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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**22 June 2006, London (IASB)** **20 June 2006, Norwalk, Connecticut (FASB)**
Project:	**Conceptual Framework**
Subject:	**Elements 5: Asset Definition (IV) & Liability Definition (III): Application of the working definitions to certain contracts—a forward contract and an entity's own shares (Agenda Paper 7)**

Introduction

1. During the April 2006 joint meeting, Board members discussed the following working definitions of an asset and a liability:

   An *asset* is a present economic resource of an entity.

   An asset of an entity has three essential characteristics:

   a. There is an underlying economic resource.
   b. The entity has rights or other privileged access to the economic resource.
   c. The economic resource and the rights or other privileged access both exist at the financial statement date.

   A *liability* is a present economic obligation of an entity.

   A liability of an entity has three essential characteristics:

   a. The obligation is economic—it requires the entity to provide or stand ready to provide its economic resources to others, or to forgo economic resources that it might otherwise be able to obtain.

b. The entity is obligated to others to act or perform in a certain way (or refrain from acting or performing).

c. The economic obligation and the legal enforceability (or its equivalent) both exist at the financial statement date.

2. During those discussions several concerns were raised, including:

a. The need for a better understanding of what constitutes an *economic resource*. (The discussion for this and the next concern focused on a contract to acquire corn at a future date as an example).

b. The question of whether the asset is the economic resource or the right.

c. The contention that the proposed definition of an asset would result in an entity's own shares being an asset. Board members objected to this conclusion and requested that staff consider the need to modify the definition to avoid this result.

3. This paper evaluates each of these concerns.[1] First, since each of the concerns arises primarily in the case of assets and liabilities established by contract, the paper reviews the essential components of a contract, as a framework for evaluation. Second, the paper then assesses each of the concerns and makes recommendations as to how they can be addressed.

4. Based on this analysis, we propose to:

a. Revise the first essential characteristic of an asset to exclude the term *underlying* (see paragraph 36).

b. Revise the corn example in the amplifying text (see paragraph 37).

c. Revise the definition of an asset[2] to state:

An *asset* is a present economic resource to which the entity has a present right or other privileged access[3] (see paragraph 38).

d. Explain that a promise with no external counter party, in the form of unissued or treasury shares (or unissued debt), constitutes neither an economic resource nor an economic burden to the entity (see paragraph 48(a)).

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1 This paper considers only certain issues arising in April. In July, we plan to consider the need for further modifications to the working definitions and essential characteristics. That will include consideration of comments as to whether the working definitions might be a little too terse, as well as the need for any technical changes.

2 In July, we will consider the need for a corresponding amendment to the definition of a liability.

3 Alternatively, we might state, "An *asset* is an entity's present right or other privileged access to an economic resource." Either way, both the "economic resource" and the "right or other privileged access" must presently exist.

e. Explain that a promise by an entity in the form of issued shares (or issued debt) constitutes an economic burden—not an economic resource (see paragraph 48(b)).

f. Explain that a contract that does not involve an inbound promise by a party external to the entity cannot constitute an economic resource of the entity (see paragraph 48(c)).

5. We request your views on the recommended solutions.

6. In July, we plan to present revised working definitions of assets and liabilities and amplifying text, together with further examples illustrating their application.

Framing the discussion—Contract Law

7. Assets and liabilities may arise from contractual promises and from promises that are not legally binding but are equivalently enforceable. Assets also may arise from property rights and as a result of other advantages such as the ability to deny others' access to resources. Because the issues that we are primarily concerned with in this paper arise mainly from contracts, this section of the paper reviews some basic principles of contract law.[4]

8. Contract law is concerned with legally binding promises. "The most popular description of a contract that can be given is also the most exact one, namely that it is a promise or set of promises which the law will enforce."[5]

9. A contract requires offer, acceptance and, in most cases, consideration (among other characteristics). The *offer* is a tentative promise made by one party, the *offeror*, subject to a condition or containing a request to another party. When the other party, the *offeree*, accepts the offer by agreeing to the condition or request, the offer is transformed into a contract. The promise is no longer tentative: the offeror (now the *promisor* or *obligor)* is bound to carry out its promise and the offeree (now the *promisee* or *obligee)* is bound to carry out the condition or request. A legally binding contract has been formed. Contracts commonly involve exchanges of promises, whereby one party agrees to an action or inaction in return

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[4] While we have referred to contract law as it exists in Canada, the United Kingdom and the United States, we understand that the basic principles on which we rely for the subsequent analysis also exist in other jurisdictions.

