

# STAFF PAPER

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<b>Project</b>	<b>Revenue recognition</b>		
<b>Paper topic</b>	<b>Performance obligations satisfied over time</b>		
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## Purpose of this paper

1. This paper considers possible improvements to the criteria proposed in the Boards' revised exposure draft *Revenue from Contracts with Customers* (the 2011 ED) for determining whether an entity satisfies a performance obligation over time and, hence, can recognise revenue over time.
2. The paper does not consider the feedback received on how an entity should measure its progress towards complete satisfaction of a performance obligation that meets those criteria. This will be considered in a future agenda paper.

## Staff recommendation

3. The staff recommend that the Boards make the following refinements to the criteria proposed in paragraph 35 of the 2011 ED for determining whether an entity satisfies a performance obligation over time:
  - (a) retain the criterion in paragraph 35(a);
  - (b) combine the criteria in paragraphs 35(b)(i) and (b)(ii) into a single criterion that would apply to 'pure service' contracts; and

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- (c) link more closely the ‘no alternative use’ criterion in paragraph 35(b) and the ‘right to payment for performance to date’ criterion in paragraph 35(b)(iii).

## Background

4. Under the Boards’ proposed revenue model, an entity recognises revenue when (or as) goods or services transfer to a customer. A good or service transfers to the customer when (or as) the customer obtains control of that good or service. Many respondents to the 2010 ED agreed with using control as the basis for assessing when the transfer of a promised good or service occurs. However, they further stated that the additional guidance for assessing the transfer of control was most helpful when applied to performance obligations for the transfer of goods, but not services or construction-type contracts because it could be difficult to determine when a customer obtains control of a service.
5. As a result, in developing the revised proposals, the Boards considered whether to develop specific requirements for the transfer of control of services and for the transfer of control of goods. Because of the difficulties in clearly distinguishing between goods and services (especially if the service creates a good), the Boards decided instead to specify requirements that would focus on the attribute of the timing of when a performance obligation is satisfied.
6. Consequently, paragraphs 35-37 of the revised 2011 ED propose criteria for determining whether a performance obligation is satisfied over time or at a point in time. In summary, the criteria in paragraph 35 of the 2011 ED specify that a performance obligation is satisfied over time and thus revenue can be recognised over time if either:
  - (a) the entity’s performance creates or enhances an asset that the customer controls as the asset is created or enhanced (ie paragraph 35(a)); or
  - (b) the entity’s performance does not create an asset with alternative use and at least one of the following criteria are met:

- (i) the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs (ie paragraph 35(b)(i)).
  - (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 without the benefit of any asset that is presently controlled by the entity (ie paragraph 35(b)(ii)).
  - (iii) the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised (ie paragraph 35(b)(iii)).
7. When evaluating whether an asset has an alternative use to the entity, paragraph 36 of the 2011 ED proposes an entity should 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.
8. The 2011 ED proposes that all performance obligations that do not meet the criteria as performance obligations satisfied over time should be accounted for as performance obligations satisfied at a point in time.
9. The criteria in paragraphs 35 and 36 of the 2011 ED are re-produced at Appendix A.

### **Main themes of the feedback received on 2011 ED proposals**

10. In response to question 1 of the exposure draft, most respondents supported the addition of the criteria for determining when a performance obligation is satisfied over time and, thus, when revenue can be recognised over time because the criteria provide guidance on how to assess whether the customer obtains control of a service. Most respondents also broadly supported the thinking underlying the criteria in paragraph 35(b) as explained in the Basis for Conclusions. However, they also observed that the criteria appear complex and, in some cases, may be difficult to apply consistently in practice, especially to contracts beyond the construction and

production of tangible goods. In their view, some of this complexity results from duplication or overlap in the criteria or concepts that require greater explanation.

11. In particular, respondents requested the Boards to:
- (a) clarify the ‘alternative use’ criterion in paragraph 35(b), particularly in relation to the effect that a contractual restriction has on the ability of an entity to readily direct the asset to another customer;
  - (b) clarify the application of the criterion in paragraph 35(b)(ii), which considers whether the customer receives a benefit from the entity’s performance on the basis of a hypothetical assessment of whether *another* entity would need to substantially re-perform the work completed to date;
  - (c) clarify the relationship between the criterion in paragraph 35(b)(ii) and paragraph 35(b)(i), which considers whether the customer simultaneously receives and consumes the benefits of the entity’s performance as the entity performs; and
  - (d) clarify the ‘right to payment for performance to date’ criterion (in paragraph 35(b)(iii)) and the relevance of a right to payment as a necessary, but not sufficient, condition for recognising revenue over time for some, but not all, types of service contracts.
12. Those respondents noted that a helpful explanation was often included in the Basis for Conclusions; however they suggest that some of those explanations be brought forward to the body of the standard.
13. Some respondents questioned the conceptual basis for the criteria in paragraph 35(b) and they suggested that the Boards should explain whether those criteria are consistent with the definition of control. A few of those respondents thought the criteria in paragraph 35 of the 2011 ED might result in revenue recognition over time in some circumstances where it would not be appropriate to recognise revenue over time. This is because in their view, the criteria in paragraph 35 (for determining when revenue can be recognised over time) may be met in circumstances where control does not transfer over time, for example in the production of some inventory-type items (this is discussed further in paragraph 57). In addition, some respondents

highlight that the reference in paragraph BC91 to AICPA Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* might be interpreted to mean that ‘all contracts previously accounted for using a percentage-of-completion approach under US GAAP would automatically qualify for revenue recognition under paragraph 35(a)’ (CL #77 Ernst & Young). In light of that possible interpretation, those respondents suggested the Boards emphasise that the criteria for determining when revenue can be recognised over time (paragraph 35) are based on the transfer of control rather than an activities model.

