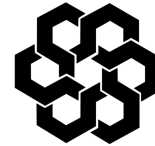

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International Accounting Standards Board

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INFORMATION FOR OBSERVERS

Board Meeting:	**17 April 2008, London**
Project:	**Revenue Recognition**
Subject:	**Satisfaction of performance obligations (Agenda paper 11D)**

CHAPTER 4 (DRAFT)

WHEN ARE ECONOMIC RESOURCES TRANSFERRED?

1. If a performance obligation is a promise in a contract between the entity and a customer to transfer an economic resource to that customer, then satisfaction of a performance obligation depends entirely on when the promised economic resource is *transferred* to the customer. When the economic resource is transferred, the obligation to transfer the resource can no longer exist and is thus satisfied. As a result, the entity's net position in a contract (whether a contract asset or a contract liability) will increase and lead to revenue recognition.

2. The discussion in the prior chapter suggests that when an entity promises to transfer a good, it means that the entity is promising to transfer to the customer the enforceable right or access to that good. When an entity promises to provide a service, it means that the entity is promising to provide a service or

access to a service, even though the service itself may be simultaneously consumed. Thus, to determine when a promised good has been transferred, an entity must search for indications (within the contract and the operation of law) that the enforceable rights or other access to the good have transferred from the entity to the customer. To determine when a promised service has been provided, an entity must search for indications (within the contract and the operation of law) that access to the service has been provided to the customer.

3. In essence, performance obligations are satisfied when promised economic resources are transferred to customers. This means that, in relation to performance obligations, revenue is recognized for the *output* of economic resources to customers and not the *activity* of the entity. Activities that an entity undertakes pursuant to a contract are themselves only performance obligations if they transfer economic resources to the customer.

Enforceable Rights, Access, and the Risks and Rewards of Ownership

4. It is important to distinguish enforceable rights or access to a good from the risks and rewards of ownership of the good. In the proposed revenue recognition model, performance obligations to transfer goods are satisfied when the enforceable rights or other access to the good transfer from the entity to the customer. The transfer of enforceable rights or other access to a good does not always coincide with a transfer of the risks and rewards of ownership of the good. In fact, as already noted in Chapter 2, it is this potential inconsistency that leads to difficulties in applying existing IFRS revenue recognition guidance. Although the definition of an asset in IFRS depends on the notion of control (a term that this paper equates with enforceable rights and access), the revenue recognition guidance depends on both the notion of control and the notion of risks and rewards of ownership. Hence, it is important that the proposed model clearly distinguish between these two notions.

5. How do the risks and rewards of ownership of a good differ from the enforceable rights or access to a good? Consider the following example:

> A ski shop sells and rents skis to customers. Occasionally, a customer is uncertain whether they will be pleased with a pair of skis. To encourage customers to make the purchase, the ski shop allows customers to purchase the skis with a right to return them within 30 days, as long as the skis are in good condition when returned. The terms of the sale indicate that the customer has legal title to the skis after the point of sale, although the ski shop bears a more than insignificant risk that the skis will be returned.

6. In this example, the customer clearly has the enforceable right or other access to the skis after the point of sale. The customer can decide how to use the skis and whether to return the skis to the ski shop. She can also sell or rent the skis to someone else if she chooses. Moreover, the ski shop has no rights or access to the skis. For instance, it cannot require that the customer return the skis.

7. On the other hand, the risks and rewards usually associated with owning the skis do not reside only with the customer. It is true that the customer gets to experience the rewards of owning the skis, such as the ability to use them at the local ski resort, the right to sell them on eBay, and the right to etch drawings all over the top of the skis. The customer also bears a number of the usual risks of owning the skis, such as the risk that the skis are stolen, lost, or damaged. However, some of the usual risks of owning the skis are still borne by the ski shop for the first 30 days after the customer's purchase. For instance, the ski shop bears the risk of obsolescence because the customer can return the skis for any reason as long as they are in good condition. If the customer decides that the skis are not fashionable, she can simply return the skis and all the risks and rewards of owning the skis revert back to the ski shop.

