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October 21, 2024

Mr. Jackson M. Day
Technical Director
Financial Accounting Standards Board
801 Main Avenue
PO Box 5116
Norwalk, CT 06856-5116

RE: Proposed Accounting Standards Update, 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 (File Reference No. 2024-ED100)

Dear Mr. Day:

We appreciate the opportunity to comment on Proposed Accounting Standards Update, *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*. We support the Board's objectives to:

- expand the scope exception from derivative accounting for certain contracts with a variable based on operations or activities specific to one of the parties to the contract; and
- clarify the scope for share-based payment received from a customer that is consideration for the transfer of goods or services.

This cover letter describes our key observations and suggestions regarding the proposed ASU. The Appendix provides our responses to the questions for respondents and includes more detailed recommendations for the Board to consider.

Issue 1: Derivatives scope refinements

As discussed in Appendix B and Question 1 of Appendix A, we encourage the Board to consider a separate standard-setting project to address the accounting for certain arrangements that would be excluded from the scope of Topic 815 after the adoption of this proposed ASU. However, we believe that a final ASU on the scope of Topic 815 could be issued prior to completion of such a project.

Issue 2: Scope clarification for a share-based payment from a customer in a revenue contract

As discussed in Question 8 of Appendix A, we recommend that the proposed guidance be amended to further clarify when to apply the guidance in Topic 321 or Topic 815 to the noncash consideration (share-based payment) from a customer for the transfer of goods or services in a revenue contract.

* * * * *

If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at kbascom@kpmg.com or Mark Northan at mnorthan@kpmg.com.

Sincerely,

KPMG LLP

KPMG LLP

Appendix A – Responses to Questions for Respondents

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?

We believe the proposed scope exception captures the population of contracts that should not be accounted for as derivatives and generally does not capture any contracts that should continue to be accounted for as derivatives under Topic 815.

We recommend that the Board undertake a separate standard-setting project for litigation funding arrangements that are excluded from derivative accounting. While we acknowledge that paragraph 15 of the Basis for Conclusions refers to existing guidance that applies if litigation funding arrangements are not accounted for as derivatives, we understand there are currently diverse views about which Topics should be applied directly or by analogy to these arrangements if they are not accounted for as derivatives under Topic 815. Therefore, without additional guidance from the Board, we believe there likely will be diversity in practice in the recognition, initial measurement and subsequent measurement for litigation funding arrangements that would reduce comparability for financial statement users and potentially result in higher costs to preparers. We discuss this topic further, and provide our specific recommendations, in Appendix B under 'Other Issue 1 observations'.

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?

We generally believe the proposed scope exception is clear and operable. However, while we acknowledge that paragraph 815-10-15-59(e)(2) is clear that the term 'party to the contract' includes any entity within a consolidated group, paragraph 23 of the Basis for Conclusions appears to contemplate that contracts indexed in part to the activities or operations of other entities (specifically, parties 'within an entity's value chain' in the context of loans whose interest may vary with ESG metrics) would qualify for the scope exception. It is therefore unclear whether the Board intends for the scope exception to be applied more broadly than just to contracts indexed to activities or operations of a 'party to the contract'.

We believe in practice the types of contracts based in part on the activities or operations of the reporting entity's consolidated group and in part based on the activities or operations of parties external to the reporting entity's consolidated group are not, and will not, be limited to the example in paragraph 23 of the Basis for Conclusions. As a result, it is important to provide clear and operable guidance on these arrangements. If the Board's intention is that the scope exception be applied more broadly, we recommend that the Board clarify, through additional amendments to the Codification, the principles an entity should use to evaluate whether, when and how activities or operations of parties external to the reporting entity's consolidated group are considered in applying the scope exception.

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?

<u>Operability of the proposed predominant characteristics assessment</u>

We generally believe the proposed predominant characteristics assessment is more operable than the current predominant characteristics assessment and agree with the Board's rationale outlined in paragraphs 28 to 30 of the Basis for Conclusions. However, we recommend the Board consider alternatives to reduce the instances in which applying this assessment is necessary. Consistent with the Board's assessment in paragraph 27 of the Basis for Conclusions, we believe the proposed guidance would lead to more instances when applying this assessment would be necessary compared to existing GAAP. Further, we believe that applying a predominant characteristics assessment is inherently burdensome and complex for preparers and practitioners.

One example of an alternative approach the Board could consider is to exclude a contract from qualifying for the scope exception if any of the underlyings in the contract is a market rate, market price or market index (including those in subparagraphs 815-10-15-88(a) to (f)). We believe an advantage of this approach is that, in most cases, when a contract includes an underlying that is a market rate, market price or market index, it generally is designed such that the market-based underlyings are predominant. As a result, this approach generally would lead to the same outcome without the need for performing and documenting a predominant characteristics assessment that in many cases may be complex and burdensome for preparers and practitioners.

