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STAFF PAPER

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IASB meeting

Project	**Conceptual Framework**		
Paper topic	**Asset and liability definitions—executory contracts**		
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SUMMARY

1 The purpose of the meeting is to decide:

(a) whether to propose concepts for executory contracts in the *Conceptual Framework*; and

(b) if so, what concepts to propose.

2 To help the IASB reach a decision, this paper:

(a) notes the scope of the term 'executory contract' (paragraphs 4-5);

(b) explains the reasons for reviewing the concepts for executory contracts (paragraphs 6-12);

(c) analyses different views of, and reaches conclusions on:

i) the nature of the assets and liabilities in executory contracts (paragraphs 13-37);

ii) measurement of executory contract assets and liabilities (paragraphs 38-42);

(d) considers the implications for existing Standards (paragraphs 43-55);

(e) considers whether concepts developed from these conclusions would be useful (paragraphs 56-58); and

(f) summarises feedback from the Accounting Standards Advisory Forum (paragraphs 59-63).

3 The staff recommend that:

(a) the *Conceptual* Framework should include concepts explaining the nature of the assets and liabilities in executory contracts. It should state that:

i) an enforceable executory contract contains a right and an obligation to exchange economic resources (or to pay or receive the difference in values between two economic resources if the contract will be settled net). The combined right and obligation constitute a single asset or liability. (See paragraphs 14-28.)

ii) if an entity enters into a forward contract to purchase a resource at a future date, the entity's asset is normally its right to buy the underlying resource, not the underlying resource itself. However, there may be circumstances in which the terms of a forward contract to purchase a resource give the purchaser control of that resource. In such circumstances, the purchaser should identify both an asset (the underlying resource that it already controls) and a liability (its obligation to pay for the resource). In these circumstances, the contract is not executory: the seller has substantively performed its obligations. (See paragraphs 31-34.)

(b) the *Conceptual Framework* should not address specifically the measurement of executory contract assets or liabilities. Instead, the IASB should apply the general measurement concepts in the *Conceptual Framework* when specifying requirements for particular types of executory contract within the applicable Standard. Many Standards implicitly apply the same measurement bases for executory contract assets or liabilities as they specify for the assets or liabilities that arise when one of the parties subsequently performs its obligations. The result is that many executory contract assets and liabilities would be measured at zero (and hence are not recognised) unless the contract is onerous. (See paragraphs 38-42.)

THE SCOPE OF THE TERM 'EXECUTORY CONTRACT'

4 Executory contracts are defined in IFRS as:

> Contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.[1]

5 Executory contracts are not limited to contracts for the purchase or sale of non-monetary goods or services. Forward contracts for the delivery of financial assets or financial liabilities are also within the scope of the definition. These contracts are within the scope whether they will require an exchange of financial instruments, or can instead be settled net in cash or another financial instrument.

REASONS FOR REVIEWING THE CONCEPTS FOR EXECUTORY CONTRACTS

6 Executory contracts arise in many contexts because all types of contract can go through an executory phase (if the contract is created before performance is required from either party). Currently, several Standards specify requirements for particular types of executory contract. In each case, the IASB has had to consider whether the contracts give rise to assets or liabilities (or both assets *and* liabilities) that should be recognised in the financial statements and, if so, how these assets and liabilities should be measured.

7 The existing *Conceptual Framework* does not provide clear concepts to guide the IASB on these questions:

> **Recognition of liabilities**
>
> 4.46 … In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

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1 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 3.

8 For some executory contracts, no requirements are specified in the applicable Standards. For example, the IASC (the predecessor of the IASB) decided not to specify requirements for contracts for the sale of biological assets or agricultural produce.[2] If a particular Standard has no specific requirements for executory contracts, those that are onerous are within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, the IAS 37 requirements and guidance on identifying and measuring onerous contract liabilities are brief and, in the absence of robust concepts, have given rise to differing interpretations.

9 In the *Conceptual Framework* Discussion Paper, the IASB suggested that it could improve the *Conceptual Framework* by clarifying that:

(a) in principle, a net asset or a net liability arises under an executory contract if the contract is enforceable.

(b) however, if the contract was priced on arm's length terms, the initial measurement of that contract would typically be zero, because the rights of one party have the same value as its obligations to the other party. Accordingly, it is usually the case that neither party recognises a net asset or a net liability at contract inception. After contract inception, one or both parties may need to recognise its asset or liability depending on the measurement basis applied.

