October 28, 2024

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

Re: File Reference No. 2024-ED100

Dear Mr. Day:

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on the Financial Accounting Standards Board's (FASB or Board) 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* (Proposed Update).

The IMA is a global association representing over 140,000 accountants and finance professionals. Our members work inside organizations of various sizes, industries, and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The Committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

The Committee applauds the Board for the Proposed Update. We believe it will produce more decision-useful information and reduce complexity in financial reporting. We have a few recommendations for each Issue outlined below.

Issue 1: Derivatives Scope Refinements

The Committee is supportive of expanding the scope exceptions to derivative accounting for contracts with underlyings that are based on operations or activities specific to one of the parties to the contract. The Proposed Update more closely aligns to our first preference in our letter dated March 24, 2023. However, we have a few recommendations for the Board to consider as it finalizes the Proposed Update.

We recommend that the FASB address areas where the objective of the Proposed Update is not clear or appears to be redundant or inconsistent with other guidance. While we recognize that it is not practical to specifically define instruments that are within scope, it is helpful to include examples to illustrate the FASB's intent in application.

In particular, we are concerned that the guidance at the end of proposed paragraph 815-10-15-59(e), which states "…This scope exception does not apply to variables based on…price or performance (including default) of a financial asset or financial liability of one of the parties to the contract…", will potentially reduce the intended benefit of the scope exception. There can be varying views on how this provision could be interpreted in relation to debt instruments. For example, we understand that failure to achieve ESG targets that results in an interest rate increase for a debt instrument would qualify for the proposed scope exception, even though this could affect price or performance of the debt. Similarly, when the interest rate is adjusted because the entity's credit rating is downgraded, or the entity does not file its Form 10-K on time, or the entity is acquired, we believe the adjustment resulting from these events should be eligible for the proposed scope exception. However, given the wording in the exception to the scope exception, it is not clear. We understand that the Board's intent was to address the price or performance of a third-party's financial asset or financial liability when the exposure to the price or performance was embedded in a financial asset or financial liability issued by one of the parties to the arrangement being assessed under the scope exception (i.e., a credit-linked note). If our understanding is correct, we recommend clarifying the distinction between the events that will be eligible for the scope exception and those that will not be.

Other issues we identified that may require clarification or resolution of redundancies include the following.

- It appears that paragraph 815-10-15-59(d) may become redundant if proposed paragraph 815-10-15-59(e) is adopted. We recommend assessing whether paragraph 815-10-15-59(d) should be removed simultaneously with the addition of the new proposed scope exception.
- We recommend clarifying which party is intended to apply the accounting in the example in proposed paragraph 815-10-55-65 on contingently convertible debt. We assume that the example is intended to apply to the holder; however, there is a reference to paragraph 815-10-15-74, which only applies to issuers.
- The example in proposed paragraph 815-10-55-143D illustrates that the approach to assessing whether embedded put/call provisions in debt hosts should be bifurcated may change when the Proposed Update is finalized. Specifically, puts and calls may then qualify for the proposed scope exception, which will obviate the need to assess whether the features are clearly and closely related to the debt host (existing paragraphs 815-10-15-25-41 and 25-42) as is the case today. If our understanding that the Proposed Update supplements the existing guidance is consistent with the Board intent, it may be helpful to state that, either in the final Update or the basis for conclusions. As the example illustrates, reporting entities will need to take care in identifying the underlyings in a put/call feature. The fact that the

debt is puttable on an IPO, which is a variable that is based on the operations or activities specific to the issuer of the debt, would suggest that the underlying qualifies for the proposed new scope exception. However, when the feature has multiple underlyings, as with a put/call feature, the fair value of the debt instrument represents an additional underlying. It is that additional underlying that triggers the requirement to assess which of the underlyings is the predominant feature. It would be helpful if the Board addressed that in the basis for conclusions to the final Update. Further, it would be helpful to note if the same analysis applies to arrangements where the redemption of the host contract is required as opposed to optional. We believe, in that circumstance, the only underlying is the occurrence of the IPO. In that regard, the mandatory redemption (which will affect the fair value of the debt) is similar to an adjustment of the interest rate on the debt on the occurrence of an event (for example, satisfying greenhouse gas emission targets). In the latter case, we understand that the reporting entity would not need to consider the guidance in paragraph 815-10-15-60. Again, it would be helpful for the Board to confirm our understanding.

Practice issues may arise regarding the application of the predominant characteristics proposal for scenarios where there are more than two variables and further when those underlyings are dependent on each other (e.g., change of control and redemption feature). For example, a contract may have three variables. Variable 1 could result in fair value changes of $400. Each of Variables 2 and 3 could result in fair value changes of $300, and $600 if looked at together. Variable 1 meets the proposed scope exception whereas Variables 2 and 3 do not. We recommend clarifying whether the predominant characteristics assessment should be based on (1) which **individual** variable has the largest expected effect on changes in the fair value of the contract or (2) whether the **aggregation** of variables that are in scope or out of scope have the largest expected effect. Under interpretation (1) this would be Variable 1, providing the scope exception for the entire instrument. Under interpretation (2), this would be Variables 2 and 3, and the instrument would not qualify for the scope exception. As drafted, it appears that the Proposal points to using individual variables. This could result in counterintuitive conclusions that may not be consistent with the intent of the guidance or the substance of various instruments. We also recommend that the Board consider allowing a qualitative assessment of the predominant characteristics, as the Board did for qualifying for hedge accounting.

