IFRS

STAFF PAPER

November 2017

IFRS Interpretations Committee Meeting

Project	**Right to payment for performance completed to date (IFRS 15)**		
Paper topic	Initial consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a request about whether to recognise revenue over time or at a point in time. Specifically, for a particular real estate contract, the request asked whether a real estate developer (the entity) has an enforceable right to payment for performance completed to date as described in paragraph 35(c) of IFRS 15 *Revenue from Contracts with Customers*.

2. The objective of the paper is to:

   (a) provide the Committee with background information on the matter (paragraphs 4–5);

   (b) present our research and analysis (paragraphs 6–33); and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda (paragraph 34).

3. There are two appendices to the paper:

   (a) Appendix A—Proposed wording of the tentative agenda decision; and

   (b) Appendix B—Submission.

Background information

4. Appendix B to this paper provides full details of the submission. Below we have reproduced the main facts we considered in our analysis:

   (a) The entity and the customer enter into a contract for the sale of a real estate unit in a residential multi-unit development before the entity constructs the unit.

   (b) Once the contract is signed, the entity is obliged to deliver the completed real estate unit as specified in the contract—it cannot change or substitute the unit agreed to in the contract. The entity retains legal title to the real estate unit (and any land attributed to it) until construction is complete.

   (c) The customer pays 10% of the purchase price for the real estate unit at contract inception, and pays the remainder when construction is complete.

   (d) The customer is able to cancel the contract at any time before construction is complete. If the customer cancels the contract:

      (i) the entity has a legal right to obtain the original purchase price for the real estate unit, plus costs arising from cancellation. The entity is required to make reasonable efforts to resell the real estate unit to a third party. If there is any shortfall between the resale price to be obtained from the third party and the original purchase price (plus any sale and marketing costs), the customer has a legal obligation to pay the difference to the entity.

      (ii) the customer does not have any rights to sell, use or develop the real estate unit, nor is it entitled to any excess of resale proceeds over the original purchase price.

   (e) Court rulings have confirmed the legal right of the entity and the legal obligation of the customer described in bullet (d)(i) above.

5. In addition, the submission says it can be assumed that the entity:

(a) has concluded the contract is in the scope of IFRS 15 and all the criteria in paragraph 9 of IFRS 15 are met;

(b) has identified one performance obligation in the contract applying paragraphs 22-30 of IFRS 15—a promise to transfer the real estate unit to the customer; and

(c) has concluded the criteria in paragraphs 35(a) and 35(b) for recognising revenue over time are not met.

Summary of our analysis

Outreach

6. We decided not to perform outreach on this submission for two reasons:

(a) We are aware that customers buy real estate units before construction is complete in many jurisdictions. We are also aware, however, that contracts and legislation vary in different jurisdictions, thereby resulting in differing patterns of revenue recognition. As a consequence, we concluded that outreach would not provide additional information about this matter.

(b) Because the matter relates to the application of IFRS 15, we considered it to be urgent in nature and thus proceeded to bring it to the Committee's November 2017 meeting.

Application of IFRS requirements

7. Paragraph 31 of IFRS 15 specifies the principle for recognising revenue:

> An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (ie an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

8. An entity is required by paragraph 32 of IFRS 15 to determine whether it satisfies a performance obligation, and thus recognises revenue, over time or at a point in time. To do so, at contract inception the entity assesses each of the three criteria in paragraph 35. If any one (or more) of the three criteria in paragraph 35 is met, then the entity recognises revenue over time. Otherwise, the entity recognises revenue at a point in time.

9. As noted in paragraph 5(c) of this paper, the entity has concluded the criteria in paragraphs 35(a) and 35(b) are not met. The submission, therefore, focuses on the application of paragraph 35(c):

> An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:
>
> …
>
> (c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37).

10. To recognise revenue over time applying paragraph 35(c), both parts of the criterion in that paragraph must be met, ie the asset created by an entity's performance must not have an alternative use to the entity and the entity must have an enforceable right to payment for performance completed to date.

Does the real estate unit have an alternative use to the entity?

11. The submission says the first part of the criterion in paragraph 35(c) is met, ie the real estate unit being constructed has no alternative use to the entity. This is because the entity is restricted contractually from readily directing the real estate unit for another use during the construction of the unit, as specified in paragraph 36 of IFRS 15.

