Suggested revised drafting of paragraphs 35 and 36 of the 2011 ED

In paragraph 76 of paper 7C/161C, the staff recommends that the criteria in paragraph 35 of the 2011 ED could be re-expressed as follows. The marked-up text that has been added to paragraph (c) is from paragraph 35(b)(iii) of the 2011 ED.

> 35. An entity transfers control of a good or service over time and, hence, satisfies a performance obligation and recognises revenue over time if one of the following criteria is met:
>
> (a) the customer is receiving and consuming the benefits of the entity's performance as the entity performs. A customer obtains the benefits of the entity's performance as the entity performs if another entity would not need to substantially re-perform the work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer. In evaluating this criterion, an entity shall disregard potential limitations (contractual or practical) that would prevent it from transferring a remaining performance obligation to another entity.
>
> (b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced. An entity shall apply the requirements on control in paragraphs 31–33 and paragraph 37 to determine whether the customer controls an asset as it is created or enhanced; or
>
> (c) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised.
>
> The **right to payment for performance completed to date** does not need to be for a fixed amount. However,

the entity must be entitled to an amount that is intended to at least compensate the entity for performance completed to date even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised.

As noted in paragraph 51 of the paper, the staff recommend clarifying that:

- the payment schedule specified in the contract does not indicate whether an entity has a right to payment for performance to date
- the right to payment should be enforceable and, in assessing the enforceability of that right, an entity should consider the contractual terms as well as any legislation or legal precedent that could override those contractual terms.

Compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date (for example, recovery of the entity's costs plus a **reasonable profit margin**) rather than compensation for only the entity's potential loss of profit if the contract is terminated.

As noted in paragraph 54 of the paper, the staff recommend clarifying that:

- a 'reasonable profit margin' should represent either:
  - a reasonable proportion of the expected profit margin under the contract (ie a contract specific margin); or
  - a reasonable return on the entity's cost of capital for similar contracts (ie the entity's typical operating margin) if the contract specific margin is higher than the return the entity usually generates from similar contracts; and
- the entity should assess whether, for the entire duration of the contract, the entity would be entitled to an amount that is intended to at least compensate the entity for performance completed to date.

The staff also recommends retaining paragraph 36, with the following clarifications:

> 36. When evaluating whether an asset has an **alternative use** to the entity, an entity shall consider at contract inception the effects of contractual and practical limitations on the entity's ability to readily direct the promised asset to another customer. A promised asset would not have an alternative use to an entity if the entity is unable, either contractually or practically, to readily direct the asset to another customer. For example, an asset would have an alternative use to an entity if the asset is largely interchangeable with other assets that the entity could transfer to the customer without breaching the contract and without incurring significant costs that otherwise would not have been incurred in relation to that contract. Conversely, the asset would not have an alternative use if the contract has substantive terms that preclude the entity from directing the asset to another customer or if the entity would incur significant costs (for example, costs to rework the asset) to direct the asset to another customer.

In paragraphs 29-35, the staff recommend clarifying the assessment of 'alternative use' by explaining that:

- there must be a substantive reason for the presence of a contractual restriction in the contract
- a practical limitation might exist if the entity would face a significant economic loss (through either incurring significant costs of rework or selling the asset at a significant loss) if it redirected the asset to another party
- the assessment of alternative use is made at contract inception and the entity considers its ability throughout the product process to readily re-direct the partially completed asset to another customer.

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35 An entity transfers control of a good or service over time and, hence, satisfies a performance obligation and recognises revenue over time ~~if at least~~ one of the following ~~two~~ criteria is met:

(a) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced. An entity shall apply the requirements on control in paragraphs 31–33 and paragraph 37 to determine whether the customer controls an asset as it is created or enhanced; or

(b) the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and ~~at least one of the following criteria is met:~~

(i) the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs.

(ii) another entity would not need to substantially re-perform the work the entity has completed to date if that other entity were to fulfil the remaining obligation to the customer. ~~In evaluating this criterion, the entity shall presume that another entity fulfilling the remainder of the contract would not have the benefit of any asset (for example, work in progress) presently controlled by the entity.~~ In addition, an entity shall disregard potential limitations (contractual or practical) that would prevent it from transferring a remaining performance obligation to another entity.

(iii) the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised. The right to payment for performance completed to date does not need to be for a fixed amount. However, the entity must be entitled to an amount that is intended to at least compensate the entity for performance completed to date even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised. Compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date (for example, recovery of the entity's costs plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated.

Recommended paragraph 76(b)

- retains 35(a) criterion
- clarify that the WIP asset could be tangible or intangible

Recommended paragraph 76(a)

- merges (b)(i) and (b)(ii) criteria into a single criterion to apply to pure service contracts

This sentence is not necessary because the staff recommend that this criterion should apply only to pure service contracts

- Additional clarification of the meaning of 'alternative use' is recommended (refer paragraphs 29-35 of the paper).
- The staff will also consider using a label other than 'alternative use' because of comprehension and translation difficulties.

Recommended paragraph 76(c)

- integrates 'alternative use' and 'right to payment' into a single criterion

Additional clarification of the existence of a 'right to payment for performance completed to date' is recommended (refer paragraph 51 of the paper).

Additional clarification on 'compensation for performance completed to date' is recommended (paragraph 54 of the paper).