

STAFF PAPER

October 2016

IASB Meeting

Project	Conceptual Framework		
Paper topic	Executory contracts		
CONTACT(S)	Yulia Feygina	yfeygina@ifrs.org	+44 (0)20 7332 2743
	Joan Brown	jbrown@ifrs.org	

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

Purpose of the paper

1. This paper discusses whether any changes are needed to the proposed concepts on executory contracts in the light of the comments received on the Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft). In particular, this paper discusses:
 - (a) assets and liabilities arising from executory contracts;
 - (b) recognition of assets and liabilities arising from executory contracts; and
 - (c) explanations in the Basis for Conclusions accompanying the Exposure Draft.
2. Appendix A sets out other comments received on the proposed concepts on executory contracts and provides staff responses to those comments.

Structure of the paper

3. This paper is structured as follows:
 - (a) staff recommendations (paragraph 4);
 - (b) Exposure Draft proposals (paragraphs 5–7);
 - (c) summary of feedback (paragraphs 8–12); and

- (d) staff analysis and questions for the Board (paragraphs 13–26).

Staff recommendations

4. The staff recommend:
- (a) the Board confirms the following Exposure Draft proposals:
 - (i) an executory contract establishes a right and an obligation to exchange economic resources;
 - (ii) that right and the obligation to exchange economic resources are interdependent and cannot be separated; and
 - (iii) the combined right and obligation constitute a single asset or liability.
 - (b) the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*) should contain no more discussion of recognition of executory contract assets and liabilities than was included in the Exposure Draft. In other words, the *Conceptual Framework* should state only that whether or not the asset or the liability arising from an executory contract is included in the financial statements depends on both the recognition criteria and the measurement basis adopted for the contract, including, if applicable, any test for whether that contract is onerous.
 - (c) none of the discussion of executory contracts included in the Basis for Conclusions is brought into the *Conceptual Framework* itself.

Exposure Draft proposals (paragraphs 4.40–4.42 and BC4.82–BC4.92)

5. The Exposure Draft described an executory contract as:
- a contract that is equally unperformed: neither party has fulfilled any of its obligations, or both parties have fulfilled their obligations partially and to an equal extent.
6. The Exposure Draft proposed that:

- (a) an executory contract establishes a right and an obligation to exchange economic resources;
- (b) the right and the obligation to exchange economic resources are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset (if the terms of the exchange are favourable) or a single liability (if the terms of the exchange are unfavourable);
- (c) whether the asset or liability arising from an executory contract is included in the financial statements depends on both the recognition criteria and the measurement basis adopted for the contract; and
- (d) to the extent that a party fulfils its obligation under the contract, the contract ceases to be executory.

7. The Basis for Conclusions on the Exposure Draft:

- (a) explained why the Exposure Draft proposed that:
 - (i) an executory contract gives rise to a right and obligation to *exchange* economic resources rather than a right to *receive* one economic resource and a separate obligation to *transfer* another economic resource; and
 - (ii) the combined right and obligation give rise to a *single* asset (if the terms are favourable) or a *single* liability (if the terms are unfavourable, rather than a separate asset (a right to exchange resources, equivalent to a purchased option) and separate liability (an obligation to exchange resources, equivalent to a written option).
- (b) described the implications of the proposed approach to executory contracts for lease contracts and ‘trade date accounting’:¹
 - (i) a lease contract is no longer an executory contract once the lessor has delivered the right-of-use asset to the lessor; and

¹ IFRS 9 *Financial Instruments* permits ‘trade date accounting’ for a ‘regular way’ purchase or sale of a financial asset. This treats the financial asset as having already been delivered at the commitment (trade) date, instead of accounting for the purchase or sale contract as a derivative until settlement.

- (ii) ‘trade date accounting’ is a simple and practical method of managing and recording transactions that only have a short duration and, hence, is justified on cost-benefit grounds.
- (c) explained why the Board expects that the current practice of not recognising many executory contract assets and liabilities is likely to continue— measurement of an executory contract at its historical cost, results in the contract being measured at zero (which has the same practical effect as not recognising the contract) unless the contract is onerous.

