



# Snapshot

NOVEMBER 11, 2025

SNAPSHOT 2025-12

## Derivatives scope refinements

The FASB issued ASU 2025-07 to address two discrete issues:

- (1) The application of derivative accounting to contracts with an underlying based on the operations or activities of one of the parties to the contract; and
- (2) The diversity in accounting for share-based noncash consideration from a customer for the transfer of goods or services.

This Snapshot summarizes the amendments in the ASU related to the first issue. For more on the amendments related to share-based payments from a customer, please see [Snapshot 2025-13](#).

### Background

ASC 815, *Derivatives and Hedging*, defines a “derivative” as a contract that meets all of the following criteria:

- The contract has one or more underlyings.
- The contract has one or more notional amounts or payment provisions or both.
- The contract requires no initial net investment or an initial net investment that is smaller than would be necessary to enter into a contract that would have a similar response to changes in market factors.
- The contract can be net-settled contractually or through a market mechanism or by delivery of an asset that is readily convertible into cash.

Under ASC 815, entities must initially, and then subsequently, measure freestanding derivatives and certain derivatives embedded in a hybrid instrument at fair value, with changes in fair value recognized in earnings.

The definition of a derivative is broad and can apply to a wide variety of contracts. To narrow its application, the FASB has provided an extensive list of scope exceptions, many of them narrowly tailored to address specific types of contracts. However, in feedback received from the FASB’s 2021 Invitation to Comment, *Agenda Consultation*, stakeholders indicated that challenges exist in determining whether certain contracts are eligible for these scope exceptions, including debt arrangements with interest payments that vary based on environmental, social, and governance (ESG)-linked metrics, research and development (R&D) funding arrangements, and litigation funding arrangements.

As a result, the amendments in ASU 2025-07 exclude from the scope of ASC 815 non-exchange-traded contracts with underlyings based on operations or activities specific to one of the parties to the contract (the “operations or activities scope exception”).

## Scope

The new, principles-based operations or activities scope exception, which applies to certain non-exchange-traded contracts with underlyings that are based on operations or activities specific to one of the parties to the contract, does not apply to any of the following:

- Underlyings based on a market rate, market price, or market index
- Underlyings based on the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract
- Contracts involving the issuer’s own equity that are subject to the guidance in ASC 815-40, *Contracts in Entity’s Own Equity*
- Call options and put options on debt instruments

For purposes of evaluating whether a contract or an embedded feature is eligible for the operations or activities scope exception, the term *party to the contract* includes the parent, subsidiaries, or other entities consolidated by the parent for both consolidated financial statements and the standalone financial statements of individual entities within the consolidated group.



### ASC 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:

...

- e. An underlying that is based on operations or activities specific to one of the parties to the contract. This scope exception applies to underlyings based on the financial operating results (or components of those results) of one of the parties to the contract. This scope exception also applies to underlyings based on the occurrence or nonoccurrence of an event specific to the operations or activities of one of the parties to the contract (such as obtaining regulatory approval, achieving a product development milestone, or achieving a greenhouse gas emissions reduction 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 any of the following:
  1. Underlyings that are based on a market rate, market price, or market index (including those in paragraph 815-10-15-88(a) through (f)). (See Example 14A—Case F [paragraph 815-10-55-143K] and Case I [paragraphs 815-10-55-143P through 55-143Q] that illustrate the application of this exclusion to the scope exception.)
  2. Underlyings that are based on the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract. For example, the scope exception does not apply to underlyings based on (i) a rate of return or a default rate on a pool of loans held by one of the parties to the contract or (ii) the occurrence or nonoccurrence of an event of default or other credit event by a borrower (or reference entity) on a loan held by one of the parties to the contract. (See Example 14A—

Case J [paragraphs 815-10-55-143R through 55-143S] that illustrates the application of this exclusion to the scope exception.)

3. Contracts involving an entity's own equity that are subject to paragraph 815-10-15-74(a) and Subtopic 815-40.
4. Call options and put options on debt instruments that are subject to paragraphs 815-15-25-41 through 25-43.

Solely for purposes of applying the scope exception in (e), the term *party to the contract* includes the parent, subsidiaries, or other entities consolidated by the parent for both consolidated financial statements and the standalone financial statements of individual entities within the consolidated group.

The operations or activities scope exception applies equally to freestanding contracts and to embedded features in hybrid instruments being analyzed for bifurcation under Subtopic 815-15, *Embedded Derivatives*.

