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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**21 September 2006, London**
Project:	**Conceptual Framework**
Subject:	**Elements 7: Asset Definition (VI)—Options over Assets (Agenda Paper 5)**

Introduction

1. This paper considers a single cross-cutting issue identified for consideration as part of the elements phase of the conceptual framework project—what constitutes the asset when an entity holds an option over an asset. This issue is being considered at this time to ensure that Board members agree on the treatment of an option over an asset before considering the treatment of an option over an entity (in which an asset might be placed), which is considered in papers for phase D of the conceptual framework project on *Reporting Entity*, and is also being presented at the September Board meetings.

Issue

2. Cross-cutting issue EL.11, in relation to options over assets, asks:

   a. Which is controlled, the option or the underlying asset?

   b. If it is concluded that the option gives control over the underlying asset, should the entity recognize a liability to pay the exercise price? Is there an obligation prior to exercise of the option?

c. Is there asymmetry between definitions of assets and liabilities—that is, does the answer to these questions hold equally for the option writer?

3. [Paragraph omitted from Observer Notes].

Proposed conclusion

4. The staff thinks that an entity does not control (or have rights or other privileged access to) any underlying item by virtue of having an option over it. Regardless of the nature of the subject matter of the contract (the underlying item),[1] all that the entity controls is whether or not to exercise, or perhaps transfer to others, the option. Accordingly, the staff concludes that the entity controls the option, and that the other questions in the cross-cutting issue—which only apply if it is concluded that an option gives control over the subject matter of the contract—fall away.

Do Board members agree with this conclusion?

Analysis

Applying the working definition of an asset

5. In applying the essential characteristics of our working definition of an asset (as last discussed in July 2006), the staff concluded that an asset of an entity has three essential characteristics:

   a. **There is an economic resource**. In the case of an option contract, the economic resource is the promise that gives the option holder the ability to do something in the future if it so chooses—for example, to acquire something, or to take some other action—which is capable of being economically beneficial (eventually resulting in cash inflows to the entity or a reduction in cash outflows from the entity).

   b. **The entity has rights or other privileged access to the economic resource**. In the case of an option contract, the option holder has rights to the promise (the economic resource) by virtue of being a party to the contract.

[1] The cross-cutting issue refers to the subject matter of the contract as the *underlying item*. To avoid confusion with the different use of the *underlying* in standards on accounting for derivatives, the remainder of this paper refers to *the subject matter of the contract*.

c. **The economic resource and the rights or other privileged access both exist at the financial statement date**. In the case of an option contract, the existence of the contract and the entity being a party to the contract establish that the rights and the promise presently exist.

Does the nature of the subject matter of the option contract matter?

6. The analysis as to whether the option holder has an asset does not depend on the nature of the subject matter of the option contract—the thing that the option holder will acquire or otherwise be able to do if it exercises the option. The asset is the right to the promise in the option contract rather than the subject matter. An option contract provides no ability for the option holder to do anything with the subject matter, even though it might choose to buy, sell, or hold the rights to the promise in the option contract.

Does the likelihood of the option being exercised matter?

7. One might wonder whether the analysis changes for options for which performance is based on conditions virtually certain to occur or for which performance is based on conditions that would be highly remote. The question arises as to whether either of these scenarios, extreme ends of a spectrum, results in effective control of the subject matter of the option, rather than the option.

8. **Virtually certain conditions**. Consider an option to acquire/control/do something (it could be to acquire a physical asset or shares or to take an action) as long as the sun rises tomorrow morning. It is virtually certain that the sun will rise tomorrow morning.[2] However, until the sun rises, the option holder does not yet have the ability to do anything with the item to be acquired/controlled or to take the other action subject to the contract. Only once the sun rises does the option holder have that ability. Until that time, the asset is

[2] One might wonder whether the analysis changes if there is a simple condition that is within the option holders' control. For example, an entity might hold an option to acquire something from another party, merely on condition that the entity advises the option writer of its intent to exercise the option. In this case, too, the staff thinks that the asset is the promise of something by the other party (in exchange for notification), rather than the item promised. Even though the condition is within the option holder's control, and is easy to meet, the asset remains the promise until such time as the option is exercised. The option holder has no ability to do anything with the promised thing until it has taken the action to exercise the option.

the right to the promise in the option contract.[3] The option holder might be able to sell its rights under the option contract, but it cannot do anything with the subject matter of the contract. It is likely in this case that the valuation of the option contract would be very similar to the valuation of the subject matter. However, valuation does not affect whether an asset exists.