8. The fact that the risks of owning the skis do not entirely belong to the customer (for the first 30 days) is what makes the notion of risks and rewards difficult to apply. If the transfer of the skis was defined in terms of the risks and rewards of owning the skis, the ski shop would find itself having to judge whether a preponderance (or some other balance) of the risks and rewards of owning the skis had transferred to the customer. Despite the fact that the customer clearly has the enforceable rights to the skis and can limit the use of the skis by others (suggesting that the skis are indeed the customer's asset), a

judgment about the risks and rewards of owning the skis might lead the ski shop to conclude that the skis should still be reported as if they were its asset.

9. Consider another example:

> WholesaleCo ordinarily ships its goods to customers FOB shipping point via a third party shipper. That is, the title to the good transfers to the customer at the point of shipping. As a new service to customers, WholesaleCo decides to insure the goods while they are in transit to the customer. The title still transfers to the customer at shipping point, but WholesaleCo promises customers that it will replace any goods that are lost, stolen, or destroyed in transit. The customer can only return goods that are defective.
>
> Note that because title transfers to the customer at shipping point, the customer can redirect the goods at any point during transit. The customer also bears the risk of obsolescence (driven by changes in technology of its own customers' tastes) after the shipping point because it cannot return the goods.

10. In this example, the customer clearly has the enforceable right or other access to the goods at WholesaleCo's shipping point. The customer can redirect the goods to any store of its choosing. The customer can sell the goods or pledge the goods as collateral. Moreover, WholesaleCo cannot require that the customer return the goods, thus WholesaleCo's access to the goods is limited.

11. On the other hand, the risks and rewards usually associated with owning the goods do not reside only with the customer during transit. It is true that the customer has the rewards of owning the goods, such as the ability to redirect the goods to any location, the ability to pledge the goods as collateral, and even the right to sell them while in transit. The customer also bears a number of the usual risks of owning the goods, such as the risk that the goods become obsolete during shipping, either because technology changes or tastes change. However, some of the usual risks of owning the goods are still borne by WholesaleCo during transit. For instance, WholesaleCo bears the risk that the goods are lost, stolen, or damaged during transit. If something happens to the goods in transit, WholesaleCo will have to replace them, not the customer.

12. The fact that the risks of owning the goods do not entirely belong to the customer while the goods are in transit is what makes the notion of risks and rewards difficult to apply in this situation. If the transfer of the goods was defined in terms of the risks and rewards of owning the goods, WholesaleCo

would find itself having to judge whether a preponderance (or some other balance) of the risks and rewards of owning the goods had transferred to the customer. Despite the fact that the customer clearly has the enforceable rights to the goods and can limit access to the goods by others (suggesting that the goods are indeed the customer's asset), a judgment about the risks and rewards of owning the goods might lead WholesaleCo to conclude that the goods should still be reported as if they were its asset.

13. To avoid the confusion and inconsistency that exists in the current literature when the notion of enforceable rights or access are pitted against the risks and rewards of ownership, the proposed revenue recognition model judges the transfer of a good strictly in terms of the enforceable right or other access to the good. To be clear, judgment about the balance of risks and rewards will often give the same answer as a judgment about who holds the enforceable right or other access to the good. But because these judgments can differ, this model proposes that the transfer of a good depends only on the enforceable rights or other access to the good.

Customer Acceptance

14. Customer acceptance is another notion that can sometimes lead to different answers than the basic transfer notion proposed in this model. Customer acceptance clauses are included in many contracts. Most often, the clauses are meant to enumerate the required aspects of a particular good or service. As a way of ensuring that the selling entity has satisfied those required aspects of the good or service, the contract often states that the customer is not required to make payment until the good or service is accepted by the customer.

15. Customer acceptance clauses such as these can be problematic when they are pitted against the notion of transferring the enforceable rights or other access to a good. For example, suppose that a customer contracts for the construction of an office building on its own land. In the contract, the customer specifies an extensive list of criteria that the builder must meet when pouring the foundation, framing the structure, and finishing the interior. The customer and the builder agree that the customer is not obliged to pay for the foundation,

framing, or finishing work until the customer has formally accepted each of those phases.