### ***Operations or activities specific to one of the parties to the contract***

Underlyings based on *operations specific to one of the parties to the contract* include those based on the financial operating results (or on the components of those results) of one of the parties to the contract. Examples of financial operating results (or components of those results) include, but are not limited to, the following:

- Earnings before interest, taxes, depreciation, and amortization (EBITDA)
- Net income
- Total expenses



### **Grant Thornton insight: Underlyings based on income statement metrics linked to financial assets and financial liabilities**

In Paragraph 24 of the Basis for Conclusions (BC24) in ASU 2025-07, the FASB addressed whether income statement metrics linked to financial assets and financial liabilities, such as interest income, interest expense, and credit losses, are underlyings based on the performance of financial assets or financial liabilities and are, therefore, ineligible for the scope exception. The FASB indicated that underlyings based on many financial statement metrics will qualify for the scope exception, but that the determination will be a matter of judgment, similar to the application of the scope exception for specified volumes of sales or service revenues of one of the parties to the contract in ASC 815-10-15-59(d).

The amendments also provide the following nonexclusive examples of underlyings other than financial operating results that are linked to the operations of one of the parties to the contract:

- Obtaining or failing to obtain regulatory approval
- Achieving or failing to achieve a product development milestone
- Achieving or failing to achieve a greenhouse gas emissions target

The amendments further specify that a reporting entity does not need to consider whether the outcome of an operation or activity is within its control when determining whether the operation or activity is specific to one of the parties to the contract. Accordingly, the key determinant is whether the underlying is linked to an *operation or activity of the entity*, not whether the *outcome* is controlled by the entity.



#### Grant Thornton insight: Outcomes outside an entity's control

The amendments in ASU 2025-07 include several new examples (Example 14A, Cases A through J) that illustrate how the operations and activities scope exception applies to various fact patterns. Cases A and B address R&D funding arrangements where one of the underlyings to the contract is regulatory approval. Both cases emphasize the fact that regulatory approval, which is outside the control of the entity, does not impact the underlying's qualification for the operations or activities scope exception, because the referenced regulatory approval relates to an operation or activity of the entity—that is, a drug being developed by the entity.

### Exclusions from the exception

While the operations or activities scope exception is founded on a principle—contracts with underlyings based on the operations or activities of one of the parties to the contract should not be accounted for as derivatives—the FASB determined that this principle might exclude certain contracts or embedded features from derivative accounting that are commonly recognized as derivatives or those for which a scope exception already exists. Therefore, the FASB provided several rule-based exclusions from the new principle-based scope exception.

#### Underlying based on a market rate, price, or index

Underlying based on a market rate, market price, or market index are excluded from the operations or activities scope exception. While the amendments do not define the terms *market rate*, *market price*, and *market index*, the amendments point to the existing guidance in ASC 815-10-15-88, which lists several examples of market rates, prices, and indices

- A security price or security price index
- A commodity price or commodity price index
- An interest rate or interest rate index
- A credit rating or credit index
- An exchange rate or exchange rate index
- An insurance index or catastrophe loss index

In BC22 of ASU 2025-07, the FASB points out that a similar exclusion related to market prices already exists for underlyings based on specified volumes of sales or services revenues in ASC 815-10-15-59(d). That is, underlyings based on changes in sales or service revenues attributable to changes in market prices, as opposed to the volume of goods or services sold, are ineligible for the derivative scope exception in ASC 815-10-15-59(d).

An entity may need to apply judgment to determine if an underlying constitutes a market rate, price, or index.

Some contracts have underlyings based on a combination of variables that includes a market rate, price, or index. BC22 of ASU 2025-07 emphasizes that the exclusion of contracts with underlyings based on a market rate, market price, or market index from the operations or activities scope exception does not preclude an entity from

applying the scope exception to payment provisions that are based on a combination of variables rather than solely on a market price index.

### Underlyings based on the price or performance of a financial asset or liability

Underlyings based on the price or performance of a financial asset or financial liability of one of the parties to the contract are excluded from the operations or activities scope exception. For example, a guarantee contract such as a credit default swap in which the payoff depends on the performance of a financial asset or financial liability of one of the parties to the contract would not be eligible for the operations or activities scope exception.

This exclusion applies to *underlyings* in a contract and does not preclude a contract that meets the definition of a *financial asset* or *financial liability* from qualifying for the scope exception. For example, a litigation funding arrangement with a contingent payment provision may meet the definition of a financial asset and yet qualify for the operations or activities scope exception because the underlying is based on the occurrence of a successful litigation outcome (that is, an activity of one of the parties to the contract) rather than on the price or performance of that financial asset.

### Contracts involving an entity's own equity

Contracts involving an entity's own equity are subject to the existing derivative scope exception guidance in ASC 815-10-15-74 and in ASC 815-40. Accordingly, the FASB also chose to exclude those contracts from the operations or activities scope exception.

