

Proposed Accounting Standards Update

Issued: July 23, 2024
Comments Due: October 21, 2024

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

The Board issued this Exposure Draft to solicit public comment on proposed changes to Topic 815, Topic 606, and Topic 321 of the *FASB Accounting Standards Codification*®. Individuals can submit comments in one of three ways: using the electronic feedback form on the FASB website, emailing comments to director@fasb.org, or sending a letter to “Technical Director, File Reference No. 2024-ED100, FASB, 801 Main Avenue, PO Box 5116, Norwalk, CT 06856-5116.”

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft until October 21, 2024. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at [Exposure Documents Open for Comment](#)
- Emailing comments to director@fasb.org, File Reference No. 2024-ED100
- Sending a letter to “Technical Director, File Reference No. 2024-ED100, FASB, 801 Main Avenue, PO Box 5116, Norwalk, CT 06856-5116.”

All comments received are part of the FASB’s public file and are available at www.fasb.org.

The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective. A copy of this Exposure Draft is available at www.fasb.org.

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Summary and Questions for Respondents

The Board is issuing the amendments in this proposed Update to address stakeholders' concerns about (1) the application of derivative accounting to contracts with features based on the operations or activities of one of the parties to the contract and (2) the diversity in accounting for a share-based payment from a customer that is consideration for the transfer of goods or services. The proposed amendments are expected to (a) reduce the cost and complexity of evaluating whether these contracts are derivatives, (b) better portray the economics of those contracts in the financial statements, and (c) reduce diversity in practice resulting from changing interpretations of the existing guidance. The proposed amendments also are expected to reduce diversity in practice by clarifying the applicability of Topic 606 to a share-based payment from a customer that is consideration for the transfer of goods or services.

Issue 1: Derivatives Scope Refinements

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

Topic 815, Derivatives and Hedging, establishes accounting requirements for contracts that meet the characteristics-based definition of a derivative and are not otherwise excluded from the Topic's scope. Because of the broad interpretation of the definition of a derivative, many types of contracts are being evaluated and potentially accounted for as derivatives.

In response to the 2021 Invitation to Comment, *Agenda Consultation*, stakeholders indicated that practice questions have emerged about the application of the definition of a derivative (and the related scope exceptions) to (1) certain emerging transactions, such as bonds in which interest payments may vary based on environmental, social, and governance (ESG)-linked metrics, and (2) certain longstanding transactions, such as research and development funding arrangements and litigation funding arrangements.

A frequently cited challenge was the broad and evolving interpretation of the derivative definition and the complexity of applying scope exceptions to certain contracts with variables (referred to as “underlyings”) based on operations or activities specific to one of the parties to the contract. Some respondents noted that because those contracts relate to the performance of a party to the contract, accounting for those contracts as derivatives measured at fair value does not provide decision-useful information. Those respondents indicated that other guidance in generally accepted accounting principles (GAAP) exists to account for those contracts. Furthermore, respondents noted that because of the cost and complexity of applying the derivative guidance, some entities may structure those transactions to avoid accounting for them as derivatives. The amendments in this proposed Update address the issues raised by stakeholders by expanding the scope of an existing exception in Topic 815.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would apply to all entities that enter into certain contracts with underlyings based on operations or activities specific to one of the parties to the contract.

What Are the Main Provisions?

The amendments in this proposed Update would exclude from derivative accounting contracts with underlyings that are based on operations or activities specific to one of the parties to the contract. The scope exception would include variables based on financial statement metrics of one of the parties to the contract (for example, earnings before interest, taxes, depreciation, and amortization; net income; expenses; or total equity), as well as the occurrence or nonoccurrence of an event related to the operations or activities specific to one of the parties to the contract. However, contracts with a single 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 would not qualify for the proposed scope exception.

Contracts with multiple underlyings for which some are excluded from derivative accounting and some are not would be evaluated on the basis of the predominant characteristics of the contract to determine whether the entire contract (or embedded feature) is subject to the requirements of Topic 815.

The amendments in this proposed Update would change the predominant characteristics assessment to require that an entity assess which underlying is expected to have the largest expected effect on changes in the fair value of the contract (or embedded feature).

How Would the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

A contract may meet the definition of a derivative in its entirety or contain provisions or features that may be required to be accounted for separately as derivatives. Existing GAAP provides certain scope exceptions from Topic 815, including for contracts that are not traded on an exchange when settlement is based on the specified volume of sales or service revenues of one of the parties to the contract.

The amendments in this proposed Update would expand the scope exception for certain contracts not traded on an exchange to include contracts for which settlement is based on operations or activities specific to one of the parties to the contract. This improvement is expected to result in more contracts and embedded features being excluded from the scope of Topic 815.

The amendments in this proposed Update also would change the predominant characteristics assessment applicable to certain contracts that are not traded on an exchange by replacing the existing correlation assessment in the predominant characteristics assessment with a fair value assessment.

The amendments in this proposed Update are expected to improve the decision usefulness of financial reporting for contracts with underlyings based on operations or activities specific to one of the parties to the contract and reduce cost and complexity for entities analyzing and applying the derivative guidance.

When Would the Amendments Be Effective and What Are the Transition Requirements?

The effective date for the amendments in this proposed Update will be determined after the Board considers stakeholders' feedback on the proposed amendments.

The amendments in this proposed Update would be applied prospectively to contracts entered into after the date of adoption. 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.

An entity that no longer applies Topic 815 to existing contracts (or embedded features) as a result of applying the amendments in this proposed Update 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, Financial Instruments.

Issue 2: Scope Clarification for a Share-Based Payment from a Customer in a Revenue Contract

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

The Board received feedback from some stakeholders that there is a lack of clarity about which guidance an entity should apply to recognize share-based payments, such as warrants or shares, received from a customer that are consideration for the transfer of goods or services. For example, if an entity receives share-based payments from a customer and those share-based payments are contingent on the satisfaction of performance obligations, some stakeholders recently indicated that it is unclear to them whether those share-based payments (1) should be recognized at contract inception as a derivative asset under Topic 815 or an equity security under Topic 321, Investments—Equity Securities, or (2) should not be recognized until the entity satisfies its performance obligations under Topic 606, Revenue from Contracts with Customers. In response to this feedback, the Board decided to clarify the accounting by an entity that receives a share-based payment from a customer that is consideration for the transfer of goods or services.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in this proposed Update would apply to all entities that receive a share-based payment from a customer that is consideration for the transfer of goods or services.

What Are the Main Provisions?

The amendments in this proposed Update would clarify that an entity should apply the guidance in Topic 606, including the guidance on noncash consideration in paragraphs 606-10-32-21 through 32-24, to a contract with a share-based payment (for example, shares, share options, or other equity instruments) from a customer that is consideration for the transfer of goods or services. Accordingly, under Topic 606, the share-based payment should be recognized as an asset measured at the estimated fair value at contract inception under Topic 606 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.

In addition, the amendments in this proposed Update would clarify that the guidance in Topic 815 and Topic 321 should not be applied unless and until the share-based payment from a customer that is consideration for the transfer of goods or services is recognized as an asset under Topic 606.

How Would the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

The amendments in this proposed Update would reduce diversity in the accounting for share-based payments from a customer that are consideration for the transfer of goods or services by clarifying that entities should apply the guidance in Topic 606. The proposed amendments would provide investors with more comparable information and would reduce accounting complexity and related reporting costs for preparers and auditors.

When Would the Amendments Be Effective and What Are the Transition Requirements?

The effective date for the amendments in this proposed Update will be determined after the Board considers stakeholders' feedback on the proposed amendments.

An entity would be required to apply the amendments in this proposed Update 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.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Issue 1: Derivatives Scope Refinements

Question 1: Does the proposed scope exception in paragraph 815-10-15-59(e) capture the population of contracts with entity-specific payment provisions that, in your view, should not be accounted for as a derivative and, instead, should be accounted for under other Topics? Conversely, does the proposed scope exception capture any types of contracts that, in your view, should continue to be accounted for as a derivative under Topic 815? Please explain why or why not. If not, what changes would you suggest?

Question 2: Is the proposed scope exception in paragraph 815-10-15-59(e) clear and operable? Please explain why or why not. If not, what changes would you suggest?

Question 3: Is the proposed predominant characteristics assessment in paragraph 815-10-15-60 operable, including for contracts with multiple

underlyings that are dependent on each other? Please explain why or why not. If not, what changes would you suggest?