We anticipate the Proposed Update could lead to more questions and potentially greater diversity in practice with respect to litigation funding arrangements that are not accounted for as derivatives, specifically with respect to whether and if so how to apply an effective interest model of accounting to those arrangements. However, <u>we do not recommend that the FASB delay this project</u>. Rather, we recommend the Board address the accounting for litigation funding arrangements that are not within the scope of Topic 815 in a future project and perhaps leverage the EITF. Similarly, there will likely be a need for guidance on research and development arrangements when the proceeds received are classified as debt. We think a possible solution to the subsequent accounting for litigation funding and research and development arrangements would be to apply the guidance in ASC 470-10 on sales of future revenues.

Issue 2: Scope Clarification for a Share-Based Payment from a Customer in a Revenue Contract
The Committee is also supportive of the proposed updates in Issue 2. We have the following recommendations to further clarify the intent of the updates:

- As drafted, we believe proposed paragraph 606-10-15-3A is not clear in certain respects. For example, it is not clear that the "asset" that should be recognized when the right to receive it is no longer contingent on satisfaction of a performance obligation refers specifically to the share-based payment received (receivable), but not, for example, to a contract asset. We believe that while proposed paragraph 606-10-55-250A appears to clarify the intent, it is difficult to navigate the related guidance that is in different sections and not explicitly referenced to each other.
- The intended interaction with the guidance in Topic 606, *Revenue from Contracts with Customers,* related to the application of constraint on variable consideration is not clear. In a license and collaboration contract in scope of Topic 606, the vendor's right to retain a share-based payment award granted by its customer may be subject to performance conditions beyond the performance obligations identified in the revenue contract (for example, obtaining FDA approval or commencing commercial sales or achieving a certain level of royalties). When those performance conditions will not be satisfied until after the vendor has satisfied its performance obligations, it appears the proposed guidance would require the vendor to recognize an asset for the share-based payment because its right to receive the share-based payment is no longer contingent on the satisfaction of a performance obligation. In these situations, entities do not record the right to collect milestone payments or royalties until ASC 606 criteria for recognition of variable consideration and/or royalty payments are met. If an entity is required to record an asset for a share-based payment that is contingent on future performance conditions that are not within the entity's control, it is not clear where the credit side of the entry would go or how this asset would be measured initially or subsequently. If the entity is required to measure the fair value of the share-based payment asset under ASC 820, it would need to determine the likelihood of the contingent events that result in its ability to retain the award. We do not believe this would generate useful information for financial statement users, for the same reasons that entities are not required to record cash consideration receivable from milestones and royalties until ASC 606 recognition criteria are met. We encourage the FASB to reevaluate the recognition threshold for share-based payment consideration to align it with the requirements of ASC 606.
- We recommend that disclosure requirements be included for the changes in the fair value (FV) of the share-based consideration received following the revenue contract's inception

and through the recording of the financial instrument. The following example illustrates the importance of providing users additional information:

- At revenue contract inception, the fair value of share-based consideration is $1,200 for 120 shares (FV of $10 per share) for which the performance obligation will be recognized ratably over a one-year period, and shares will be issued and vest in monthly increments, 10 shares per month. Five months after contract inception, the fair value per share has decreased to $7. Under the proposal, at that time the entity will have recognized revenue of $500 (10 shares x 5 months x $10 per share), a share-based payment asset of $350 (10 shares x 5 months x $7 per share), and other loss of $150 (10 shares x 5 months x ($10 - $7)). These amounts will be reflected in the financial statements. The entity is also entitled to the remaining 70 shares, and once earned, will recognize revenue of $700 (10 shares x 7 months x $10 per share). In addition, if the value of these shares at the end of month 5 ($7 per share) does not change, the entity will recognize a loss of $210 (10 shares x 7 months x ($10 - $7)).

  We believe it is important for investors to be aware of the current value of future consideration receivable, especially when that value indicates a loss.

- We recommend that the Standard or its basis for conclusions be updated to state that fair value should be measured without regard to vesting contingency / probability of performance, i.e. not based on the provisions of ASC 820. Currently ASC606-10-15-3A refers to the "estimated fair value" which can in practice be implied to refer to the fair value as defined in ASC 820, especially as it relates to financial instruments.

In summary, we are happy to have a few less derivatives to worry about. Thank you.

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We would be pleased to discuss our comments with the FASB or its staff at your convenience.

Sincerely,

Josh Paul
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Institute of Management Accountants
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