(c) the nature of the purchaser's rights and obligations under an executory contract may depend on the circumstances:

i) in some cases, the purchaser might have a single net right or net obligation to exchange the underlying asset and the purchase price simultaneously. Often that net right or net obligation would be measured at zero.

ii) in other cases, the purchaser might have a separate gross right to receive the asset and a separate gross obligation to pay the purchase price. In practice, such rights and obligations are sometimes offset, ie presented as a single net amount.[3]

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[2] IAS 41 *Agriculture*, Basis for Conclusions, Sales Contracts, paragraphs B47-B54

[3] Discussion Paper *A review of the Conceptual Framework for Financial Reporting*, July 2013, paragraph 3.110.

10 Respondents who commented on this part of the Discussion Paper generally welcomed the proposal to improve the concepts for executory contracts. However, some respondents thought that the proposed guidance focuses too much on rationalising current practice, and that the underlying concepts will have to be clearer and more fully developed if they are to assist in improving financial reporting and help the IASB make rational, consistent decisions in individual cases.

11 In particular, respondents suggested that:

(a) the *Conceptual Framework* needs to explain why rights and obligations arising under executory contracts can give rise to a net asset or net liability. Why should rights and obligations arising from executory contracts be treated any differently from other rights and obligations?

(b) it is not sufficient to say that in *some circumstances* there is a single net right or net obligation, whereas in *other circumstances* there are separate rights and obligations, which are sometimes offset. The IASB should clarify the nature of the circumstances in each case. The discussion should cover some of the difficult areas, such as take-or-pay contracts and contracts for which specific performance could be enforced. Clarifying the nature of the assets and liabilities that arise under executory contracts could help provide the answers.

(c) the IASB needs to explain the basic difference or relationship between executory contracts and right-of-use assets received under lease contracts.

(d) if there are circumstances in which an entity has separate (gross) rights and obligations: (i) how the gross assets and liabilities should be classified; (ii) whether the assets and liabilities would be measured and presented gross or net and (iii) the timing and manner of recognition in profit or loss.

12 This paper explores the main matters for which respondents requested clearer concepts.

THE NATURE OF THE ASSETS AND LIABILITIES IN EXECUTORY CONTRACTS

13 This section analyses different views of, and reaches tentative conclusions on, the nature of the assets and liabilities in executory contracts. It explores the following questions:

(a) What are the rights and obligations in executory contracts that will be settled by exchanging economic resources?

(b) Do a right and an obligation to exchange resources give rise to a separate asset <u>and</u> liability, or a single asset <u>or</u> liability?

(c) How do the assets and liabilities differ from those identified in (a) if the contract will be settled net, rather than by exchanging economic resources?

(d) When does the exchange occur if the parties perform at different times?

(e) Are there circumstances in which the resource to be received and the resource to be transferred should be presented as an asset and a separate liability?

What are the rights and obligations in executory contracts that will be settled by exchanging economic resources?

View 1—a right to receive one resource and an obligation to transfer another resource

14 Executory contracts are often described as a combination of:

(a) a right to receive one economic resource; and

(b) an obligation to transfer a different economic resource.

15 An implication of this description is that an entity with an enforceable executory contract that will be settled by exchanging resources has both an asset (the right to receive a resource) and a liability (the obligation to transfer a resource).

Illustration 1—Right to receive and obligation to transfer resources

An entity enters into a contract to purchase a resource for 100 currency units ('CU'). The value of the resource at the time of exchange is expected to be CU100. Assume that the time value of money is immaterial.

The entity would identify:

An asset:	Right to receive resource	CU100	
A liability:	Obligation to transfer cash		CU100

16 Identifying both an asset and a liability within an executory contract does not imply that the asset and liability would have to be recognised, measured and presented separately. They, like other assets and liabilities that arise from a single source, could be combined into a single unit of account. In the *Conceptual Framework* Discussion Paper, the IASB expressed a preliminary view that the unit of account should normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information.[4]

View 2—a right and an obligation to exchange resources

17 An alternative view is that an executory contract contains a right and an obligation to *exchange* economic resources. IAS 32 *Financial Instruments—Presentation* applies this description in its definitions of financial assets and financial liabilities:

(a) it defines the term 'financial asset' to include:

> "(c) a contractual right:
>
> (i) to receive cash or another financial asset from another entity, or
>
> (ii) *to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity*."