Question 4: The Board rejected an alternative to the proposed amendments to the predominant characteristics assessment in paragraph 815-10-15-60 that would have eliminated that assessment and replaced it with a requirement that if any underlying does not qualify for a scope exception in paragraph 815-10-15-59, the entire contract would not qualify for the scope exception (see paragraphs BC31 through BC32). Do you have any views on the alternative rejected by the Board and whether it would be more operable, be less complex, or provide more decision-useful information?

Question 5: Is the proposed transition method operable? If not, why not, and what transition method would be more appropriate and why? Would the proposed transition disclosure be decision useful? Please explain why or why not.

Question 6: In evaluating the effective date, how much time would be needed to implement the proposed amendments? Should the effective date for entities other than public business entities be different from the effective date for public business entities? Please explain why or why not.

Question 7: Would the expected benefits of the proposed amendments justify the expected costs? If not, please describe the nature and magnitude of those costs, differentiating between one-time costs and recurring costs.

Issue 2: Scope Clarification for a Share-Based Payment from a Customer in a Revenue Contract

Question 8: Do you agree that an entity should apply the guidance in Topic 606, including the guidance on noncash consideration in paragraphs 606-10-32-21 through 32-24, to a share-based payment from a customer that is consideration for the transfer of goods or services in a revenue contract? Do you agree that the share-based payment should be recognized as an asset under Topic 606 when an 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? Please explain why or why not for both questions. If not, what changes would you suggest?

Question 9: Should Topic 815 and Topic 321 be amended as proposed to clarify that the guidance in those Topics does not apply 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 Topic 606? Please explain why or why not. If not, what changes would you suggest?

Question 10: Are the proposed amendments clear and operable? Please explain why or why not. If not, what changes would you suggest?

Question 11: Subtopic 610-20, Other Income—Gains and Losses from the Derecognition of Nonfinancial Assets, refers to the revenue recognition principles in Topic 606, including the recognition and measurement guidance. Should the scope of Subtopic 610-20 be amended to be consistent with the proposed clarification in Topic 606? That is, should the Board clarify that a share-based payment from a noncustomer that is consideration for the transfer of a nonfinancial asset (that is within the scope of Subtopic 610-20) should be accounted for under Subtopic 610-20? Please explain why or why not. Do you expect any unintended consequences of providing that clarification? If so, please explain what those unintended consequences would be.

Question 12: Is the proposed transition method operable? If not, why not, and what transition method would be more appropriate and why? Would the proposed transition disclosures be decision useful? Please explain why or why not.

Question 13: In evaluating the effective date, how much time would be needed to implement the proposed amendments? Should the effective date for entities other than public business entities be different from the effective date for public business entities? Please explain why or why not.

Question 14: Would the expected benefits of the proposed amendments justify the expected costs? If not, please describe the nature and magnitude of those costs, differentiating between one-time costs and recurring costs.

Amendments to the *FASB Accounting Standards Codification*[®]

Summary of Proposed Amendments to the Accounting Standards Codification

1. The following table provides a summary of the proposed amendments to the Accounting Standards Codification.

Codification Subtopic	Description of Changes
Issue 1: Derivatives Scope Refinements	
Subtopic 815-10, Derivatives and Hedging—Overall	<ul style="list-style-type: none"> • Amended paragraph 815-10-15-59 to add a derivatives scope exception for contracts with underlyings that are based on operations or activities specific to one of the parties to the contract. • Amended the predominant characteristics assessment in paragraph 815-10-15-60 to require a fair value assessment and clarify the frequency of the assessment. • Superseded the guidance in paragraph 815-10-15-61. • Amended paragraph 815-10-55-1 to add the predominant characteristics assessment to the list. • Amended paragraph 815-10-55-43 to remove a contract with a payment provision from the list. • Superseded and moved the content in paragraph 815-10-55-44 to paragraph 815-10-55-137. • Added implementation guidance in paragraphs 815-10-55-64 through 55-65 for the predominant characteristics assessment. • Amended paragraph 815-10-55-137 to add the content moved from paragraph 815-10-55-44.

Codification Subtopic	Description of Changes
	<ul style="list-style-type: none"> • Added paragraphs 815-10-55-143A through 55-143E, which include illustrative examples of the derivative scope exception in paragraph 815-10-15-59(e). • Added paragraphs 815-10-55-143F through 55-143I, which include illustrative examples of the predominant characteristics assessment.
Issue 2: Scope Clarification for a Share-Based Payment from a Customer in a Revenue Contract	
Subtopic 606-10, Revenue from Contracts with Customers—Overall	<ul style="list-style-type: none"> • Added paragraph 606-10-15-3A to clarify the applicability of Topic 606 to a share-based payment from a customer that is consideration for the transfer of goods or services. • Amended the illustrative example in paragraphs 606-10-55-247 through 55-250 and added paragraph 606-10-55-250A, which illustrates the accounting for a revenue contract with noncash consideration in the form of shares.
Subtopic 321-10, Investments—Equity Securities—Overall	<ul style="list-style-type: none"> • Added paragraph 321-10-15-7 to clarify the interaction between Topic 321 and Topic 606 related to the accounting for a share-based payment from a customer that is consideration for the transfer of goods or services.
Subtopic 815-10, Derivatives and Hedging—Overall	<ul style="list-style-type: none"> • Amended paragraph 815-10-25-5 to add revenue contracts with a share-based payment from a customer to the list. • Added paragraph 815-10-25-16A to clarify the interaction between Topic 815 and Topic 606 related to the accounting for a share-based payment from a customer that is consideration for the transfer of goods or services.

Introduction

2. The Accounting Standards Codification is amended as described in paragraphs 3–9. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Issue 1: Derivatives Scope Refinements

Amendments to Topic 815

3. Amend paragraphs 815-10-15-10 and its related heading, 815-10-15-59 through 15-60, 815-10-15-74 through 15-75, 815-10-15-98, 815-10-55-1, 815-10-55-43, and 815-10-55-136 through 55-137 and their related headings, supersede paragraphs 815-10-15-61 and 815-10-55-44 and its related heading, and add paragraphs 815-10-55-64 through 55-65 and their related heading and 815-10-55-143A through 55-143I and their related headings, with a link to transition paragraph 815-10-65-8, as follows:

Derivatives and Hedging—Overall

Scope and Scope Exceptions

> Instruments

• > Instruments ~~Within~~ within Scope

815-10-15-10 The guidance in the General Subsections of this Subtopic applies to all derivative instruments, as that term is defined in paragraph 815-10-15-83, unless explicitly excluded by this Subsection (see paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-82). The General Subsections of this Subtopic also identify incremental guidance that applies specifically to **forward commitment dollar rolls**.

• > Instruments Not within Scope

• • > Certain Contracts That Are Not Traded on an Exchange

815-10-15-59 Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:

- a. A climatic or geological variable or other physical variable. Climatic, geological, and other physical variables include things like the number of inches of rainfall or snow in a particular area and the severity of an earthquake as measured by the Richter scale. (See Example 13 [paragraph 815-10-55-135].)
- b. 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. This scope exception applies only if both of the following are true:
 1. The nonfinancial assets are unique.
 2. The nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset. (If the contract is a call option, the scope exception applies only if that nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset above the option's strike price.)
- c. 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.
- d. Specified volumes of sales or service revenues of one of the parties to the contract. (This scope exception applies to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. This scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices.)
- e. A variable that is based on operations or activities specific to one of the parties to the contract. For example, this scope exception applies to contracts with underlyings based on the following:
 1. The financial statement metrics of one of the parties to the contract. The financial statement metrics include metrics derived from amounts presented in financial statements and components of amounts included in financial statements (for example, earnings before interest, taxes, depreciation, and amortization; net income; expenses; or total equity of one of the parties to the contract).
 2. The occurrence or nonoccurrence of an event specific to the operations or activities of one of the parties to the contract (for example, obtaining regulatory approval, achieving a product development milestone, or achieving a greenhouse gas emissions target).

When evaluating whether operations or activities are specific to one of the parties to the contract, an entity does not need to consider whether the outcome is within its control. This scope exception does not apply to variables based on a market rate, market price, or market index (including those in paragraph 815-10-15-88(a) through (f)) or the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract. For purposes of applying the scope exception in this paragraph, the term *party to the contract* refers to any entity within a consolidated group. (See Example 14A [paragraphs 815-10-55-143A through 55-143E].)