12. We agree with this conclusion based on the fact pattern described in the submission. The contract is for a specific real estate unit in a specific location, and the entity cannot change or substitute the unit agreed to in the contract. We think

there is therefore a substantive contractual restriction as described in paragraph B7 of IFRS 15, because the customer would be able to enforce its right to the unit if the entity were to seek to direct the unit for another use.

13. In addition, paragraph B6 of IFRS 15 says the possibility of the contract being terminated is not relevant for this consideration. Therefore, the fact that the entity would resell the real estate unit if the customer were to cancel the contract does not affect the assessment.

Does the entity have an enforceable right to payment?

What IFRS 15 says

14. Paragraphs 37 and B9-B13 provide requirements for determining whether the entity has an enforceable right to payment for performance completed to date. Paragraph 37 states:

> An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c). The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised…

15. Paragraph B9 distinguishes between a right to payment for performance completed to date and compensation for loss of profit, as follows:

> …An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation

> for only the entity's potential loss of profit if the contract were to be terminated…

16. Accordingly, if an entity is entitled only to compensation for loss of profit, it does not have an enforceable right to payment for performance completed to date and, thus, the criterion in paragraph 35(c) is not met.

Staff analysis

17. In the fact pattern described in the submission, we think the main question is to determine whether, throughout the duration of the contract, the entity would have an enforceable right to payment for performance completed to date if the customer cancels the contract or, instead, would be entitled only to compensation for loss of profit (as described in paragraph B9 of IFRS 15). In other words, does the entity's legal right to obtain (and the customer's legal obligation to pay) any shortfall between the resale price and the original purchase price of the real estate unit compensate the entity for performance completed to date or compensate it only for loss of profit?

Objective underlying paragraph 35(c) of IFRS 15

18. To answer this, it is helpful to understand the Board's objective in developing the criterion in paragraph 35(c) and supporting application guidance.

19. Paragraph BC124 of IFRS 15 explains that the Board developed the criteria in paragraph 35 to provide an objective basis for assessing when control of a good or service transfers over time. This is reflected in the opening words of paragraph 35, which says 'an entity transfers control of a good or service over time…'. Paragraph 31 also says an asset is transferred when (or as) the customer obtains control of that asset. Accordingly, in considering the criterion in paragraph 35(c), the underlying objective is to determine whether the customer obtains control of the real estate unit as it is being constructed.

20. The Board explained in paragraph BC141 that 'to demonstrate that a customer controls an asset that has no alternative use as it is being created, an entity must also have an enforceable right to payment for performance completed to date'. IFRS 15 distinguishes between a payment for performance completed to date and compensation for loss of profit. This is because the former is reflective of the

customer obtaining control as the asset is being created, whereas compensation for loss of profit is not. Paragraph BC143 explains 'assuming there is rationale behaviour and that there are no broader perceived economic benefits that might exist outside the scope of the contract with the customer, the entity would only agree to transfer control of the goods or services to the customer if the entity is compensated for the costs associated with fulfilling the contract and it receives a profit margin that includes a return on those costs'.

21. With this in mind, in our view the entity's legal right to obtain any shortfall between the resale price and the original purchase price of the real estate unit from the customer is compensation for loss of profit—the entity does not have an enforceable right to payment for performance completed to date. This is because, on cancellation of the contract, the entity controls the real estate unit and, in the context of performance under the original contract, has the right only to compensation for loss of profit.

Customer's rights and obligation on cancellation

22. In the fact pattern described in the submission, if the customer cancels the contract it does not obtain legal title to the real estate unit, nor does it have any rights to sell, use or develop the unit. Instead, the entity resells the unit, and thus will transfer the unit to a third-party under a new contract. The facts indicate that, on cancellation, the customer does not take delivery of a real estate unit and thus is not using the entity as a selling agent on its behalf. Instead, the entity controls the unit and directly resells it to a third party.

23. This is confirmed by the customer's rights on cancellation. If the resale price of the real estate unit is higher than the original purchase price, the entity receives all the benefit. The customer is unable to benefit from any increase in the price. Therefore, the fact that the customer is liable for any downside but has no access to any upside indicates that the payment the customer makes to the entity is compensation for loss of profit.