(b) it defines the term 'financial liability' to include:

> "(a) a contractual obligation:
>
> (i) to deliver cash or another financial asset to another entity, or
>
> (ii) *to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity*."[5]

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4 Discussion Paper *A review of the Conceptual Framework for Financial Reporting*, July 2013, Unit of account, paragraphs 9.35-9.41.

5 IAS 32, paragraph 11. (Emphasis added.)

Staff analysis and conclusions

18 The staff note that the entity's rights and obligations under an executory contract are highly interdependent:

(a) the entity's right to receive one resource is conditional on it fulfilling its obligation to transfer the other resource, and its obligation to transfer the other resource is conditional on it receiving the first resource; and

(b) there is only a net inflow or outflow of resources when the parties perform their obligations: each party transfers one resource but receives another resource in exchange.

19 In some (relatively uncommon) cases, a court may enforce 'specific performance' of a contract—ie the court may rule that a party in breach of its obligations must perform those obligations, instead of paying compensation or penalties. However, even in these cases, the court would not enforce performance by one of the parties without also enforcing performance by the other party (except perhaps if one party is in insolvent liquidation).

20 The staff think that the right to receive one resource and the obligation to transfer another resource are so interdependent that they are not separable. Consequently, we conclude that the entity's right and obligation are to *exchange* resources.

Do a right and an obligation to exchange resources give rise to a separate asset <u>and</u> liability, or a single asset <u>or</u> liability?

21 If we view an executory contract as a right and an obligation to exchange economic resources, we have to consider whether:

(a) the right to exchange resources on favourable terms is an asset, and the obligation to exchange resources on unfavourable terms is a separate liability (paragraphs 22-23); or

(b) the combined right and obligation constitute a single asset or liability (see paragraphs 24-25).

View A—separate asset ***and*** *liability*

22 One view is that the right and obligation to exchange economic resources give rise to a separate asset and liability. A rationale for this view is that the right to exchange resources is equivalent to a purchased option, and the obligation to exchange resources is equivalent to a written option.

23 Viewed in isolation, a purchased option gives rise to an asset and a written option gives rise to a liability. Consequently, analysing an executory contract as a combination of two options implies that the entity has a separate asset (the purchased option) and a separate liability (the written option). Unless there is zero probability of the exchange being favourable for the option holder, both options have a value prior to the exchange date.

Illustration 2—Combination of purchased and written option

The facts are the same as in Illustration 1: the entity enters into a contract to purchase a resource for CU100. The value of the resource at the time of exchange is expected to be CU100.

Suppose that this value of CU100 reflects the following expectations about the market price at the date of exchange:

Possible market price	CU80	CU90	CU100	CU110	CU120
Probability[6]	10%	20%	40%	20%	10%

Assuming, for simplicity that the time value of money and effects of risk are not material, the value of an option to exchange could be estimated by reference to the expected value of the outcomes in which the exchange is favourable to the party holding the option:

Purchased option
[(CU110 - CU100) × 20%] + [(CU120 - CU100) × 10%] = CU4

Written option
[(CU90 - CU100) × 20%] + [(CU80 - CU100) × 10%] = CU -4

The entity would identify:

An asset: Right to exchange CU4

A liability: Obligation to exchange CU4

6 Strictly speaking, the probabilities used in this calculation are those implied by market prices.

View B—single asset or liability

24 An alternative view is that the entity's combined right and obligation to exchange resources constitute a single asset or liability. The entity has an asset if the terms of the exchange are expected to be favourable; it has a liability if the terms of the exchange are expected to be unfavourable. The terms are favourable (or unfavourable) if, at the time of the exchange, the value of the economic resource that the entity receives is greater (or less) than the value of the economic resource that the entity transfers or grants to the other party.

25 A rationale for this view is that the rights and obligations in executory contracts are not the same as options. An option gives the holder the right *either* to make an exchange (if it turns out to be favourable) *or* to withdraw from the exchange without penalty (if it turns out to be unfavourable). In contrast, neither party to an enforceable executory contract has the right to avoid an unfavourable outcome. There is only one outcome under the terms of the contract—the exchange will occur. If the exchange is expected to be on favourable terms, it is an asset; if it expected to be on unfavourable terms, it is a liability.