16. In this situation, the builder transfers an economic resource to the customer when it pours the foundation according to specified criteria. The conforming foundation is an economic resource to the customer because the customer has the enforceable rights to the foundation that is now attached to the customer's land. If the builder has transferred the foundation to the customer, and the builder can objectively determine that the required specifications have been met, is the performance obligation to provide a foundation satisfied? Or is satisfaction of the performance obligation delayed until the customer formally accepts that phase?

17. For many customer acceptance clauses, the criteria for acceptance are relatively objective. As a result, the entity can readily determine whether the criteria have been met. For example, if the customer requires that the foundation be of a certain thickness and grade of concrete, the entity can judge for itself that the thickness and grading requirements have been met long before the customer formally accepts the foundation. In most cases, the customer cannot refuse the promised good if it meets the specified criteria. As a result, the formal acceptance by the customer in this case does not trump the model's determination of when an economic resource transfers.

18. When the entity can readily determine that a promised good or service meets the specified criteria in a contract, then the usual principle for satisfying a performance obligation applies. The performance obligation is satisfied when the enforceable rights or other access to the good or service transfers to the customer. The formality of customer acceptance does not affect whether a performance obligation is satisfied if the entity can determine on its own that the customer's specified criteria have been met.

Distinguishing Between Goods and Services

19. The previous chapter explained how both goods and services represent economic resources, and promises to transfer those economic resources give rise to performance obligations. Unfortunately, it is often difficult to determine

whether the promise in a contract is to transfer a good or to provide the materials and services required to produce a good. The key to resolving this difficulty is found in the definition of a performance obligation—a promise to *transfer* an economic resource to the customer. To determine whether an entity is promising to transfer a good or the materials and services necessary to produce a good, an entity must determine *when* an economic resource is actually transferred to the customer.

20. In some cases it is not too tricky to figure this out. For instance, if a customer provides a special wood to a cabinet maker together with a design for a table, then the cabinet maker is transferring services to the customer as work progresses. This is because the services being consumed are enhancing an existing resource of the customer (the wood). As another example, if a contract calls for the construction of a building on the customer's own land, then the builder is transferring services to the customer as work progresses. This is because the services (and materials) being consumed are enhancing an existing resource of the customer.

21. Where the distinction between a good and a service seems to get difficult is when a new resource is created. Consider the following example:

> StandardCo is a manufacturer of standardized, structural steel used in the construction of basic office buildings. StandardCo contracts with a customer to deliver a system of steel girders, which will require about six months to manufacture. Because StandardCo can sell these girders to many other customers, the contract specifies that StandardCo retains title to the steel girders until delivery in six months' time. Although the customer is required to pay a 10% down payment, the customer is not obliged to pay the remaining amounts until the girders are delivered.

22. In this example, is StandardCo promising to deliver the finished girders or is it promising to provide the services and materials necessary to produce the girders? According to the terms of this contract, the title to the girders transfers to the customer when the girders are delivered. This is the first point in the contract at which an economic resource transfers to the customer. Until that time, the customer has no enforceable right to the girders, nor can it limit access to the girders by others. Moreover, until delivery all activities

undertaken by StandardCo pursuant to the contract improve an economic resource to which StandardCo has an enforceable right.

23. This analysis suggests that the promise in this contract to deliver standardized steel girders is a promise to transfer a good. As a result, the performance obligation is for a finished good rather than for construction services and materials. This performance obligation is satisfied when the enforceable rights to the girders transfer to the customer at delivery. It is at this point that StandardCo's net position in the contract increases (that is to say, its contract asset increases or its contract liability decreases) and revenue is recognized.

24. Now consider another example:

> SteelCo is a manufacturer of specialized, structural steel used in the construction of tall buildings. SteelCo contracts with a customer to deliver a system of specialized steel girders, which will require about six months to manufacture. Because the girders will be of no value to SteelCo or any other customer once the steel is cast, the contract states that the title to the girders transfers to the customer once the girders are cast. After casting, SteelCo applies a specialized paint and fire reduction agent to the girders, a process that requires an additional month of activity.

25. In this example, is SteelCo promising to deliver the finished girders or is it promising to provide the services and materials necessary to produce the girders? According to the terms of this contract, the title to the girders transfers to the customer when the steel is cast. This is the first point in the contract at which an economic resource transfers to the customer. Up to that point, none of the activities undertaken by SteelCo pursuant to the contract result in an economic resource transferring to the customer. After that point, every activity undertaken by SteelCo that enhances the value of the girders transfers a resource to the customer because the customer has the enforceable rights to the girders.

