**FASB Emerging Issues Task Force**

**Issue No.** 03-17  
**Title:** Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet

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**Previously distributed EITF materials:** None

**References:**
FASB Statement No. 13, *Accounting for Leases* (FAS 13)
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 141)
FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140)
FASB Statement No. 141, *Business Combinations* (FAS 141)
FASB Statement No. 142, *Goodwill and Other Intangible Assets* (FAS 142)
FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144)
FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (FAS 146)

* The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.
FASB Interpretation No. 45, *Guarantor's Account and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45)

FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6)


FSP FIN 45-a, "Whether FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value" (proposed FSP FIN 45-a)

EITF Issue No. 99-14, "Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts" (EITF 99-14)

EITF Issue No. 00-26, "Recognition by a Seller of Losses on Firmly Committed Executory Contracts" (EITF 00-26)

EITF Issue No. 01-3, "Accounting in a Business Combination for Deferred Revenue of an Acquiree" (EITF 01-3)

EITF Issue No. 03-9, "Interaction of Paragraphs 11 and 12 of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, Regarding Determination of the Useful Life and Amortization of an Intangible Asset" (Issue 03-9)

APB Opinion No. 29, *Accounting for Nonmonetary Transactions* (APB 29)

AICPA Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (ARB 43)

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-01)
Introduction
1. The EITF Agenda Committee received a request to consider an issue regarding the subsequent accounting for an asset arising from an energy contract acquired in a business combination (assuming the energy contract is not a derivative because it meets the definition of a normal purchases and sales contract described in paragraph 10 of FAS 133, as amended). The Agenda Committee agreed that the scope of the issue should be extended to address the subsequent accounting of all assets and liabilities arising from executory contracts that are recognized on a company's balance sheet. This Issue will not address questions about the initial recognition and measurement of assets and liabilities arising from executory contracts. The purpose of this Issue Summary is to present the Task Force with the FASB staff's proposed framework for addressing the subsequent accounting of such assets and liabilities.

Background
2. Authoritative accounting literature does not provide comprehensive guidance on the recognition and measurement of assets and liabilities arising from executory contracts. For purposes of this Issue, an executory contract is a contract that remains wholly unperformed or for which there remains something to be done by either or both parties of the contract.

3. The Task Force previously addressed, without reaching a consensus, the issue of when a buyer and seller under a firmly committed executory contract should recognize and measure an impairment of their remaining contractual right to receive goods or services (buyer) or contractual obligation to deliver goods or services (seller) under Issues 99-14 and 00-26. In November 2002, the Task Force removed both of those issues from its agenda due to the broad nature of the topic and significant implications on financial reporting. However, the Task Force

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1 Issue 99-14 and Issue 00-26 defined the term firm commitment as

An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics: (a) The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. (b) The agreement includes a disincentive for nonperformance that is sufficiently large to make nonperformance probable.
requested that the FASB staff explore a Board-level project. In December 2002, the Board deferred consideration of the accounting for executory contracts.

4. However, specific authoritative pronouncements require the recognition of contractual rights and obligations associated with executory contracts on an entity's balance sheet. That literature includes:

   a. **Business Combinations – Intangible Assets.** FAS 141 requires that an acquirer recognize assets associated with executory contracts assumed in a business combination. Paragraph 39 states, "An intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights…." Appendix A to FAS 141 provides examples of contractual rights associated with executory contracts that could be recognized as an intangible asset, including: order or production backlog, customer contracts, lease agreements, licensing agreements, and royalty agreements.

   b. **Intangible Assets Not Acquired in a Business Combination.** FAS 142 requires that an acquirer recognize assets associated with executory contracts assumed in an acquisition that does not qualify as a business combination. Paragraph 9 of FAS 142 states, "An intangible asset that is acquired either individually or with a group of other assets (but not those acquired in a business combination) shall be initially recognized and measured based on its fair value."

   c. **Business Combinations – Liabilities.** FAS 141 also requires that an acquirer recognize liabilities associated with executory contracts assumed in a business combination. Paragraph 37(k) states that acquirers recognize, "other liabilities and commitments – such as unfavorable leases, contracts, and commitments…." 

   d. **Leases.** FTB 79-15 requires recognition of losses on operating subleases. Paragraph 2 of FTB 79-15 states, "… if costs expected to be incurred under an operating sublease (that is, executory costs and either amortization of the leased asset or rental payments on an operating lease, whichever is applicable) exceed anticipated revenue on the operating sublease, a loss should be recognized by the sublessor."

