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To the Point

FASB – proposed guidance

Proposal would refine derivative scope exceptions and clarify the accounting for certain share-based payments

The proposal is intended to reduce the cost and complexity of applying derivative accounting to certain contracts and clarify the applicability of ASC 606 to certain share-based payments.

What you need to know

- The FASB proposed amendments that would exclude from the scope of derivative accounting contracts with underlyings that are based on the operations or activities of one of the parties to the contract.
- The predominant characteristics assessment in ASC 815 applicable to certain non-exchange traded contracts would be amended to require an entity to assess which underlying is anticipated to have the largest expected effect on changes in the fair value of the contract (or embedded feature).
- The proposal would also clarify that an entity receiving a share-based payment from a customer that is consideration for the transfer of goods or services in a revenue contract would apply the guidance on noncash consideration in ASC 606.
- An entity would not apply the guidance in ASC 815 and ASC 321 to a share-based payment from a customer that is consideration for the transfer of goods or services unless and until the share-based payment is recognized as an asset under ASC 606.
- Comments are due by 21 October 2024.

Overview

The Financial Accounting Standards Board (FASB or Board) proposed amendments to expand the scope of contracts that would be excluded from derivative accounting (i.e., measured at fair value through earnings). The proposal is in response to stakeholder questions about the application of the definition of a derivative and related scope exceptions to contracts such as bonds with interest payments based on environmental, social and governance (ESG) metrics, research and development funding arrangements, and litigation financing arrangements.

Stakeholders have said that applying derivative accounting to contracts with variables (referred to as "underlyings") based on the operations or activities specific to one of the parties to the contract is complex and does not always provide decision-useful information. The proposal is intended to better portray the economics of these contracts in the financial statements and reduce the complexity and cost for entities applying the guidance in Accounting Standards Codification (ASC) 815, *Derivatives and Hedging*.

In addition, the proposal would clarify the accounting by an entity that receives share-based payments (such as warrants or shares) from a customer that are consideration for the transfer of goods or services in a revenue contract. Stakeholders have said there is a lack of clarity about which guidance an entity should apply to recognize these share-based payments.

For example, stakeholders raised questions on whether share-based payments that are contingent on the satisfaction of a performance obligation should be (1) recognized at contract inception under ASC 815 or ASC 321, *Investments — Equity Securities*, or (2) recognized upon the satisfaction of the performance obligation under ASC 606, *Revenue from Contracts with Customers*. The proposed amendments are intended to reduce diversity in practice and provide investors with more comparable information.

Key Considerations

Derivatives scope refinements

Scope exceptions

The proposal would expand the scope exceptions for certain contracts that are not traded on an exchange to include contracts with underlyings based on:

- The financial statement metrics of one of the parties to the contract, such as earnings before interest, taxes, depreciation and amortization (EBITDA), net income, expenses or total equity
- The occurrence or nonoccurrence of an event specific to the operations or activities of one of the parties to the contract (e.g., obtaining regulatory approval, achieving a product development milestone or a greenhouse gas emissions target)

The proposed scope exception would not apply to underlyings based on (1) a market rate, market price or market index or (2) the price or performance (e.g., default) of a financial asset or financial liability of one of the parties to the contract.

Predominant characteristics assessment

When a contract (or an embedded feature) contains multiple underlyings, and only some of them qualify for a scope exception from derivative accounting, ASC 815-10-15-60 requires the entity to perform a predominance assessment to determine whether the contract (or embedded feature) is excluded from derivative accounting under ASC 815. The entity would not exclude a contract (or embedded feature) from derivative accounting if all of its underlyings, considered in combination, are highly correlated with any of the underlyings that do not qualify for a scope exception.

The proposal would replace the correlation-based predominant characteristics assessment in ASC 815-10-15-60 with a fair value-based analysis. A contract (or embedded feature) would not be subject to the requirements of ASC 815 if the underlying that has the largest expected effect on changes in the fair value of the contract (or embedded feature) qualifies for a scope exception.