### **Matters for consideration**

14. Based on feedback from respondents, this paper addresses the following matters:
- (a) clarifying each of the criteria in paragraph 35 and the intended interaction between those criteria in assessing whether a performance obligation is satisfied over time (paragraphs 15-56);
  - (b) clarifying the conceptual basis for the criteria in paragraph 35 and explaining why those criteria are consistent with the definition of control (paragraphs 57-65);
  - (c) considering possible improvements to the drafting of the paragraph 35 criteria (paragraphs 66-76).

### **Clarifications to the paragraph 35 criteria**

15. This section of the paper analyses comments requesting clarification of the paragraph 35 criteria and identifies issues that the Boards might wish to clarify in the revenue standard.

### ***Paragraph 35(a) criterion – customer controls asset as created or enhanced***

16. The paragraph 35(a) criterion specifies that an entity satisfies a performance obligation over time if the entity’s performance creates or enhances an asset that the

customer controls as the asset is created or enhanced. An entity would consider the definition of control (in paragraph 32 of the 2011 ED) and the indicators of control (in paragraph 37 of the 2011 ED) to determine whether the customer controls the asset (eg work in progress) as it is created or enhanced.

17. Only a few comments were received on this criterion. The staff thinks that is because the criterion is similar to a proposal in the 2010 ED that received general support, which was that goods or services would be transferred over time if the customer controls the work in progress as it is created. Also, it was clear how this criterion related to the control principle.
18. One respondent requested further guidance on applying this criterion to the creation or enhancement of intangible assets. The staff notes that paragraph BC90 mentions that the work in progress asset that is created or enhanced by the entity's performance could be either tangible or intangible. This could be clarified in the revenue standard.
19. Another respondent noted that many of the indicators of control in paragraph 37 of the 2011 ED are designed to assist in the assessment of when a performance obligation is satisfied at a point in time, and therefore an entity may be required to make difficult judgements to apply those indicators to assess whether a performance obligation is satisfied over time. The staff note that the difficulty of making those judgements for performance obligations satisfied over time was the reason that led the Boards to develop the criteria in paragraph 35(b). The confusion about the relevance of applying the paragraph 37 indicators to assessments under paragraph 35(a) was evident in some responses which queried how an entity should account for customer acceptance clauses. The staff notes that a customer acceptance clause should not influence the determination of whether a performance obligation is satisfied at a point in time or over time. However, it could influence the timing of when a performance obligation is deemed to be satisfied because it could determine the point in time when a point-in-time performance obligation is satisfied or it could lead to a reassessment of the entity's measure of progress towards complete satisfaction if the performance obligation is satisfied over time.

*Conclusion*

20. The staff are not recommending any substantive clarifications to the paragraph 35(a) criteria. As part of suggestions to streamline the criteria for determining whether a performance obligation is satisfied over time, paragraphs 69-71 discuss whether paragraph 35(a) should be retained as a standalone criterion.

***Paragraph 35(b) – the notion of ‘alternative use’***

21. Paragraph 35 of the 2011 ED specifies that a necessary, but not individually sufficient, condition for a performance obligation to be satisfied over time is that the entity’s performance does not create an asset with alternative use to the entity. This means that either:
- (a) the entity’s performance does not create a recognised asset (because the asset that is created is simultaneously received and consumed by the customer as the entity performs); or
  - (b) the entity’s performance creates an asset that the entity is unable, either contractually or practically, to readily direct to another customer.

***Assessing alternative use if the entity’s performance does not create a recognised asset***

22. A small number of respondents questioned whether ‘alternative use’ was a necessary criterion for ‘pure service’ contracts, which are the types of performance obligations that would be within the scope of either paragraph 35(b)(i) (ie when the customer simultaneously receives and consumes the benefits of an entity’s performance) or paragraph 35(b)(ii) (ie no need to reperform). They explained that, in cases where the entity’s performance creates an asset that is not recognised because it is immediately consumed by the customer, the ‘alternative use’ criterion is irrelevant because an asset that is immediately consumed by the customer cannot have an alternative use to the entity. Others have highlighted that it is difficult to apply the notion of alternative use to situations contemplated by paragraph 35(b)(i) because, as explained in the Basis, it may not be clear that any asset is created by the entity’s performance.