[5] Winfield, *Pollock's Principles of Contract* (13th ed.), p.1. London: Stevens & Sons Limited, 1950, as cited in Smyth, Soberman and Easson, *The Law and Business Administration in Canada*, Ninth Edition, Prentice Hall, 2001.

for an action or inaction by another party. In this case, each promise serves as consideration for the other promise.

10. The contract itself can be seen as consisting of three components:

    a. One or more *promises,* or required actions (or inaction) to be taken

    b. One or more *promisors* or *obligors,* the party required to undertake the action (which might be the original maker of the promise or another party if the promise has been laid off by the original maker to that other party)

    c. One or more *promisees* or *obligees,* the holder or recipient of the promise (which may be the original holder of the promise or another party if the promise has been sold or otherwise been transferred by the original promisee to that party).

11. [Paragraph omitted from Observer Notes].

12. [Paragraph omitted from Observer Notes].

13. [Paragraph omitted from Observer Notes].

Application to a Forward Contract to Buy/Sell Corn

Example

14. On April 15, 2006, a farmer contracts to sell to a canner 1,000 bushels of corn (fixed quantity of the product) on September 20, 2006 for a fixed price (equal to the market price for corn on April 15, 2006).

What Is the Economic Resource?

15. This contract results from an exchange of promises by two parties—the farmer and the canner. Each party has promised to do something for the other. The farmer has promised to sell the canner a fixed quantity of product at a fixed price on a specific date. In other words, the farmer as promisor has made a promise to the canner—the promisee. The canner has promised to buy from the farmer the fixed quantity of product at the fixed price on the specified date. In other words, the canner as promisor has made a promise to the farmer—the promisee.

16. These promises provide the promisees with economic resources. The farmer has obtained a buyer for the fixed quantity of corn at the fixed price and the canner

has obtained a supply of the fixed quantity of corn at the fixed price. The effect is similar to the farmer having the ability to put the corn to the canner and the canner having the ability to call the corn from the farmer.

17. From the farmer's perspective, the economic resource is the canner's promise to buy the corn. The farmer is connected to that resource by means of its contractual right. (From the canner's perspective, the promise to buy is an economic burden to which the canner is connected by means of its contractual obligation.)

18. From the canner's perspective, the economic resource is the farmer's promise to sell the corn. The canner is connected to that promise by means of its contractual right. (From the farmer's perspective, the promise to sell is an economic burden to which the farmer is connected by means of its contractual obligation.)

19. Those promises bring each party a step closer to generating cash inflows. The farmer has obtained a customer and is a step closer to obtaining cash for the corn. The canner has obtained a supplier and is a step closer to filling cans with corn and selling them for cash. Thus, both the farmer and the canner have economic resources, albeit different resources—separate promises that are each capable of generating cash inflows.

20. Depending on the market supply and demand for the product, the market price of the product will change. If demand increases or supply decreases, the market price of corn will go up, and the canner will be better off by having locked in a supply of corn at a lower price.[6] If demand decreases or supply increases, the market price of corn will go down, and the farmer will be better off by having locked in an outlet for corn at a higher price.[7] By fixing the price and quantity of the corn in the promises, the parties have managed their risk exposures and the promises have made them better or worse off, depending on what happens to supply and demand in the marketplace.[8]

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[6] If the market price of corn increases above the fixed price, the farmer will be worse off than would have been the case if the farmer had not entered into the contract, although the fixed price may still result in the farmer making a profit.

[7] If the market price of corn decreases below the fixed price, the canner will be worse off than would have been the case if the canner had not entered into the contract, although the fixed price may still result in the canner making a profit.

[8] Even when the contract is out-of-the-money to a particular party, that party continues to have an economic resource representing the time value of the promise. However, whether that would be accounted for separately is an issue for consideration when we discuss the unit of account at a later date.

21. Although the promises originated with the farmer and the canner, they may sell or otherwise transfer to other parties their rights to the promises that they obtained before the promises mature. Similarly, they may lay off to other parties their obligations for the promises that they incurred before the promises mature.[9] As a result, by the date the promises mature, neither of the original counterparties may still be parties to the contract, having been replaced by other parties. Nonetheless, the promises remain intact and unchanged.

22. The fact that the counterparties may change, even though the promises do not, illustrates one way that an economic resource, in the form of a contractual promise, may generate cash prior to fulfillment of the promise, that is, by sale to another party of the right to the promise.

