FASB | IASB Education Meeting

September 29, 2023

Definition of a Derivative

Background

- As part of the June 2021 Invitation to Comment, *Agenda Consultation*, the Board asked the following question to stakeholders:
  - What challenges, if any, are there in applying the guidance on the definition of a derivative and the related derivative scope exceptions in Subtopic 815-10? Please explain the challenges and whether and how they could be addressed through standard setting.
- The Board received feedback from 28 stakeholders on this question:

Type of Stakeholder	Number of Respondents
Investors and Other Financial Statement Users	0
Practitioners	14
Preparers	6
State CPA Societies	4
Trade Groups	4
Total Respondents	28

Stakeholder Feedback

- The definition of a derivative often captures transactions that, some stakeholders state, were not originally intended to be accounted for as derivative instruments.
- Stakeholders identified the following examples of arrangements (or components of arrangements) that generally meet the definition of a derivative:
  - R&D funding arrangements
  - ESG-linked financial instruments
  - Litigation funding arrangements
  - Certain variable consideration provisions in revenue arrangements.
- In some cases, derivative scope exceptions do not exist (or may not be directly on point), creating practical application and interpretative challenges that result in diversity in practice.
- Stakeholders also provided feedback on the bifurcation criteria for embedded derivatives and derivative contract modifications.
- The Definition of a Derivative project on the research agenda is intended to further research this feedback.

Definition of a Derivative Research Project

Project Objective:

- Consider potential refinements to the scope of Topic 815, *Derivatives and Hedging*, including certain aspects of the definition of a derivative and derivative scope exceptions, and the application to certain arrangements.
- Consider whether to address related areas such as the bifurcation criteria for an embedded derivative and the accounting for derivative contract modifications.

Current Guidance:

- Companies must evaluate whether an arrangement as a whole meets the definition of a derivative (or has an embedded feature that meets the definition of a derivative).
- If it does, companies must evaluate whether the arrangement (or embedded feature) qualifies for any of the derivative scope exceptions.
- Derivative definition criteria:
  1. It has (a) underlying and (b) notional or payment provisions.
  2. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
  3. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

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R&D Funding Arrangements

- R&D can be both time-consuming and costly.
  - Pharmaceutical companies reduce research costs by (a) outsourcing research to external partners, (b) acquiring promising products in preclinical and clinical-stage development, or (c) entering into various funding relationships through collaborations, licensing arrangements, partnerships, funding arrangements, etc.
- Three broad types of R&D arrangements:
  - **R&D Funding**

    Passive third-party investors (e.g., private equity firms) provide funds to offset the cost of R&D activities in exchange for milestone payments or other forms of consideration (such as sales-based royalties) that are contingent on the successful completion of such R&D projects.
  - **Licensing**

    A pharmaceutical company acquires (or licenses) intellectual property rights from another pharmaceutical company needed to pursue the development and commercialization of a drug candidate. Those arrangements may require initial/annual license fees, subsequent contingent payments such as milestone-based payments, and/or sales-based royalties.
  - **Collaborative Arrangements**

    Two pharmaceutical companies enter into a collaborative arrangement to jointly perform R&D activities to develop and commercialize drug candidates in an effort to share in both the costs and risks associated with such activities. In collaborations, the parties may allocate responsibility for individual activities to each other or share the responsibility for one or more activities under a joint operating arrangement. The participants may share in the profits or losses associated with these joint activities.
- Accounting for R&D arrangements as derivatives depends on the facts and circumstances.

ESG-Linked Financial Instruments

- A variety of financial instruments that are linked to sustainability initiatives, indices, or targets exist. They can be broadly categorized into the following types:
  - **Use of Proceeds Bonds/Loans**: Financial instruments in which the proceeds will be exclusively applied to eligible environmental and social projects.

    Example: A green bond in which proceeds are used for a renewable energy project.
  - **Sustainability-Linked Bonds/Loans**: Financial instruments for which the financial characteristics (i.e., coupon, maturity, repayment amount) can vary depending on whether the issuer achieves predefined ESG objectives.

    Example: A sustainability-linked bond whose interest rate increases if the issuer fails to achieve a greenhouse gas emission target.
- Most of the questions raised by stakeholders are related to sustainability-linked bonds/loans. The terms and features of these bonds/loans can vary, and the types and number of ESG targets can be specific to the issuer.
- Stakeholders noted challenges determining whether ESG-related provisions within financial instruments are required to be bifurcated and separately accounted for as stand-alone derivatives.
- Certain stakeholders noted that if bifurcation is required, estimating the fair value of ESG-linked features requires significant judgment, and the fair value of these features may not provide decision-useful information to investors.

Other Arrangements

Litigation Funding Arrangements

- A litigation funding arrangement is a contract between an investor and a litigant where an investor agrees to fund some or all of the litigation expenses (e.g., legal fees) in exchange for a share of the proceeds recovered from the resolution of a dispute.
- In litigation funding arrangements, contract payoff could be based on monetary compensation received as a result of litigation.
- Stakeholders noted that litigation funding arrangements could meet the definition of a derivative and they expressed concern that initial and subsequent measurement at fair value may not best reflect the economics of those contracts.

Variable Consideration Provisions in Revenue Arrangements

- Revenue arrangements with variable consideration provisions may require payment contingent on the occurrence or nonoccurrence of a future event.
- Stakeholders noted that the interaction between the application of variable consideration guidance in Topic 606 and the derivatives guidance, or navigation of that guidance may not always be clear.
- Stakeholders noted that certain variable consideration provisions could meet the definition of a derivative.

Potential Solutions Being Considered

- The following potential solutions are being considered:
  - Create a new characteristic-based derivative scope exception to capture:
    - Nonfinancial variables specific to a party to the contract (similar to IFRS 9),
    - The occurrence or nonoccurrence of an event based on the operations or activities of one of the parties to the contract, or
    - Underlyings based on financial statement metrics and the occurrence or nonoccurrence of an event that is specific to a party to the contract.
  - Create new targeted derivative scope exceptions for specific arrangements (e.g., R&D funding arrangements and ESG-linked financial instruments)
- The staff plans to come back to the Board in Q4 2023