23. The staff agrees that, in most cases, the alternative use criterion adds unnecessary complexity to determining whether a ‘pure service’ contract would meet the criteria in paragraph 35(b) to be recognised as a performance obligation that is satisfied over time. Instead, the primary criteria that are relevant for assessing those types of performance obligations are paragraphs 35(b)(i) and (b)(ii). However, the existing structure of the paragraph 35(b) criteria is needed to assess whether consulting services (including audit services) are capable of being performance obligations that are satisfied at a point in time. That is because, with those services, the customer may not perceive that they benefit from the service until completion. However, the ‘no need to re-perform’ notion in the paragraph 35(b)(ii) criterion would not apply to professional service contracts that involve the entity providing professional opinions. Consequently, those services should be assessed on the basis of whether the entity would have a right to payment for performance to date (in accordance with the paragraph 35(b)(iii) criterion).

*Assessing alternative use if the entity’s performance creates an asset*

24. In those cases where the entity’s performance creates an asset and it is unclear whether the customer controls that asset, many respondents agreed with ‘alternative use’ being a necessary, but not sufficient, criterion for determining if the entity has a performance obligation that is satisfied over time.
25. The comments and requests for clarification that were received on the alternative use criterion can be categorised as follows:
- (a) the relevance of contractual restrictions in determining whether an asset has an alternative use to the entity;
  - (b) assessing practical constraints in redirecting the asset;
  - (c) how to address circumstances when the assessment of whether an asset has ‘alternative use’ changes throughout the life of the contract;
  - (d) concerns associated with reader comprehension of the notion of ‘alternative use’ and difficulties with translating that notion into other languages.



*Contractual restrictions*

26. Paragraph 36 of the 2011 ED provides the following guidance for determining whether an entity would be contractually unable to readily direct an asset to another customer:
- (a) an asset would not have an alternative use if the contract has substantive terms that preclude the entity from directing the asset to another customer; and
  - (b) an asset would have an alternative use to the entity if the asset is largely interchangeable with other asset that the entity could transfer to the customer without breaching the contract.
27. However, several respondents were concerned about the possible consequences of including contractual restrictions as a determining factor of whether or not an asset has an alternative use to the entity. One respondent, in particular, commented that a contractual restriction might only be a protective right, which in their view would not provide sufficient evidence to conclude that the asset does not have an alternative use to the entity.

We disagree, however, with the proposed definition of when an asset has no alternative use as we believe it might lead to an unintended consequence and require that revenue is recognised over time as typical inventory items are manufactured in some situations. This is because the proposed definition considers customer protective rights (such as contractual terms that preclude transfer to another customer) as a determining factor of when an asset has no alternative use. The definition is inconsistent with recognising revenue when control transfers because customer protective rights do not determine control. It is inconsistent with the guidance in paragraph 37b, which states that retention of legal title solely as a protective right does not preclude a customer from obtaining control of an asset. (CL#33 PwC)

28. Other respondents requested further guidance on determining whether a contractual restriction is substantive. Some commented that the proposals as drafted may enable an entity to conclude that the following arrangements could meet the definition of an asset with no alternative use:
- (a) a contract that identifies the serial number of the asset that the entity has promised to a particular customer;
  - (b) a contract that specifies the first car of a new model is for a particular customer;
  - (c) a contract that specifies the next 200 widgets produced and sold are for a particular customer.
29. The staff agrees with the comment that a protective right does not determine control. However, the existence of a protective right is not sufficient to establish that an asset has no alternative use or that an entity can recognise revenue as the asset is being manufactured or constructed. The staff thinks that a protective right, like any other contractual restriction, would only provide evidence that an asset has no alternative use to the entity if there is a substantive reason for the presence of the contractual restriction on transfer and if the entity does not have the practical ability to physically substitute or re-direct the asset without the customer being aware or objecting to the change. In each of the examples mentioned in paragraph 28 above, the assets would have an alternative use to the entity if the entity would be able to satisfy its performance obligation by substituting the assets being manufactured or constructed for another asset. However, the staff thinks that an entity would be precluded from substituting assets if the contractual restriction conferred valuable rights to the customer relative to any other customers. Using the examples in paragraph 28 above to illustrate, this could be the case if the first car of a new model is a collector's item at the time of transfer to the customer or if, by purchasing the next 200 widgets the entity produces, the customer has acquired the full production capacity of the entity and, as such, the customer has a valuable right because it has effectively denied other parties from gaining immediate access to that production capacity.

30. Even if an asset has no alternative use to the entity, the entity is only able to recognise revenue over time for satisfying the performance obligation only if it also has a right to payment for performance to date. Consequently, in the examples mentioned in paragraph 28 above, the entity could only recognise revenue only if the customer agreed to pay the entity for performance to date if the customer terminated the contract at any time. The staff expects that it would not be common for contracts to possess both a substantive contractual restriction and confer the entity with the right to be paid for performance to date for the sale of inventory items or standardised assets.

*Practical limitations*

31. Paragraph 36 of the 2011 ED explains that an entity would be practically unable to readily direct an asset to another customer if the entity would incur significant costs (eg costs to rework the asset) to direct the asset to another customer.
32. There appears to be general support for a practical restriction providing evidence that an asset has no alternative use to the entity. Some respondents requested the Boards to describe more clearly what would constitute a practical limitation. For instance, some respondents queried whether factors other than ‘cost of rework’ would provide evidence of a practical limitation. Paragraph BC94 states that the need to sell the asset for a significantly reduced price could also indicate that the presence of a practical limitation. Consequently, the staff notes that 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.