26. This analysis suggests that the promise in this contract to deliver specialized steel girders is a promise to provide the materials and services necessary to produce the girders. As a result, the performance obligation is for construction services and materials rather than a finished good. This performance obligation is satisfied when the enforceable rights to the girders transfer to the

customer during the construction process (ie, when the steel is cast) and when further services and materials enhance the value of the girders. As a result, SteelCo recognizes revenue when the girders are cast and when further services and materials enhance the value of those girders.

27. It is not the uniqueness of the good that leads to the conclusion that a contract is for construction services instead of a finished good. The uniqueness of a good is a flag suggesting that the contract may be for construction services, but uniqueness in and of itself does not lead to this conclusion. Instead, the contract must be examined (and sometimes the operation of law must be considered) to determine when the enforceable rights or other access to the good transfer to the customer. It is this determination alone that indicates whether a promise is for a good or a service and (consequently) when a performance obligation is satisfied.

28. Consider the following example:

> SpecCo is a manufacturer of specialized, structural steel used in the construction of tall buildings. SpecCo contracts with a customer to deliver a system of specialized steel girders, which will require about six months to manufacture. Even though the girders will be of no value to SpecCo or any other customer once the steel is cast, the contract is silent regarding when the enforceable rights or access to the girders transfers to the customer. Although the customer is required to pay a 10% down payment, the customer is not obliged to pay the remaining amounts until the girders are delivered.

29. In this example, is SpecCo promising to deliver the finished girders or is it promising to provide the services and materials necessary to produce the girders? The contract does not indicate that the title or the enforceable rights to the girders transfer to the customer at any point before delivery. This suggests that an economic resource is not transferred to the customer until delivery of the girders. Thus, the promise seems to be for finished girders.

30. However, the uniqueness of the promised girders raises a flag. When a unique good is promised, not only should the contract be examined to determine when the enforceable right to the girders transfers, but the operation of local law should also be considered. If the customer would effectively retain the girders (no matter what stage of completion) in the event of the contract being

terminated before construction is complete, this would suggest that the enforceable rights or access to the girders is effectively transferring to the customer throughout the construction process.

31. In other words, the operation of law might behave just like the contract terms in the SteelCo case, effectively transferring the enforceable rights to the girders from SpecCo to the customer once the girders are cast because the girders are of no value to anyone else after that point. Up to that point, none of the activities undertaken by SpecCo pursuant to the contract result in an economic resource transferring to the customer. After that point, every activity undertaken by SpecCo that enhances the value of the girders transfers a resource to the customer because the customer effectively has the enforceable rights to the girders.

32. In most cases, contracts for unique goods contain terms indicating that the title to the good transfers to the customer throughout the production process. However, just because a contract promises a unique good to a customer does not mean that the enforceable rights or access to the good actually or effectively transfer to the customer before delivery. Careful judgment of the facts and circumstances is required in these cases, but the objective is clear—the point at which an economic resource transfers to the customer (whether by contract terms or the operation of local law) is the point when a performance obligation is or begins to be satisfied.

33. Consider another example:

> ConsultCo contracts with a customer to analyze the customer's pension plans in four different countries. The analysis requires six months to perform. Because of the uniqueness of the report (that is, because the final report and the intangible knowledge gathered during the analysis phase is of no value to any other customer), ConsultCo requires the customer to make progress payments that roughly approximate ConstultCo's time and materials expended to date, which are only refundable if ConsultCo fails to provide the required report..
>
> ConsultCo does not offer any intermediate reports to the customer. Only a final report is required in the contract.

34. In this example, is ConsultCo promising to deliver a finished report (an intangible good) or is it promising to provide the services and materials necessary to produce the finished report? The intangible knowledge cannot be transferred to the customer until it is synthesized into a report, and the report cannot represent an economic resource to the customer until it is delivered. This suggests that the contract is for a finished intangible good, and the resulting performance obligation would not be satisfied until that report is delivered.