   e. **Construction-Type and Certain Production-Type Contracts.** Losses on contracts within the scope of SOP 81-1 must be accrued. Paragraph 85 of SOP 81-1 states, "When the
current estimates of total contract revenue and contract cost indicate a loss, a provision for the entire loss on the contract should be made. Provisions for losses should be made in the period in which they become evident under either the percentage-of-completion method or the completed-contract method."

f. **Guarantee Contracts Subject to the Initial Recognition and Measurement Provisions of FIN 45.** Certain guarantee contracts, such as an irrevocable undertaking by a guarantor to make payments in the event a specified third party fails to perform under a nonfinancial contractual obligation, are executory contracts. Paragraph 9 of FIN 45 states, "At the inception of a guarantee, the guarantor shall recognize in its statement of financial position a liability for that guarantee."

g. **Inventory.** ARB 43 requires recognition of losses on firm purchase commitments for goods for inventory. ARB 43, Chapter 4, Statement 10, states "Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts thereof separately disclosed in the income statement."

h. **Operating Leases and Other Contracts Terminated as a Result of an Exit or Disposal Activity.** For operating leases and other contracts that are terminated as a result of exit or disposal activities that meet the scope of FAS 146, paragraphs 15 and 16 require that the entity recognize a liability for (a) "costs to terminate the contract before the end of its term…" or (b) "costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity…".

i. **Employee Compensation.** Certain employee compensation arrangements, such as employee stock-based compensation arrangements and post-retirement benefits, are executory contracts.

j. **Derivatives and Other Financial Instruments.** FAS 133 acknowledges that derivative instruments are executory contracts that contain both rights and obligations, and under FAS 133, the net fair value of the right and the obligation is recognized. Certain contractual arrangements associated with financial assets, such as the obligation to service financial assets, may give rise to either a servicing assets or a servicing liability (an executory contract) that is recognized under FAS 140.
Scope Clarification

5. This Issue does not address the subsequent accounting for rights and obligations arising from executory contracts that have been recognized as assets and liabilities that are addressed by existing authoritative literature, such as (a) derivatives accounted for under FAS 133, as amended, (b) financial assets and financial liabilities, as defined by and accounted for under FAS 140, (c) employee compensation accounted for under FAS 87, FAS 106, FAS 123, and APB 18, and (d) costs associated with exit or disposal activities accounted for under FAS 146. The authoritative literature listed in paragraph 4 of this Issue Summary may give rise to the recognition of assets or liabilities associated with an obligation to provide goods or perform services, such as an obligation to perform services under an arrangement acquired in a business combination.\(^2\) The subsequent accounting for assets and liabilities arising from revenue transactions is beyond the scope of this Issue and is being addressed in the Board's project on revenue recognition.

Proposed Framework

6. The FASB staff believes that the most expedient way to address questions about asset amortization and liability derecognition is to separate the accounting issues into (a) amounts related to executory contracts that have been recognized on an entity's balance sheet as an asset, and (b) amounts related to executory contracts that have been recognized on an entity's balance sheet as a liability or a credit.

Accounting Issues

Issue 1: The appropriate method of amortization of an asset arising from an executory contract.

7. Assets arising from executory contracts, such as customer contracts and licensing arrangements, are intangible assets. FAS 142 governs the subsequent accounting for intangible assets acquired in a business combination and asset acquisitions that do not qualify for business combinations. Paragraph 4 of FAS 142 states, "The initial recognition and measurement

\(^2\) Issue 01-3 provides guidance in determining whether the deferred revenue of an acquired entity represents a liability that should be recognized by the acquiring entity when the business combination is recorded, and how the amount assigned to that liability should be measured.
provisions of this Statement apply to intangible assets acquired individually or with a group of other assets (but not those acquired in a business combination). The remaining provisions of this Statement apply to goodwill that an entity recognizes in accordance with Statement 141 and to other intangible assets that an entity acquires, whether individually, with a group of other assets, or in a business combination” (footnote references omitted).

8. FAS 142, therefore, provides guidance as to the appropriate method of amortization of an asset arising from an executory contract. Paragraph 12 of FAS 142 states, "A recognized intangible asset shall be amortized over its useful life to the reporting entity unless that life is determined to be indefinite…. The method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be reliably determined, a straight-line amortization method shall be used." Therefore, the FASB staff believes that the authoritative literature provided in FAS 142 is complete as to the appropriate methodology to amortize assets arising from executory contracts.