815-10-15-60 ~~If a contract has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in the preceding paragraph 815-10-15-59, the application of this Subtopic to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Subtopic if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for a scope exception. When making this evaluation, the contract is eligible for a scope exception in accordance with paragraph 815-10-15-59 if the underlying that has the largest expected effect on changes in the fair value of the contract qualifies for a scope exception in accordance with paragraph 815-10-15-59. This assessment shall be performed at contract inception. In addition, for contracts that are subject to the guidance in this paragraph, when an underlying in the contract ceases to exist (for example, a contingency is resolved) but the contract continues to have more than one underlying, an entity shall reevaluate the remaining underlyings under the predominant characteristics assessment to determine whether the contract is required to be accounted for as a derivative. (See Example 14B [paragraphs 815-10-55-143F through 55-143I]. For related implementation guidance for a hybrid instrument, see paragraph 815-10-55-65.)~~

815-10-15-61 ~~Paragraph superseded by Accounting Standards Update 202X-XX.A contract based on any variable that is not specifically excluded by paragraph 815-10-15-59 is subject to the requirements of this Subtopic if it has the other two characteristics (initial net investment and net settlement) identified in this Subsection.~~

• • > Certain Contracts Involving an Entity's Own Equity

815-10-15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-139, the reporting entity shall not

consider the following contracts to be derivative instruments for purposes of this Subtopic:

[The remainder of this paragraph is not shown here because it is unchanged.]

815-10-15-75 The scope exceptions in paragraph 815-10-15-74 do not apply to either of the following:

- a. The counterparty in those contracts. For example, the scope exception in (b) in ~~the preceding paragraph 815-10-15-74~~ related to share-based compensation arrangements does not apply to equity instruments (including stock options) received by nonemployees as compensation for goods and services.
- b. A contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock. That contract can be a derivative instrument for the issuer under paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-139, in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Subtopic. For example, a forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for the exception in (a) in ~~the preceding paragraph 815-10-15-74~~ with respect to that entity's accounting because the forward contract is indexed in part to something other than that entity's own stock (namely, currency exchange rates).

> Definition of Derivative Instrument

• > Initial Net Investment

815-10-15-98 The phrase *initial net investment* is stated from the perspective of only one party to the contract, but it determines the application of this Subtopic for both parties. Even though a contract may be a derivative instrument as described in paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-139 for both parties, the scope exceptions in paragraphs 815-10-15-74 through 15-75 apply only to the issuer of the contract and will result in different reporting by the two parties. The normal purchases and sales scope exception (beginning in paragraph 815-10-15-22) also may apply to one of the parties but not the other.

Implementation Guidance and Illustrations

> Implementation Guidance

815-10-55-1 This Section provides guidance on the following implementation matters:

- a. Determining whether a contract is within the scope of this Subtopic
- b. Unit of accounting—a transferable option is considered freestanding, not embedded
- c. Definition of derivative instrument
- d. Instruments not within scope
- e. Scope application to certain contracts
- f. Other presentation matters
- g. Synthetic guaranteed investment ~~contracts~~ ~~contracts~~.
- h. Predominant characteristics assessment ~~Subparagraph not used~~.

• > Scope Application to Certain Contracts

815-10-55-43 This guidance illustrates the application of Section 815-10-15 in the following situations:

- a. Subparagraph superseded by Accounting Standards Update No. 202X-XX. Contract with payment provision
- b. Credit derivatives
- c. Equity options issued to employees and nonemployees
- d. Subparagraph superseded by Accounting Standards Update No. 2018-07.
- e. Repurchase agreements and wash sales
- f. Short sales (sales of borrowed securities)
- g. Take-or-pay contracts.

~~• > Contract with Payment Provision~~

815-10-55-44 Paragraph superseded by Accounting Standards Update No. 202X-XX. ~~If the contract contains a **payment provision** that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of this Subtopic. [Content moved to paragraph 815-10-55-137]~~

• > Predominant Characteristics Assessment

815-10-55-64 Paragraph 815-10-15-60 requires that an entity perform the predominant characteristics assessment if a contract has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in paragraph 815-10-15-59. Paragraph 815-10-15-60 also requires that an entity assess which underlying has the largest expected effect on changes in the fair value of the contract. When performing the assessment, the entity should consider all reasonably possible changes in fair value. Paragraph not used.

815-10-55-65 If a contract is a hybrid instrument, the contract is subject to the requirements in Subtopic 815-15. Under that guidance, an entity is required to assess a hybrid instrument under the criteria in paragraph 815-15-25-1 to determine whether bifurcation of one or more embedded features is required. If the embedded feature has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in paragraph 815-10-15-59, the entity should perform the predominant characteristics assessment to determine whether the embedded feature qualifies for the scope exception. For example, a conversion option embedded in a contingently convertible debt instrument that is convertible into the issuer's common stock in the event of a change in control may qualify for either the exception in paragraph 815-10-15-74 for certain contracts involving an entity's own equity or the exception in paragraph 815-10-15-59(e) for non-exchange-traded contracts involving operations or activities specific to one of the parties to the contract. The conversion option has two underlyings (a security price and the occurrence of a change in control). The occurrence of a change in control would qualify for the scope exception in paragraph 815-10-15-59(e), while the security price underlying would not qualify for that scope exception. Therefore, whether the conversion option qualifies for the scope exception in paragraph 815-10-15-59(e) depends on the predominant characteristics assessment in paragraph 815-10-15-60. Under the predominant characteristics assessment, each underlying should be assessed to determine how it affects the change in the fair value of the conversion option to identify the underlying that has the largest expected effect on changes in the fair value of the conversion option. If the underlying that has the largest expected effect on changes in the fair value of the conversion option qualifies for the scope exception in paragraph 815-10-15-59, bifurcation of the conversion option would not be required. Paragraph not used.

> Illustrations

• > **Example 13: Certain Contracts That that Are Not Traded on an Exchange—Distinguishing between Between Physical and Financial Variables**

• • > **Case A: Contract Containing both Both a Physical Variable and a Financial Variable**

815-10-55-136 A contract's {add glossary link}payment provision{add glossary link} specifies that the issuer will pay to the holder \$10,000,000 if aggregate property damage from all hurricanes in the state of Florida exceeds \$50,000,000 during the year 2001.

815-10-55-137 If the contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of this Subtopic. [Content moved from paragraph 815-10-55-44] In this Case, the payment under the contract occurs if aggregate property damage from all hurricanes in the state of Florida exceeds \$50,000,000 during the year 2001. The contract contains 2 underlyings—a physical variable (that is, the occurrence of at least 1 hurricane) and a financial variable (that is, aggregate property damage exceeding a specified or determinable dollar limit of \$50,000,000). Because of the presence of the financial variable as an underlying, the derivative instrument does not qualify for the scope exclusion in paragraph 815-10-15-59(a).

• > **Example 14A: Certain Contracts That Are Not Traded on an Exchange—Underlyings Based on Operations or Activities Specific to One of the Parties to the Contract**

815-10-55-143A The following Cases illustrate application of the scope exception in paragraph 815-10-15-59(e):

- a. Underlyings based on the occurrence of regulatory approval and achieving a financial statement target (Case A)
- b. Underlying based on the occurrence of an initial public offering (Case B)
- c. Underlying based on the nonoccurrence of a greenhouse gas emissions reduction target (Case C).

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

815-10-55-143B 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.

815-10-55-143C 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).

• • > Case B: Underlying Based on the Occurrence of an Initial Public Offering

815-10-55-143D Entity A issues a 15-year contingently puttable bond for \$102. The bond is puttable at par if the issuer has an initial public offering. The bond is a hybrid instrument that contains an embedded put feature. The embedded put feature contains two underlyings: the security price and the occurrence of an initial public offering. Entity A may initiate an initial public offering to obtain funding to expand its operations; therefore, the occurrence of an initial public offering is deemed to relate to the operations or activities specific to one of the parties to the contract. The occurrence of an initial public offering is not 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. The security price underlying is a market price (as described in paragraph 815-10-15-88(a)) and, therefore, does not qualify for any of the scope exceptions in paragraph 815-10-15-59. Therefore, whether the embedded put feature qualifies for the scope exception in paragraph 815-10-15-59(e) depends on the predominant characteristics assessment in paragraph 815-10-15-60.

