

Revenue recognition in a real estate contract that includes the transfer of land (IFRS 15 Revenue from Contracts with Customers)—March 2018

The Committee received a request about revenue recognition in a contract for the sale of land and a building to be constructed on the land. Specifically, the request asked (a) about the identification of performance obligations in the contract and (b) for each performance obligation identified, whether the real estate developer (entity) recognises revenue over time or at a point in time.

Identifying performance obligations in the contract

Applying paragraphs 22–30, an entity identifies as a performance obligation each promise to transfer to the customer a good or service (or a bundle of goods or services) that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

Paragraph 27 specifies that a good or service promised to a customer is distinct if:

- a. the customer can benefit from the good or service on its own or together with other resources readily available to the customer (ie the good or service is capable of being distinct); and
- b. the entity's promise to transfer the good or service is separately identifiable from other promises in the contract (ie the promise to transfer the good or service is distinct within the context of the contract).

The assessment of the criteria in paragraph 27 requires judgement.

Paragraph BC100 notes that an entity assesses the criterion in paragraph 27(a) based on the characteristics of the goods or services themselves. Accordingly, an entity disregards any contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity.

Paragraph 29 explains that the objective underlying the criterion in paragraph 27(b) is to determine whether the nature of the promise, within the context of the contract, is to transfer each of the promised goods or services individually or, instead, to transfer a combined item to which those goods or services are inputs. Paragraph 29 also specifies some factors that indicate that two or more promises to transfer goods or services are not separately identifiable.

Paragraphs BC105, BC116J and BC116K note that the notion of 'separately identifiable' in paragraph 27(b) is influenced by the notion of separable risks (ie whether the risk an entity assumes to fulfil its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised goods or services). The evaluation of whether an entity's promise is separately identifiable considers the relationship between the various goods or services within the contract in the context of the process of fulfilling the contract. Therefore, an entity considers the level of integration, interrelation or interdependence among the promises to transfer goods or services. Rather than considering whether one item, by its nature, depends on the other (ie whether two items have a functional relationship), an entity evaluates whether there is a transformative relationship between the two items in the process of fulfilling the contract.

A real estate contract for the transfer of land and a building

The following paragraphs outline factors an entity considers in assessing whether, for a contract that involves the transfer of land and a building that the entity constructs on the land, the promise to transfer land is a separate performance obligation. The land represents all of the area on which the building will be constructed and the contract is for the entire building. Those paragraphs do not consider whether the entity identifies one or more performance obligations in relation to the transfer of the building.

When assessing the criterion in paragraph 27(a), the entity assesses whether the customer could benefit from the land on its own or together with other resources readily available to it. For example, could the customer hire another developer to construct a building on the land? Similarly, the entity assesses whether the customer could benefit from the construction of the building on its own or together with other resources readily available to it. For example, could the customer obtain the construction services from the entity or another developer without any transfer of land? In a contract for the transfer of an area of land

and of an entire building to be constructed on the land, the Committee concluded that the land and the building are each capable of being distinct.

The entity then assesses the criterion in paragraph 27(b) and its underlying objective explained in paragraph 29 (ie determining whether the nature of the promise, within the context of the contract, is to transfer the land and the building individually or, instead, to transfer a combined item to which the land and building are inputs). In assessing the criterion in paragraph 27(b), the Committee observed that the entity considers, among other factors, the following:

- a. whether the entity provides a significant service of integrating the land and the building into a combined output as described in paragraph 29(a)—for example, is there a transformative relationship between the transfer of the land and the construction of the building in the process of fulfilling the contract? Would the entity’s performance in constructing the building be any different if it did not also transfer the land and vice versa? There is a functional relationship between the land and the building—the building cannot exist without the land; its foundations will be built into the land. However, this does not necessarily mean that the risks the entity assumes in transferring the land to the customer are inseparable from the risks it assumes in constructing the building.
- b. whether the land and the building are highly interdependent or highly interrelated as described in paragraph 29(c)—for example, would the entity be able to fulfil its promise to transfer the land even if it did not construct the building, and would it be able to fulfil its promise to construct the building even if it did not transfer the land?

The Committee concluded that the promise to transfer the land would be separately identifiable from the promise to construct the building on that land if the entity concluded that (a) its performance in constructing the building would be the same regardless of whether it also transferred the land; and (b) it would be able to fulfil its promise to construct the building even if it did not also transfer the land, and would be able to fulfil its promise to transfer the land even if it did not also construct the building.