### Put and call options on debt instruments

Put and call options on debt instruments are subject to the existing guidance in ASC 815-15-25-41 through 25-43 for determining whether a put or call option embedded in a hybrid debt instrument is clearly and closely related to the host contract and thereby exempted from derivative accounting. Accordingly, the FASB chose to exclude those options from the operations or activities scope exception.

### Contracts with multiple underlyings

In addition to the operations or activities scope exception, the existing guidance in ASC 815-10-15-59 provides several other exceptions from derivative accounting for non-exchange-traded contracts if the contract's underlying is based on any of the following:

- A climatic or geological variable or other physical variable
- The price or value of a nonfinancial asset of one of the parties to the contract that meets certain criteria
- The fair value of a nonfinancial liability of one of the parties to the contract, provided the liability does not require delivery of an asset that is readily convertible into cash
- Specified volumes of sales or service revenues of one of the parties to the contract

Some contracts have multiple underlyings where only some of them qualify for the scope exceptions in ASC 815-10-15-59. Such contracts are not eligible for these scope exceptions if all of the 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.

**ASC 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 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.

The guidance regarding contracts with multiple underlyings is applied even if the contract's underlyings are related to contingent events. Such contracts should be reassessed, however, when the contingencies are resolved.

**Grant Thornton insight: Contracts with multiple underlyings**

BC29 of ASU 2025-07 provides examples of contracts with two underlyings where one of the underlyings is a contingency that qualifies for a scope exception in ASC 815-10-15-59 and the other does not qualify for those scope exceptions.

***Deal-contingent interest rate swaps***

For instance, *deal-contingent interest rate swaps* have two underlyings: an interest rate and the occurrence or nonoccurrence of a qualifying financing transaction. The underlying related to a qualifying financing transaction may qualify for the operations or activities scope exception while the interest rate underlying does not.

***ESG-linked interest rate swaps***

In addition, *ESG-linked interest rate swaps* also have two underlyings: an interest rate and either meeting or failing to meet an ESG-based metric. The underlying related to the ESG-based metric may qualify for the operations or activities scope exception while the interest rate underlying does not.

If either of these types of contracts are not accounted for as derivatives at contract inception due to the operations or activities scope exception, they must be reassessed after the resolution of the contingency related to the underlying that qualifies under that exception.

## Subsequent accounting

The operations or activities scope exception will impact both freestanding contracts evaluated in their entirety for derivative accounting under Subtopic 815-10 as well as features embedded in a hybrid instrument evaluated for bifurcation under Subtopic 815-15.

***Freestanding contracts***

The operations or activities scope exception will result in certain freestanding contracts that were previously accounted for as derivatives being scoped out of ASC 815. As such, entities will need to identify and apply other relevant GAAP to these contracts. The amendments in ASU 2025-07 do not specify which GAAP might apply, though the FASB did indicate in BC16 that they believe other guidance exists to address these contracts.

Examples of freestanding contracts that may have previously been accounted for as derivatives but may now qualify for the operations or activities scope exception include the following:

- R&D funding arrangements
- Litigation funding arrangements
- Contingent consideration in asset acquisitions

### ***Embedded features***

The operations or activities scope exception will also result in certain embedded features that were previously separated from host contracts and accounted for as freestanding derivatives being scoped out of ASC 815. As a result, those features will not be accounted for separately from the host contract, and their impact on the host contract will generally be recognized when the feature is triggered or exercised.

An example of an embedded feature that may have previously been accounted for as a derivative but may now qualify for the operations or activities scope exception is a contingent interest feature linked to certain ESG-metrics in an entity's issued debt obligations.

## **Effective date and transition**

The amendments in ASU 2025-07 related to the derivative scope refinements are effective for all entities for annual reporting periods, including interim reporting periods within those annual reporting periods, beginning after December 15, 2026. Early adoption is permitted in interim and annual reporting periods if the financial statements have not been issued or made available for issuance.

An entity is permitted to apply the amendments in ASU 2025-07 either (1) prospectively to new contracts entered into on or after the date of adoption, or (2) on a modified retrospective basis through a cumulative-effect adjustment made to the opening balance of retained earnings as of the beginning of the annual reporting period of adoption for contracts existing as of the beginning of that annual reporting period.

Under the modified retrospective transition method, an entity may elect, on an instrument-by-instrument basis, to measure at fair value, with changes in fair value recognized in earnings, both (1) contracts that previously qualified as derivatives but no longer qualify as derivatives, and (2) contracts with bifurcated embedded derivatives that are no longer accounted for as derivatives due to the adoption of the amendments. Also under the modified retrospective transition method, an entity may elect, on an instrument-by-instrument basis, to stop applying the fair value option to contracts with embedded features that would have been, but are no longer, accounted for as derivatives because they qualify for the operations or activities scope exception.

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