23. Moreover, a promise might be capable of being fulfilled in more than one way. In the example, the farmer is to physically settle the contract on the due date by delivering corn. However, the farmer also might be able to net-cash settle the contract, either on the due date or prior to it, by paying the canner to compensate for any increase in the price of corn that has occurred (and possibly also for having to obtain a different source of supply).

24. In this example, the *existence* of the product—corn—is irrelevant. Whether the farmer has grown corn on hand or has yet to grow the corn does not affect the terms of the promise because the corn is not the present economic resource. The farmer's present economic resource is the promise by the canner, and the canner's present economic resource is the promise by the farmer. The terms of those promises, agreeing to buy and sell corn at a fixed price and in a fixed quantity, enable each party to derive economic benefits from the promise that it obtained.

25. Neither are the rights the economic resource. Rights are what link the economic resources—the promises—to the parties. Rights provide the entity with the means to control and benefit from the economic resource. Rights are a mechanism that society uses as a way to distinguish who is entitled to a specific resource and to facilitate exchanges of resources. In the corn example, either the farmer or canner

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9 The ability to exchange, transfer or sell the promise is not a necessary condition to be an economic resource. The promise can still be an economic resource, even if exchange, transfer, or sale of the promise is prohibited, because fulfillment of the promise can provide economic benefits. Moreover, benefits also may be transferred to other parties by means of separate contracts or by bundling the asset stemming from the promise with other assets that collectively constitute a business and selling the business.

can and may transfer its rights to some or all of the economic resource to another party. However, the economic resource remains the promise. The economic resource could become linked to other parties that buy rights from the farmer or the canner, such that different parties could now have assets. Thus, the rights themselves are not the economic resource.

26. *In this example, do you agree that the promise (rather than the corn) is the economic resource?*

Do the Farmer and the Canner Have Assets?

27. The foregoing analysis of the corn contract example indicates that the promises constitute the economic resources rather than the corn that underlies those promises. However, having concluded that the promises are the economic resources, the next question is whether the farmer and the canner have assets.

28. [Paragraph omitted from Observer Notes].

29. [Paragraph omitted from Observer Notes].

30. [Paragraph omitted from Observer Notes].

31. [Paragraph omitted from Observer Notes].

32. *In this example, do you agree that the three essential characteristics of an asset are met?*

Implications

33. The analysis of the corn contract can be extended to other contractual arrangements, since an essential element of all contracts is a promise. That promise is the economic resource.

34. This analysis also holds true in arrangements that are not legally enforceable contracts, but that are enforceable by equivalent means. For example, in the case of a self-regulatory organization, the members of that organization “promise” to abide by the rules. That promise gives rise to liabilities on the part of members that do not abide by the rules, even though such promises may only be enforceable by the self regulatory organization (and not at law).

35. This analysis is prepared from a conceptual perspective and focuses primarily on the proposed asset definition, although it has implications for the proposed liability definition as well. In this context, a binding contractual arrangement between unrelated parties in which the parties exchange promises can create assets and liabilities for each party.[10] The guidance for how such assets and liabilities are to be accounted for—recognized and measured—will be considered later in this project. Only after that guidance has been developed will one be able to determine which assets and liabilities should be reported separately in financial statements. For example, in determining the unit of account for the promises in the corn contract, should the assets and liabilities be grouped to reflect the net exposure?

Recommendations

36. In the April 2006 joint meeting discussion, the first essential characteristic of an asset of an entity was described as, "There is an <u>underlying</u> economic resource" (emphasis added). The term *underlying* was used to focus the readers' attention on the importance of an economic resource to the asset definition. However, as demonstrated in the foregoing analysis of the corn example, the term is not necessary (and, in cases like the corn example, is not appropriate) and we propose to remove it.

37. To more clearly articulate the notion of an entity's right to an economic resource, we propose to revise the corn example in the proposed amplifying text to reflect the analysis in this paper.

38. In addition, several Board members asked whether the asset was the economic resource or the right. As the analysis of the corn contract example indicates, the asset is not one or the other, but rather both. That is, for an entity to have an asset, not only must there be a present economic resource, but the entity also must have a present right or other privileged access to that resource. We acknowledge that the phrasing of the proposed definition (which explicitly referred to "a present economic resource" but made no mention of a right or other privileged access to that resource) could have given the impression that the asset was the resource. To correct that and to make clear in the definition that both are required, we propose revising the definition to state:

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[10] A unilateral promise, such as an agreement to make a non-reciprocal transfer, also would create assets and liabilities — in this case, an asset for only one party and a liability for the other party.