35. In this case, the uniqueness of the report raises a flag. However, examining the contract terms and the operation of law does not change the conclusion that ConsultCo transfers no economic resource to the customer until the customer obtains the final report. The fact that the contract and the law might require the customer to pay for service and materials if the customer terminates the contract does not mean that the customer has a present right or access to any economic resource. This is perhaps one of the toughest situations to analyze under the proposed revenue recognition model, and the Boards welcome any comments regarding this conclusion.

EXAMPLES OF SATISFYING PERFORMANCE OBLIGATIONS

36. This section presents a few more examples to illustrate how performance obligations are satisfied. Specifically, this section presents the following examples:

- painting (paragraphs 37-51)
- multiple goods (paragraphs 52-59)
- real estate (paragraphs 60-65)
- computer assembler and retailer (paragraphs 66-68)

Painting

37. As a reminder, the painting example in the previous chapter was as follows:

> PainterCo is a contractor that provides painting services for private residences. PainterCo contracts with a customer on June 25 to paint the customer's house for CU3000. The price is inclusive of all paint, which PainterCo buys from its paint wholesaler. The customer is given the option to buy its own paint, for a corresponding reduction in the contract price, although the customer does not opt to do so.
>
> All paint and materials necessary to complete the contract are delivered to the customer's house on June 30, the end of PainterCo's reporting period. PainterCo renders the painting services continuously from July 1 through July 10. In accordance with the contract terms, the customer pays in full upon completion of the house painting.

38. The following performance obligations exist in this contract:

- paint and materials
- project management
- prepping and painting the house
- performance guarantee

Paint and materials

39. Of these obligations, determining when the paint and materials obligation is satisfied seems to be the most problematic. Indeed, in the case facts, there is very little information to suggest when the enforceable rights or other access to the paint and materials transfers to the customer. But before considering when the enforceable rights or other access transfer to the customer, focus first on what is meant by enforceable rights or other access to paint.

40. The previous section argued that the enforceable right or other access to a good is what enables an entity to use that good and preclude or limit the use of that good by others. Following this logic, the person (or entity) that holds the enforceable rights or other access to the paint and materials is able to use or direct the use of the paint and materials or limit others' use of the paint and materials. At what point in the life of the painting contract has PainterCo transferred to the customer this ability? Clearly, by the time that the paint and materials have been attached to the customer's house, PainterCo has

transferred its ability to use or direct the use of the paint and materials. However, can the enforceable rights or other access be transferred to the customer before this point?

41. The answer is yes. Whether by terms of the contract or operation of local law, the enforceable rights or other access to the paint and materials can be transferred to the customer at delivery on June 30. For example, the terms the contract may clearly indicate that the customer accepts and is obliged to pay for paint and materials when delivered. As a result, the customer would have the ability to use the paint and limit others' access to the paint. Along the same lines, the operation of local law may indicate that the title to paint and materials transfers to the customer if the customer is obliged to pay for the paint and materials and cannot return them. This would mean that the customer has the enforceable rights or access to the paint at delivery. The point here is that the contract terms or operation of law can create a situation in which the enforceable rights or other access to the paint and materials transfers to the customer at delivery.

42. On the other hand, the terms of the contract or the operation of law can also indicate that the enforceable rights or other access to the paint do *not* transfer to the customer at delivery. For example, if the terms of the contract indicate that the painter can demand the use of the delivered paint and materials to fulfill the painting services or to fulfill other contracts, then PainterCo has the ability to limit the customer's access to the paint. In this case, although the customer has physical access to the paint, that access does not give it the right to use the paint or limit its use by PainterCo. Rather, the customer is providing temporary custody over the paint to which PainterCo still retains the enforceable rights.

43. Another possible indicator of whether the entity or the customer has an enforceable right or other access to the paint is whether the customer is presently obliged to pay for the paint and materials and cannot later recover its payment because PainterCo fails to perform other promises in the contract. For instance, suppose that the contract requires the customer to pay PainterCo for the paint on delivery and the customer could not recover that payment if

44. To be clear, a performance obligation is not satisfied simply because PainterCo has a right to consideration. Nor is a performance obligation satisfied simply because the customer is obliged to pay for the paint. Rather the fact that the customer is obliged to pay for the paint even if PainterCo doesn't do the painting tells us that the customer has the enforceable rights or access to the paint rather than PainterCo.