In paragraphs BC16 and BC17 of the proposal's Background Information and Basis for Conclusions, the Board observed that the proposed amendments could apply to contracts (or embedded features) beyond those transactions identified by stakeholders (e.g., ESG-linked bonds, research and development funding arrangements, and litigation financing arrangements) that have led to complexity and diversity in applying the definition of a derivative and related scope exceptions.

For example, the proposal would require debt instruments containing redemption or conversion features that become exercisable upon the occurrence of an event related to the operations or activities of the issuer (e.g., an initial public offering) to be subject to the predominant characteristics assessment. That is because the embedded redemption or conversion features have two underlyings: (1) the occurrence of an event that would qualify for a scope exception and (2) the variability related to interest rates or equity prices, which would not.

How we see it

Under the proposal, entities may need to perform the predominant characteristics assessment for many contracts for which such an analysis is not currently required. This could result in contracts (or embedded features) that are currently accounted for as derivatives being excluded from the scope of derivative accounting.

For example, it is not uncommon for certain embedded features in hybrid instruments, such as redemption or conversion features, to be bifurcated and accounted for as derivatives based on the existing requirements in ASC 815. Under the proposal, these features may be subject to the predominant characteristics assessment and, as a result, could be excluded from derivative accounting, depending on the facts and circumstances.

The proposal would replace the existing correlation-based predominant characteristic assessment with a fair value-based assessment.

Scope clarification for a share-based payment from a customer in a revenue contract

The proposal would clarify that an entity that receives a share-based payment from a customer that is consideration for the transfer of goods or services would apply the guidance on noncash consideration in ASC 606-10-32-21 through 32-24. The entity would not apply the guidance in ASC 815 and ASC 321 unless and until the share-based payment is recognized as an asset under ASC 606. As a result, the entity would first recognize the share-based payment as an asset under ASC 606 before applying the guidance in ASC 815 and ASC 321. An asset recognized under ASC 606 is measured at the estimated fair value at contract inception.

The proposal would further clarify that the share-based payment is recognized as an asset when the entity's right to receive or retain the share-based payment from a customer is no longer contingent on the satisfaction of a performance obligation, which is generally consistent with the definition of vest in the Codification's Master Glossary.

An entity that performs by transferring goods or services to a customer before or after the entity's right to receive or retain a share-based payment is no longer contingent on the satisfaction of a performance obligation would apply the presentation guidance in ASC 606-10-45. For example, an entity that performs by transferring goods or services to a customer before the customer pays the noncash consideration or before payment of the noncash consideration is due would present the noncash consideration (i.e., the share-based payment) as a contract asset, excluding any amounts presented as a receivable, until the share-based payment is recognized.

Effective date, transition and disclosures

The effective date of the proposed amendments will be determined after the Board considers stakeholder feedback. Early adoption would be permitted, including adoption in an interim or annual period for which an entity's financial statements have not been issued or made available for issuance. An entity electing to early adopt the proposed amendments in an interim period would apply them as of the beginning of the fiscal year that includes that interim period.

While entities would apply the proposed amendments on derivatives scope refinements prospectively, they also would have the option to apply the guidance to all affected contracts existing as of the beginning of the fiscal year of adoption through a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.

In addition, an entity that no longer applies derivative accounting to existing contracts (or embedded features) after adoption would have a one-time option, as of the beginning of the year of adoption, to irrevocably elect on an instrument-by-instrument basis the fair value option in ASC 825, *Financial instruments*, and measure the entire contract at fair value through earnings.

An entity would be required to apply the proposed amendments related to share-based payments to revenue contracts existing as of the beginning of the fiscal year of adoption through a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption.

Entities would also be required to make certain transition-related disclosures in accordance with ASC 250, *Accounting Changes and Error Corrections*, for any of the amendments adopted.