shares (the same class issued in the qualifying equity raise) equal to \$50 million divided by 80 percent of the price per share in the qualifying equity raise. Assume the debt instrument is within the scope of ASC 480.

Some practitioners believe that ASC 835-30 provides a relevant subsequent measurement model for share-settled debt, with the result that share-settled debt within the scope of ASC 480 is subsequently measured using the interest method in a manner similar to other term debt arrangements. In this example, these practitioners would subsequently measure the debt instrument based on the guidance in ASC 835-30, since that guidance provides the relevant subsequent measurement model for term debt. The variable share settlement provision would be assessed as an embedded redemption feature, and would likely be separated from the host debt instrument under ASC 815-15 and subsequently measured at fair value. In other words, the accounting for the hybrid debt instrument would be the same whether the debt instrument is within or outside the scope of ASC 480.

Other practitioners believe that whether the subsequent measurement guidance in ASC 835 would apply in this example depends on whether the variable share settlement provision in the debt is considered a feature of the host contract or an embedded feature in the hybrid debt instrument. In other words, does the hybrid debt instrument consist of a variable share-settled debt host contract with an embedded fixed date cash redemption feature, or does it consist of a fixed date, cash-settled debt host contract with an embedded variable share-settled redemption feature?

These practitioners note that ASC 835-30 applies to “payables that represent ... contractual obligations to pay money on fixed or determinable dates ...” and believe that the “contractual obligation” refers to the host contract rather than an embedded feature in the hybrid debt instrument.

Further, they believe that for the model in ASC 835-30 to apply to share-settled debt, the variable share settlement provision must be a feature of the host contract and must occur on a fixed or determinable date. In other words, for the subsequent measurement guidance in ASC 835-30 to apply in this example, the debt must be akin to a typical cash-settled term loan, except that the issuer is required to transfer shares with a fixed monetary value rather than cash at maturity.

Therefore, these practitioners believe that share-settled debt for which the variable share settlement feature is deemed to be a characteristic of the host contract, and for which the variable share settlement date is neither fixed nor determinable (and which might never occur), would not be within the scope of ASC 835-30 and would be subsequently measured at fair value in accordance with ASC 480-10-35-5.



Application of ASC 480-10-25-8

While this agenda request is focused on the scope of ASC 480 and application issues associated with ASC 480-10-25-14, we are also aware that questions have arisen in practice with regard to applying the following guidance in ASC 480-10-25-8 to certain convertible debt instruments:

ASC 480-10-25-8

An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:

- a. It embodies an **obligation** to repurchase the **issuer's equity shares**, or is indexed to such an obligation.
- b. It requires or may require the **issuer** to settle the obligation by transferring assets.

ASC 480-10-25-8 is often applied to non-share instruments such as warrants that permit the holder to purchase the issuer's contingently redeemable preferred shares, resulting in a liability presentation and subsequent measurement at fair value for such instruments.

Certain debt instruments permit the holder to convert the debt into the issuer's contingently redeemable preferred shares. Such debt instruments could be within the scope of ASC 480-10-25-8 for the same reason as warrants to purchase contingently redeemable preferred shares—that is, the financial instrument is not a share, and it embodies an obligation to repurchase the issuer's equity shares by transferring cash to the counterparty. Under such a view, practitioners are faced with the same subsequent measurement issues described earlier for share-settled debt instruments.

Proposed resolution

In our view, the challenges we face in applying the guidance in ASC 480, particularly ASC 480-10-25-14, to share-settled debt stem from the fact that a legal form debt instrument, by its nature, encompasses an obligation of the issuer. It does not appear to us that the Board's intent in developing FASB Statement 150 was to require practitioners to apply that guidance to financial instruments that are debt in legal form.

Therefore, we propose that the Board amend ASC 480 to exclude legal form debt instruments from its scope. We suggest that this be done without attempting to define legal form debt. Instead, we believe that the Board could leverage extant guidance from ASC 815-40-25 to refine the scope of ASC 480.

A key distinction between legal form debt and other financial instruments is the rights of the holder in the event of the issuer becoming insolvent. Prior to its amendment by ASU 2020-06, ASC 815-40-25 specified that, as a criterion for equity classification, an instrument or embedded feature does not "give the counterparty any of the rights of a creditor in the event of the entity's [issuer's] bankruptcy." The guidance related to this extant criterion could be used to refine the scope of ASC 480 as follows:

> Instruments



15-3 The guidance in the Distinguishing Liabilities from Equity Topic applies to any **freestanding financial instrument**, except as described in ASC 480-10-15-4A through 15-4D, including one that has any of the following attributes...

15-4A A freestanding financial instrument that conveys to the counterparty any of the rights of a creditor in the event of the issuer's bankruptcy is excluded from the scope of this Topic. A counterparty is deemed to have rights of a creditor if its claim in the issuer's bankruptcy would receive higher priority than claims of the holders of the issuer's equity shares.

15-4B In federal bankruptcy proceedings, a debtor cannot be compelled to affirm an existing contract that would require it to pay cash to acquire its shares (which could be the case, for example, with a physically settled forward purchase or written put). As a result, even if the contract requires that the issuer pay cash to settle the contract, the issuer could not be required to do so in bankruptcy. Because of the complexity of federal bankruptcy law and related case law, and because of the differences in state laws, it is not possible to address all of the legal issues associated with the status of the contract and the claims of the counterparty in the event of bankruptcy.

15-4C A contract provision requiring net cash settlement in the event of bankruptcy does not preclude application of the guidance in this Topic if it can be demonstrated that, notwithstanding the contract provisions, the counterparty's claims in bankruptcy proceedings in respect of the issuer could be net share settled or would rank no higher than the claims of the holders of the issuer's equity shares.

15-4D Determination of the status of a claim in bankruptcy is a legal determination.

We believe that these proposed amendments would exclude from the scope of ASC 480 most legal form debt instruments. We also believe that these proposed amendments would be operable because practitioners have experience in applying the extant guidance from ASC 815-40-25 to equity-linked contracts.

In our view, it will be clear in many cases whether a counterparty has creditor rights in the event of the issuer's bankruptcy. To address cases where this is not clear, we believe the Board could add a "readily determinable" provision that would effectively require an analysis under ASC 480 if the issuer cannot readily determine whether an issued freestanding financial instrument conveys creditor rights to the counterparty. Such a provision could be modeled on the guidance in ASC 842-10-15-15, which addresses a customer's evaluation of whether a contract contains a lease in situations where the customer cannot readily determine if the supplier has substantive substitution rights:

15-4E If an entity cannot readily determine whether a freestanding financial instrument conveys to the counterparty any of the rights of a creditor in the event of the issuer's bankruptcy, then the entity shall presume that the freestanding financial instrument does not convey such rights to the counterparty.



In summary, we believe that the primary issue to be addressed is whether certain legal form debt instruments are within the scope of ASC 480.

If it is determined that certain legal form debt instruments are within the scope of ASC 480, then we believe additional implementation guidance regarding the application of ASC 480-10-25-14 and 35-5 (and, possibly, ASC 835-30) to share-settled debt instruments would help practitioners apply this guidance and promote consistent application.

We appreciate your attention to this matter and would be pleased to discuss this request with you. If you have any questions, please contact Ryan Brady, Partner, at ryan.brady@us.gt.com.

Sincerely,

/s/ Grant Thornton LLP