*Conclusion: clarifying contractual and practical limitations.*

33. The staff thinks that it would be difficult to provide too much more specific guidance on what constitutes a contractual or practical limitation. The assessment will require judgement after considering the individual facts and circumstances that would influence whether the entity has the ability to readily direct the asset to another customer without contravening a substantive contractual requirement or without the risk of incurring a significant economic loss.

*Changes in the assessment of alternative use*

34. Paragraph 36 of the 2011 ED specifies that, when evaluating whether an asset has an alternative use to the entity, an entity should 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.
35. A few respondents requested clarification on how to apply paragraphs 35 and 36 of the 2011 ED if the assessment of whether an asset has 'alternative use' changes throughout the life of the contract. As an example, a respondent commented that, in the aircraft manufacturing industry, an asset may have alternative use during the beginning of its manufacture but the asset may cease having an alternative use to the entity when the asset is customised later in the production process. However, the staff thinks that the Boards' intended for the assessment, which is made at contract inception, to consider the entity's ability throughout the production process to readily re-direct the partially completed asset to another customer. Accordingly (and assuming the right to payment for performance to date criterion is also met), the entity would have a performance obligation that is satisfied over time if the asset would not have an alternative use to the entity at any time during the production process. Consistent with the assessment occurring at contract inception, the staff thinks that an entity would not change its assessment of whether a performance obligation is satisfied over time if new information subsequently became available to indicate that the asset may now have an alternative use to the entity.

*Comprehension and translation concerns*

36. The staff acknowledge the difficulties that some respondents have encountered in understanding the notion of 'alternative use', in part because it is defined more broadly in the proposals than some would intuitively understand it to mean. This is because paragraph 36 of the 2011 ED indicates that entities must also consider contractual restrictions that limit the entity's ability to readily direct the promised asset to another customer, rather than simply the practical usefulness of the asset outside of the contract.

37. ‘Alternative use’ is a drafting label to designed to encapsulate the circumstances that determine whether or not an entity would be able to readily direct an asset to another customer. In the 2011 ED, that label refers the reader to paragraph 36 for the definition of ‘alternative use’. Paragraphs 66-76 below consider possible approaches to simplify the drafting of paragraph 35(b). The staff considers that those possible improvements to paragraph 35(b) criteria might also ease translation difficulties.

***Paragraphs 35(b)(i) and (b)(ii) criteria***

38. The criteria in paragraphs 35(b)(i) and (b)(ii) are intended to apply in circumstances whereby the entity’s performance does not result in a recognisable asset. That is because any asset that is created (or any other benefits generated) by the entity’s performance would be simultaneously received and consumed by the customer as the entity performs. Hence, as mentioned at paragraph 23, the ‘alternative use’ criterion in paragraph 35(b) of the ED is not directly relevant to assessing whether the entity’s performance obligation is satisfied over time.
39. The criteria in those paragraphs are not mutually exclusive.
- (a) Paragraph 35(b)(i) is intended to apply in circumstances where the entity can readily ascertain that the customer benefits from the entity’s performance as the entity performs.
- (b) Paragraph 35(b)(ii) is intended to apply in circumstances where that assessment is more subjective. That might be because the customer does not perceive they receive a benefit until the entity’s performance is complete. For that reason, paragraph 35(b)(ii) proposes an objective basis for assessing whether a customer receives a benefit from the entity’s performance as the entity performs, which involves considering whether another entity would need to substantially re-perform the work completed to date to fulfil the remaining obligation. If another entity would not need to substantially re-perform the work completed the date and would only need to fulfil the remaining obligation, then the customer has benefited from the entity’s performance completed to date.

40. The feedback received on these criteria can be summarised as follows:
- (a) confusion about the interaction between the criteria in paragraphs 35(b)(i) and (b)(ii) and the application of paragraph 35(b)(ii) to construction contracts; and
  - (b) application to freight logistics services.

*Confusion in applying paragraphs 35(b)(i) and 35(b)(ii)*

41. Several respondents commented that the duplication within paragraph 35 (particularly paragraphs 35(b)(i) and (b)(ii)) was initially confusing because they expected each criterion in the list to be mutually exclusive.
42. Furthermore, some respondents were confused as to whether paragraph 35(b)(ii) could apply to construction or manufacturing contracts. In their view, it is clear in the case of construction contracts that ‘another entity would not need to substantially re-perform the work completed to date’ because the incoming contractor would not need to re-build whatever had been completed to date. Those respondents were confused by the relevance of the remainder of the criterion in paragraph 35(b)(ii) that: ‘the entity shall presume that another entity fulfilling the remainder of the contract would not have the benefit of any asset...presently controlled by the entity’.
43. The staff suggests that the scope and intended operation of these criteria should be clarified. Paragraphs 72-73 below considers how the drafting of these criteria can be simplified. The staff notes that paragraph 35(b)(ii) criterion is intended to apply only to pure service contracts. In theory, that criterion in conjunction with the ‘no alternative use’ criterion in paragraph 35(b) could determine that an entity can recognise revenue over time for a construction contract, but that could only occur if, in accordance with paragraph 35(b)(ii), the hypothetical entity that would fulfil the remainder of the contract would have the benefit of the part completed asset because it is presently controlled by the customer. However, if it is clear that the customer controls the asset as it is created, an entity could also assess its contracts in accordance with the paragraph 35(a) criteria.

