Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: +1 212 773 3000
ey.com

Ms. Susan M. Cosper
Technical Director
File Reference No. 2019-400
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

18 April 2019

Re: Proposed Accounting Standards Update, *Compensation — Stock Compensation (Topic 718) and Revenue from Contracts with Customers: Codification Improvements — Share-Based Consideration Payable to a Customer* (File Reference No. 2019-400)

Dear Ms. Cosper:

We appreciate the opportunity to comment on the proposed Accounting Standards Update (ASU) issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's proposal and believe it would reduce potential diversity in practice and prevent additional diversity from arising by requiring entities to measure and classify share-based payments to a customer in conjunction with selling goods or services by applying the guidance in Accounting Standards Codification (ASC or Codification) 718.

However, we have identified several areas where we believe the Board should provide more clarity. Our recommendations are described in detail below.

We also recommend that the FASB expand the scope of any final guidance to clarify in ASC 705-20, *Cost of Sales and Services — Accounting for Consideration Received from a Vendor*, that an entity that receives a share-based payment award from a vendor in conjunction with a purchase of goods or services should look to ASC 718 to initially measure that award. We discuss this recommendation regarding the scope of the proposal in more detail below.

Variable consideration

We recommend that the Board specify in any final guidance that an entity would first be required to apply the variable consideration measurement guidance under ASC 606, *Revenue from Contracts with Customers*, if, under the contract, the number of equity instruments expected to vest is variable due to a service and/or performance condition (e.g., the number is dependent on the volume or amount of goods or services sold to the customer). That is, entities would apply the variable consideration measurement guidance under ASC 606 to estimate the number of shares to be issued under the contract. That number would be multiplied by the grant-date fair value determined under ASC 718 to arrive at the amount to be reflected as a reduction of the transaction price and, therefore, revenue.

We believe that when a contract includes variable consideration, the entity is required to update its estimate of the number of shares that should be used to determine the reduction of the transaction price throughout the term of the contract to depict conditions that exist at each reporting date. This will involve updating the estimate of variable consideration (including any amounts that are constrained) to reflect the entity's revised expectations about the number of shares to be issued under the contract and, therefore, the amount of consideration to which it expects to be entitled. In updating the estimate, the entity would consider whether any uncertainties have been resolved, along with new information about any other uncertainties.

We believe this approach is consistent with the Board's intent. However, if this clarification is not made, we believe that diversity in practice could develop. For example, an entity may determine it is appropriate to reduce the transaction price and, therefore, revenue by the fair value of all equity instruments granted under ASC 718, ignoring the variability in the number of equity instruments expected to vest due to the related service and/or performance condition. We do not believe it is appropriate for an entity to reduce its transaction price and, therefore, revenue by the fair value of all equity instruments to which a customer may be entitled without considering whether the service and/or performance conditions are expected to be met. This approach would result in an increase in revenue when the equity instruments expire without vesting and would not be consistent with the principles for revenue recognition under ASC 606.

We recommend that the Board revise the proposed paragraph ASC 606-10-32-25A to (added text is underlined):

Equity instruments granted by an entity in conjunction with selling goods or services shall be measured and classified under Topic 718 on stock compensation. If the number of equity instruments promised in a contract is variable due to a service and/or performance condition, an entity shall estimate the number of equity instruments to which the entity will be obligated to issue its customer and update the estimate throughout the term of the contract in accordance with the variable consideration measurement guidance in paragraphs 606-10-32-5 through 32-14. The equity instrument shall be measured at the grant date in accordance with Topic 718 (for both equity-classified and liability-classified share-based payments). Changes in the measurement of the equity instrument (through the application of Topic 718) after the grant date that are due to the form of the consideration are not included in the transaction price. Any changes due to the form of the consideration shall be reflected elsewhere in the grantor's income statement.

Contract modifications

We recommend that the Board specify which guidance should be applied when the share-based consideration payable to the customer under a contract is modified. We believe an entity should first apply the modification guidance under ASC 606 to determine the type of modification because the consideration results from a contract that is accounted for under ASC 606.

When a modification to a service and/or performance condition affects the number of equity instruments expected to vest, the entity would have to apply the variable consideration measurement guidance in ASC 606 to determine the change in quantity of the equity instruments it expects to issue to the customer.

To measure the effect of the modification, the entity would apply the modification guidance in ASC 718 to measure the incremental change in fair value of the instrument, if any, resulting from the modification. The entity would then recognize the incremental value of the instrument, if any, following the modification guidance under ASC 606, which ultimately determines the timing of recognition. We believe this approach is consistent with the Board's intent; however, if this clarification is not made, we believe diversity in practice could develop.

Consider a service contract whereby Company A grants shares to Customer B as a sales incentive to enter into the arrangement. The shares cliff vest upon completion of the service. During the contract period, Company A's share price declines significantly. To continue to incentivize Customer B, Company A agrees to modify the contract to grant additional shares to Customer B. Assume that Company A has determined that this modification does not represent a separate contract under ASC 606, as the modification is not for additional goods or services, and the remaining services to be delivered under the contract are not distinct.