Illustration 3—Single asset or liability

The facts are the same as in Illustration 1: the entity enters into a contract to purchase a resource for CU100. The value of the resource at the time of exchange is expected to be CU100.

The entity would identify a single asset or liability. In this illustration, there is no difference between the values of the resources to be exchanged, so the asset or liability would be measured at zero. (Paragraphs 38-42 discuss in more detail the measurement of this type of asset or liability.)

Staff conclusion

26 For the reasons in paragraph 25, the staff conclude that the combined right and obligation to exchange resources constitute a single asset or liability.

How do the assets and liabilities differ from those in paragraphs 14-26 if the contract will be settled net, rather than by exchanging economic resources?

27 If a forward contract will be settled net, the entity does not have a right and an obligation to *exchange* resources at a future date. Instead, it has a right and an obligation to pay or receive the difference between the value of two resources at the future date. Like a right and an obligation to exchange resources, this right and obligation to pay or receive the difference in value of two resources could be viewed as giving rise to:

(a) an asset (akin to a purchased option) and a liability (akin to a written option); or

(b) a single asset or liability.

28 Here too, the staff think that the right and obligation are not the same as purchased and written options, because they do not give either party the right to avoid an unfavourable outcome. Consequently, the staff conclude that the combined right and obligation to pay or receive the difference in the values of the two resources (like a combined right and obligation to exchange resources) constitute a single asset or liability.

When does the exchange occur if the parties perform at different times?

29 The parties to an executory contract that is settled by the exchange of economic resources may be required to perform their obligations (transfer the underlying resources) at the *same* time or at *different* times. Even if the parties perform their obligations at different times, there is a simultaneous exchange, which occurs when the first party performs its obligations. At that time, the first party transfers one resource (the first underlying resource) and simultaneously receives another resource (a right to receive the second underlying resource from the second party). Before the first exchange (ie while the contract remains executory), each party has the right and the obligation to make this first exchange.

Illustration 4—the parties perform at different times

4A Purchase contract with deferred payment

At time T_0, an entity enters into a contract to purchase equipment. It will receive the equipment at time T_1 and pay for it a later time T_2.

An exchange will occur at time T_1: the entity will receive equipment, and the supplier will receive a financial asset (a right to receive cash). Before T_1, while the contract is executory, the entity and the supplier have a right and an obligation to make this first exchange.

4B Purchase contract with advance payment

At time T_0, an entity enters into a contract to purchase equipment. It will pay for the equipment at time T_1 and receive it a later time T_2.

An exchange will occur at time T_1: the entity will receive a right to receive equipment, and the supplier will receive cash. Before T_1, while the contract is executory, the entity and the supplier have a right and an obligation to make this first exchange.

Are there circumstances in which the resource to be received and the resource to be transferred should be presented as an asset and a separate liability?

30 The general conclusions that the staff have reached so far in this paper are that an enforceable executory contract contains a right and an obligation to exchange economic resources (or to pay or receive the difference in values between two economic resources if the contract will be settled net). The combined right and obligation constitute a single asset or liability. Possible exceptions are discussed below.

A purchase agreement gives the purchaser control of the resource it will be purchasing

31 If an entity enters into a forward contract to purchase a resource at a future date, the entity's asset is normally its right to buy the underlying resource, not the underlying resource itself. However, there may be circumstances in which the terms of a forward contract to purchase a resource give the purchaser control of that resource.

32 The staff think that, in such circumstances, the entity should identify both an asset (the underlying resource that it controls) and a liability (its obligation to pay for the resource). However, we do not view this treatment as an exception to the general principle that executory contracts give rise to a single asset or liability to exchange resources. We think that in these circumstances, the forward contract is not executory: the seller has substantively performed its obligation to deliver the underlying asset.

33 Whether a purchase agreement is sufficient to give an entity control of the underlying asset would need to be judged by reference to the facts and circumstances of the transaction. The staff suggest that requirements and guidance applicable to specific types of transaction should be developed in individual Standards, rather than in the *Conceptual Framework*. Some factors that might indicate that a particular type of purchase agreement gives control of an asset to the purchaser might include, for example:

(a) the contract being of a type for which the courts would enforce specific performance; and

(b) the seller being unable to substitute an equivalent asset. In such a situation, the seller could have lost the practical ability to sell to another party the specific asset that it has contracted to sell to the purchaser.