In assessing the criterion in paragraph 27(b), paragraph BC116N notes that the factors in paragraph 29 are not intended to be criteria that an entity evaluates independently of the ‘separately identifiable’ principle in paragraph 27(b). In some instances, one or more of the factors may be less relevant to the evaluation of that principle.

Applying paragraph 35 of IFRS 15

Paragraph 35 specifies that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if any one (or more) of the three criteria in paragraph 35 is met. Paragraph 32 states that if an entity does not satisfy a performance obligation over time, it satisfies the performance obligation at a point in time. Accordingly, the Committee observed that, at contract inception for each performance obligation, an entity applies the criteria in paragraph 35 to determine whether it recognises revenue over time.

The Committee has included explanatory information about the application of paragraph 35 to real estate contracts in its agenda decision ‘*Revenue recognition in a real estate contract*’ published in March 2018.

Application of paragraph 35 to the fact pattern in the request

The assessment of whether to recognise revenue over time or at a point in time requires an assessment of the particular facts and circumstances of the contract, taking into account the legal environment within which the contract is enforceable. Accordingly, the outcome of an entity’s assessment depends on those particular facts and circumstances.

In the fact pattern described in the request, the contract includes the following features:

- a. *the entity and the customer enter into a non-cancellable contract for the sale of a building yet to be constructed by the entity that will comprise residential units. The contract is for the sale of the entire building.*
- b. *at contract inception, the entity irrevocably transfers to the customer legal title to the land on which the entity will construct the building. The contract specifies a price for the land, which the customer pays on signing the contract.*

- c. *the entity and the customer agree upon the structural design and specification of the building before the contract is signed. As the building is being constructed:*
 - i. *if the customer requests changes to the structural design or specification, the entity prices the proposed changes based on a methodology specified in the contract; the customer then decides whether to proceed with the changes. The entity can reject the customer's request for changes for only a limited number of reasons, such as if the change would breach planning permission.*
 - ii. *the entity can request changes to the structural design or specification only if not doing so would lead to an unreasonable increase in costs or delay to construction. The customer must approve those changes.*
- d. *the customer is required to make milestone payments throughout the construction period. However, these payments do not necessarily correspond to the amount of work completed to date.*

It is assumed that (i) all the criteria in paragraph 9 are met and (ii) the entity identifies two performance obligations applying paragraphs 22–30—a promise to transfer the land to the customer and a promise to construct the building on that land.

Application of paragraph 35 to the promise to transfer land

The entity's performance transfers the land to the customer. The land is not consumed immediately and, thus, the criterion in paragraph 35(a) is not met. Nor does the entity's performance create or enhance the land and, thus, the criteria in paragraphs 35(b) and 35(c) are not met.

Consequently, the entity recognises revenue for the transfer of the land to the customer at a point in time applying paragraph 38 of IFRS 15.

Application of paragraph 35 to the promise to construct the building

The criterion in paragraph 35(a) is not met because the entity's performance creates an asset that is not consumed immediately.

Paragraph 35(b)

In assessing the criterion in paragraph 35(b), the entity assesses whether, as the building is being constructed, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the part-constructed building.

The customer controls the part-constructed building as it is being constructed because the customer has the following:

- a. *the ability to direct the use of the building as it is being constructed. The customer has this ability through its control of the land, and by being able to change the structural design and specification of the building as it is being constructed. The contract also enables the customer to prevent the entity or others from directing the use of the building.*
- b. *the ability to obtain substantially all of the remaining economic benefits from the building. The entity cannot redirect the building for another use or to another entity. Accordingly, on signing the contract, the customer has the ability to obtain substantially all of the remaining benefits from the building. The contract also enables the customer to prevent the entity or others from obtaining the benefits from the building.*

Accordingly, the criterion in paragraph 35(b) is met. The Board observed in paragraph BC129 that 'in the case of a construction contract in which the entity is building on the customer's land, the customer generally controls any work in progress arising from the entity's performance'.

The Committee concluded that the principles and requirements in IFRS 15 provide an adequate basis for an entity to recognise revenue in the fact pattern described in the request. Consequently, the Committee decided not to add this matter to its standard-setting agenda.