45. Given the difficulty of determining when the enforceable rights or access to paint transfer, some have suggested a rebuttable presumption for such situations. The presumption is that the enforceable rights to an economic resource (such as paint and materials) that will be used in satisfying another performance obligation in the contract (such as the painting service) is not transferred until the goods are used in satisfying that later obligation. This presumption would be rebutted if the terms of the contract or operation of law clearly specify that the rights or access to the economic resource transfer to the customer sooner. In the painting services contract in this example, the terms of the contract are silent on the matter. However, PainterCo would need to consider the operation of local law to see whether it clearly indicated when the rights or access to paint and materials transfers to the customer. Absent a clear indication, the presumption would be that the rights to the paint are not transferred to the customer until the paint is used in satisfying the painting performance obligation, that is, until the paint is on the wall.

46. A few Board members object to this presumption. Although they recognize the practical need for the presumption, they worry that the presumption may be used in place of careful judgment about when the enforceable rights or access to goods transfers to customers. Not wanting to encourage a disregard for the model, these Board members are hesitant to support this presumption. Most Board members are less troubled by the presumption. They think the practical benefit outweighs the potential risk that some entities will ignore obvious indicators of when the rights or access to goods transfer to customers.

47. In summary, the promise to transfer paint and materials to the customer is satisfied when the enforceable rights or other access to paint and materials transfers to the customer. This can occur at delivery or at the latest when those goods are utilized to provide painting services. Contract terms or the operation of law may clearly indicate when these rights or access transfer to the customer, but when it is not clear, the presumption is that the paint and materials do not transfer to the customer until they are used in the painting services.

Project management

48. The promise to manage the painting services contract is satisfied as PainterCo provides the service or access to the service to the customer. If PainterCo still holds the enforceable rights or access to the paint and materials when they are delivered on June 30, then no amount of the project management obligation is satisfied as of that date. This is because the resources thus far provided by project management (that is, obtaining and delivering paint) do not enhance an economic resource of the customer. Rather they have enhanced an economic resource of PainterCo by adding additional (location) utility to the paint. Hence, no economic resource has been transferred to the customer.

49. On the other hand, if the customer does have the enforceable right or access to paint after it is delivered, then the project management activity of acquiring and delivering the paint has enhanced the customer's economic resource. So an economic resource (of obtaining and delivering the paint) would have been transferred to the customer and part of the project management obligation would have been satisfied as of June 30. Not all of the project management obligation would be satisfied at this point, because the additional activity of coordinating paint crews (and other subcontractors on larger construction projects) still remains unperformed.

Painting service and performance guarantee

50. The obligation to provide painting services is satisfied as PainterCo paints. That is, an economic resource (painting service) transfers to the customer as the painting progresses (assuming the painting is undertaken in accordance

with the terms of the contract) because PainterCo provides the service or access to the service throughout the process. In this case, the painting services enhance an asset of the customer, but the focus is on the fact that PainterCo is providing a service or access to a service while painting the customer's house. This implies that the painting services performance obligation is satisfied continuously. That is, after PainterCo has painted half of the customer's house, PainterCo no longer has an obligation to paint that half of the customer's house. Thus, the painting obligation is half satisfied at that point.

51. Similarly, the obligation to provide a performance guarantee is satisfied over the guarantee period. That is, an economic resource (warranty coverage) transfers to the customer over the warranty period because the customer receives that benefit or has access to it during that period.

Multiple Goods

52. It is important to note that the focus on transferring economic resources to the customer does *not* mean that the proposed revenue recognition model depends on customer intent. Consider the following example:

> EngineeringCo sells high-speed aerosol can manufacturing equipment. It sells a complete manufacturing process, which consists of Equipment X, Y, and Z. It does not sell Equipment X, Y, and Z separately; however, other entities do sell the same equipment separately. Installation is performed by the customer.
>
> EngineeringCo delivers Equipment X and Z on March 27, but does not deliver Equipment Y until the next quarter. Without Equipment Y, the customer cannot use Equipment X and Z as intended.