34 Paragraphs 31-33 consider a forward purchase transaction from the perspective of a purchaser. If the same principles applied to the seller, the seller would derecognise the resource, and recognise its right to receive payment for the resource. However, IFRS requirements for derecognising assets do not always mirror the requirements for identifying and recognising assets. Concepts for derecognition are being developed as part of the Conceptual Framework project and these concepts would apply when the IASB develops new IFRSs or reviews existing IFRSs that address sale agreements.

The entity has to perform its obligations first

35 Some executory contracts require the entity to perform its obligations first, ie to transfer one underlying resource to the other party before the other party transfers a different underlying resource to the entity. In the period between the two transfers, the entity will be exposed to default risk for the full amount of the resource to be received. This period could be long (for example, if the contract is a commitment to provide a long term loan to a customer). Alternatively, it could be very short (for example if the contract is for the exchange of financial assets, with the transfers clearing at different times on the same day).

36 During this period, the entity will be exposed to default risk for the gross amount that it has a right to receive. However, while the contract remains executory, this gross exposure will not be recognised in the statement of financial position if the asset or liability recognised reflects only the *difference* in the values of the resources being exchanged. Some might argue that in these circumstances, the executory contract asset or liability should be 'grossed up' to reflect the entity's full exposure.

37 However, the staff think that an entity has the same type of right and obligation irrespective of the order in which the two parties perform their obligations. As explained in paragraph 29, the entity's right and obligation is to make the exchange that occurs when the first party performs its obligations, whichever party that is. The staff suggest that the statement of financial position is not meant to portray future gross exposures; it is meant to portray existing rights and claims. Information about the nature and amounts that could be at risk in future could be disclosed in the notes to the financial statements.

MEASUREMENT OF EXECUTORY CONTRACT ASSETS AND LIABILITIES

Application of general measurement concepts

38 The staff think that the IASB should develop measurement requirements for executory contracts in the same way as it develops measurement requirements for other assets and liabilities. In other words, the IASB should apply the general measurement concepts in the *Conceptual Framework* when specifying requirements for particular types of executory contract within the applicable Standard. That said, we think it is useful to explore the consequences of measurement requirements that the IASB *might* specify for the executory contract assets or liabilities described in paragraphs 24-26, that is, the single asset or liability to exchange resources.

A possible approach to measurement

39 Paragraph 24 suggests that an entity has an asset (or a liability) if the value of the economic resource that the entity will receive is expected to be greater (or less) than the value of the economic resource that the entity will transfer or grant to the other party. An implication is that the measure of the asset or liability would:

(a) reflect the expected difference between the values of the resources exchanged; and hence

(b) depend on the bases used to measure the ‘value’ of each of the resources.

40 The IASB might decide that a particular Standard should apply the same measurement bases for executory contract assets or liabilities as it specifies for the assets and liabilities that arise when one of the parties subsequently performs its obligations, ie when the contract is no longer executory. Applying this approach to existing Standards, many executory contract assets and liabilities would be measured at zero (and hence need not be recognised) unless the contracts were onerous:

Illustration 5—measurement bases for executory contracts that would be consistent with those for executed contracts

5A Contracts for the purchase of inventories

Applying IAS 2 *Inventories*, inventories are measured at the lower of cost and net realisable value. To be consistent, an executory contract for the purchase of inventories would be measured by comparing:

(a) the cash to be transferred (the contract price), and

(b) the lower of the cost of the inventories (the contract price) and their net realisable value.

The difference is zero unless the net realisable value of the inventories is expected to be lower than their cost. In this latter case, the executory contract is onerous and the liability would be measured as the difference between the cost and net realisable value of the inventories.

5B Loan commitments

Applying the classification and measurement requirements currently being finalised for IFRS 9 *Financial Instruments*, some financial assets would be measured at amortised cost with a loss allowance for expected credit losses. To be consistent, a commitment to provide a loan that gives rise to such a financial asset would be measured at zero, with a liability for expected contract losses determined applying the same impairment model as that specified for the related financial assets.