Summary of feedback

8. The invitation to comment on the Exposure Draft did not include a specific question on the concepts proposed on executory contracts. However, some respondents provided comments on those concepts.
9. Some respondents, including some standard-setters and preparers, explicitly agreed with the proposed concepts.
10. However, some respondents disagreed with the proposal that executory contracts give rise to a combined right and obligation to exchange resources that constitute a single asset or liability. Those respondents expressed a view that executory contracts give rise to a separate right (to receive one economic resource) and separate obligation (to transfer a different economic resource). They expressed different views on whether, and if so when, the separate right and separate obligation should be treated as a single unit of account:
 - (a) the separate right and separate obligation should be treated as giving rise to a separate asset and a separate liability;
 - (b) the separate right and separate obligation should be treated as a single unit of account because of their interdependency; or
 - (c) the separate right and separate obligation should either be treated as a separate asset and a separate liability or combined into a single unit of account depending on which treatment provides the most relevant information.

11. Some respondents commented on the recognition of assets and liabilities arising from executory contracts:
- (a) some asked the Board to clarify how the proposed recognition criteria would apply to the identified right and obligation arising from executory contracts, for example when recognition of assets and liabilities arising from executory contracts would provide useful information;
 - (b) some expressed a concern that the proposed concepts could result in more assets and liabilities arising from executory contracts being recognised (an outcome that they would not welcome); and
 - (c) others suggested that assets and liabilities arising from executory contracts should not be recognised except for recognising a liability when the executory contract is onerous.
12. Some respondents, mainly from Europe, suggested that the concepts on executory contracts could be clarified by moving some of the material from the Basis for Conclusions to the *Conceptual Framework* itself. Some of those respondents suggested that the *Conceptual Framework* should explain why in many cases an asset or a liability will not be recognised for an executory contract. Others suggested explaining in the *Conceptual Framework*:
- (a) that the entity's right and obligation to exchange economic resources is not a right to receive one economic resource and an obligation to transfer another economic resource; and
 - (b) why a single net asset or liability is recognised for an executory contract.

Staff analysis

Assets and liabilities arising from executory contracts

13. Some respondents disagreed with the proposals to view executory contracts as giving rise to a combined right and obligation to exchange resources that constitute a single asset or liability. Specifically, those respondents expressed a view that executory contracts instead give rise to a right (to receive one economic resource) and separate

obligation (to transfer another economic resource). They suggested that the separate right and obligation should be recognised ‘gross’—ie as separate assets and liabilities—in some circumstances at least. However, no respondents expressed objections to the conclusion that a combined right and obligation to exchange resources would constitute a single asset or liability. Accordingly, the rest of this section focuses on whether executory contracts represent a combined right and obligation to exchange resources as opposed to a separate right to receive one economic resource and a separate obligation to transfer another economic resource.

14. The Board had considered this question when it was developing the Exposure Draft. The Board noted that both the right and the obligation under the executory contract are conditional upon each other. That is, 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. For example, in a forward contract to purchase a machine, the entity’s right to receive the machine is conditional on it fulfilling its obligation to pay for the machine, and its obligation to pay for the machine is conditional on it receiving the machine.
15. The Board also noted that there is only a net inflow or outflow of economic resources when the parties perform their obligations: each party transfers one economic resource but receives another economic resource in exchange. That is the case even when the parties perform their obligations at different times: when the first party transfers one economic resource (the first underlying resource), it simultaneously receives another economic resource (a right to receive the second underlying resource from the second party). For example, in an executory contract to deliver goods, the party that delivers the goods simultaneously receives the right to the payment for the goods from the other party.
16. The Board therefore concluded that an executory contract contains a right and an obligation to exchange economic resources (instead of a right to receive an economic resource and an obligation to transfer an economic resource).
17. The Board further considered whether the right and the obligation to exchange economic resources could give rise to both a separate asset (a right to exchange economic resources, equivalent to a purchased option) and a separate liability (an

obligation to exchange economic resources, equivalent to a written option). However, the Board concluded that executory contracts are different from options because neither party has the right to avoid exchanging economic resources. Moreover, the right and obligation under an executory contract are so interdependent that they cannot be separated. Hence, the contract cannot be disaggregated into more than a single asset or a single liability.