*Application to freight logistics services*

44. Paragraph BC97 explains the application of paragraph 35(b)(ii) by using the examples of a performance obligation to transport a customer's asset to a destination point. The Basis indicates that because another entity hypothetically could fulfil the remaining obligation to the customer without having to re-perform the transportation service to date, the customer must be obtaining benefit over time. Accordingly, the entity is satisfying its performance obligation over time and, as such, the entity should recognise revenue over time.
45. Some respondents disagreed with the conclusions in the Basis because, in their view, the entity has not satisfied its performance obligation to deliver the asset to the customer by an agreed-upon date. In other words, they perceive the service to be the act of delivering the customer's goods to the destination. Some other respondents queried whether the satisfaction of the performance obligation under a freight logistics service depends on the nature of the entity's obligation in each individual contract. The staff thinks that these comments highlight the importance of specifying a criterion that objectively determines whether the customer is receiving a benefit from the entity's performance. However, even though the entity is satisfying its performance obligation over time, the entity may not recognise revenue over time if the customer consideration is contingent on entity meeting specified conditions associated with delivering the customer's goods to the destination point. In those cases, the customer has promised variable consideration and the entity would only recognise that consideration as revenue as the service is provided when the entity is reasonably assured to be entitled to that amount of revenue or when the contingency has been resolved.

***Paragraph 35(b)(iii) – right to payment for performance to date***

46. Many respondents agreed that a performance obligation is satisfied over time and, hence, revenue should be recognised over time, if both of the following conditions are met:

- (a) the asset created by the entity's performance does not have alternative use to the entity (as per paragraph 35(b)); and
  - (b) the entity has a right to payment for performance completed to date (as per paragraph 35(b)(iii)). The 2011 ED explains that a 'right to payment for performance to date' is a payment that is intended to compensate an entity for its performance completed to date rather than, for example, payment for a deposit or to compensate the entity for inconvenience or loss of profit.
47. Furthermore, some respondents commented that, although they view those criteria as being inconsistent with the underlying principle that revenue is recognised when control of an asset is transferred to the customer, they consider that a right to consideration is an appropriate trigger for revenue recognition. (Paragraph 61 below presents the staff's analysis of the relationship between paragraph 35(b) and the concept of control.)
48. The comments and requests for clarification that were received on the 'right to payment for performance to date' criterion can be categorised as follows:
- (a) how to determine whether an entity has a right to payment for performance to date; and
  - (b) how to determine the amount that would compensate the entity for the performance to date.

*Determining whether an entity has a right to payment for performance to date*

49. Many respondents raised questions about the meaning of the term 'right to payment for performance to date'.
50. A frequent question related to whether a 'right to payment' would exist only if the contract specifies milestone or progress payments that in timing and amount would at least correspond to the value of work performed to date by the entity under the contract. The staff notes that it is the existence of the right to payment for performance to date that is important rather than whether the payment schedule in the contract correlates with the entity's performance. However, the staff acknowledges that this distinction between the right to payment and the receipt of payments from the



customer was not clear in the 2011 ED and example 7 of the Illustrative Examples (about the development of residential real estate) perhaps confused the distinction because the facts in that example included that the payment schedule specified in the contract was intended to at least compensate the entity for performance completed to date.

51. Accordingly, the staff suggests that the revenue standard should clarify that:
- (a) The payment schedule specified in the contract does not indicate whether an entity has a right to payment for performance to date—The payment schedule in a contract specifies the timing and amount of consideration that is payable by the customer to the entity. In that sense, the payment schedule establishes the entity’s right to payment on the basis that both the entity and the customer continue to perform their respective obligations in the contract. However, the purpose of the right to payment for performance to date criterion is to establish the entity’s rights under the contract to demand and/or retain amounts of contract consideration if the customer were to terminate the contract prior to completion. In that case, the payment schedule is not directly relevant to that assessment because the contract could specify that either:
    - (i) consideration received from the customer is refundable for reasons other than the entity failing to perform as promised in the contract; or alternatively
    - (ii) the customer must compensate the entity for performance to date even if the payment schedule specifies that the contract consideration is only due at contract completion.
  - (b) The right to payment should be enforceable—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. Therefore:
    - (i) a contractually specified right to payment for performance to date would not be enforceable if a court has previously

decided that similar rights in similar contracts have no binding legal effect;

- (ii) legislation or legal precedent could confer to the entity a right to payment for performance to date even though that right is not specified in the contract with the customer; and
- (iii) if an entity has a customary business practice of choosing not to enforce a right to payment, the entity should consider whether its past actions would be expected to result in the right being rendered as unenforceable in that legal environment. If the entity concludes that the right would still be enforceable, the entity would have a right to payment for performance to date notwithstanding that the entity chooses to waive that right.

