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In This Issue

FASB Proposes Derivatives Scope Refinements and Scope Clarification for a Share-Based Payment From a Customer in a Revenue Contract

Overview

On July 23, 2024, the FASB issued a proposed ASU[1] that would (1) refine the scope of the guidance on derivatives in ASC 815[2] and (2) clarify the scope of the guidance on share-based payments from a customer in ASC 606. The proposed ASU is intended to address concerns about the application of derivative accounting to contracts that have features based on the operations or activities of one of the parties to the contract and to reduce diversity in the accounting for share-based payments in revenue contracts. Comments on the proposal are due by October 21, 2024.

Background

The proposed ASU was issued on the basis of feedback received from stakeholders during the 2021 Invitation to Comment, *Agenda Consultation*. Citing the "broad and evolving interpretation" of the definition of a derivative, some stakeholders noted the difficulties associated with applying that definition as well as the derivative scope exceptions to certain transactions, including those involving (1) financial instruments linked to environmental, social, and governance matters and (2) other operations-specific activities, such as R&D funding arrangements and litigation funding arrangements.

[1] FASB Proposed Accounting Standards Update (ASU), *Derivatives and Hedging (Topic 815) and Revenue From Contracts With Customers (Topic 606): Derivatives Scope Refinements and Scope Clarification for a Share-Based Payment From a Customer in a Revenue Contract.*

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

In addition, there has been uncertainty in the accounting for share-based payments from customers under ASC 606, prompting the need for clarification. Specifically, stakeholders have questioned which guidance an entity should apply to recognize share-based payments received from a customer that are consideration for the transfer of goods and services.

Main Provisions of the Proposed Amendments

Derivatives Scope Refinements

The proposed ASU would refine the scope of ASC 815 to exclude certain "contracts with underlyings based on operations or activities specific to one of the parties to the contract." Contracts that may qualify for this exception would include those in which the underlying is a business operation or an event such as obtaining regulatory approval or achieving specific business milestones. The proposal would also change how the "predominant characteristics" of a contract are assessed when a contract has multiple underlyings, some of which qualify for scope exceptions and some of which do not.

Scope Exception for Contracts With Specific Underlyings

The proposal would add a new scope exception in ASC 815-10-15-59(e) for contracts with underlyings that are based on (1) "financial statement metrics of one of the parties to the contract" (e.g., "earnings before interest, taxes, depreciation, and amortization; net income; expenses; or total equity") and (2) the "occurrence or nonoccurrence of an event specific to the operations or activities of one of the parties to the contract." However, the proposed ASU specifies that the exception could *not* be applied to contracts with an "underlying based on either (1) a market rate, market price, or market index or (2) the price or performance of a financial asset or financial liability of one of the parties to the contract." As a result of this refinement, entities would be able to avoid using derivatives accounting for more contracts or arrangements. Case A of Example 14A below is reproduced from the proposed ASU.

ASC 815-10

Proposed Content

Case A: Underlyings Based on the Occurrence of Regulatory Approval and Achieving a Financial Statement Target

55-143B Entity A and Entity B enter into a funding arrangement. Under the arrangement, Entity B provides funding of $50 million so that Entity A may develop and commercialize a drug compound. The arrangement has no clawback feature. Upon FDA approval of the drug, Entity A pays $20 million to Entity B. Entity A also pays an additional $80 million to Entity B upon sales of the drug exceeding $500 million.

55-143C The arrangement contains two underlyings: the occurrence or nonoccurrence of FDA approval and sales of the drug exceeding $500 million. The occurrence of FDA approval relates to the drug that Entity A is developing as part of its operations. Achieving drug sales exceeding $500 million is related to Entity A's sales revenue. Neither underlying is based on a market rate, market price, or market index or the price or performance of a financial asset or financial liability of one of the parties to the contract. Therefore, those two underlyings each qualify for the scope exception in paragraph 815-10-15-59(e).

Predominant Characteristics Assessment

The proposed amendments would refine the predominant characteristics assessment in ASC 815-10-15-60, which is used for contracts with multiple underlyings, to focus on the fair value impacts of the underlyings rather than their correlations. The objective of this change would be for entities to determine which underlying has the most significant effect on the contract's (or embedded feature's) fair value. The example below is reproduced from the proposed ASU.

ASC 815-10

Proposed Content

Example 14B: Predominant Characteristics Assessment

55-143F This Example illustrates the application of the predominant characteristics assessment in paragraph 815-10-15-60.

55-143G On July 1, 20X1, Entity A enters into a five-year pay-fixed, receive-variable interest rate swap. If Entity A fails to meet a specified greenhouse gas emissions reduction target by June 30, 20X4, the fixed interest rate on the swap increases by 0.25 percent for the remaining term. The contract contains two underlyings: an interest rate (the floating leg of the swap) and the nonoccurrence of Entity A achieving a specified greenhouse gas emissions reduction target. The nonoccurrence of Entity A achieving a specified greenhouse gas emissions reduction target underlying is related to Entity A's greenhouse gas emissions from its operations; therefore, that underlying qualifies for the scope exception in paragraph 815-10-15-59(e). The interest rate underlying is a market rate (as described in paragraph 815-10-15-88(c)) and, therefore, does not qualify for any of the scope exceptions in paragraph 815-10-15-59.