Company A measures the effect of the modification under ASC 718-20-35-3 by comparing the modification date fair value of the equity instruments issued to the customer under the modified contract to the modification date fair value of the equity instruments under the original contract. Because the fair value of the equity instruments increased as a result of the modification, the incremental value would be recognized as a reduction of the transaction price. Following the contract modification guidance in ASC 606-10-25-13(b), Company A recognizes the effect on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, as an adjustment to revenue at the date of the transaction. The adjustment to revenue made on a cumulative catch-up basis following the modification guidance in ASC 606 is different than the timing of recognition following the modification guidance in ASC 718, which is generally accounted for on a prospective basis.

Intrinsic value

We recommend that the Board specify that when a nonpublic entity applies the intrinsic value policy election and subsequently accounts for liability-classified awards issued as consideration payable to a customer, it will remeasure the award at the higher of the intrinsic value and the grant-date fair value until the award is ultimately settled.

We do not believe it would be appropriate for a nonpublic entity to measure liability-classified awards issued at fair value at the grant date and then immediately switch its measurement approach to use intrinsic value to subsequently measure its awards each financial reporting date. This would allow a nonpublic entity to recognize income solely because it changed its measurement approach. We recommend that the Board allow nonpublic entities to apply the intrinsic value approach only if the intrinsic value of the award exceeds the grant-date fair value. We believe this is consistent with the Board's intent of providing the intrinsic value accounting election to minimize nonpublic entities' costs of applying the standard by not requiring them to remeasure their liabilities at fair value.

We recommend that the Board revise the proposed paragraph ASC 718-30-30-2 to (added text is underlined):

A nonpublic entity shall make a policy decision of whether to measure all of its liabilities incurred under share-based payment arrangements (for employee and nonemployee awards) issued in exchange for distinct goods or services at fair value or to measure all such liabilities at intrinsic value. However, a nonpublic entity also shall measure awards determined to be consideration payable to a customer (as described in paragraph 606-10-32-25A) at fair value at the grant date. Subsequently, a nonpublic entity that applies the intrinsic value accounting policy will measure the award at the higher of the intrinsic value and the grant-date fair value until the award is ultimately settled.

Attribution method

The proposed guidance in ASC 606-10-32-25A states that changes in the measurement of an equity instrument through the application of ASC 718 after the grant date that are due to the form of the consideration (e.g., a liability-classified award) are not included in the transaction price and are recognized elsewhere in the income statement. However, ASC 718 does not specify the attribution for such changes in measurement. Therefore, we recommend that the Board specify the attribution model that an entity should apply when remeasuring a liability-classified equity instrument in accordance with ASC 718. We believe an entity should be required to recognize the change in fair value only for the portion of the equity instrument that has been recognized as a reduction of the transaction price under ASC 606 and a liability under ASC 718. We believe this approach is consistent with the Board's intent and would reasonably align the recognition of the change in fair value with the recognition of the grant-date fair value in revenue; however, if this clarification is not made, we believe diversity in practice could develop.

We recommend that the Board revise the proposed paragraph ASC 606-10-32-25A to (added text is underlined):

Equity instruments granted by an entity in conjunction with selling goods or services shall be measured and classified under Topic 718 on stock compensation. The equity instrument shall be measured at the grant date in accordance with Topic 718 (for both equity-classified and liability-classified share-based payments). Changes in the measurement of the equity instrument (through the application of Topic 718) after the grant date that are due to the form of the consideration are not included in the transaction price. Any changes due to the form of the consideration shall be reflected elsewhere in the grantor's income statement and should be recognized only for the portion of the equity instrument that has been recognized as a reduction of the transaction price and, therefore, revenue under ASC 606.

Transition

We recommend the Board clarify the transition approach by stating when the cumulative-effect adjustment should be recorded to retained earnings. Further, we note that entities were allowed to adopt ASU 2018-07, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting,* in an interim period. Therefore, we recommend that the Board revise the proposed paragraph ASC 718-10-65-15(b) to (added text is <u>underlined</u>):

An entity that has adopted the pending content that links to paragraph 718-10-65-11 shall apply both of the following:

1. The pending content that links to this paragraph in the first reporting period beginning after [date to be inserted after exposure], including interim periods within those fiscal years

2. The pending content that links to this paragraph retrospectively to all relevant prior periods beginning with the fiscal year <u>(or interim period, if early adopted)</u> in which the pending content that links to paragraph 718-10-65-11 was initially applied through a cumulative-effect adjustment to retained earnings <u>recorded as of the beginning of the period this Update is adopted</u>

We also recommend that the Board revise paragraph BC18 in the Basis for Conclusions accordingly.