52. A few respondents have queried whether a 100 per cent non-refundable upfront payment would meet the ‘right to payment for performance to date’ criterion. The staff thinks that it would meet that criterion if the entity’s right to retain (and not refund) that payment would be enforceable if the customer terminated the contract. However, as explained throughout this paper, the existence of a right to payment for performance to date is not sufficient for an entity’s performance obligation to be deemed to be a performance obligation that is satisfied over time in accordance with paragraph 35(b)—the asset created or enhanced by the entity’s performance would also have to have no alternative use to the entity.

#### *Compensation for performance to date*

53. Some respondents also questioned whether, in the event of termination, it would be appropriate to require an entity to obtain compensation that ‘approximates the selling price of the goods or services transferred to date’ to be able to meet the criterion of ‘right to payment’ in paragraph 35(b)(iii). This is because the selling price or compensation that would be obtained on termination of an incomplete contract may not necessarily be the compensation that would be received if the contract was completed as expected. Respondents suggested that, in the case of contract termination, it should be sufficient to consider that an entity has a right to payment if they are compensated for their costs plus a ‘reasonable profit margin’, even though

that profit margin may be less than what they would receive if the contract was completed as expected.

54. The staff broadly agrees with that suggestion. The right to payment for performance to date should compensate the entity for more than just the costs incurred because the underlying objective of the paragraph 35(b)(iii) is to ascertain whether the entity is providing a service to the customer as an asset is being created for that customer. Therefore, assuming rational behaviour and ignoring any broader perceived economic benefits associated with that contract, the entity would only agree to provide that service to the customer if the entity is compensated for the costs associated with fulfilling the contract and a profit margin that includes a return on the entity's cost of capital. Consequently, the staff suggests that the revenue standard should clarify that:
- (a) a 'reasonable profit margin' should represent either:
    - (i) a reasonable proportion of the expected profit margin under the contract (ie a contract specific margin); or
    - (ii) 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
  - (b) 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.

### ***Applying the criteria to multi-storey residential real estate developments***

55. Some respondents in the residential real estate industry particularly supported the addition of the paragraph 35(b) criteria because they thought it would assist them in assessing whether revenue could be recognised over time for sales of residential units in a multi-unit apartment block that are currently within the scope of IFRIC 15 *Agreements for the Construction of Real Estate*. Other respondents in this industry explained that although they were able to conclude that their performance does not create an asset with alternative use, they were unable to meet the criterion in paragraph 35(b)(iii); that is, they could not conclude that they had a right to payment

for performance to date. This would mean that they would only be able to recognise revenue at a point in time for the sales of their units, which in their view would not be an appropriate depiction of their performance.

56. The staff thinks that clarifying the ‘no alternative use’ criterion in paragraph 35(b) and the ‘right to payment for performance to date’ criterion in paragraph 35(b)(iii) should ensure greater certainty and consistency in recognising revenue for multi-storey residential real estate developments. If either of those criteria are not met, the staff thinks recognising revenue over time would not faithfully depict the entity’s performance and the entity’s and customer’s respective rights and obligations in the contract. Some respondents identified that example 7 of the Illustrative Examples was confusing because it contained some facts that are superfluous in concluding that the entity’s performance obligation is satisfied over time. The staff intend to refine the facts in that example and suggest including a second example that illustrates a circumstance when the performance obligation would be satisfied at a point in time.

### Clarifying the conceptual basis

57. Some respondents have questioned the conceptual basis of the criteria in paragraph 35(b) (to determine if a performance obligation is satisfied over time) and whether those criteria are consistent with the transfer of control concept that underpins the proposed revenue model. Specifically, respondents thought it was unclear how the notions of ‘alternative use’ (paragraph 35(b)), ‘another entity would not need to re-perform’ (paragraph 35(b)(ii)) and in particular a ‘right to payment for performance completed to date’ (paragraph 35(b)(iii)) link to the control principle in paragraph 32 in the 2011 exposure draft. For instance, one respondent commented that “The ongoing application issues for IFRS reporting entities arising from IFRIC 15 *Agreements for the Construction of Real Estate* highlight the challenges of implementing a ‘continuous transfer’ approach without clarity as to the underlying principle and how it is to be applied” (CL#64 KPMG).
58. Paragraph BC92 of the 2011 ED explained that the paragraph 35(b) criteria were developed for performance obligations for which it may not be clear whether any

asset that is created or enhanced is controlled by the customer (eg for some construction contracts or specialised manufacturing contracts), or for which the entity's performance does not result in a recognisable asset (eg for some service contracts). However, the Basis did not clearly explain or justify that the criteria is consistent with the concept of control. To address that concern, the staff suggests that the revenue standard should therefore explain the relationship between the concept of control and the paragraph 35(b) criteria. The following section provides that explanation.