18. The staff did not identify any new arguments in the feedback received that could lead the Board to different conclusions from those it had reached when developing the Exposure Draft. Consequently, the staff think that the Board’s conclusions remain valid and recommend that the Board should confirm the following Exposure Draft proposals:

- (a) an executory contract establishes a right and an obligation to exchange economic resources;
- (b) that right and the obligation to exchange economic resources are interdependent and cannot be separated; and
- (c) the combined right and obligation constitute a single asset or liability.

Question 1 for the Board

Does the Board agree with the staff recommendation in paragraph 18?

Recognition of assets and liabilities arising from executory contracts

19. Some respondents asked the Board to provide more guidance on recognition of executory contract assets and liabilities, for example, to explain when recognition of those assets and liabilities would result in useful information.

20. However, the staff think that the *Conceptual Framework* should not specifically address recognition of executory contract assets and liabilities. This is because the *Conceptual Framework* does not set out specific recognition requirements for any other particular types of assets or liabilities. Instead, the staff think that the Board should develop recognition requirements for executory contracts in setting the Standards in the same way it develops those requirements for other assets and liabilities. In other words, the Board should apply the general recognition concepts

set out in the *Conceptual Framework* when specifying requirements for particular types of executory contracts within the applicable Standards.

21. The staff note concerns expressed by some respondents about more assets and liabilities arising from executory contracts being recognised under the proposed concepts. However, as explained in the Basis for Conclusions on the Exposure Draft, that is not expected to be the case. Rather, the current practice of not recognising an asset or a liability for many executory contracts is expected to continue. As the Basis for Conclusions explained, when a historical cost measurement is applied to an executory contract, the contract is measured at zero, which has the same practical effect as not recognising the contract unless it is onerous. Some respondents might want further reassurance that the Board will continue to specify a historical cost measurement basis for many executory contracts in future. However, the staff think that it would not be appropriate to discuss how often a particular measurement basis would be applied to assets or liabilities arising from executory contracts.

22. Finally, the staff note that some respondents argued that liabilities arising from executory contracts should not be recognised unless they are onerous. However, as noted in paragraph 20 of this paper, the *Conceptual Framework* does not set out specific recognition requirements for particular types of assets or liabilities. There is no reason why the recognition of assets and liabilities arising from executory contracts should be treated in the *Conceptual Framework* any differently from the recognition of other assets and liabilities.

23. Accordingly, the staff recommend that the *Conceptual Framework* should contain no more discussion of the recognition of executory contract assets and liabilities than was included in the Exposure Draft. In other words, the *Conceptual Framework* should state only that whether or not the asset or the liability arising from an executory contract is included in the financial statements depends on both the recognition criteria and the measurement basis adopted for the contract, including, if applicable, any test for whether the contract is onerous.

Question 2 for the Board

Does the Board agree with the staff recommendation in paragraph 23?

Explanations in the Basis for Conclusions

24. The proposed concepts for executory contracts are new to the *Conceptual Framework*, which has created a need for comprehensive explanations of the rationale for, and implications of, the proposed concepts. Consequently, the Basis for Conclusions included nearly three pages of discussion on executory contracts. The staff acknowledge the requests made by some respondents to move some of these explanations from the Basis for Conclusions to the *Conceptual Framework* itself. However, the staff are of the view that the explanations are appropriately placed in the Basis for Conclusions. For example, the staff think that the explanation of why the Board expects that many assets and liabilities arising from executory contracts will not be recognised belongs in the Basis for Conclusions. This is because such explanation is not part of the concepts. Instead, it is the discussion of potential implications of the proposed concepts.
25. Likewise, the staff think that the *Conceptual Framework* should describe what executory contracts *are* rather than what they are *not*. In other words, it is appropriate for the *Conceptual Framework* to state that executory contracts contain a right and an obligation to exchange economic resources. However, the statement that executory contracts do not contain a right to receive one economic resource and an obligation to transfer another economic resource belongs to the Basis for Conclusions.
26. Accordingly, the staff recommend that none of the discussion of executory contracts in the Basis for Conclusions accompanying the Exposure Draft is moved to the *Conceptual Framework* itself.