> An *asset* is a present economic resource to which the entity has a present right or other privileged access.[11,12]

39. *Do you agree to the revisions proposed in paragraphs 35-37, above? Do you agree that both an economic resource and a right (or other privileged access) must exist in order for an asset to be present?*

Application to an Entity's Own Shares

40. During the April 2006 joint meeting, some Board members contended that an entity's own unissued equity shares and treasury shares would meet the proposed working definition of an asset. Such shares seemingly might meet the definition because (a) issuing the shares would result in cash (or equivalent) inflows, thereby constituting an economic resource; (b) the entity possesses the shares, thereby constituting the right to that economic resource; and (c) the rights and economic resource presently exist. Thus, it seems as if the essential characteristics of an asset are met.

41. However, we think that we need to more carefully consider whether the conditions required for an asset are present in these circumstances.[13]

42. Equity shares represent a contract between the issuing entity (the promisor) and the shareholder (the promisee). The promise is to provide an ownership interest in the entity, which includes (but is not limited to) a residual interest in the net assets of the entity, a portion of any distributions to the shareholder, such as in the form of cash dividends, and voting privileges. Whether the shares in question are treasury shares or authorized shares that have not previously been issued should

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[11] Alternatively, we might state, "An *asset* is an entity's present right or other privileged access to an economic resource." Either way, both the economic resource" and the "right or other privileged access" must presently exist.

[12] In July, we will consider the need for a corresponding amendment to the definition of a liability, as well as whether any other amendments to the definitions might be necessary as a result of considering additional issues.

[13] It is interesting to note that in the legal case of *Continental Vending* [*U.S. v. Simon*, 425 F.2d 796 (2d Cir. 1969)], the Judge commented on the unsuitability of shares in Continental Vending, owned by its president being used as collateral to secure a loan by the company to the President. The Judge noted, "As men experienced in financial matters, they must have known that the one kind of property ideally unsuitable to collateralize a receivable whose collectibility was essential to avoiding an excess of current liabilities over current assets and a two-thirds reduction in capital already reduced would be securities of the very corporation whose solvency was at issue … Failure to disclose that 80% of the 'marketable securities' by which the Valley receivable was said to be 'secured' were securities of Continental was thus altogether unlike a failure to state how much collateral were bonds or stocks of General Motors and how much of U.S. Steel." This suggests that a company's own shares are not assets of that company.

not matter in economic substance—the history of how they came to be held by the entity is not relevant.

43. [Paragraph omitted from Observer Notes].

44. [Paragraph omitted from Observer Notes].

45. [Paragraph omitted from Observer Notes].[14]

46. To illustrate, assume that an entity with cash and equity of 100 issues another 50 shares (either previously authorized shares or treasury shares) at their market price of 1 per share. The entity would receive 50 of cash and convey an ownership interest in the entity equal at that time to 50. The shares are incapable of generating economic benefits without simultaneously conveying a corresponding ownership interest. All the entity can do with them is to issue them and convey a corresponding ownership interest in the entity (of course, the entity also could cancel the shares—but this clearly would not generate an economic benefit). Thus, the issued shares are not an economic resource and, hence, one of the essential characteristics of an asset is not met. In contrast, an entity can sell an asset with no strings attached—it receives cash (or other consideration), but does not also have to convey either a creditor interest or ownership interest.

47. We also note that a similar analysis holds for an entity's own unissued debt. While an entity might have a prospectus approved for the issue of debt, that does not create an asset representing the debt. There is no external party that has made a promise to the entity (there is no external promisor). The entity has prepared an offer, but has neither made that offer to external parties, nor had the offer accepted. On the issuance of the debt the entity would convey a corresponding creditor interest— there would be no net economic benefit.

Recommendations

48. We propose to explain in amplifying text that:[15]

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[14] This paper does not consider the distinction between liabilities and equity. That will be the subject of future papers. The point being made here is that there is now a complete contract—promise, promisor, and promisee— and that it is an outbound promise—hence, not an asset of the reporting entity.

[15] In July, we plan to consider whether a promise by an external party to purchase shares from an entity—for example, by subscription—can be an asset of the entity. We think that it can—although that asset is distinct from authorized but unissued, or treasury, shares.

a. A promise with no external counter party, in the form of unissued or treasury shares (or unissued debt), constitutes neither an economic resource nor an economic burden to the entity.

b. A promise by an entity in the form of issued shares (or issued debt) constitutes an economic burden—not an economic resource.

c. A contract that does not involve an inbound promise by a party external to the entity cannot constitute an economic resource of the entity.

49. *Do you agree with the staff recommendations in paragraph 48?*