9. For example, assume an entity acquired an energy contract in either a business combination or an asset acquisition that does not qualify as a business combination. The amortization of the intangible asset (that is, the contractual right under an executory contract to sell energy in the future at a rate in excess of market rates prevailing at the measurement date) is subject to paragraph 12 of FAS 142. The FASB staff acknowledges that determining (a) the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up, or (b) whether the "pattern [of economic benefits] cannot be reliably determined," is a matter of judgment based on all relevant facts and circumstances. That issue is being addressed by the Task Force in Issue 03-9.

Issue 2: The appropriate method of derecognition of a balance sheet credit arising from an executory contract.

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3 Assume that the contract is not a derivative because it meets the normal purchases and sales criteria described in paragraph 10 of Statement 133 as amended, and its interpretations
10. The FASB staff observes that a balance sheet credit arising from an executory contract can be classified into one of two categories: (a) a liability or (b) an estimated loss on a purchase contract that is, in concept, a reduction of an asset.

11. The first category is a liability arising from an executory contract. The FASB staff believes that FAS 140 provides the requisite authoritative literature for liability derecognition. Paragraph 16 of FAS 140 states:

   A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

   a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
   b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. [Original footnote reference omitted; footnote No. 4 added by staff.]

Paragraph 3 of FAS 140 states:

    An entity may settle a liability by transferring assets to the creditor or otherwise obtaining an unconditional release. Alternately, an entity may enter into other arrangements designed to set aside assets dedicated to eventually settling a liability. Accounting for those arrangements has raised issues about when a liability should be considered extinguished. This Statement establishes standards for resolving those issues.

Paragraph 315 articulates the Board's intention that FAS 140 be applied to all liabilities by stating, "The Board concluded that the basic principle that liabilities should be derecognized only if the debtor pays the creditor or is legally released from its obligation applied not just to debt securities but to all liabilities."

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4 The Board is presently considering issues regarding liability extinguishment in its project to determine when the debtor is legally released from being the primary obligor.
12. A guarantee recognized under FIN 45 is an example of a liability arising from an executory contract. Although FIN 45 does not provide guidance regarding the subsequent accounting for liabilities associated with guarantees, paragraph 12 of FIN 45 makes an observation about past accounting practices, and states that "the guarantor's release from risk has typically been recognized over the term of the guarantee (a) only upon either expiration or settlement of the guarantee, (b) by a systematic and rational amortization method, or (c) as the fair value of the guarantee changes (as is done, for example, for guarantees accounted for as derivatives)" (emphasis added). Proposed FSP FIN 45-a, states that a guarantor is not free to choose from any of the three options under paragraph 12. Further, proposed FSP FIN 45-a proposes to limit the use of fair value to circumstances "supported by other pronouncements or guidance under generally accepted accounting principles, as is the case, for example, for guarantees accounted for as derivatives under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities." Notwithstanding the previous observations, some believe that guarantees recognized under FIN 45 are subject to paragraph 16 of FAS 140, other than those guarantees in which subsequent derecognition guidance is supported by other pronouncements or guidance under generally accepted accounting principles.

13. The second category is a balance sheet credit associated with executory contracts that is, in concept, a reduction of an asset. Paragraphs 251 and 252 of CON 6 describe an estimated loss on a purchase contract as follows:

Estimated loss on purchase commitments belongs in the second group of elements (paragraph 231) [that is, a liability, a reduction of an asset, a revenue or a gain]. It is not a revenue or gain because it results from a loss. It is at best part of a liability and is not by itself an obligation to pay cash or otherwise sacrifice assets in the future. There is no asset from which it may be a deduction in present practice. Thus, it seems not to fit in the second group, after all. That predicament results, however, because estimated loss on purchase commitments is the recorded part of a series of transactions and events that are mostly unrecorded. A purchase commitment involves both an item that might be recorded as an asset and an item that might be recorded as a liability. That is, it involves both a right to receive assets and an obligation to pay. A decrease in the price that leaves the committed buyer in the position of now being able to buy the assets cheaper were it not committed to buy them at the former, higher price does not by itself create an
obligation that was not already present. If both the right to receive assets and the obligation to pay were recorded at the time of the purchase commitment, the nature of the loss and the valuation account that records it when the price falls would be clearly seen. The obligation to pay has been unaffected by the price decrease—the full amount must be paid if the assets are accepted upon delivery, or damages must be paid if the assets are not accepted. However, the future economic benefit and value of the right to receive the assets has decreased because the market value of the assets to be received has declined, and the estimated loss on purchase commitment is in concept a reduction of that asset.