9. **Highly remote conditions**. Consider an option to acquire/control/do something if Martians abduct the U.S. president between 6 am and 8 am next Tuesday. Again, the option holder has no ability to do anything with the subject matter of the option contract. It might be able to sell the rights to the promise in the option contract. However, it cannot do anything with the subject matter. Measurement of such a contract would be incredibly small – perhaps even so small as to be insignificant for accounting purposes - but an asset exists, representing the right to the contractual promise.

10. [Paragraph omitted from Observer Notes].

The option writers' perspective

11. It is also instructive to consider the position of the option writer. Does the subject matter of the contract remain an asset of the option writer? If so, that indicates that the subject matter of the contract cannot be, at the same time, an asset of the option holder.[4]

12. Consider an option written that provides the option holder with rights to acquire a readily available asset, such as shares in a large publicly-listed company. If the value of the shares increases above the exercise price of the option contract, then, all else being equal, an economically rational option holder would exercise the option. However, until it does so the option writer continues to have the shares. The option writer might have effectively forgone any further appreciation in the value of the shares, but it has not forgone the rights to the shares themselves until the option holder exercises the option. Thus, the shares are an asset of the option writer and cannot be, simultaneously, an asset of the option holder.

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3 Indeed, even once the sun rises the option holder might not immediately be able to do anything with the subject matter of the contract. Only when the option is exercised can the option holder replace the option contract with an asset representing the subject matter of the contract.

4 The Boards concluded previously that an asset cannot be an asset of two parties at the same time (subject to clarifying the situation when there is joint tenancy).

13. Similarly, an entity might write an option for the sale of a physical asset, such as a well-known luxury hotel. As with the previous example, if the value of the hotel increases above the exercise price of the option contract, then, all else being equal, an economically rational option holder would exercise the option. However, until the option holder exercises the option, the option writer continues to have property rights to the hotel—it can continue to use the hotel, to rent bedrooms and meeting space, hold functions, etc.—the hotel remains the option writers' asset. The option writer might give up future appreciation in value of the hotel, but it has not given up the hotel itself until the option is exercised.

14. [Paragraph omitted from Observer Notes].

What about related circumstances?

15. Can one control the subject matter of the contract by virtue of a combination of factors? For example, if an entity already owns 40 percent of something and has an in-the-money option to acquire the remaining 60 percent, does that result in the entity effectively owning the asset? An entity might, for example, own a 40 percent interest in a parcel of land and have an in-the-money option to acquire the remaining 60 percent interest in that parcel.

16. In this situation, it has to be considered what assets the entity has. Consistent with the previous analysis, an option to acquire something is not the same as owning that thing. Until the entity exercises the option, it has no rights to the subject matter of the option contract. It cannot make decisions as to whether to hold or sell the subject matter. It can only make such decisions regarding the asset it has—the option contract. In the example above, the entity can make decisions about the 40 percent interest in the parcel of land that it owns—for example it might decide to sell its 40 percent interest, but with respect to the remaining 60 percent it cannot do anything until it exercises the option. It can only make decisions regarding the option contract. The assets that exist are a 40 percent ownership interest and an option to acquire the remaining 60 percent.

17. When the subject matter of a contract is shares, the asset represented by the rights to the promise in the option contract might be considered in combination with other ownership rights for purposes of defining a reporting entity (see separate Agenda Paper 5A, FASB Memorandum 32, for analysis). However,

even here, the assets that exist in the option contract do not change—they remain rights to the promise in the option contract.

Conclusions

18. It does not matter what is the subject matter of the option, or what is the likelihood of the option being exercised to assess whether an asset exists. These factors are taken into account in measurement. Related circumstances also do not change the nature of the asset. In all cases, the option holders' asset in an option contract is the right to the promise in that contract and not the subject matter.