Further, if this proposal is allowed to be early adopted in an interim period, we recommend that the Board specify whether the cumulative-effect adjustment noted in ASC 718-10-65-15(b)(2) should be recorded as of the beginning of the interim period or as of the beginning of the annual period of adoption. Without this clarification from the Board, we believe there could be diversity in practice. That is, some entities might record the adjustment at the beginning of an interim period, and others may record the adjustment at the beginning of the annual period of adoption.

We recommend that the transition guidance address share-based payments issued to a customer after an entity adopts ASC 606 but before it adopts ASU 2018-07. While ASC 606 amended the nonemployee guidance in ASC 505-50, *Equity — Equity-Based Payments to Non-Employees*, the new guidance is not explicit on how to account for share-based payments issued to a customer under ASC 606. Therefore, we believe it would be appropriate to apply the new guidance when the entity first applies ASC 606.

Under this approach, an entity that has not adopted ASC 606 would adopt this guidance at the time it adopts ASC 606. An entity that has already adopted ASC 606 would calculate its cumulative-effect adjustment to retained earnings as if it had applied the guidance retrospectively to all periods that ASC 606 has been applied.

Disclosure

We recommend that the Board specify which disclosure requirements would apply to any final guidance. We believe that an entity should consider the relevant disclosure requirements in both ASC 606 and ASC 718 because the consideration is being paid as part of a contract with a customer in the scope of ASC 606 and it is in the form of a share-based payment.

ASC 718-10-50-1 states that an entity with share-based payment arrangements should annually provide disclosures that allow users of the financial statements to understand (1) the nature and terms of such arrangements that existed during the period, and the potential effects of those arrangements on shareholders, (2) the effect of compensation cost arising from share-based payment arrangements on the income statement, (3) the method it uses to estimate the fair value of the equity instruments granted (or offered) during the period, and (4) the cash flow effects of share-based payment arrangements. We believe these disclosures would be required even when that share-based payment is consideration payable to a customer, to the extent material.

ASC 606-10-50-1 requires qualitative disclosure about significant judgments, and changes in the judgments, made in determining the timing of satisfaction of performance obligations, the transaction price and amounts allocated to performance obligations, including methods, inputs and assumptions used to estimate variable consideration, adjust consideration for the effects of the time value of money, measure noncash consideration and apply the constraint. We believe that when the number of shares to be issued to a customer is variable, an entity would be required to disclose the significant judgments it made to determine the number of shares that would be issued to a customer and, therefore, would be reflected as a reduction of the transaction price, if the amount is material.

Scope of the proposal

We recommend that the Board expand the scope of the proposal to specify how entities that receive a share-based payment award from a vendor under ASC 705-20 should measure that award. We believe there should be symmetry in the initial measurement by vendors and customers. That is, the proposal should specify that entities that receive a share-based payment award from a vendor under ASC 705-20 should look to ASC 718 to initially measure that award. We recommend that the Board also clarify that the instrument would be measured subsequent to vesting by reference to other applicable US GAAP.

We recommend that the Board amend ASC 705-20-25-1 as follows to align the guidance in Subtopic 705-20 with the guidance in ASC 606-10-32-35 (added text is <u>underlined</u>):

Consideration from a vendor includes cash amounts that an entity receives or expects to receive from a vendor (or from other parties that sell the goods or services to the vendor). Consideration from a vendor also includes credit or other items (for example, a coupon or voucher) that the entity can apply against amounts owed to the vendor (or to other parties that sell the goods or services to the vendor). <u>Consideration from a vendor also includes equity instruments granted in conjunction with selling goods or services (for example, shares, share options or other equity instruments).</u> The entity shall account for consideration from a vendor as a reduction of the purchase price of the goods or services acquired from the vendor unless the consideration from the vendor is one of the following:

a. In exchange for a distinct good or service (as described in paragraphs 606-10-25-19 through 25-22) that the entity transfers to the vendor

b. A reimbursement of costs incurred by the entity to sell the vendor's products

c. Consideration for sales incentives offered to customers by manufacturers.

The equity instrument shall be measured at the grant date in accordance with Topic 718 and shall be recognized pursuant to this Topic in the same manner as if the vendor had paid cash. Subsequent to vesting, the measurement guidance applicable to the instrument shall be determined by reference to other applicable US GAAP. Changes in the measurement of the instrument after the vesting date are not recognized as a reduction of cost of sales.

Further, we recommend that the Board add a separate paragraph to ASC 705-20 similar to the following:

ASC 705-20-25-10A — A rebate in the form of equity instruments of a vendor that is consideration payable pursuant to a binding arrangement to purchase goods or services from the vendor shall be measured under Topic 718 on stock compensation. The equity instrument shall be measured at the grant date in accordance with Topic 718 and shall be recognized pursuant to this Topic in the same manner as if the vendor had paid cash for the rebate. Subsequent to vesting, the measurement guidance applicable to the instrument shall be determined by reference to other applicable US GAAP. Changes in the measurement of the instrument after the vesting date are not recognized as a reduction of cost of sales.

* * * * *

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

Very truly yours,

Ernst + Young LLP