• • > Case C: Underlying Based on the Nonoccurrence of Achieving a Greenhouse Gas Emissions Reduction Target

815-10-55-143E On July 1, 20X1, Entity A issues a five-year fixed-rate bond. If Entity A's parent entity, Parent A, fails to meet a specified greenhouse gas emissions reduction target at its consolidated group level by June 30, 20X3,

the fixed interest rate on Entity A's bond increases by 0.25 percent for the remaining term. The bond is a hybrid instrument that contains an embedded feature (that is, the interest rate adjustment) that is required to be evaluated for bifurcation. Because Entity A is a subsidiary of Parent A, the nonoccurrence of Parent A achieving Parent A's consolidated greenhouse gas emissions reduction target is considered an activity specific to one of the parties to the contract for the purposes of both Entity A's standalone financial statements and Parent A's consolidated financial statements. The embedded feature is not 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, the interest rate adjustment underlying qualifies for the scope exception in paragraph 815-10-15-59(e).

• > Example 14B: Predominant Characteristics Assessment

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

815-10-55-143G 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.

815-10-55-143H 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.

815-10-55-143I 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.

4. Add paragraph 815-10-65-8 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Issue 1 of Accounting Standards Update No. 202X-XX, *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*

815-10-65-8 The following represents the transition and effective date information related to Issue 1 of Accounting Standards Update No. 202X-XX, *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*:

Effective date and early adoption

- a. All entities shall apply the pending content that links to this paragraph for fiscal years beginning after [date to be inserted after exposure] including interim periods within those fiscal years.

- b. Early adoption of the pending content that links to this paragraph is 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). If an entity early adopts the pending content that links to this paragraph in an interim period, the entity shall apply the pending content as of the beginning of the fiscal year that includes that interim period.

Transition method

- c. An entity shall apply the pending content that links to this paragraph prospectively to contracts entered into during fiscal years (and interim periods within those fiscal years) beginning on or after the adoption date.
- d. An entity may elect to apply the pending content that links to this paragraph to all contracts that exist as of the beginning of the fiscal year of adoption through a cumulative-effect adjustment to the carrying amount of the asset or liability (the instrument previously accounted for as a derivative or as a host contract with a bifurcated embedded derivative) and the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the fiscal year of adoption.
- e. If an entity had contracts that were accounted for as derivatives (or bifurcated embedded derivatives) but are no longer accounted for as derivatives as a result of applying the pending content that links to this paragraph, the entity will have a one-time option as of the beginning of the fiscal year for which the pending content that links to this paragraph is adopted to irrevocably elect to apply the fair value option and measure the contract in its entirety at fair value with changes in fair value recognized in earnings on an instrument-by-instrument basis if that instrument is within the scope of paragraphs 825-10-15-4 through 15-5. For financial liabilities, an entity shall present separately in accumulated other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the instrument-specific credit risk. For those instruments for which the entity elects the fair value option, the effects of initially complying with the pending content that links this paragraph shall be reported as a cumulative-effect adjustment directly to the opening balance of retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted.

Transition disclosures

- f. An entity that applies the transition method in (c) shall disclose the nature of and reason for the change in accounting principle in both the interim period and the fiscal year that the entity adopts the pending content that links to this paragraph.
- g. An entity that applies the transition method in (d) shall disclose the following in both the interim period and the fiscal year that the entity adopts the pending content that links to this paragraph:
 - 1. The nature of and reason for the change in accounting principle
 - 2. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption and a description of the financial statement line items affected by the adjustment.

5. Amend paragraphs 815-20-25-8 and 815-20-55-115 through 55-116, with a link to transition paragraph 815-10-65-8, as follows:

Derivatives and Hedging—Hedging—General

Recognition

> Eligibility of Hedged Items and Transactions

• > Hedged Item and Transaction Criteria Applicable to both Fair Value Hedges and Cash Flow Hedges

• • > Normal Purchases or Normal Sales as Hedged Items or Transactions

815-20-25-8 In emphasizing the conditions in the definition of a **derivative instrument** in paragraphs 815-10-15-83 through 15-139, paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-82 essentially exempt contracts that meet the definition of a derivative instrument from the requirements of Subtopic 815-10 applicable to derivative instruments. However, paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-82 are not intended to preclude such contracts from being subject to the requirements of Subtopic 815-10 applicable to the hedged item in a fair value hedge.

Implementation Guidance and Illustrations

> Illustrations

• > Example 8: All-in-One Hedges

• • > Case A: Purchase of a Nonfinancial Asset

815-20-55-115 Entity A plans to purchase a nonfinancial asset. To fix the price to be paid (that is, to hedge the price), Entity A enters into a contract that meets the definition of a firm commitment with an unrelated party to purchase the asset at a fixed price at a future date. Assume that the terms of the contract (such as net settlement under the default provisions) or the nature of the asset cause the contract to meet the definition of a derivative instrument and the contract is not excluded by paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-82 from the scope of the Derivatives and Hedging Topic. As such, Entity A has entered into a derivative instrument under which it is expected to take delivery of the asset. Entity A may designate the fixed-price purchase contract (that is, the derivative instrument) as a cash flow hedge of the variability of the consideration to be paid for the purchase of the asset (that is, the forecasted transaction) even though the derivative instrument is the same contract under which the asset itself will be acquired.

• • > Case B: Purchase of a Financial Asset

815-20-55-116 Entity B plans to purchase U.S. government bonds and expects to classify those bonds in its available-for-sale portfolio. To fix the price to be paid (that is, to hedge the price), Entity B enters into a contract that meets the Derivatives and Hedging Topic's definition of a firm commitment with an unrelated party to purchase the bonds at a fixed price at a future date. Assume the contract meets the definition of a derivative instrument and is not excluded by paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-82 from the scope of this Topic. As such, Entity B has entered into a derivative instrument under which it is expected to take delivery of the asset. Entity B may designate the fixed-price purchase contract (that is, the derivative instrument) as a cash flow hedge of the variability of the consideration to be paid for the purchase of the bonds (that is, the forecasted transaction) even though the derivative instrument is the same contract under which the asset itself will be acquired.

Issue 2: Scope Clarification for a Share-Based Payment from a Customer in a Revenue Contract

Amendments to Topic 606

6. Add paragraphs 606-10-15-3A and 606-10-55-250A and amend paragraphs 606-10-55-247 through 55-250, with a link to transition paragraph 606-10-65-2, as follows:

Revenue from Contracts with Customers—Overall

Scope and Scope Exceptions

> Transactions

606-10-15-3A An entity shall apply the guidance in this Topic, including the guidance on noncash consideration in paragraphs 606-10-32-21 through 32-24, to a contract with a share-based payment (for example, shares, share options, or other equity instruments) from a customer that is consideration for the transfer of goods or services. Accordingly, under this Topic, the share-based payment is 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 guidance in Topic 815 and Topic 321 does not apply 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 this Topic.

Implementation Guidance and Illustrations

> Illustrations

• > Noncash Consideration

606-10-55-247 Example 31 illustrates the guidance in paragraph 606-10-15-3A on the accounting by an entity that receives a share-based payment from a customer that is consideration for the transfer of goods or services and the guidance in paragraphs 606-10-32-21 through 32-24 on noncash consideration. In addition, the following guidance is illustrated in this Example:

- a. Paragraph 606-10-25-14 on identifying performance obligations
- b. Paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

• • > **Example 31—Entitlement to Noncash Consideration**

606-10-55-248 An entity enters into a contract with a customer to provide a weekly service for one year. The contract is signed on January 1, 20X1, and work begins immediately. ~~The entity concludes that the service is a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).~~ **[Content moved to paragraph 606-10-55-249]** In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service. **[Content moved from paragraph 606-10-55-249]**

606-10-55-249 ~~In exchange for the service, the customer promises 100 shares of its common stock per week of service (a total of 5,200 shares for the contract). The terms in the contract require that the shares must be paid upon the successful completion of each week of service. **[Content moved to paragraph 606-10-55-248]**~~ In accordance with paragraph 606-10-15-3A, the entity applies the guidance in this Topic to a contract with a share-based payment from a customer that is consideration for the transfer of a service (the shares). The entity concludes that its right to receive 100 shares from the customer is no longer contingent on its performance once it completes each week of service. As a result, the 100 shares are recognized as assets under this Topic as each week of service is complete. In this Example, the timing of the recognition of the shares coincides with the timing of the payment of the shares. The guidance in other Topics does not apply to the shares until the shares are recognized as assets under this Topic. The entity concludes that the service is a single performance obligation in accordance with paragraph 606-10-25-14(b). This is because the entity is providing a series of distinct services that are substantially the same and have the same pattern of transfer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress). **[Content moved from paragraph 606-10-55-248]**

606-10-55-250 To determine the transaction price (and the amount of revenue to be recognized), the entity measures the estimated fair value of 5,200 shares at contract inception (that is, on January 1, 20X1). The entity measures its progress toward complete satisfaction of the performance obligation and recognizes revenue and the corresponding 100 shares (measured at the estimated fair value at contract inception) as each week of service is complete. The entity does not reflect any changes in the fair value of the 5,200 shares after contract inception in the transaction price. Once the 100 shares are recognized under this Topic as each week of service is complete, the entity then applies the guidance in other Topics to determine whether and how any changes in fair value that occurred after contract inception due to the form of the noncash consideration should be recognized and presented. However, the entity assesses any related contract asset or receivable for impairment. Upon receipt of the noncash consideration, the entity would apply the guidance related to the form of the noncash consideration to determine whether and how any changes in fair value that occurred after contract inception should be recognized.