24. In addition, we note that the overriding principle in paragraph 31 of IFRS 15 for the recognition of revenue (reproduced in paragraph 7 of this paper) is all about the relationship between the entity and the customer. The criteria in paragraph 35

were developed to provide an objective basis to assess whether the customer controls the asset as it is being created. Therefore, in determining whether the entity has a right to payment for performance completed to date, we think it is the payment the entity is entitled to from (or specifically on behalf of) the customer, relating to performance under the original contract, that is relevant.

25. In the fact pattern described in the submission, on cancellation by the customer the entity sells the real estate unit to a third-party in a separate contract. The customer does not novate the original contract to the third-party. Consequently, we think the payment made by the third-party should be considered to be payment for the entity's performance in the contract with that third-party. It should not be considered to be part of the payment for performance under the original contract with the customer.

26. This is supported by the Board's explanation in the Basis for Conclusions on IFRS 15. In particular, paragraph BC142 explains (emphasis added):

> …Consequently, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. That protection will be established by requiring that if the contract is terminated, **the customer must pay for the entity's performance completed to date**. This is consistent with other exchange contracts in which a **customer would typically be obliged to pay** only if it has received control of goods or services in the exchange. Consequently, the fact that the **customer is obliged to pay for the entity's performance** (or, in other words, is unable to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance.

27. We acknowledge that, in the extreme (assuming the value of the real estate unit on cancellation is zero), the customer's obligation would represent all of the original purchase price of the unit plus cancellation costs. However, even if that highly unlikely scenario were to occur, we would still not regard the entity as having the right to compensation for performance completed to date. Paragraph 37 of

IFRS 15 says '…at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised…'. The nature of the payment from the customer to which the entity has a right under the contract is a payment for the difference between the resale price and the original purchase price. In some situations, as in the above extreme scenario, the entity may obtain an amount from the customer that in effect compensates it for performance completed to date. However, we regard those situations as arising from the operation of a loss of profit provision in the contract in extreme circumstances; they are not the result of the entity having a right to payment for performance completed to date at all times throughout the contract.

Contrast with the circumstances described in paragraph B11

28. Paragraph B11 of IFRS 15 outlines circumstances in which an entity has an enforceable right to payment:

> In some contracts, a customer may have a right to terminate the contract only at specified times during the life of the contract or the customer might not have any right to terminate the contract. If a customer acts to terminate a contract without having the right to terminate the contract at that time (including when a customer fails to perform its obligations as promised), the contract (or other laws) might entitle the entity to continue to transfer to the customer the goods or services promised in the contract and require the customer to pay the consideration promised in exchange for those goods or services. In those circumstances, an entity has a right to payment for performance completed to date because the entity has a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration).

29. From the entity's perspective, the fact pattern described in the submission could be viewed as similar to the circumstances in paragraph B11 in that the entity is entitled to receive at least the original purchase price for the real estate unit.

30. There is, however, an important difference between the fact pattern in the submission and the circumstances outlined in paragraph B11. In the circumstances outlined in paragraph B11, the entity has the right to force the customer to accept the goods in exchange for the original purchase price. The facts are such that, in effect, the customer cannot decide to cancel the contract. On receipt of the goods, the customer would have the right to sell those goods and, if it did, then it would be entitled to all of the resale price. This indicates that the entity has the right to payment for performance completed to date on the original contract.

31. In contrast, in the fact pattern in the submission, the customer can at any time cancel the contract before construction is complete. If it does, it does not obtain the real estate unit and has no rights to any upside on resale of the unit. Its obligation is only to pay to the entity any shortfall between the resale price and the original purchase price (plus cancellation costs).

Conclusion

32. In our view, in the fact pattern described in the submission, the entity does not have an enforceable right to payment and, thus, the criterion in paragraph 35(c) of IFRS 15 is not met.

Question 1 for the Committee
Does the Committee agree with our analysis of the application of paragraph 35(c) of IFRS 15 to the fact pattern described in the submission?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[1]

33. On the basis of our analysis in paragraphs 7-32 of the paper, we think the principles and requirements in IFRS 15 provide an adequate basis for an entity to determine whether to recognise revenue over time or at a point in time in the fact pattern described in the submission.

Staff recommendation

34. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16-5.17 of the *Due Process Handbook* (discussed in paragraph 33 above), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that outlines how the entity applies paragraph 35(c) of IFRS 15 to the fact pattern described in the submission.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

[1] Paragraph 5.16(b) of the *Due Process Handbook*.