Question 3 for the Board

Does the Board agree with the staff recommendation in paragraph 26?

Appendix A—other comments on the proposed concepts on executory contracts

A1. This appendix sets out other comments received on the proposed concepts on the executory contracts and the staff’s proposed response.

	Respondents’ comments	The staff’s response
A1	<p>Two respondents thought that the proposed concepts do not appear to allow a contract to be disaggregated into a series of portions, with remaining unperformed portions continuing to be treated as executory. Deloitte suggested that, in this respect, the proposed concepts are inconsistent with the requirements of IFRS 15 <i>Revenue from Contracts with Customers</i> (which requires entities to disaggregate contracts into performance obligations, and account for each performance obligation as executory until either party performs in respect of that obligation). The Singapore Accounting Standards Council suggested that the concepts could imply that an unequally performed contract could be considered as no longer executory in its entirety. In their view, that could result in:</p> <ul style="list-style-type: none"> - any rights and obligations arising from the portion of the contract that remains equally unperformed being accounted for as a separate asset and a separate liability; and - a partially unperformed contract swinging between executory and non-executory depending on whether the parties to the contract have performed their obligations to an equal or unequal extent. 	<p>The staff think that the proposed concepts are clear that the contract ceases to be executory only <i>to the extent</i> that a party fulfils its obligations under the contract. Accordingly, the contract that is partially unperformed will not cease to be executory in its entirety and will not swing between executory and non-executory depending on whether the parties performed to an equal extent. Rather, the fulfilled portion of the contract will cease to be executory and will give rise to an asset for the party that has performed and an obligation for the other party. The unfulfilled portion of the contract will continue to be executory. This is consistent with the requirements of IFRS 15.</p> <p>Accordingly, the staff think that no further action is necessary.</p>
A2	<p>Two standard-setters requested that the <i>Conceptual Framework</i> should provide guidance on unequally performed</p>	<p>The staff think that the proposed concepts can be applied to unequally performed contracts and no additional</p>

Respondents' comments	The staff's response
<p>contracts.</p> <p>A3 The Institute of Chartered Accountants in England and Wales suggested the Board should broaden the concepts for executory contracts to cover other executory arrangements, such as levies and taxes. They suggested that doing that would help to address concerns that entities have about recognising levies relating to future periods as liabilities.</p>	<p>guidance is necessary.</p> <p>The staff think that the concepts in the <i>Conceptual Framework</i> could be applied by analogy to other executory arrangements when doing so would be appropriate.</p>
<p>A4 A few respondents requested that the Board should clarify what it means by 'favourable' and 'unfavourable' terms of the exchange, in particular how those notions would apply to similar contracts with similar customers with different profit margins and to contracts that are not priced on market terms. In particular, they asked the Board to clarify the recognition and initial and subsequent measurement of assets and liabilities arising from those contracts.</p>	<p>The staff think that the proposed concepts are clear that if the terms of the contract are favourable—regardless of the profit margin and whether the contract is priced 'on market'—the entity has an asset. Likewise, if the terms of the exchange are unfavourable—regardless of the profit margin and whether the contract is priced 'on market'—the entity has a liability. The staff do not think that the <i>Conceptual Framework</i> should specify what 'favourable' or 'unfavourable' should mean in any particular context. This should be a matter that is determined at Standards-level, and is likely to depend on the measurement basis applied in the Standard to the underlying resources being exchanged.</p> <p>In addition, as discussed in paragraphs 24–26, the staff think that it would not be appropriate for the Board to provide further discussion about recognition and measurement of assets and liabilities arising under executory contracts in the <i>Conceptual Framework</i> or in the Basis for Conclusions.</p>