606-10-55-250A In situations in which an entity performs by transferring goods or services to a customer before or after the entity's right to receive or retain a share-based payment from the customer is no longer contingent on the satisfaction of a performance obligation, the entity should apply the guidance in Section 606-10-45.

7. Add paragraph 606-10-65-2 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Issue 2 of Accounting Standards Update No. 202X-XX, 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

606-10-65-2 The following represents the transition and effective date information related to Issue 2 of Accounting Standards Update No. 202X-XX, 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:

Effective date and early adoption

- a. All entities shall apply the pending content that links to this paragraph for fiscal years beginning after [date to be inserted after exposure], including interim periods within those fiscal years.
- b. Early adoption of the pending content that links to this paragraph is permitted, including adoption in an interim or annual period for which an entity's financial statements have not yet been issued (or made available for issuance). If an entity early adopts the pending content that links to this paragraph in an interim period, the entity shall apply the pending content as of the beginning of the fiscal year that includes that interim period.

Transition method

- c. An entity shall apply the pending content that links to this paragraph 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 (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the fiscal year of adoption.

Transition disclosures

- d. In both the interim period and the fiscal year that an entity adopts the pending content that links to this paragraph, the entity shall disclose both of the following:
 - 1. The nature of and reason for the change in accounting principle
 - 2. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the fiscal year of adoption.

Amendments to Topic 321

- 8. Add paragraph 321-10-15-7, with a link to transition paragraph 606-10-65-2, as follows:

Investments—Equity Securities—Overall

Scope and Scope Exceptions

> Instruments

321-10-15-7 The guidance in this Topic does not apply 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 Topic 606 on revenue from contracts with customers.

Amendments to Topic 815

9. Amend paragraph 815-10-25-5 and add paragraph 815-10-25-16A and its related heading, with a link to transition paragraph 606-10-65-2, as follows:

Derivatives and Hedging—Overall

Recognition

815-10-25-5 The remainder of this Section addresses the following matters:

- a. Unit of accounting for recognition purposes
- b. Subparagraph not used.
- c. Forward commitment dollar rolls
- d. Derivative financial instruments subject to a **registration payment arrangement** ~~arrangement~~.
- e. A share-based payment from a customer in a revenue contract.

> A Share-Based Payment from a Customer in a Revenue Contract

815-10-25-16A The guidance in this Topic does not apply 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 Topic 606 on revenue from contracts with customers.

The amendments in this proposed Update were approved for publication by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Frederick L. Cannon
Susan M. Cospers
Marsha L. Hunt
Dr. Joyce T. Joseph

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The following paragraphs are organized by issue. This organization mirrors the organization in the proposed amendments to the Codification section.

BC3. The Board is issuing the amendments in this proposed Update to address stakeholders' concerns about (a) the application of derivative accounting to contracts with features based on the operations or activities of one of the parties to the contract and (b) the diversity in accounting for a share-based payment from a customer that is consideration for the transfer of goods or services. The proposed amendments are expected to (i) reduce the cost and complexity of evaluating whether these contracts are derivatives, (ii) better portray the economics of those contracts in the financial statements, and (iii) reduce diversity in practice resulting from changing interpretations of the existing guidance. The proposed amendments also are expected to reduce diversity in practice by clarifying the applicability of Topic 606 to a share-based payment from a customer that is consideration for the transfer of goods or services.

Issue 1: Derivatives Scope Refinements

Background Information

BC4. Subtopic 815-10 provides guidance on evaluating whether a financial instrument or other contract must be accounted for as a derivative instrument. Specifically, in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the Board provided a definition of a derivative instrument based on three distinguishing characteristics rather than referring to specific classes of instruments. However, when Statement 133 was issued,

the Board did not want certain transactions that otherwise met the definition of a derivative to be accounted for as derivative instruments; therefore, the standard provided a list of scope exceptions. In addition to the original scope exceptions in Statement 133, others have been added through subsequent amendments to the Codification.

BC5. A contract may not meet the definition of a derivative in its entirety but contains a provision or feature that could modify the cash flows of a contract based on a change in an underlying. That provision or feature is required to be bifurcated from the host contract and accounted for separately as a derivative if it meets certain criteria. In theory, this provides investors and other allocators of capital with transparency and allows them to understand the effects of the embedded features. Accordingly, Subtopic 815-15, Derivatives and Hedging—Embedded Derivatives, provides guidance on evaluating those features for potential bifurcation from the host contract.

BC6. Following the 2021 Invitation to Comment, the Board received feedback indicating that entities experience challenges in applying the definition of a derivative and derivative scope exceptions to certain emerging transactions, such as bonds in which interest payments may vary based on ESG-linked metrics. In addition, emerging and sometimes inconsistent scope interpretations have resulted in challenges in evaluating longstanding transactions such as research and development funding arrangements and litigation funding arrangements. Some stakeholders stated that, in their view, if derivative accounting were applied to those arrangements, it may lead to unintuitive accounting outcomes and may not be the best reflection of the economics of those contracts and, therefore, supported excluding those contracts from the scope of Topic 815.

BC7. Stakeholders noted that they incur significant costs to assess contracts under the scope of Topic 815 and to evaluate whether a contract qualifies for a scope exception. Furthermore, when those contracts qualify as a derivative, some stakeholders indicated that applying the derivative guidance is complex, which has led to diversity in practice. Some stakeholders observed that the potential application of derivative accounting has resulted in certain entities avoiding those types of contracts, which has limited certain types of activities altogether. As a result, the Board decided to refine the scope of Topic 815 specifically to exclude certain contracts from derivative accounting.

Benefits and Costs

BC8. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC9. The amendments in this proposed Update would result in removing certain contracts from the scope of derivative accounting. The Board observed that accounting for certain contracts as derivatives may not result in decision-useful information because the contracts relate to the performance of one of the parties to the contract. The Board also noted that, in many instances, derivative accounting and the requirement to carry derivatives at fair value required the use of complex valuation models. In addition, accounting for those derivatives at fair value often resulted in assets and liabilities being recorded at amounts that they would be unlikely to be realized or settled at, further reducing their predictive value for investors. In many cases, derivative accounting also results in a liability being recorded when the related asset fails to meet the recognition requirement under GAAP, which is viewed as counterintuitive by many investors.

BC10. The Board also considered the costs of implementing the amendments in this proposed Update. These proposed amendments are not expected to result in any contracts not currently accounted for as a derivative being accounted for as a derivative under Topic 815. Therefore, the Board believes that because other existing guidance applies if those contracts are not accounted for as derivatives, the implementation costs likely would not be significant. The Board acknowledged that costs may be incurred (a) to establish new controls and accounting policies for contracts that are no longer accounted for as derivatives or embedded derivatives (for example, establishing accounting policies for the recognition of interest income or interest expense

for ESG-linked financial instruments), (b) for education on the proposed amendments, and (c) for a fair value assessment of contracts that would be subject to the predominant characteristics assessment. However, the Board observed that those incremental costs would be nonrecurring.

BC11. The Board also considered the benefits of implementing the amendments in this proposed Update. The Board concluded that applying derivative accounting to the types of contracts affected by the proposed amendments may lead to unintuitive accounting results that do not reflect the economics of those contracts. Therefore, investors would receive more decision-useful information if derivative accounting is not applied. In addition, entities would benefit from a reduction in costs because they do not have to navigate and apply derivative accounting to those excluded contracts or embedded features.

BC12. Overall, the Board concluded that the expected benefits of the amendments in this proposed Update would justify the expected costs.