Appendix A—Proposed wording of the tentative agenda decision

IFRS 15 *Revenue from Contracts with Customers*—Right to payment for performance completed to date

The Committee received a request about whether to recognise revenue over time or at a point in time in a contract for the sale of a unit in a residential multi-unit complex (real estate unit). Specifically, the request asked whether, in the fact pattern described in the request, the real estate developer (entity) has an enforceable right to payment for performance completed to date as described in paragraph 35(c) of IFRS 15.

Paragraph 35 of IFRS 15 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 of IFRS 15 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, an entity assesses the criteria in paragraph 35 to determine whether it recognises revenue over time.

The request specifically asked about the application of paragraph 35(c) of IFRS 15. Applying paragraph 35(c), an entity recognises revenue over time if (a) the asset created by an entity's performance does not have an alternative use to the entity; and (b) the entity has an enforceable right to payment for performance completed to date.

Paragraph 37 of IFRS 15 states that, to have an enforceable right to payment, at all times throughout the duration of the contract the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated for reasons other than the entity's failure to perform as promised.

Paragraph B9 of IFRS 15 states that an amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date, rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Accordingly, if an entity is entitled only to compensation for loss of profit, it does not have an enforceable right to payment for performance completed to date and, thus, the criterion in paragraph 35(c) is not met.

Application of paragraph 35(c)—enforceable right to payment—to the fact pattern in the request

The assessment of whether an entity has an enforceable right to payment for performance completed to date requires an entity to consider the rights and obligations created by the contract, taking into account the legal environment within which the contract is enforceable. Accordingly, the Committee observed that the outcome of an entity's assessment depends on the particular facts and circumstances pertaining to the contract.

In the fact pattern described in the request, the contract for the real estate unit includes the following features:

a. the entity and the customer enter into a contract for the sale of a real estate unit in a residential multi-unit complex before the entity constructs the unit. The entity's obligation under the contract is to deliver the completed real estate unit as specified in the contract. The entity retains legal title to the real estate unit (and any land attributed to it) until construction is complete.

b. the customer pays 10% of the purchase price for the real estate unit at contract inception, and pays the remainder of the purchase price to the entity after construction is complete.

c. the customer has the right to cancel the contract at any time before construction is complete. If the customer cancels the contract:

   i. the entity is legally required to make reasonable efforts to resell the real estate unit to a third party. If the resale price to be obtained from the third party is less than the original purchase price (plus selling costs), the customer is legally obliged to pay the difference to the entity.

   ii. the customer does not have any rights to sell, use or develop the real estate unit, nor is it entitled to any excess of resale proceeds over the original purchase price (plus selling costs).

The Committee noted that the principle in paragraph 31 of IFRS 15 for the recognition of revenue is about the relationship between the entity and the customer. It is, therefore, the payment the entity is entitled to from (or on behalf of) the customer relating to performance under the original contract that is relevant in determining whether the entity has a right to payment for performance completed to date. The consideration received by the entity from the third-party in the resale contract is consideration relating to that resale contract—it is not payment for performance under the original contract.

The Committee observed that, based on the fact pattern described in the request, the nature of the payment from the customer to which the entity has a right under the contract is a payment for the difference between the resale price and the original purchase price. Accordingly, the entity has a right to compensation for loss of profit on termination of the contract—it does not have an enforceable right to payment for performance completed to date as described in paragraph 35(c) of IFRS 15.

The Committee concluded that the principles and requirements in IFRS 15 provide an adequate basis for an entity to determine whether it has an enforceable right to payment for performance completed to date. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B—Submission

A1. We have reproduced the submission below. We have removed details that might identify the submitter of this request.

<u>IFRIC submission</u>

The issue is whether the "enforceable right to payment" criterion in IFRS 15.35(c) is met in a situation in which the seller is entitled to receive the full amount of the transaction price, but the payment may ultimately be fully or partially collected from a party other than the original customer.

The more fundamental issue is how to establish when an enforceable right to payment exists in the context of IFRS 15.35(c). More broadly, how is the control concept applied in the standard?

IFRS 15.35(c) raises a range of issues internationally due to differences in local laws and regulations.

This submission discusses the interpretative issue outlined above based on the specific circumstances of a multi-unit residential development [in one jurisdiction]. This issue is also of broader interest. An IFRIC agenda decision on this issue, together with the IFRIC papers and discussion, will assist preparers and auditors in the implementation of IFRS 15 internationally. A resolution of the issue may facilitate more consistent application of IFRS 15.35(c) in different sectors and jurisdictions.