Applying IFRS 9, other financial assets resulting from loan commitments are measured at fair value through profit or loss. To be consistent, a commitment to enter into such loans would also be measured at fair value through profit or loss.[7]

[7] To simplify the accounting for issuers and holders of loan commitments, existing and proposed requirements for some loan commitments are different from those for the related loans. For example, it is proposed that IFRS 9 will not require a loan commitment to be measured at fair value through profit or loss if it relates to a structured loan that would fail the cash flow characteristics condition in IFRS 9 (and hence should be measured at fair value through profit or loss) when it is drawn down. For such a commitment, a liability would be recognised for expected credit losses.

5C Contracts for the sale of goods or services

Applying the requirements of IFRS 15 *Revenue from Contracts with Customers*, an entity would measure obligations to transfer goods or services to customers at the transaction price, with any additional onerous contract liability being recognised and measured applying the requirements of IAS 37.[8] To be consistent, an executory contract for the sale of goods or services would be measured at zero, unless the contract is onerous, as defined in IAS 37. If onerous, the executory contract liability would be measured applying the measurement requirements of IAS 37.

Cancellation penalties could cap the amount of the asset or liability

41 It could be argued that, for any enforceable executory contract, the amount of the entity's liability (or asset) is no more than the compensation or penalties that the entity (or the other party) could be required to pay if it breached its obligations under the contract. In some cases, penalties might be stated in the contract, and could provide a cap on the measure of the asset or liability.

42 If the contract is of a type for which the courts would enforce specific performance, the entity would not have an opportunity to pay compensation or penalties in lieu of performance. Accordingly, the asset or liability would always be measured by reference to the relative values of the resources being exchanged.

IMPLICATIONS OF TENTATIVE CONCLUSIONS FOR EXISTING STANDARDS

43 In general, the requirements of existing Standards, and the proposed requirements of forthcoming new Standards, are consistent with the tentative conclusion that an executory contract gives rise to a single asset or liability to exchange resources (or to pay or receive the difference in values between two resources if the contract will be settled net):

8 IFRS 15 *Revenue from Contracts with Customers*, paragraph 46 and consequential amendments to paragraph 5 of IAS 37.

(a) only a single asset or liability is recognised, and that asset or liability is measured by reference to the difference in the values of the resources being exchanged (or settled net); and

(b) often no asset or liability is recognised unless the contract is onerous, which is consistent with an approach that measures the asset or liability using the same measurement bases as those specified for the rights and obligations that arise when one of the parties subsequently performs its obligations.

44 Some (apparent) differences identified by the staff—and the possible rationales for those differences—are discussed below.

Trade date accounting for regular way purchases or sales of financial assets

45 A ‘regular way’ purchase or sale of a financial asset is a purchase or sale ‘under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned’.[9] IFRS 9 permits entities to apply either ‘trade date accounting’ or ‘settlement date accounting’ to these contracts. Applying trade date accounting, the entity accounts for the financial asset as if it had already been delivered at the commitment (trade) date. In contrast, applying settlement date accounting, the entity accounts for the forward contract until delivery, and then recognises the underlying financial asset purchased (or derecognises the financial asset sold) from delivery date.[10]

46 Trade date accounting can be a simpler and more practical method of managing and recording regular way purchases and sales. The permitted alternatives in IFRS 9 have been carried forward from IAS 39 *Financial Instruments—Recognition and Measurement*, which permitted both alternatives ‘because of the short duration of the commitment’. Trade date accounting has been permitted on practical, not conceptual, grounds and the staff do not think there would be any need to reopen this aspect of IFRS 9 following any changes to the concepts for executory contracts.

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9 IFRS 9 *Financial Instruments*, Appendix A—Defined terms.

10 IFRS 9 *Financial Instruments*, paragraph 3.1.2 and B3.1.3-B3.1.6.

Sale and repurchase agreements

47 An entity may sell an asset and at the same time enter into a contract to repurchase that asset at a future date. Applying the tentative conclusions in this paper, the accounting would depend on whether the entity loses control of the asset between the sale and repurchase dates. If it loses control of the asset, the repurchase agreement would be executory and the entity would identify a single executory contract asset or liability. If the entity retains control (as discussed in paragraphs 31-33), the repurchase agreement would not be executory: the entity would recognise the asset that it continues to control and its obligation to pay for that asset.