Basis for Conclusions

Scope Exception for Contracts with Underlyings Based on Operations or Activities Specific to One of the Parties to the Contract

BC13. An underlying, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. An underlying is defined as a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). The occurrence or nonoccurrence of a specified event was added to the definition of an underlying when FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, was issued in April 2003. After the issuance of Statement 149, some stakeholders noted that, in practice, the definition of a derivative may have been applied more broadly by some than may have been intended by the Board.

BC14. The Board decided to refine the scope of Topic 815 by incorporating a scope exception for contracts with underlyings based on operations or activities specific to one of the parties to the contract. This proposed scope exception would expand the existing scope exception for certain contracts not traded on an exchange. The proposed scope exception would capture (a) financial statement metrics of one of the parties to the contract, including metrics derived from amounts or components of amounts presented in the financial statements of one of the parties to the contract (for example, earnings before interest, taxes, depreciation, and amortization; net income; expenses; or total equity) and (b) the occurrence or nonoccurrence of an event related to operations or activities specific to one of the parties to the contract (for example, an entity obtaining regulatory approval, achieving a product development milestone, or achieving a greenhouse gas emissions target). The Board observed that the various contracts described by stakeholders such as research and development funding arrangements, ESG-linked financial instruments, and litigation funding arrangements have the common characteristic that their contractual payments are based on an entity's own performance. The Board also received feedback that accounting for those contracts as derivatives may lead to unintuitive accounting results.

BC15. The Board observed that guidance exists in GAAP on how to account for these contracts if they are not accounted for as derivatives. For example, research and development funding arrangements that are not accounted for as derivatives are accounted for under Subtopic 730-20, Research and Development—Research and Development Arrangements. In addition, ESG-linked features that are not accounted for as derivatives are commonly accounted for in accordance with the indexed-debt guidance in Subtopic 470-10, Debt—Overall, the structured note guidance in Subtopic 320-10, Investments—Debt Securities—Overall, or Topic 450, Contingencies. Litigation funding arrangements that are not accounted for as derivatives are commonly accounted for as reimbursements of litigation expenses with any obligation to share proceeds being accounted for in accordance with Subtopic 450-20, Contingencies—Loss Contingencies. The Board determined that applying existing guidance would provide investors with more decision-useful information than accounting for those contracts as derivatives and would narrow the diversity associated with how those arrangements are accounted for in practice, even if some diversity remains.

BC16. The Board observed that certain contingencies embedded in convertible debt may meet the proposed scope exception, such as a convertible debt instrument with an embedded conversion option that is exercisable upon a change in control. Under existing GAAP, issuers generally evaluate whether the conversion feature meets the derivative scope exception related to certain contracts involving an entity's own equity in paragraph 815-10-15-74(a) to determine whether the conversion feature should be bifurcated from the debt host contract. However, under the amendments in this proposed Update, an embedded conversion feature may meet the proposed scope exception in paragraph 815-10-15-59(e). Therefore, when determining whether the embedded conversion feature should be bifurcated, an entity would consider whether either scope exception is met. The Board observed that applying the proposed scope exception may result in fewer conversion features in debt instruments being accounted for as bifurcated embedded derivatives.

BC17. Furthermore, the Board also considered that certain put or call options embedded in a debt instrument that is contingently exercisable (for example, upon the occurrence of an initial public offering or a change in control) may meet the proposed scope exception. The Board observed that applying the proposed scope exception may result in fewer put and call options in debt instruments being accounted for as bifurcated embedded derivatives than under the existing guidance in paragraph 815-15-25-42 (formerly known as Statement 133 Implementation Issue No. B16, "Embedded Derivatives: Calls and Puts in Debt Instruments").

BC18. The Board considered amending the definition of a derivative, including the definition of an underlying, rather than adding a new scope exception. However, some stakeholders mentioned that other areas of GAAP (such as Topic 460, Guarantees) reference the term *underlying* in the Master Glossary. In addition, those definitions have been applied in practice for many years and are well understood. The Board concluded that a proposed amendment to the definition of a derivative (including the definition of an underlying) would require significant effort to evaluate and identify how the proposed amendments would affect other areas of GAAP. Moreover, some stakeholders noted that amending the definition may make assessing whether contracts are included within the scope of Topic 815 more complex. For those reasons, the Board decided not to change the definition of a derivative in this proposed Update, but instead to create a derivative scope exception. The Board concluded that having a clear derivative scope exception would maximize the potential for cost savings

because entities typically review the list of scope exceptions first and evaluate whether the contract meets the definition of a derivative only if it does not qualify for a scope exception.

BC19. The Board decided that underlyings based on (a) a market rate, market price, or market index, including those in paragraph 815-10-15-88(a) through (f), or (b) the price or performance of a financial asset or financial liability of one of the parties to the contract would not be captured by the proposed scope exception in paragraph 815-10-15-59(e). The Board added this restriction so that instruments that are commonly understood to be derivatives (such as interest rate swaps and commodity forward contracts) would not be inadvertently captured by the proposed scope exception. The Board observed that the restriction related to underlyings based on a market price currently exists in the specified volume of sales or service revenues scope exception in paragraph 815-10-15-59(d). Similar to current interpretations of the specified volume of sales or service revenues scope exception in paragraph 815-10-15-59(d), the restriction in paragraph 815-10-15-59(e) is not intended to preclude an entity from applying the scope exception to payment provisions that are based on a combination of variables, rather than solely based on a market price.

BC20. The Board also decided that an underlying based on the price or performance of a financial asset or financial liability of one of the parties to the contract should not be captured by the proposed scope exception in paragraph 815-10-15-59(e). For example, certain guarantee contracts in which the payoff depends on the performance of a financial asset or financial liability (such as loans and debt) of one of the parties to the contract would not be captured by the scope exception. The Board added this restriction because similar instruments such as credit default swaps are commonly understood to be derivatives and without this restriction, that type of instrument would be inadvertently captured by the proposed scope exception in paragraph 815-10-15-59(e). Furthermore, paragraph 815-10-15-58 provides a narrow scope exception for certain financial guarantee contracts, and, without this restriction, the proposed scope exception would conflict with and override (that is, be broader than) the financial guarantee contracts scope exception.

Operations or Activities Specific to One of the Parties to the Contract

BC21. The Board considered whether the phrase “party to the contract” should be limited to the legal entity that entered into the contract. Stakeholders explained that some contracts may reference activities at the consolidated level or parent-entity level rather than at an individual reporting entity level and limiting “party to the contract” to the legal entity that entered into the contract may narrow the application of the expanded scope exception. Therefore, the Board decided that the proposed scope exception should capture not only the activities of the legal entity that is the party to the contract, but also the activities of its parent, subsidiaries, and any entities in the consolidated group of the legal entity for the purposes of both consolidated financial statements and the standalone financial statements of individual entities within the consolidated group.

BC22. The Board considered whether an entity would need to determine whether the “activity” is within the control of one of the parties to the contract. Stakeholders provided examples of underlyings that may be subject to operations or activities specific to one of the parties to the contract but the outcomes of those underlyings may not be fully within the control of the entity, such as regulatory approval and favorable litigation outcomes. In response to stakeholders’ feedback, the Board decided that when evaluating whether operations or activities are “specific to one of the parties to the contract,” an entity does not need to determine whether the outcome is within the control of an entity. Stakeholders noted that a control-based principle would be subjective, be challenging to apply, and potentially create diversity in practice. In addition, including a control-based principle would significantly narrow the application of the expanded scope exception.

BC23. The Board also considered whether a Scope 3 emissions target that would affect the interest rate paid by the borrower would be considered to be based on operations or activities specific to one of the parties to the contract. Scope 3 emissions include indirect emissions that occur within the borrower’s value chain. Because the ESG target is set by the borrower and the borrower has discretion over its value chain, the Board concluded that a Scope 3 emissions target relates to the operations or activities specific to one of the parties to the contract.

BC24. In developing the proposed scope exception, the Board considered the definition of a derivative in International Financial Reporting Standards (IFRS) 9, *Financial Instruments*. In IFRS 9, a contract with an underlying that is a nonfinancial variable that is specific to a party to the contract is not considered a derivative. The Board observed that certain contracts and embedded features that stakeholders raised in the 2021 Invitation to Comment are not currently accounted for as a derivative by entities that apply that definition. The Board concluded that the concept of “specific to a party to the contract” is a relevant and useful concept and, therefore, incorporated that concept into the amendments in this proposed Update. However, the Board decided not to incorporate the exact same guidance in IFRS 9 because the term *nonfinancial variable*, which is included in IFRS 9, is not defined in GAAP. The Board was concerned that redefining an existing term from IFRS 9 in GAAP could create confusion in practice, and some may interpret that to exclude certain financial statement metrics.