There are two different views on the appropriate accounting treatment of contracts under which the transaction price may be collected fully or partially from a different party than the original customer:

1) View 1 – Under IFRS 15.35(c) a seller has an enforceable right to payment for performance to date only when it can enforce the contract against and collect payment from the original customer. The "enforceable right to payment" criterion in IFRS 15.35(c) is not met if a seller has a right to collect from the original customer only any shortfall between the original sale price and the proceeds of resale of the asset to a third party following termination without cause of the contract by the original customer. Accordingly, the seller is not permitted to recognise revenue over time on this basis.

2) View 2 – Under IFRS 15.35(c) a seller has an unconditional right to payment for performance to date whenever the seller is entitled to receive the full sales price, including when some or all of the sales price may be collected from a party other than the original customer following termination without cause of the original contract. As such a right to receive the full sales price exists and the asset has no alternative use, revenue must be recognised over time.

Description of facts and circumstances

The relevant facts in [this] context can be described as follows.

When a customer contracts to buy a residential unit including land[2] (below collectively referred to as "residential unit") that has not yet been constructed, the customer accepts a financial obligation to pay the agreed sale price for the fully developed residential unit. The customer has an exclusive right to a specific residential unit, which the developer may not sell to another customer. The customer usually pays a 10% cash deposit, and the remaining 90% of the sales price when the residential unit is completed.

The [local] Residential Property Construction Act (*[Act]*) regulates developer-consumer relations. Residential unit purchase contracts refer to the Act, which grants the customer (but not the developer) a right to cancel the contract before construction of the residential unit in question is complete. In effect, cancellation entails refusal by the customer to take delivery of the residential unit. After cancellation, the customer no longer has an asset to sell, use or develop further. However, the customer's financial obligation is not cancelled. The developer is still entitled to the full sales price, although the developer may not receive the gross cash payment from the original customer.

In the event of cancellation by the customer, the developer is entitled to the original sales price for the completed residential unit, plus costs arising due to the cancellation. The Act establishes a settlement mechanism under which the developer must make reasonable efforts to resell the specific residential unit in full or partial settlement of the customer's financial obligation. The customer must pay to the developer the total shortfall between the resale price and the originally agreed sale price, as well as sale and marketing costs, interest, etc. Through cancellation, the customer surrenders all rights to any upside.

Court rulings in [the jurisdiction] have confirmed the legal enforceable right of the developer and the legal obligation of the customer. According to the preparatory works to the Act, the developer shall not be put in a worse economic position than if the contract had not been cancelled.

Relevant sections of IFRS 15 *Revenue from Contracts with Customers*

The paragraphs quoted below are the most relevant when evaluating the issues described above. We have also referred to IFRS15.BC187 in our discussion of View 2 below to aid understanding of who must make actual payment in cash.

IFRS 15.35(c) is the paragraph of primary relevance in this context:

> *An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:…*

[2] The reason for the phrase "including land" here is that different circumstances apply when the customer owns the land. However, in this context the intention is not to discuss how land should be accounted for.

(c)the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37).

Further explanations are found in IFRS 15.36-37 and B6-B13.Below we include the most relevant text.

> IFRS 15.37: *An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c).The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. ParagraphsB9–B13 provide guidance for assessing the existence and enforceability of a right to payment and whether an entity's right to payment would entitle the entity to be paid for its performance completed to date.*
>
> IFRS 15.B9 (excerpt): *In accordance with paragraph 37, an entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for its performance completed to date in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated…*
>
> IFRS 15.B10: *An entity's right to payment for performance completed to date need not be a present unconditional right to payment. In many cases, an entity will have an unconditional right to payment only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. In assessing whether it has a right to payment for performance completed to date, an entity shall consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised.*
>
> IFRS 15.B12: *In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:*
>
> *(a) legislation, administrative practice or legal precedent confers upon the entity a right to payment for performance to date even though that right is not specified in the contract with the customer;…*

The Basis for Conclusions (BC) in IFRS 15 discusses the control concept and how it should be applied. We have included relevant extracts from the BC below.