53. In this example, Equipment X, Y, and Z each represent separate economic resources because each of them can be bought or sold separately. As a result, the promise to transfer each piece gives rise to a separate performance obligation. The question then is when each obligation is satisfied.

54. Based on the proposed model, each of these performance obligations is satisfied when the enforceable rights or other access to each piece of equipment transfers to the customer. However, in this particular case, the customer does not receive the intended benefit from Equipment X and Z until

Equipment Y is delivered. Does the customer's intended use have any effect on when a performance obligation is satisfied?

55. The proposed model does not take into account the customer's intent. Instead, it focuses only on the transfer of economic resources to the customer. If the EngineeringCo transfers the enforceable rights or other access to Equipment X and Z before transferring the rights or access to Equipment Y, then those two performance obligations are satisfied before the obligation to transfer Equipment Y. That is, if the customer can use and direct the use of Equipment X and Z through an enforceable right, or the customer can limit anyone else (including EngineeringCo) from accessing Equipment X and Z, then the obligation to transfer those pieces of equipment to the customer have been satisfied.

56. It does not matter that the customer does not intend to use Equipment X and Z without Equipment Y. The fact that the customer has a right or access to two economic resources means that the entity no longer has an obligation to transfer these economic resources.

57. The Boards rejected the focus on customer intent for a number of reasons. First, the financial statements are prepared by the entity to reflect its financial position, cash flows, and comprehensive income. From a practical point of view, it also would be difficult for an entity to establish what the customer's intent was in any given contract. There would be no guarantee that the entity's interpretation of customer intent within a contract accurately reflected the customer's own view. Because the way in which a customer may intend to use promised goods and services will frequently not coincide with the actual transfer of economic resources, the Boards decided that this model should focus strictly on the transfer of economic resources and not the particular way in which a customer intends to use those resources.

58. That said, this decision does not mean that the customer's intended use of promised goods and services cannot affect how the enforceable rights or other access are transferred in a contract. For example, in a contract in which a customer has no intent of using two pieces of equipment without delivery of a

third piece of equipment, the customer may negotiate terms into a contract which indicate that the entity does not transfer the enforceable rights or other access to the earlier pieces of equipment until the enforceable rights or access to the last piece of equipment is transferred. In other words, the contract may clearly indicate that the customer is a custodian of the entity's equipment until the final piece of equipment is delivered. Until that time, the entity has the enforceable rights to the equipment and can use the equipment in whatever way it chooses—even to satisfy another customer's order.

59. If such an arrangement exists, then the customer's intended use of the equipment will coincide with the transfer of enforceable rights or access to the equipment. However, it is important to note that—even in this example—it is not the customer's intended use that determines when a performance obligation is satisfied. It is when the enforceable rights or access to the equipment transfers to the customer that determines when the performance obligation is satisfied.

Real Estate Contracts

60. Real estate contracts are another example in which it has been difficult to determine when the obligation to transfer an economic resource is satisfied. The IFRIC's recent deliberations on whether real estate contracts should be accounted for as contracts for construction services (pursuant to IAS 11 *Construction Contracts*) or as contracts for goods (pursuant to IAS 18 *Revenue*) highlights this difficulty.[1] Consider the following situation:

HomebuilderCo contracts with a customer to construct a home in accordance with the features and designs chosen by the customer. The home is to be built on the homebuilder's plot of land, and the title (that is to say, the enforceable rights or other access) to the land and house do not transfer to the customer until the house is completed. The customer cannot take possession of the house until it is completed, nor can the customer fire HomebuilderCo and have another builder complete the home. The customer pays a 10% deposit and agrees to pay the remaining price upon completion of the home or forfeit its deposit.

[1] See IFRIC draft interpretation D21 *Real Estate Sales*

61. The difficulty in this example is determining whether Homebuilder is promising construction services or a completed house. Generally speaking, a real estate contract can be a contract for a good or a contract for time and materials. The contract will determine which type of performance obligation exists based on when the entity transfers economic resources to the customer.