BC25. The Board considered introducing scope exceptions for specific types of contracts rather than including a principles-based scope exception based on operations or activities specific to one of the parties to the contract. However, the Board decided that defining the specific types of contracts may not be feasible because the contract-specific approach may be more susceptible to structuring and may result in economically similar contracts being accounted for differently. Also, in the absence of a common principle, determining which contracts should be excluded from or included within the scope of Topic 815 could be more challenging. The Board decided that a principles-based scope exception would be more durable because it would address a broad population of existing and emerging types of contracts. In contrast, adding contract-specific scope exceptions may result in ongoing requests for additional standard setting as new types of contracts emerge.

Predominant Characteristics Assessment

BC26. Currently, when a contract (or an embedded feature in a hybrid instrument) has more than one underlying and some, but not all, of them qualify for the scope exception in paragraph 815-10-15-59, an entity must perform a predominant characteristics assessment. That assessment is needed to determine whether the freestanding contract (in its entirety) or an embedded feature (in a hybrid instrument) qualifies for the scope exception.

BC27. The Board observed that the current requirement to perform a correlation assessment makes the predominant characteristic assessment difficult to apply. Although stakeholders indicated that the predominant characteristics assessment guidance is not currently frequently applied, the proposed expansion of the scope exception is expected to result in more frequent application of that guidance.

BC28. The Board decided to refine the predominant characteristics assessment in paragraph 815-10-15-60 to replace the existing correlation assessment with a fair value assessment. The fair value assessment would require an entity to assess how each underlying affects the fair value of the contract and determine which underlying has the largest expected effect on changes in the fair value of the contract (or an embedded feature in the case of hybrid instruments). Determining how to perform the fair value assessment would be a matter of judgment that depends on the relevant facts and circumstances. 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 fair value of the contract. The underlying that has the largest expected effect on fair value would be considered the predominant underlying. Whether the predominant underlying qualifies for the scope exception in paragraph 815-10-15-59 would determine the accounting for the contract or embedded feature.

BC29. The Board expects that the proposed fair value assessment will be more operable than the existing correlation assessment and will result in more consistent application of the guidance. Moreover, the proposed change would prevent a single underlying with an immaterial effect on fair value from determining the accounting for the entire contract, which stakeholders highlighted is an unintuitive outcome of the existing correlation assessment.

BC30. Some stakeholders stated that the proposed fair value assessment may be challenging to perform when a contract has one underlying that depends on another underlying, for example, a contract with settlement determined by a market index that is contingent on the occurrence of a specified event that is captured by the proposed scope exception. However, most stakeholders indicated that the expected benefits of changing the predominant characteristics assessment would outweigh the potential challenges.

BC31. In light of the challenges outlined in paragraph BC30, the Board considered an alternative approach whereby a contract would be accounted for as a derivative if any individual underlying does not qualify for any of the scope exceptions in paragraph 815-10-15-59. Some Board members preferred this approach. Those Board members believe that it would be more straightforward to apply and would mitigate the risk of structuring by including underlyings that would qualify for a scope exception in paragraph 815-10-15-59 to circumvent derivative accounting. Furthermore, those Board members believe that the fair values of underlyings that would qualify for a scope exception are not meaningful to investors; therefore, an assessment of how changes in the fair values of those underlyings affect the changes in fair value of the overall contract would not be meaningful and could produce uneconomic and unintuitive outcomes.

BC32. The Board, however, rejected that alternative approach because the proposed fair value assessment would result in accounting outcomes that better reflect the economics of the contract. In addition, the alternative approach could override the proposed scope exception, which would be inconsistent with the Board's objective of excluding those contracts from the scope of Topic 815. For example, the alternative approach would circumvent the application of the scope exception in paragraph 815-10-15-59 in circumstances in which a nonqualifying underlying's effect on changes in fair value of the overall contract is minimal.

BC33. The Board also decided that an entity should perform the predominant characteristics assessment only at the inception of the contract because performing the fair value assessment on an ongoing basis would be costly. In addition, accounting for changes in the predominant characteristics assessment during the life of the contract (that is, the contract being accounted for as a derivative in one period but not in a subsequent period) would be operationally challenging and would not necessarily provide investors with decision-useful information. However, for contracts that are subject to the guidance in paragraph 815-10-15-60, when an underlying in the contract ceases to exist (for example, a contingency is resolved) but the contract continues to have more than one underlying, the Board decided that an entity should reevaluate the remaining underlying(s) under the predominant characteristics assessment to determine whether the contract or embedded feature should be accounted for as a derivative. That decision is consistent with other existing reassessments in Topic 815 (for example, when the asset that is

delivered becomes exchange traded, an entity is required to reevaluate whether the contract meets the net settlement criterion in paragraph 815-10-15-83).

Effective Date and Transition

BC34. The Board will determine the effective date of this proposed Update after considering stakeholders' feedback.

BC35. The Board decided that entities should apply the amendments in this proposed Update prospectively to all new contracts entered into on or after the effective date of the guidance. An entity would continue to apply existing GAAP to contracts issued before the adoption date until those contracts are settled or otherwise derecognized. The Board believes that this approach would be less costly than retrospective transition, which would require an entity to apply the proposed amendments to contracts outstanding as of the beginning of the earliest period presented.

BC36. The Board recognized that some entities with longer term contracts may not want to continue to apply derivative accounting to contracts that exist as of the beginning of the period of adoption. As a result, the Board proposes to provide an option to apply the proposed amendments to contracts that exist as of the beginning of the period of adoption with the cumulative effect of the change reflected in the opening balance of retained earnings (or other appropriate components of equity or net assets). Said differently, those contracts would be accounted for as if other applicable GAAP had been applied since the inception of the contract. Early adoption would be permitted, and if early adoption is elected in an interim period, the guidance would be effective as of the beginning of the fiscal year that includes that interim period.

BC37. The Board also decided to provide a one-time instrument-by-instrument option to irrevocably elect the option to measure certain contracts in their entirety at fair value with changes in fair value recognized in earnings. A contract that is within the scope of paragraphs 825-10-15-4 through 15-5, which is no longer accounted for as a derivative because of applying the amendments in this proposed Update, would be eligible for this option. The option is intended to permit entities that otherwise would have applied the fair value option at contract inception to apply the fair value option. For financial liabilities, an entity would present separately in other comprehensive income the portion of the total change in the fair value of the liability that results from a change in the

instrument-specific credit risk. For those instruments for which an entity elects the fair value option, the adoption date effects of complying with the amendments in this proposed Update would be reported as a cumulative-effect adjustment in the opening balance of retained earnings (or other appropriate components of equity or net assets) as of the beginning of the fiscal year in which the proposed amendments are adopted.

BC38. The Board decided to require certain disclosures in accordance with Topic 250, Accounting Changes and Error Corrections. An entity would disclose in the period of adoption the nature of and reasons for the change in accounting principle. Additionally, an entity that elects retrospective transition would be required to disclose (a) the cumulative effect of the change in retained earnings or other components of equity or net assets as of the beginning of the period of adoption and (b) a description of the financial statement line items affected. An entity that issues interim financial statements would provide the required disclosures in the financial statements of both the interim period and fiscal year of adoption.

Issue 2: Scope Clarification for a Share-Based Payment from a Customer in a Revenue Contract

Background Information

BC39. In 2023, the FASB staff received a technical inquiry about how an entity should account for warrants granted by a customer in a revenue contract when the warrants vest upon the entity's satisfaction of its performance obligation. This question was later raised at the November 10, 2023 public roundtable meeting on FASB's Post-Implementation Review (PIR) of Topic 606.

BC40. Some stakeholders noted that, in their view, there is a lack of clarity about which guidance an entity should apply to recognize share-based payments, such as warrants or shares, that are received from a customer that are consideration for the transfer of goods or services. As a result, interpretations about the application of Topic 815 or Topic 321 to consideration that has not yet been earned and recognized in a revenue contract are occurring in practice. For example, if an entity receives share-based payments from a customer (the grantor) when providing goods or services and those share-based payments are contingent on the satisfaction of performance obligations, some stakeholders recently indicated that it is unclear to them

whether those share-based payments (a) should be recognized at contract inception as a derivative asset under Topic 815 or an equity security under Topic 321 or (b) should not be recognized until the entity satisfies its performance obligations under Topic 606.