Control should be assessed primarily from the perspective of the customer (BC121). The boards developed the criteria in paragraph 35 of IFRS 15 to provide an objective basis for assessing when control transfers over time and, thus, when a performance obligation is satisfied over time (BC124). The boards observed that, in some cases, applying the criteria in paragraph 35(a) and (b) of IFRS 15 could be challenging. Consequently, the boards developed a third criterion to help with the assessment of control (BC132).

If a contract precludes an entity from transferring an asset to another customer and that restriction is substantive, the entity does not have an alternative use for that asset because it is legally obliged to direct the asset to the customer. Consequently, this indicates that the customer controls the asset as it is created, because the customer has the present ability to restrict the entity from directing that asset to another customer (an entity would also need to consider whether a right to payment exists to conclude that control of the asset transfers over time as it is created, see paragraphs BC142–BC148). The boards observed that contractual restrictions are often relevant in real estate contracts. (BC137)

The boards decided that there is a link between the assessment of control and the factors of no alternative use and a 'right to payment'. This is because if an asset that an entity is creating has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer. Consequently, the entity will want to be economically protected from the risk of the customer terminating the contract and leaving the entity with no asset or an asset that has little value to the entity. That protection will be established by requiring that if the contract is terminated, the customer must pay for the entity's performance completed to date. This is consistent with other exchange contracts in which a customer would typically be obliged to pay only if it has received control of goods or services in the exchange. Consequently, the fact that the customer is obliged to pay for the entity's performance (or, in other words, is unable to avoid paying for that performance) suggests that the customer has obtained the benefits from the entity's performance (BC142).

The boards intended the term 'right to payment' to refer to a payment that compensates an entity for its performance completed to date rather than, for example, a payment of a deposit or a payment to compensate the entity for inconvenience or loss of profit. This is because the underlying objective of the criterion is to determine whether the entity is transferring control of goods or services to the customer as an asset is being created for that customer. Consequently, assuming there is rational behaviour and that there are no broader perceived economic benefits that might exist outside the scope of the contract with the customer, the entity would only agree to transfer control of the goods or services to the customer if the entity is compensated for the costs associated with fulfilling the contract and it receives a profit margin that includes a return on those costs (BC143).

In addition, the boards clarified that an entity need not have a present unconditional right to payment but, instead, it must have an enforceable right to demand and/or retain payment for performance completed to date if the customer were to terminate the contract without cause before completion (BC145).

> *The boards considered but rejected specifying a right to payment as a more overarching criterion in determining when revenue is recognized (BC148).*

We have also referred to the objective of IFRS 15.1:

> *The objective of this Standard is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.*

Discussion of the issue by using the example of the multi-unit residential development in [the jurisdiction]

This analysis assumes that an IFRS 15 contract exists. Furthermore, it is assumed that the contract contains only one performance obligation, and that IFRS 15.35(a) and (b) are not met.

The first criterion in IFRS 15.35(c) (no alternative use) is met. IFRS 15.B6-B7 provides guidance on "no alternative use". The developer is contractually restricted from deciding a different use for the asset. IFRS 15.B6 clarifies that the possibility of contract termination is not a relevant consideration in this assessment.

The key question in order to conclude whether control is transferred over time is therefore whether the second criterion in IFRS 15.35(c) "*enforceable right to payment for performance completed to date*" is met.

IFRS 15 contains no clear definition of what constitutes "compensation for loss of profit" and what constitutes "compensation for performance completed to date" in a situation in which the seller is entitled to receive the full amount of the transaction price, but the payment may ultimately be fully or partially collected from a party other than the original customer. As a consequence, there are different opinions on whether or not IFRS 15.35(c) is met in such a situation.

Unrelated to the "right to payment" issue, some claim that the fact that in the event of cancellation, the customer does not receive any excess over and above the original agreed price generated by resale, is an indicator that the customer has not assumed control continuously. Others claim that from the time the contract is entered into, the customer has the right to and risk for any changes in the value. The customer lose the upside if he cancels the contract. The developer does not have this cancellation right. The fact that the customer has a right to knowingly give up an upside is not an indication that control does not transfer over time, and is also not relevant when assessing transfer of control over time in these situations. IFRS 15.35(c) (see also IFRS 15.BC122-124) has established the two criteria that must be met to assess if control is transferred over time, as discussed above and below.

View 1: IFRS 15.35(c) is not met

There is no enforceable right to payment.