48 Such a concept is applied in IFRS 15 *Revenue from Contracts with Customers*. IFRS 15 prohibits an entity from recognising the sale of an asset if the sale agreement includes a forward contract for the repurchase of the asset. The entity must treat the sale and repurchase as a lease or a financing arrangement (whereby it would continue to recognise the asset and also recognise a financial liability for any consideration received from the customer). The rationale is that the repurchase agreement means that the seller retains control of the asset it has 'sold'. The customer is limited in its ability to direct the use of and retain substantially all the remaining benefits from the asset—it cannot consume the entire asset or sell it to another party.[11]

49 However, IFRS 9 applies a different approach. It prohibits an entity from derecognising a financial asset if the entity retains substantially all the risks and rewards of ownership of the financial asset. It states that this will be the case if the sale of that asset is subject to an agreement to buy the asset back at a fixed price or at the sale price plus a lender's return. IFRS 9 requires the entity to continue to recognise the financial asset, and a financial liability for the consideration received.[12]

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[11] IFRS 15 *Revenue from Contracts with Customers*, May 2014, paragraphs B64-B68 and Basis for Conclusions paragraphs BC424.

[12] IFRS 9, paragraphs 3.2.6(b), 3.2.7 and 3.2.15.

50 The IFRS 9 requirement reflects the fact that IFRS requirements for derecognising assets do not always mirror the requirements for identifying and recognising assets. Concepts for derecognition are being developed as part of the Conceptual Framework project and these concepts would apply when the IASB develops new IFRSs or reviews existing IFRSs that address sale and repurchase agreements.

Leases

51 The Exposure Draft *Leases* proposes to require a lessee to recognise a separate asset (for its right to use the leased asset) and liability (for its obligation to pay the lessor).

52 Some people view leases as executory service contracts: the lessee has a right and obligation to exchange lease payments for use of the leased asset, and the lessee's continuing right to use the asset is conditional on it making the lease payments. For this reason, they think that lessees should account for leases in the same way as other executory contracts, ie recognising a liability only if the lease is onerous.

53 However, the IASB has concluded that leases are not executory contracts once the lessor has delivered the underlying asset to the lessee (or made it available for use by the lessee). The explanation is in the Basis for Conclusions accompanying the Exposure Draft:

> **Why leases are different from service contracts for the lessee**
>
> BC20 The boards have concluded that leases create rights and obligations that are different from those that arise from service contracts. That is because the lessee obtains and controls the right-of-use asset at the time that the underlying asset is delivered to (or made available for use by) the lessee.
>
> BC21 When the lessor delivers (or makes available) the underlying asset for use by the lessee, the lessor has fulfilled its obligation to transfer the right to use that asset to the lessee—the lessee now controls that right of use. Consequently, the lessee has an unconditional obligation to pay for that right of use… [13]

[13] Exposure Draft *Leases*, May 2013, Basis for Conclusions.

Staff conclusions

54 Our review of existing Standards leads us to conclude that:

(a) existing IFRS requirements are broadly consistent with the tentative staff conclusions in this paper; and

(b) where they are (or may appear) different, there are reasons for the differences.

55 Consequently, we have not identified any fundamental conflicts.

WHETHER CONCEPTS WOULD BE USEFUL

Staff analysis

56 If there are no fundamental conflicts between existing Standards and the concepts developed in this paper, it might be argued that there is no practical need for those concepts—the IASB has managed to develop Standards without them.

57 However, there are several ways in which the concepts developed in this paper may assist the IASB and others in developing and interpreting Standards in future:

(a) several Standards require executory contract liabilities to be recognised only if the contracts are onerous. There is a view that, by not requiring recognition of *other* executory contract assets and liabilities, those Standards are creating exceptions from general principles—executory contract assets and liabilities are being treated differently from other assets and liabilities. However, applying the concepts in this paper, the IASB could demonstrate that non-recognition of some executory contract assets and liabilities flows from the concepts. The IASB could explain that an asset or liability to exchange resources exists but, if that asset or liability were recognised and measured applying the measurement requirements specified in the applicable Standard, it would be measured at an amount that is locked at zero except when the contract is onerous.