<u>Clarity in performance of the proposed predominant characteristics assessment</u>

While we acknowledge that paragraph 815-10-55-64 is clear that all reasonably possible changes in fair value should be considered in the predominant characteristics assessment, we recommend that the Board clarify how to perform this assessment. If the Board's intent is for the assessment to be based on probability-weighted outcomes, we believe the Board should state so in the Codification.

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?

Consistent with our response to Question 3, we believe it would be beneficial to reduce the instances in which applying the proposed predominant characteristics assessment would be necessary. However, we believe the alternative approach goes too far in limiting the application of the scope exception, which is inconsistent with the Board's objective.

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.

We believe the proposed transition method is operable. The proposed transition disclosure would be decision-useful and is consistent with current guidance in Topic 250 for a change in accounting principle.

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.

We believe preparers are best positioned to comment on the time needed to implement the proposed ASU. We are not aware of factors specific to entities other than public business entities that would warrant a different implementation period.

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.

We believe preparers are best positioned to describe what, if any, incremental costs they would expect to incur if the proposed amendments are finalized.

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?

We agree that an entity should apply the guidance in Topic 606, including the guidance on noncash consideration in paragraphs 606-10-32-21 to 32-24, to a share-based payment from a customer that is consideration for the transfer of goods or services in a revenue contract. However, we recommend that the proposed guidance be amended to clarify (1) when to apply the guidance in Topic 321 or Topic 815 to the noncash consideration in these revenue contracts and (2) that Topic 606 continues to apply to the noncash consideration until all of the vesting conditions in share-based payments have been met.

The proposed language in paragraph 606-10-15-3A states that "… 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." Similarly, paragraphs 321-10-15-7 and 815-10-25-16A state that: "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".

We are concerned about the ambiguity of the word 'asset' in these paragraphs. A contract asset can be recognized under Topic 606 when the entity's right to receive or retain the share-based payment from a customer is still contingent. Based on our interpretation of the proposed ASU, including the Basis for Conclusions, we do not believe that it is the Board's intent for entities to apply Topic 321 or Topic 815 to a contract asset that has been recognized under Topic 606. But by only using the word 'asset' throughout the proposed amendments, the Board's intent is not clear, and the guidance may be applied inconsistently or differently from the Board's intent.

We believe the Board's intent is to require application of the guidance in Topic 321 or Topic 815 at the point when the entity has an unconditional right to receive or retain the share-based payment. That is, the entity has met all vesting conditions (other than the passage of time) related to the share-based payment. If our understanding of the Board's intent is correct, there is a related issue concerning the subsequent measurement of a contract asset, which we have discussed further in Appendix B under 'Other Issue 2 observations'.

We also believe the use of the phrase 'contingent on the satisfaction of a performance obligation' in paragraph 606-10-15-3A is too narrow and there can be situations where an entity vests in share-based payments from either its efforts to transfer goods or services or a specific outcome from transferring goods or services. We believe applying the guidance as proposed in the following scenarios would not result in the outcome that the Board intends.

Scenario A

An entity enters into a contract to provide market research services and assist the customer by recommending a new retail location in exchange for noncash consideration in the form of warrants in the customer's common stock. The warrants vest when the customer opens the retail facility at the location recommended by the entity. However, the entity satisfies its performance obligation when it provides its recommendation for the new retail location based on the research performed. In this scenario, vesting is contingent on a specific outcome linked to the usefulness of the service provided by the entity (i.e. the customer opening the retail facility) and not the satisfaction of the performance obligation by the entity (i.e. providing the recommendation of a site to the customer). The entity records a contract asset upon satisfaction of the performance obligation because it would not have the unconditional right to receive the warrants until the customer opens the retail facility.

The proposed language in paragraph 606-10-15-3A indicates that the entity should begin applying Topic 815 or Topic 321 to the warrants when the performance obligation is satisfied. However, we believe the Board's intent is for the entity to apply Topic 815 or Topic 321 at the point in time that the vesting condition has been met (i.e. the opening of the retail facility by the customer). Further, we believe that approach results in a better financial reporting outcome because:

- the variability related to whether the warrants vest based on the outcome of the entity's efforts continues to be accounted for under the Topic 606 variable consideration guidance as revenue; and
- the variability associated with the form of the consideration (i.e. the stock price) is accounted for outside of revenue when the award has vested as a result of the entity's efforts.

We believe this approach is consistent with the existing guidance in paragraph 606-10-32-23.