The settlement mechanism prescribed in the Act in the event of cancellation by the customer means that the amount that a developer may claim from the customer is limited to the developer's loss arising from the cancellation, and that the resulting payment must be regarded as compensation for loss of profit. According to B9 and BC143, compensation for loss of profit does not satisfy the "right to payment" criterion. Even though the developer is guaranteed full payment for work completed to date through the settlement mechanism, the payment from the customer is recovery of damages or other compensation.

BC142, BC143 BC149 and BC152 imply that control is transferred only when the right to payment is a right to receive full consideration gross and directly from the customer. A reasonable interpretation of IFRS 15 is that only direct payment by the original customer is relevant, and that the payment made by the customer in this case constitutes compensation for loss of profit, rather than payment for performance completed to date.

This implies that the right to compensation for any shortfall arising on resale of a residential unit is not a right to payment for performance completed to date, and that the developer's rights take the form of compensation for loss of profit, rather than a right to payment.

B12 appears to provide that a right to payment only exists when the developer can enforce its right to be paid by the customer for work completed to date, or for specific performance regardless of whether the residential unit is resold.

The customer only has a contingent payment obligation, which is not sufficient to fulfil IFRS 15.35(c). In the event of cancellation, the customer is not required to pay the total contract amount unless the asset (including land) has no value. This is an unrealistic scenario, and thus of limited relevance.

Any payment received from a new customer when the residential unit is resold is a payment under a future contract, and should not be regarded as an enforceable right to payment for performance completed to date. Revenue recognition must reflect the relationship between the contracting parties, not a potential relationship with a future contracting party.

View 2: IFRS 15.35(c) is met.

An enforceable right to payment exists.

As stated by the board in the Basis for Conclusions in IFRS 15, when an asset has no alternative use for the entity, this indicates that the customer controls the asset during its creation. The control concept must be evaluated from the customer's perspective. However, the board also requires the entity to have an enforceable right to payment. This right to payment is assessed from the entity's perspective[3], and requires that the entity is economically protected against the risk that the customer terminates the contract and leaves the entity with no asset or an asset that has little value to the entity. The facts in [this scenario] meet these conditions.

Once a developer has entered into a contract with a customer and commenced construction work, the developer has a legal right to receive the agreed sale price, i.e. to a minimum payment for performance completed to date pursuant to IFRS 15.B9. This is consistent with the *rational behaviour* discussion in IFRS 15.BC143. When a developer has a contract and commences construction it has a customer for a residential unit with no alternative use, and a right to be paid in full even if the customer cancels. After entering into the contract and commencing construction, the developer is, as stated in BC142: "*...economically protected from the risk of the customer terminating the contract and*

[3] Refer e.g. to IFRS 15.37, B9, B10, BC142 and BC143.

leaving the entity with no asset or an asset that has little value to the entity…" The developer is assured payment for the asset and for performance completed to date. The developer does not have to reverse revenue even if the customer cancels.

BC142 says further that "*… Consequently, the fact that the customer is obliged to pay for the entity's performance (or, in other words, is unable to avoid paying for that performance)suggests that the customer has obtained the benefits from the entity's performance.*" The customer cannot avoid paying for the developer's performance. The customer has a legally enforceable financial obligation for an amount up to the agreed sale price and additional costs arising due to cancellation. The Act provides a settlement mechanism, namely that the developer must make reasonable efforts to resell the residential unit. The settlement mechanism secures for the customer the value of the contracted asset up to the agreed sale price, which is then used to settle the customer's financial obligation in full or in part. This further indicates that the customer controls the asset during construction. See also IFRS 15.33(c). Alternatively ,the customer could resell the residential unit or the contract position(the latter subject to some limitations),instead of cancelling the contract.

As the developer has a legal enforceable right to receive the agreed sale price in a cancellation situation, it is clear that the developer is entitled to compensation for performance to date. The amount the developer has legal right to receive is not limited to loss of profit. The developer is guaranteed to receive the agreed sales price. This interpretation is supported by BC143, which explains the rationale behind this requirement, namely that "*the entity would only agree to transfer control...if the entity is compensated for the costs associated with fulfilling the contract and it receives a profit margin that includes a return on those costs.*"

It is not a requirement of IFRS 15.35(c) that the gross cash payment must be paid by the original customer. IFRS 15.35(c) contains no reference as to the payment source. The requirement, and the underlying principle, is that the contract establishes an enforceable right to payment for performance completed to date, not payment from a particular source.