55-143H The contract is subject to the predominant characteristics assessment in paragraph 815-10-15-60 because it has two underlyings and one (the nonoccurrence of Entity A achieving a specified greenhouse gas emissions reduction target), but not both, of the underlyings qualifies for the scope exception in paragraph 815-10-15-59. Determining how to perform a fair value assessment is a matter of judgment that depends on the relevant facts and circumstances. Entity A determines which underlying is expected to have the largest effect on changes in the fair value of the contract. Specifically, Entity A computes how much the fair value of the contract moves if the interest rate underlying changes over the life of the contract while keeping the greenhouse gas emissions reduction target underlying constant. Entity A performs the same assessment for the greenhouse gas emission reduction target underlying while keeping the interest rate underlying constant. Entity A compares the results of the two assessments and determines that the interest rate underlying has the largest expected effect on changes in the fair value of the contract. Because the interest rate underlying is the predominant underlying and does not qualify for any of the scope exceptions in paragraph 815-10-15-59, Entity A concludes that the interest rate swap should be accounted for as a derivative under Topic 815.

55-143I If Entity A had concluded that the greenhouse gas emissions reduction target underlying is the predominant underlying, the contract would not have been accounted for as a derivative. Upon the resolution of the greenhouse gas emissions target underlying on June 30, 20X4, the contract would have only one underlying (the interest rate underlying); therefore, Entity A would be required to reevaluate whether the contract would be included within the scope of Topic 815. Because there is only an interest rate underlying, which is a market rate, and all other characteristics of a derivative are met, the interest rate swap would be required to be accounted for as a derivative under Topic 815.

Scope Clarification for Share-Based Payments

The proposed ASU would also clarify that when an entity has a right to receive a share-based payment from its customer in connection with a contract with that customer, the share-based payment would be accounted for as noncash consideration in the scope of ASC 606. That is, the proposed ASU provides that "unless and until the share-based payment is recognized as an asset" in accordance with ASC 606, the right to receive the share-based payment would not be in the scope of ASC 815 or ASC 321. The estimated fair value of the share-based payment as of contract inception would be included in the transaction price, and the share-based payment would not be recognized as an asset by the grantee until "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." Timing differences between (1) when "an entity performs by transferring goods or services to a customer" and (2) "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" would be accounted for as a contract asset or liability. In a manner consistent with the guidance on noncash consideration, the share-based payment would be initially "measured at the estimated fair value at contract inception" when the recognition criteria are met (i.e., the performance obligation is satisfied). Reporting entities would look to ASC 321 or ASC 815, as applicable, for subsequent measurement, which might result in the recognition of an immediate gain or loss once that share-based payment is received.

Example

Entity X enters into a revenue contract on January 1, 20X1, with Customer Y, a publicly traded company, to transfer 100 widgets on September 30, 20X1. The promise to transfer the widgets represents a performance obligation that is satisfied at a point in time. Upon the delivery of widgets, Y promises 100 shares of its common stock to X. Under the proposed ASU, X would measure the fair value of the share-based payment (noncash consideration) at contract inception. The fair value of Y's shares on January 1, 20X1, would be $10 per share, so X would determine the transaction price for the contract with the customer to be $1,000.

Between January 1, 20X1, and September 30, 20X1, the fair value of Y's shares increases to $15 per share. Under the proposed ASU, there would be no accounting for the change (i.e., changes in the fair value of X's right to receive Y's shares upon satisfaction of its performance obligation would not be reflected in X's interim financial statements until the right to receive or retain the shares is no longer contingent on X's performance).

Entity X satisfies its performance obligation on September 30, 20X1, and recognizes revenue and an asset of $1,000 (representing X's right to $1,000 worth of shares of Y, which is no longer contingent on X's performance). Under the proposed ASU, on September 30, 20X1, X would apply the guidance in ASC 321 to the share-based payment once the award is received and thereafter. This would likely result in the recognition of a gain of $500 on September 30, 20X1, under ASC 321.

Connecting the Dots

Note that in the above example, the accounting treatment would be different if the shares had been received in exchange for cash rather than in exchange for the sale of goods. For example, assume that on January 1, 20X1, Entity X had instead entered into a physically settled forward contract to purchase 100 shares of Customer Y's common stock for $10 per share on September 30, 20X1 (i.e., payment for the shares is in cash rather than in $1,000 worth of widgets). Unlike the right to receive shares in connection with a contract with a customer in the scope of ASC 606, a contract to acquire equity shares on a future date for a fixed price that must be physically settled would have been recognized at fair value under ASC 815 regardless of whether the forward contract meets the definition of a derivative; as a result, the forward contract would be marked to fair value at each reporting period before settling on September 30, 20X1.

Proposed Effective Date and Transition

Effective Date

The Board will determine the effective date after considering stakeholder feedback on the proposed ASU.

Transition

Entities would apply the derivative scope exception guidance in the proposed ASU prospectively to contracts entered into after the date of adoption. In addition, "[e]ntities 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." The proposal also specifies that if, after adopting the proposed amendments, an entity no longer applies ASC 815 to existing contracts (or embedded features), it "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 Topic 825."

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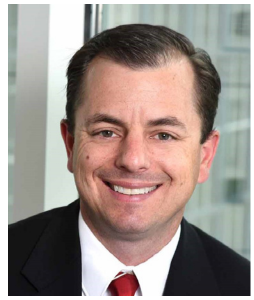

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