Scenario B

An entity enters into a contract with a customer to sell a product in exchange for an agreed upon amount of cash consideration per unit. In addition, the customer promises 100 warrants in its common stock when the entity reaches a specified milestone in the build-out of the entity's production capacity that will be used to satisfy the entity's future performance obligations to the customer (e.g. delivery of the product). The warrants are not promised upon satisfying a performance obligation but instead by meeting a milestone that is related to the entity's efforts to transfer a product under the contract.

One interpretation of the proposed language in paragraph 606-10-15-3A is that the entity should begin applying Topic 815 or Topic 321 to the warrants at contract inception because the entity's right to receive the warrants is not contingent on the satisfaction of a performance obligation. However, we believe the Board's intent is for the entity to apply Topic 815 or Topic 321 at the point in time that the vesting condition has been met (i.e. the specified milestone has been reached).

Suggested Approach

We believe the Board should modify the language in paragraph 606-10-15-3A as follows:

'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. However, the share-based payment becomes subject to the requirements of other Topics (Topic 815 and Topic 321) when and only when the entity has an unconditional right to receive (other than by the passage of time) or retain the share-based payment. ~~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.~~'

Further, we recommend that the Board provide additional examples to illustrate how to apply the scoping guidance to scenarios where the share-based consideration is in the form of warrants, which is the more common fact pattern in practice and the one the issue being addressed by the proposal seeks to clarify. We believe that the Board's intent would be clearer if Example 31 was expanded, or additional examples were added, to provide illustrations of the following scenarios.

<u>Scenario A</u>

An entity enters into a contract with a customer to provide a weekly service for one year. In exchange for this service, the customer promises 100 warrants in the customer's common stock per week of service (a total of 5,200 warrants for the contract). The contract requires the warrants to be provided upon execution of the contract and to be immediately exercisable by the entity.

The entity recognizes the 5,200 exercisable warrants upon execution of the contract, because it has an unconditional right to receive the warrants at that time, and a corresponding contract liability. The guidance in other Topics (Topic 815 or Topic 321) applies immediately to the recognized warrants, and the entity recognizes revenue (and reduces the contract liability) upon successful completion of each week of service at the contract inception fair value of the warrants.

<u>Scenario B</u>

An entity enters into a one-year contract with a customer to sell Product A in exchange for $1 per unit delivered. If the entity delivers 1,000 units during the contract term, the customer promises a bonus in the form of 100 warrants in the customer's common stock.

The entity applies the variable consideration guidance in paragraphs 606-10-32-5 to 32-14 and 606-10-32-39 to 32-41 to estimate and allocate the variable consideration. If the entity believes the most likely outcome is that it will meet the volume threshold of 1,000 units delivered and therefore be entitled to the bonus from the customer, it allocates the variable consideration to each unit and recognizes a contract asset and revenue as the performance obligations are satisfied. The guidance in other Topics (Topic 815 or Topic 321) applies when the entity delivers the 1,000th unit because the entity has an unconditional right to receive the warrants at that time.

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?

Yes. We believe that Topic 815 and Topic 321 should be amended to clarify the point at which that guidance would apply to a share-based payment from a customer that is consideration for the transfer of goods or services in a revenue contract. However, we believe that proposed language should be further clarified based on the suggestions in our responses to Question 8.

Question 10:

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

We believe the changes suggested in our responses to Questions 8 and 9 would make the proposed amendments clear and operable.

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.

Yes. We believe it is appropriate to clarify that a share-based payment from a noncustomer that is consideration for the transfer of a nonfinancial asset is accounted for under Subtopic 610-20 because that Subtopic applies Topic 606's noncash consideration guidance. We are not aware of any unintended consequences.

We believe this clarification should be included in the scoping guidance in Subtopic 610-20 as well as in the proposed amendments in Topics 815 and 321.

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.

We believe preparers are best positioned to comment on the operability of the proposed transition method. The proposed transition disclosure would be decision-useful and is consistent with current guidance in Topic 250 for a change in accounting principle that is applicable to this Issue and the transition method proposed.

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.

We believe preparers are best positioned to comment on the time needed to implement the proposed ASU. We are not aware of factors specific to entities other than public business entities that would warrant a different implementation period.

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.

We believe preparers are best positioned to describe what, if any, incremental costs they would expect to incur if the proposed amendments are finalized.

Appendix B – Other Observations

Other Issue 1 observations:

In our response to Question 1 in Appendix A, we recommend that the Board undertake a separate standard-setting project for litigation funding arrangements that are excluded from derivative accounting. This Appendix discusses 1) the potential accounting if these arrangements are excluded from derivative accounting and no additional standard-setting takes place and 2) our recommendations for the Board to consider in a standard-setting project.

Absent further guidance from the Board, we believe the accounting for litigation funding arrangements, if they are not accounted for as derivatives under Topic 815, may be as follows.