Further, IFRS 15.BC187 states the following with regard to the transaction price: "*The boards also clarified that the amounts to which the entity has rights under the present contract can be paid by any party (ie not only by the customer)*." Although the statement does not relate directly to IFRS 15.35(c), it does indicate that the customer does not need to make direct gross payment. BC187 discusses "*the amounts to which the entity has rights under the present contract*." In the context [of this jurisdiction], the contract confers entitlement to the agreed sale price, including when the contract is cancelled by the customer.

The industry's evaluation

The industry in [this jurisdiction], regards View 2 as the correct interpretation of the standard. The industry especially notes that a residential unit under development has no alternative use as defined in IFRS 15.35(c). Since the developer also has an enforceable right to receive the full amount of the sales price, both criteria in IFRS 15.35(c) are met.

Revenue recognition over time generates useful information for users in accordance with the objective of the standard set out in IFRS 15.1. At present, the [] developers follow point-in-time recognition in accordance with IFRIC 15.12 in their primary financial statements, and disclose over-time revenue recognition in the segmental reporting notes in their financial statements. If View 1 should be adopted under IFRS 15, then the primary financial statements will continue to deviate from segmental reporting. Dialogue with investors and analysts currently focuses on segmental reporting, as over-time revenue recognition describes a developer's economic activity during a given period.

Why this is an issue for IFRIC

Responses to the IFRIC criteria are provided below. Reference is also made to the preceding discussion.

- **The issue: A description of the issue including, where relevant, any aspects that should be addressed separately.**
  - Reference is made to the preceding discussion.
  - **Current practice: A brief description of current or emerging accounting practices, outlining the major alternatives, and referring to the relevant requirements in IFRS Standards.**
    - Two different views exist on the appropriate accounting treatment of such contracts under IFRS 15. Reference is made to the preceding discussion.
    - In [this jurisdiction], these are accounted for as contracts for the sale of goods and on a point-in–time basis, as customers have limited ability to influence residential unit design; see IFRIC 15.12. IFRS 8 segment reporting is based on over-time revenue recognition. Users of industry financial reports focus primarily on segment reports when analysing and comparing companies, as they find over time more relevant.
- **Reasons for the Committee to address the issue: The issue should be evaluated using the following criteria:**
  - **Is the issue widespread and has, or is expected to have, a material effect on those affected?**
    - The issue concerns how to interpret the control concept in IFRS 15 and, specifically, the “right to payment” criterion in IFRS 15.35(c). Resolution of the issue will facilitate more consistent application of IFRS 15.35(c) in different sectors and jurisdictions.
    - The issue impacts all real estate entities [in this jurisdiction] that enter into multi-unit residential construction contracts. The impact of the two alternative views on these entities is material in that it significantly affects the timing of revenue recognition.
  - **Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?**
    - Without resolution of the issue, different entities in the [jurisdiction’s] real estate sector may apply different revenue recognition policies under similar multi-unit residential construction contracts under IFRS 15.
    - Without resolution of the issue, IFRS 15.35(c) may be interpreted differently in other sectors and other jurisdictions, again resulting in dissimilar reporting of similar transactions.

- **Can the issue be resolved efficiently within the confines of IFRS Standards and the *Conceptual Framework for Financial Reporting*?**
  - The issue can be resolved efficiently as it concerns the interpretation of a single criterion within IFRS 15. That criterion is derived from the control criterion, which is the core principle of the standard and discussed extensively in the standard, the supporting material and the Framework.
- **Is the issue sufficiently narrow in scope that the Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Committee to undertake the due process that would be required when making changes to IFRS Standards?**
  - As stated above, the issue raised is sufficiently narrow to be addressed efficiently by the IC.
  - Further, since the issue may also be relevant to the application of IFRS 15.35(c) in other sectors and industries – at least indirectly through clarification of the interaction between the right to payment criterion and the transfer of control concept – we consider that the issue is not too narrow to meet the cost-effectiveness threshold applied by the IC in deciding whether to address a given issue.
- **Will the solution developed by the Committee be effective for a reasonable time period? The Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified**
  - IFRS 15, including IFRS 15.35(c), will serve as the basis for revenue recognition for the foreseeable future. Any interpretation issued by the IC will therefore be effective in the long-term.