(b) respondents to the Discussion Paper asked whether the signing of an enforceable contract is the ‘past event’ that creates a present obligation to transfer an economic resource (and if not, why not). The concepts in this paper could answer that question. The signing of a contract *is* an event that creates a present obligation, but the obligation created at that time is an obligation to *exchange* resources. When the first party transfers the first resource, each party’s right and obligation to exchange resources is extinguished and replaced by a new right to *receive* a resource (for the first party) and a new obligation to *transfer* an economic resource (for the second party). The first party’s performance is the ‘past event’ that creates the second party’s new obligation.

(c) for some time there has been diversity in practices for identifying and measuring some onerous executory contracts within the scope of IAS 37. In 2003, the Interpretations Committee was asked to provide clarification. It decided not to take the matter on to its own agenda, but instead brought it to the attention of the IASB, which had started a project to amend IAS 37.[14] The IASB has just revived this project as a research project. The concepts developed in this paper could help the IASB to reach decisions on how IAS 37 should address onerous contracts.

Staff conclusion

58 The staff conclude that concepts developed from the staff conclusions earlier in this paper would assist the Board and others in developing and interpreting Standards in future.

[14] IFRIC *Update*, December 2003

FEEDBACK FROM THE ACCOUNTING STANDARDS ADVISORY FORUM

59 The Accounting Standards Advisory Forum (ASAF) discussed an earlier draft of this paper at its meeting on 3 June 2014. A summary of that meeting will be available soon on the ASAF meetings page of the IFRS Foundation website.

60 ASAF members supported (some strongly) the development of clearer concepts on the nature of the assets and liabilities in executory contracts, particularly if those concepts would help to correct misconceptions or address issues arising in the identification and measurement of onerous contracts.

61 ASAF members expressed different views on the conceptual analysis of the assets and liabilities in executory contracts:

(a) some ASAF members agreed with the staff view that there is a single asset or liability to exchange resources; but

(b) other ASAF members thought that, conceptually, an executory contract contains both an asset and a liability (one member noting that the resources being exchanged are different). However, they did not think that Standards should require separate presentation of the asset and liability—some for practical reasons; others because they thought that there would be conceptual justifications for offsetting or linking the presentation of the asset and liability.

62 ASAF members observed that many of the accounting issues that arise for executory contracts relate to measurement. However, none of the members called for measurement concepts in the *Conceptual Framework* specifically for executory contracts.

63 Other suggestions included:

(a) reconsidering the terminology because the term ‘executory contract’ has a different legal definition in some jurisdictions;

(b) expanding the analysis to address partial performance; and

(c) linking the discussion of executory contracts to discussions of unit of account in the *Conceptual Framework*.

STAFF RECOMMENDATIONS AND QUESTIONS FOR THE IASB

The nature of executory contract assets and liabilities

64 On the basis of the conclusions reached through this paper, the staff recommend that the *Conceptual* Framework should include concepts explaining the nature of the assets and liabilities in executory contracts. It should state that:

(a) an enforceable executory contract contains a right and an obligation to exchange economic resources (or to pay or receive the difference in values between two economic resources if the contract will be settled net). The combined right and obligation constitute a single asset or liability. (See paragraphs 14-28.)

(b) if an entity enters into a forward contract to purchase a resource at a future date, the entity's asset is normally its right to buy the underlying resource, not the underlying resource itself. However, there may be circumstances in which the terms of a forward contract to purchase a resource give the purchaser control of that resource. In such circumstances, the purchaser should identify both an asset (the underlying resource that it already controls) and a liability (its obligation to pay for the resource). In these circumstances, the contract is not executory: the seller has substantively performed its obligations. (See paragraphs 31-34.)

Question 1
Do you agree with the recommendations in paragraph 64?

Measurement of executory contract assets and liabilities

65 The staff recommend that the *Conceptual Framework* should not address specifically the measurement of executory contract assets or liabilities. Instead, the IASB should apply the general measurement concepts in the *Conceptual Framework* when specifying requirements for particular types of executory contract within the applicable Standard.

Many Standards implicitly apply the same measurement bases for executory contract assets or liabilities as they specify for the assets or liabilities that arise when one of the parties subsequently performs its obligations. The result is that many executory contract assets and liabilities would be measured at zero (and hence are not recognised) unless the contract is onerous. (See paragraphs 38-42.)

Question 2
Do you agree with the recommendation in paragraph 65?