62. In the example above, HomebuilderCo owns the land and the house as it is being constructed. As a result, any materials and services that improve the home are simply an improvement to Homebuilder's asset. This means that the services (such as contract management, materials acquisition, framing, wiring, etc.) and materials (such as concrete, wood, electrical wire, roofing, etc.) provided during the construction of the house do not actually represent economic resources that transfer to the customer in this contract. Instead, these economic resources attach to the work-in-process to which HomebuilderCo has the enforceable rights. Only when the house is completed and the customer makes the final payment does any economic resource transfer from HomebuilderCo to the customer. As a result, no performance obligation is satisfied in this contract until the house is transferred to the customer.

63. Now consider a different example:

> ContractorCo contracts with a customer to construct a home in accordance with the features and designs chosen by the customer. The home is to be built on the homebuilder's plot of land, however the title (that is to say, the enforceable rights or other access) to the land and house transfers to the customer from the moment construction begins. The customer can take possession of the house at any point, and the customer can fire ContractorCo and have another builder complete the house. The customer pays a 10% deposit upfront and makes periodic payments that are sufficient to cover the costs and margins of ContractorCo's time and materials during construction.

64. In this example, ContractorCo transfers the land and house to the customer once construction begins. As a result, any materials and services that improve the house represent the transfer of economic resources (goods and services) to the customer. This means that the services (such as contract management, materials acquisition, framing, wiring, etc.) and materials (such as concrete, wood, electrical wire, roofing, etc.) provided during the construction of the house each represent economic resources that transfer to the customer in this

contract. As a result, ContractorCo's net position in its contract is increasing as each performance obligation is satisfied, and revenue is recognized throughout the construction process.

65. Real estate sales are not simple arrangements, and judgment is often required to determine when the real estate transfers to the customer. The key in the proposed revenue recognition model is to focus on when the enforceable rights or other access to the house transfer to the customer. This occurs when the customer has the ability to use or direct the use (not the construction) of the house in its present condition and limit access to the house by others. A key indicator that the customer has such an ability is that the customer can take possession of the house, fire the contractor (perhaps with a penalty), and hire another contractor to complete the work. A key indicator that the customer does not have such an ability is that the customer cannot take possession of the house and cannot fire the contractor.

Computer Assembler and Retailer

66. This is an appropriate place to note that identified performance obligations do not always need to be accounted for separately. That is, just because two goods or services are promised in a contract, there is no need to treat them as separate performance obligations if they are transferred to the customer at the same time. Consider the following example:

> ZellCo is an assembler of computers and a retailer of computers, monitors, and other computer electronics. ZellCo receives an order from a customer for a computer system with a fairly standard configuration. ZellCo processes the order and assembles the computer with the requested software during the next week and then ships the computer directly to the customer. When assembling the computer, ZellCo incorporates a mother board, flash memory components, video cards, and optical disk drives, all of which are off the shelf goods that ZellCo has purchased from its own suppliers.

67. In this example, the customer has submitted an order for a fairly standard computer (without a monitor or keyboard). In fulfilling this order, ZellCo must transfer to the customer all the components that go into a computer, including the mother board, memory components, video cards, and optical disk drives. According to the discussion in the prior chapter, each one of these goods

represents a separate performance obligation. However, because the enforceable rights to each of these goods transfers to the customer as a single bundle (that is, the computer itself), then there is no need to account for the performance obligations separately. Instead, the computer is a single unit of account in this contract.

68. This analysis is definitely beyond how most people would ever want to think about something this simple. However, the illustration underscores the point that when separate goods and services are transferred to the customer at the same time, there is no need to account for each of them separately. This is an important practical point, especially when it comes to measurement, which is described later in Chapter 5.

CONCLUSIONS

69. This chapter explains and illustrates when a performance obligation is satisfied. It proposes that a performance obligation is satisfied when a promised economic resource in the contract is transferred to the customer. In the case of a good, this occurs when the entity has transferred to the customer the enforceable right or access to that good. In the case of a service, this occurs when the service or access to the service has been provided.

70. When a performance obligation is satisfied, the entity’s net position in a contract increases (either because a contract asset increases or a contract liability decreases), leading to the recognition of revenue. This chapter notes the important difference between enforceable rights or access to a good and the risks and rewards of owning a good. It also clarifies that the proposed model focuses strictly on the enforceable rights or access to a good when determining whether a good has been transferred to a customer. This chapter has also explained how customer acceptance clauses relate to the satisfaction of performance obligations.