### ***The control principle***

59. As paragraph 32 of the revised ED says:

Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset. The benefits of an asset are the potential cash flows that can be obtained directly or indirectly in many ways, such as by:

- (a) using the asset to produce goods or provide services (including public services);
- (b) using the asset to enhance the value of other assets;
- (c) using the asset to settle liabilities or reduce expenses;
- (d) selling or exchanging the asset;
- (e) pledging the asset to secure a loan; and
- (f) holding the asset.

***Service contracts within the scope of paragraph 35(b)(i) or 35(b)(ii)***

60. As explained at paragraph 38, the criteria in paragraphs 35(b)(i) and (ii) are intended to apply in circumstances whereby the entity's performance does not result in a recognisable asset and the customer benefits from the entity's performance as the entity performs. The staff thinks that both of those criteria are consistent with the control principle (as specified in paragraph 32 of the 2011 ED) because the fact that the customer receives and consumes the asset or benefits arising from the entity's performance means that the customer must have the ability to direct the use of or obtain the benefits from the entity's performance.

***Contracts within the scope of paragraph 35(b)(iii)***

61. This criterion is intended to typically apply in circumstances in which it may not be clear whether the asset that is created or enhanced by the entity's performance is controlled by the customer or by the entity and will transfer to the customer at a later date. Specifically, if an entity's performance completed to date does not create an asset with an alternative use to the entity and the customer is obliged to pay for that performance to date, then the customer could be regarded as receiving the benefit from that performance.
62. As noted, some respondents questioned the relationship between the 'right to payment for performance to date' criterion and the control principle. However, for control of an asset arising from the entity's performance (eg work in progress) to be deemed to have passed to the customer, the ED requires that both that asset have no alternative use to the entity and the entity have a right to payment for its performance to date. There is a logical linkage between those two requirements. If an asset that the entity is creating has no alternative use to the entity, the entity is effectively constructing an asset at the direction of the customer, and so the entity will want to be protected from the risk that the customer walks away from the contract and the entity is left with a worthless asset. The likely protection sought by the entity is for the customer to be required to pay for the entity's performance to date if the contract is terminated.

63. In such a scenario, the link with the control principle can be found in the control guidance in paragraph 32, specifically that ‘control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset’. If the asset being created by an entity’s performance has no alternative use, either through practical or contractual limitations, then in effect the customer has the ability to prevent the entity from directing the use of or receiving the benefit of the asset under construction (other than by transferring the asset to the customer). That thinking is then strengthened by the requirement for the entity to have a right to payment for its performance to date. Typically in an exchange contract, a customer would be obliged to pay only if it has received goods and services in exchange. Therefore, the fact that the customer is obliged to pay for the entity’s performance (or, said another way, is unable to avoid paying for that performance) suggests that the customer is receiving the benefits from the entity’s performance. Accordingly, the combination of these two requirements is sufficient to provide evidence that the customer, rather than the entity, controls the asset arising from the entity’s performance. In other words, the entity has exchanged its interest in the asset it is creating for a right to payment.
64. Some respondents disagree that a contractual limitation could indicate that an asset does not have an alternative use to the entity. This is discussed further at paragraph 27 above.
65. The staff suspects that some will continue to dispute the rationale for the linkage between paragraph 35(b)(iii) and the control principle. Nonetheless, feedback suggests that some seem to place more weight on the Boards providing unambiguous, objective and readily applicable guidance for making the sometimes inherently subjective assessment of whether a customer has obtained control of goods and services, rather than on the conceptual purity of that guidance. This is particularly the case in the light of the difficulties in applying the guidance in IFRIC 15 and the consequently divergent interpretations of that guidance. For instance:

We understand that some of the requirements have been developed in order to clarify the application of the transfer of control concept to specific types of contracts (certain services

and real estate). We believe the requirements result in appropriate accounting outcomes for the specific fact patterns the Boards had in mind. (CL#64 KPMG)

### **Putting it all back together—drafting refinements for paragraph 35 criteria**

66. This section of the paper considers some possible refinements to the drafting of paragraph 35 to aid comprehension.
67. Those possible refinements involve:
- (a) deleting paragraph 35(a);
  - (b) combining paragraphs 35(b)(i) and (b)(ii) into a single criterion; and
  - (c) establishing a closer linkage between the ‘no alternative use’ criterion in paragraph 35(b) and the ‘right to payment for performance to date’ criterion in paragraph 35(b)(iii).
68. The refinements could be made independently of each other. Therefore, the Boards could choose to make all, some or none of these refinements to the paragraph 35 criteria.

### ***Deleting paragraph 35(a)***

69. As noted above, the paragraph 35(a) criterion would apply where the entity’s performance creates an asset and it is clear that the customer controls that asset as it is created or enhanced. However, that criterion does not assist an entity in determining how to account for performance obligations whereby the entity’s performance creates an asset and it is unclear whether the customer controls that asset as it is created. Consequently, paragraph 35(b) specifies a different set of criteria that can be considered to determine whether the customer controls the asset—those criteria are ‘no alternative use’ and ‘right to payment for performance to date’.
70. The staff notes that a performance obligation that meets the paragraph 35(a) criterion would also meet the paragraph 35(b) criteria. Consequently, there is a source of duplication in the proposals. This duplication could be removed by deleting



paragraph 35(a) and relying solely on the criteria of ‘no alternative use’ and ‘right to payment for performance to date’ to determine whether a performance obligation is satisfied over time in those circumstances whereby the entity’s performance creates an asset. Another reason to consider deleting paragraph 35(a) is that, by retaining both paragraphs 35(a) and 35(b), an entity that fails to meet the criteria in paragraph 35(b) might attempt to justify that the customer controls the work in progress asset created by the entity’s performance.