[Emphasis added.]

14. Balance sheet credits that are a reduction of an asset are included in the measurement of the historical cost of the associated asset. Derecognition of the balance sheet credit, therefore, is dependent upon derecognition of the associated asset. That is, the credit is derecognized as the associated asset is consumed or otherwise used up.

15. The FASB staff prepared the following analysis in order to facilitate a discussion about the distinction between liabilities and reductions of an asset arising from executory contracts.

**Example 1: Lease Losses Recognized under FTB 79-15**

- **Example:** Lessee leases building from Lessor under a noncancelable operating lease. Lessee subsequently enters into an operating sublease with Company E, whereby Company E leases the building from Lessee at a rate less than Lessee's commitment to Lessor. Lessee recognizes a balance sheet credit.

- **Evaluation:** Current authoritative accounting literature does not view Lessee's rights and obligations under the operating lease as assets or liabilities. From the standpoint of rights and obligations between Lessee and Lessor, Lessee entering into the operating sublease with Company E does not change Lessee obligations to Lessor. Therefore, Lessee entering into a sublease with Company E is not an obligating event and the credit does not meet the third characteristic of a liability. On the other hand, the event that gave rise to the recognition of the credit is the decrease in the future economic benefit and value of the Lessee's right to receive an asset (leased property). Therefore, the credit recognized as a result of Lessee entering into an underwater sublease with Company E is a reduction of an asset.
Example 2: Net Loss on Firm Purchase Commitments for Goods for Inventory Recognized under ARB 43

- **Example:** Buyer purchases goods for inventory from Seller under a firm purchase commitment. Subsequent to entering into the firm purchase commitment, but prior to receiving the goods for inventory, the Buyer's prices for finished goods decreases substantially. As a result, Buyer experiences a decrease in the future economic benefit of the goods that results in a net loss on the purchase commitment (measured in the same way as an inventory loss) and recognizes a balance sheet credit.

- **Evaluation:** Current authoritative accounting literature does not view Buyer's rights and obligations under the firm purchase commitments as assets or liabilities. From the standpoint of rights and obligations between Buyer and Seller, Buyer experiencing a net loss on the firm purchase commitment does not change the rights and obligations between Buyer and Seller. Therefore, Buyer experiencing a net loss is not an obligating event and the credit does not meet the third characteristic of a liability. On the other hand, the event that gave rise to the recognition of the credit is the decrease in the value of the future economic benefit embodied in the right to receive an asset (inventory). Therefore, a credit recognized under ARB 43 is a reduction of an asset.

Interaction of the Scope of FAS 146 and Issue 03-17

16. FAS 146 requires that a *liability* for other costs that will continue to be incurred under a contract for its remaining term without economic benefit to an entity should be recognized and measured at its fair value when the entity ceases using the rights conveyed by the contract, for example, the right to use a leased property or to receive future goods or services. FAS 146 provides guidance on the subsequent measurement and derecognition of liabilities for activities accounted for under its scope; therefore, costs accounted for under FAS 146 are not subject to interpretation under this Issue. The FASB staff observes, based on the preceding analysis, that losses recognized under FTB 79-15 and ARB 43 are substantially similar to a liability recognized under FAS 146 for costs that will continue to be incurred under a contract for its remaining term without economic benefit to an entity because (a) the lessee's obligation to the lessor (under an operating lease) or a buyer's obligation to the seller (under a purchase contract) do not change
and (b) the event that gave rise to the recognition of the credit is the decrease in the future economic benefit and value of the right to receive an asset (right to use leased property or goods and services). However, the FASB staff does not believe that transactions outside the scope of FAS 146 should be analogized to FAS 146.

Summary
17. This Issue Summary provides the FASB staff's proposed framework for the subsequent accounting for assets and liabilities arising from executory contracts that are recognized on a company's balance sheet. The FASB staff has noted several issues that may be addressed in two of the Board's current agenda projects: Revenue Recognition and Liability Extinguishment. The FASB staff has also noted several issues that are already addressed in existing guidance. The FASB staff requests Task Force members' views on the following:

a. Whether there are any specific issues discussed in this Issue Summary that are not addressed in existing literature or that should be addressed now rather than waiting for them to be addressed in the Board's current agenda projects.

b. Whether there are other specific issues that should be specifically identified and addressed in this Issue.