Investor (funding party):

At the time of funding, an investor would record a financial asset. If the fair value option is not elected, the investor would develop an effective interest rate model that may be complex and may not produce decision-useful information for users.

The investor would test these arrangements for impairment, which may give rise to additional complexities given that any impairment would not be based on credit losses, but rather on the outcome of the subject litigation.

Investee (entity receiving the funding)

At the time of receiving the funding, an investee would generally record a liability even though it is not obligated to make a payment to the investor unless it receives a settlement from a successful litigation outcome. Similar to the investor's accounting, an investee would develop an effective interest rate model that may be complex and may not produce decision-useful information for users. Determining when to derecognize the liability may give rise to additional complexities, specifically when no payment is expected to occur based on developments in the litigation. In addition, in scenarios where the litigation is expected to lead to a settlement, the investee would have a mismatch in earnings given the timing difference between recognizing the portion of the settlement proceeds owed to the investor and the contingent gain from the litigation (which Subtopic 450-30 does not allow to be recognized until it is realized).

Below are approaches we recommend that the Board consider via a separate standard-setting project. These models would apply solely to contracts where the investee is not required to make a payment to the investor unless and until the investee receives a settlement payment from the litigation as specified in the contract.

Investor (funding party):

We recommend that an investor be required to record the financial asset at fair value initially and subsequently. While we acknowledge the fair value option that applies to some financial instruments, we believe requiring fair value accounting would reduce diversity in practice and provide users with more decision-useful information. In addition, this model would avoid the complexities of developing an effective interest rate model and an impairment model.

Investee (entity receiving the funding)

We recommend that an investee be required to record the cash received at commencement of the arrangement with the offsetting entry through the income statement (i.e. as a gain). This accounting reflects the fact that there is no obligation to make a payment to the investor unless litigation is successful, a settlement payment is received, and a portion of the settlement amount above a contractual threshold is owed to the investor, if applicable. After initial recognition, when the litigation meets the gain contingency recognition guidance in Subtopic 450-30, we recommend that the investee record the receivable associated with the litigation, the obligation to pay the investor and the net gain. We believe this model would more appropriately align the accounting with the economics of the arrangement and would provide decision-useful information for the users. Similar to the investor's accounting model, this would avoid the complexities of developing an effective interest rate model. This model would also eliminate earnings mismatches related to the arrangement.

Alternatively, the Board could consider an approach that requires recognition of a liability (or deferred income) at the inception of the arrangement for the cash received from the investor. Under this approach, the Board could consider providing guidance that would (1) eliminate income statement mismatches when the liability is increased, (2) specify income statement classification and presentation (e.g. noninterest expense) and (3) clarify when the liability (or deferred income) would be extinguished or derecognized.

Other Issue 2 observations:

Proposed paragraph 606-10-55-250A indicates an entity should apply the guidance in Section 606-10-45 to arrangements in Issue 2. Within that guidance, paragraph 606-10-45-3 requires an entity to assess a contract asset for impairment under Subtopic 326-20. Subtopic 326-20 applies only to the credit loss risk associated with the contract asset, and during the time that contract asset exists neither the proposed ASU nor the existing guidance provides an impairment model that would apply to the risk associated with the form of the noncash consideration (e.g. decreases in fair value) before Topic 321 or Topic 815 applies. As a result, there may be diversity in practice that the Board may want to consider addressing.

This observation is not limited to share-based payments and would exist for non-credit impairment risk associated with other noncash consideration before it is received. For example, if equipment is promised as noncash consideration, an entity may apply Topic 360 and its impairment model when the entity has title to or controls the asset. Another entity may consider whether it is appropriate to apply Topic 360 to the portion of the contract asset related to the noncash consideration before it receives the equipment. Because a contract asset is a unit of account at the customer contract level and is based on an entity's performance and customer payments, it often will not directly correlate to the noncash consideration unless the transaction price consists solely of that noncash consideration. This adds complexity if an impairment model is applied before the noncash consideration is received.

As it relates to share-based payments, if the Board's intent is to apply the guidance in Topic 321 or Topic 815 at the point when the entity has an unconditional right to receive or retain the share-based payment, then we believe the Board should consider specifically addressing non-credit risk impairment in a contract asset – i.e. whether preparers should consider impairment risk to a contract asset that is not related to credit risk under Subtopic 326-20. If so, what model should be applied? If the Board believes the impairment risk should be considered only when the asset is otherwise accounted for outside of Topic 606 (e.g. Topic 321, Topic 815, or Topic 360), we believe the guidance should be clarified to reflect that view and the Board should consider whether additional disclosure should be required related to impairment risk in a contract asset when that impairment risk is not recognized.