BC41. In response to that feedback, the Board decided to clarify the accounting by an entity that receives a share-based payment from a customer that is consideration for the transfer of goods or services. The Board included this clarification, which addresses the applicability of derivative accounting in Topic 815, in this proposed Update because it aligns with the objective of this proposed Update to reduce the cost and complexity of evaluating whether certain contracts are subject to derivative accounting.

Benefits and Costs

BC42. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Board's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC43. The amendments in this proposed Update would clarify the applicability of Topic 606 to a share-based payment from a customer that is consideration for the transfer of goods or services. The Board expects that this clarification would reduce diversity in practice and enhance consistency in the accounting for revenue contracts with different forms of consideration. Accordingly, the Board expects that investors would receive more consistent information on revenue contracts with different forms of consideration and more comparable information across different entities.

BC44. The amendments in this proposed Update would reduce financial reporting compliance costs by simplifying the accounting for a share-based payment from a customer that is consideration for the transfer of goods or

services. Although some entities may incur one-time transition costs, the Board expects that those costs would not be significant. Furthermore, the Board expects that entities that currently apply the guidance in Topic 815 or Topic 321 to account for a share-based payment from a customer that is consideration for the transfer of goods or services may experience a reduction in recurring compliance costs. This is because, except for the initial measurement at contract inception in accordance with the guidance in Topic 606, those entities would no longer measure the estimated fair value of the share-based payment until it is recognized as an asset under Topic 606.

BC45. Overall, the Board expects that the amendments in this proposed Update would provide investors with more relevant, consistent, and comparable information while reducing costs for preparers and auditors. Therefore, the Board concluded that the expected benefits of the proposed amendments would justify the expected costs.

Basis for Conclusions

BC46. Some stakeholders asserted that the increase in revenue contracts with share-based payments (such as warrants or shares) received from customers has resulted in a growing need to clarify the accounting for those revenue contracts. The Board's intent has been for entities to apply Topic 606 to account for share-based payments from customers that are consideration for the transfer of goods or services. Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, added the guidance in paragraph 505-50-05-2A to clarify that an entity should apply Topic 606 to account for a share-based payment from a customer that is consideration for the transfer of goods or services. Subsequently, Subtopic 505-50, Equity—Equity-Based Payments to Non-Employees, including paragraph 505-50-05-2A, was superseded by Accounting Standards Update No. 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*. Nevertheless, the Board's intent for an entity to apply Topic 606 to account for a share-based payment from a customer that is consideration for the transfer of goods or services did not change.

BC47. The Board acknowledges that the existing guidance in Topic 606 is not as explicit as the guidance in superseded paragraph 505-50-05-2A. The lack

of clear guidance has contributed to diversity about which guidance (that is, Topic 606, Topic 815, or Topic 321) should be applied.

BC48. The Board decided to make it explicit in Topic 606 that an entity should apply the guidance in Topic 606, including the guidance on noncash consideration in paragraphs 606-10-32-21 through 32-24, to a contract with a share-based payment from a customer that is consideration for the transfer of goods or services. The Board also decided to make consequential amendments to Topic 815 and Topic 321 to clarify that those Topics should not be applied unless and until the share-based payment is recognized as an asset under Topic 606. As a result, a share-based payment from a customer that is consideration for the transfer of goods or services would need to be recognized first as an asset (measured at the estimated fair value at contract inception) under Topic 606 before the guidance in Topic 815 and Topic 321 would apply.

BC49. The Board further clarified that an entity would recognize a share-based payment as an asset under Topic 606 when an 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 Board observes that this is generally consistent with the definition of *vest* in the Master Glossary and is expected to improve the symmetry with the grantor's accounting under Topic 718. The Board understands that sometimes there may be timing differences between when a share-based payment is recognized under Topic 606 and when it is received or exercisable (for example, there may be a time period during which an entity cannot exercise the rights in the share-based payment). The Board concluded that if a share-based payment from a customer is consideration for the transfer of goods or services, it is appropriate to base the timing of the recognition of the share-based payment under Topic 606 on when an 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.

BC50. The Board understands that there could be situations in which the timing of the recognition of a share-based payment from a customer that is consideration for the transfer of goods or services does not align with when an entity performs by transferring goods or services to a customer. As a result, the Board added an explanation in paragraph 606-10-55-250A that is based on a discussion in paragraph BC40 in Accounting Standards Update No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*. Paragraph BC40 states that if an

entity 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, the entity is required to present the noncash consideration as a contract asset, excluding any amounts presented as a receivable. In addition, the Board noted that paragraph BC40 of that Update addresses a question on the subsequent accounting under other Topics for changes in fair value of noncash consideration after contract inception. Paragraph BC40 states that if the guidance in other Topics related to the form of the noncash consideration requires that asset to be measured at fair value, an entity will recognize a gain or loss (outside of revenue) upon receipt of the asset if the fair value of the noncash consideration increased or decreased since contract inception.

BC51. The clarification on the applicability of Topic 606 to a share-based payment from a customer in a revenue contract reflects the Board's longstanding intent and is expected to result in a more consistent accounting for revenue contracts with different forms of consideration. The Board does not expect that this clarification would disrupt convergence of Topic 606 and IFRS 15, *Revenue from Contracts with Customers*.

BC52. The Board considered some stakeholders' alternative view that a share-based payment from a customer in a revenue contract should be recognized at contract inception under Topic 815 or Topic 321 because it meets the definition of *financial instrument* in the Master Glossary. However, the Board observed that meeting the definition of *financial instrument* does not automatically or necessarily lead to asset or liability recognition. As stated in the definition of *financial instrument*, some financial instruments may not be recognized because they fail to meet some other criterion for recognition. Furthermore, the Board observed that this alternative view could result in consideration and revenue in a revenue contract with a share-based payment from a customer being recognized in different periods and in a different manner than a revenue contract with cash consideration. The Board questioned the decision usefulness of this differential effect on entities' financial statements.

BC53. The Board decided not to address how to measure the estimated fair value of a share-based payment from a customer in a revenue contract at contract inception. This is not a new issue. A similar question on how to measure the estimated fair value of noncash consideration was addressed by the Board in the basis for conclusions (paragraph BC39) of Accounting

Standards Update 2016-12. The Board did not identify any new information to change its consideration from that Update.

BC54. The Board also decided not to address the accounting for certain other economically similar contracts raised by some stakeholders. The Board concluded that those contracts were not pervasive or were beyond the scope of this project.

BC55. The Board notes that the guidance in Subtopic 610-20 refers to the revenue recognition principles in Topic 606, including the guidance on recognition and measurement. As a result, the transfer of a nonfinancial asset (such as real estate) to a noncustomer under Subtopic 610-20 is generally recognized and measured in a similar manner as the sale of a nonfinancial asset to a customer that is subject to Topic 606. Because the Board proposed a scope clarification in Topic 606 for a share-based payment received from a customer in a revenue contract, the Board wanted to understand whether a similar scope clarification in Subtopic 610-20 would be needed to reach a consistent outcome. Therefore, the Board included a question in this proposed Update about the applicability of Subtopic 610-20 to a share-based payment received in exchange for the transfer of a nonfinancial asset to a noncustomer.

Effective Date and Transition

BC56. The Board will determine the effective date of this proposed Update after considering stakeholders' feedback.

BC57. The Board decided that entities would be required to apply the amendments in this proposed Update to revenue contracts that exist as of the beginning of the fiscal year of adoption. The cumulative effect of the change would be recognized as an adjustment to the opening balance of retained earnings as of the beginning of the fiscal year of adoption. The Board concluded that this approach would strike a reasonable balance between providing meaningful information and reducing transition costs. Early adoption would be permitted. If early adoption is elected in an interim period, the guidance would be effective as of the beginning of the fiscal year that includes that interim period.

BC58. The Board decided to require certain disclosures in accordance with Topic 250. In the interim period and fiscal year of adoption, an entity would disclose (a) the nature of and reason for the change in accounting principle and

(b) the cumulative effect of the change on retained earnings or other components of equity or net assets as of the beginning of the fiscal year of adoption.

Amendments to the GAAP Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require improvements to the GAAP Financial Reporting Taxonomy and SEC Reporting Taxonomy (collectively referred to as the “GAAP Taxonomy”). We welcome comments on these proposed improvements to the GAAP Taxonomy at xbrled@fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, the proposed improvements to the GAAP Taxonomy will be finalized as part of the annual release process.