71. However, a reason to retain the paragraph 35(a) criterion is that it is generally supported by respondents and its application is intuitive for many construction contracts (eg construction of a house on the customer’s land). For that reason, the staff recommends that the paragraph 35(a) criterion should be retained.

***Combining paragraphs 35(b)(i) and (b)(ii) into a single criterion***

72. As explained in paragraphs 38 and 39, there is also duplication between the criteria in paragraphs 35(b)(i) and (b)(ii). That is because those criteria were designed to apply to ‘pure service’ contracts—ie circumstances whereby the entity’s performance does not create a recognised asset (because the asset that is created is simultaneously consumed by the customer) and the customer benefits from that performance as the entity performs. The intended distinction between those criteria was for paragraph 35(b)(ii) to specify a basis for objectively determining whether the customer receives the benefit from the service as it is provided by the entity whereas paragraph 35(b)(i) would apply to those circumstances where there is clear evidence that the customer benefits from the service as it is provided rather than upon completion.
73. Given the confusion that this duplication has caused, the staff recommends simplifying the paragraph 35 criteria by combining the paragraphs 35(b)(i) and (b)(ii) criteria into a single criterion. The combining of those criteria into a single criterion is illustrated at paragraph 76 below.

***Linking more closely the ‘no alternative use’ and the ‘right to payment for performance to date’ criteria***

74. It is evident from the analysis in this paper that determining whether a performance obligation is satisfied over time is often based on applying the criteria of ‘no alternative use’ and the ‘right to payment for performance to date’. Because of that fact, the staff recommends that the paragraph 35 criteria should link those criteria more closely, which could also improve an entity’s understanding and application of those criteria. The linkage of those criteria is illustrated at paragraph 76 below
75. Although not illustrated below, the staff also plans to consider alternative ways of expressing the ‘no alternative use’ criterion.

***Suggested revised drafting***

76. The staff recommends that the criteria in paragraph 35 could be re-expressed as follows:

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 and the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised.

**Question**

The staff recommends that the Boards make the following refinements to the criteria proposed in paragraph 35 of the 2011 ED for determining whether an entity satisfies a performance obligation over time:

- (a) retain the criterion in paragraph 35(a);
- (b) combine the criteria in paragraphs 35(b)(i) and (b)(ii) into a single criterion that would apply to 'pure service' contracts; and
- (c) link more closely the 'no alternative use' criterion in paragraph 35 'right to payment for performance to date' criterion in paragraph 35(b)(iii).

Do the Boards agree?

## Appendix A

A1. The following table lists the proposed requirements from the 2011 ED that relate to performance obligations that are satisfied over time and identifies which of those proposals might change as a result of the staff recommendations in this paper.

Proposals from the 2011 exposure draft	Anticipated change?
<p><b>31</b> 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.</p>	No material change is anticipated
<p>32 Goods and services are assets, even if only momentarily, when they are received and used (as in the case of many services). Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Control includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset. The benefits of an asset are the potential cash flows that can be obtained directly or indirectly in many ways, such as by:</p> <ul style="list-style-type: none"> <li>(a) using the asset to produce goods or provide services (including public services);</li> <li>(b) using the asset to enhance the value of other assets;</li> <li>(c) using the asset to settle liabilities or reduce expenses;</li> <li>(d) selling or exchanging the asset;</li> <li>(e) pledging the asset to secure a loan; and</li> <li>(b) holding the asset.</li> </ul>	No material change is anticipated
<p>33 When evaluating whether a customer obtains control of an asset, an entity shall consider any agreement to repurchase the promised asset or a component of the promised asset. (See the application guidance on repurchase agreements in paragraphs B38–B48.)</p>	No material change is anticipated
<p>34 For each separate performance obligation identified in paragraphs 23–30, an entity shall apply the requirements in paragraphs 35 and 36 to determine at contract inception whether the entity satisfies the performance obligation over time by transferring control of a promised good or service over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.</p>	No material change is anticipated.
<p>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:</p> <ul style="list-style-type: none"> <li>(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</li> </ul>	A change is recommended – refer paragraph 76

<p>paragraph 37 to determine whether the customer controls an asset as it is created or enhanced; or</p> <p>(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:</p> <p>(i) the customer simultaneously receives and consumes the benefits of the entity’s performance as the entity performs.</p> <p>(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.</p> <p>(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.</p>	
<p>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.</p>	<p>Staff will consider whether more clarity can be provided on the meaning of contractual limitations and practical limitations, but it may be difficult to provide too much more specific guidance on those topics (refer paragraph 33)</p>