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Proposal to Clarify Derivative Scope Exception & Share-Based Payments

On July 23, 2024, FASB issued a proposal to clarify two aspects of derivative accounting guidance:

- **A new principles-based derivative scope exception for contracts with features based on the operations or activities of one of the parties to the contract, *e.g.*, financial statement metrics, regulatory approvals, product development milestones, or greenhouse gas emissions targets.**
- **Revenue recognition guidance in Accounting Standards Codification (ASC) 606 should be used for a share-based payment from a customer that is consideration for the transfer of goods or services.**

FASB believes the amendments will reduce diversity in practice, as well as the cost and complexity in applying this accounting guidance. Comments are requested by October 21, 2024.

A. Derivative Scope Refinement

Background

FASB has heard from stakeholders that applying guidance in ASC 815, *Derivatives and Hedging*, can be complicated, especially for new products and arrangements not contemplated when Statement 133, *Accounting for Derivative Instruments and Hedging Activities*, was issued in 1998 or when the derivative definition was amended by Statement 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, in 2003 to include "the occurrence or nonoccurence of a specified event," *e.g.*, research and development or litigation funding arrangements and bonds in which interest payments may vary based on environmental, social, and governance (ESG)-linked metrics.

ASC 815 establishes accounting requirements for contracts that meet the "derivative" definition and are not covered by a scope exclusion. A contract may meet the derivative definition in its entirety or have provisions or features that require bifurcation and separate accounting for as a derivative, *i.e.*, embedded derivatives. Current GAAP includes the following derivative scope exceptions:

- A climatic or geological variable or other physical variable, *e.g.*, rainfall or earthquake severity
- The price or value of a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash
- The fair value of a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash
- Specified volumes of sales or service revenues of one of the parties to the contract

The evaluation and documentation required if a transaction qualifies for a scope exception can be costly and time-consuming. Existing guidance has resulted in diversity in practice for similar products between companies and deal structuring to avoid a particular accounting outcome.

Proposed Amendments

The proposal adds a derivative scope exception for contracts with underlyings that are based on the operations or activities of one of the contract's parties and changes the predominant characteristics assessment applicable to certain contracts that are not traded on an exchange from a correlation assessment to a fair value assessment.

New Derivative Scope Exception

A new scope exception would cover a variable based on operations or activities **specific to one of the contract's parties**. Examples of financial operations metrics include:

- Earnings before interest, taxes, depreciation, and amortization;
- Net income;
- Expenses; or
- Total equity.

Examples of variable activities include:

- Obtaining regulatory approval,
- Achieving a product development milestone, or
- Achieving a greenhouse gas emissions target.

In evaluating if the variable operation or activity is specific to one of the contract's parties, an entity does not need to consider whether the outcome is within its control. For this scope exception, the term "party to the contract" refers to any entity within a consolidated group.

So that these amendments do not carve out instruments generally recognized as derivatives (such as interest rate swaps, commodity forward contracts, and credit default swaps), the scope exception "does not apply to variables based on a market rate, market price, or market index or the price or performance (including default) of a financial asset or financial liability of one of the contract's parties."

The proposal includes three illustrative examples on how to evaluate the new scope exception, including underlyings based on:

- Regulatory approval,
- An initial public offering, and
- The nonoccurrence of a greenhouse gas emissions target.

FASB expects this change will result in more contracts and embedded features being excluded from ASC 815. However, other existing accounting guidance covers any newly excluded transactions:

- R&D funding arrangements – ASC 730-20, *Research and Development Arrangements*
- ESG-linked features – ASC 470-10, *Debt—Overall*, ASC 320-10, *Investments—Debt Securities—Overall*, or ASC 450, *Contingencies*
- Litigation funding – Generally accounted for as reimbursements of litigation expenses with any obligation to share proceeds accounted for under ASC 450-20, *Contingencies*

FASB does not expect that contracts not currently accounted for as a derivative would require derivative accounting if this proposal is finalized.

Predominant Characteristics

Currently, contracts with multiple underlyings where some—but not all—of the underlyings qualify for a derivative scope exclusion are evaluated on the contract's predominant characteristics to determine if the entire contract (or embedded feature) is subject to ASC 815. The proposal changes the current predominant characteristics correlation assessment applicable to certain contracts that are not traded on an exchange to a fair value assessment. This assessment would be done only at contract inception.

Determining how to perform a fair value assessment will require judgment that depends on relevant facts and circumstances. An entity must determine which underlying is expected to have the largest effect on changes in the contract's fair value. Factors that may be considered would include:

- The magnitude and likelihood of variability in the underlyings and the related variability in cash flows,
- The relationship between the underlyings, and
- How those changes in underlyings would affect changes in the contract's fair value.

The proposal includes an illustration of the application of the new assessment with a greenhouse gas emission reduction target and a variable interest rate.

B. Share-Based Payments

Background

Financial statement preparers and accounting firms asked FASB for clarity on which accounting guidance to apply to recognize share-based payments received from a customer that are consideration for the transfer of goods or services if those share-based payments are contingent on the satisfaction of performance obligations. These transactions could be recognized at contract inception as a derivative asset under ASC 815 or an equity security under ASC 321, *Investments—Equity Securities*. Alternatively, recognition could be deferred until the entity satisfies its performance obligations under ASC 606, *Revenue from Contracts with Customers*.

Proposed Changes

Under the proposal, an entity would apply ASC 606 to a contract with a share-based payment from a customer that is consideration for the transfer of goods or services. Under ASC 606, the share-based payment should be recognized as an asset measured at the estimated fair value at contract inception 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. The amendments also state that ASC 815 and ASC 321 guidance should not be applied unless and until the share-based payment is recognized as an asset under ASC 606.

FASB believes these changes will provide investors with more comparable information and would reduce accounting complexity and related reporting costs for preparers and auditors.

Effective Date & Transition

The effective date will be determined after a review of comment letter feedback.

Changes to ASC 815 would be applied prospectively to new contracts after the adoption date. Entities would have the option to apply the guidance to contracts that exist as of the beginning of the fiscal year of adoption through a cumulative-effect adjustment made to the opening balance of retained earnings as of the beginning of the fiscal year of adoption. Early adoption would be permitted as of the beginning of the fiscal year. For contracts (or embedded features) that no longer have to apply ASC 815 as a result of these changes, an entity would have a one-time option—as of the beginning of the year of adoption—to irrevocably elect to apply the fair value option in ASC 825, *Financial Instruments,* on an instrument-by-instrument basis.

For changes to ASC 606, an entity would apply the amendments to revenue contracts that exist 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. Early adoption would be permitted as of the beginning of the fiscal year.

Conclusion

Whether you are publicly traded or privately held, Forvis Mazars can provide an independent and objective view into your financial reporting. We leverage some of the latest technologies and process automation tools to provide companies assurance on their financial statements in meeting stakeholders' needs. If you have any questions or need assistance, please reach out to one of our professionals.

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