

# AGENDA PAPER

IFRS® Foundation Trustees meeting – Due Process Oversight Committee

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## Agenda Decisions: The IFRS Interpretations Committee’s approach in responding to questions

### Purpose of paper

1. This paper explains the IFRS Interpretations Committee’s (Committee) approach in responding to questions submitted to it, including those that involve highly-specific fact patterns.
2. There is no specific due process matter to report to the DPOC and, whilst we welcome feedback, we are not asking any specific questions in this paper. We also do not see any need to consider amending the *Due Process Handbook* in relation to this matter. Nonetheless, we wanted to draw your attention to it because of its recent higher profile as the Committee has worked to improve the usefulness of its Agenda Decisions in supporting the consistent application of IFRS Standards.
3. The Committee itself discussed its approach in responding to questions given the nature of three questions it received on the new revenue recognition Standard, IFRS 15 *Revenue from Contracts with Customers*. This approach was discussed with the Board who were supportive of the Committee’s approach.

### Background—the Committee’s process and Agenda Decisions

4. The work of the Committee is outlined in the *Due Process Handbook*.<sup>1</sup> The Committee has a transparent process that allows any stakeholder to submit a question about the application of IFRS Standards through the IFRS website.

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<sup>1</sup> See paragraphs 5.14–5.22

5. For each question submitted the Committee is required to consider at a public meeting whether to add a project to its standard-setting agenda.
6. In many cases, the Committee decides not to recommend standard-setting (ie not to propose any changes to IFRS Standards or to develop an IFRIC Interpretation that has the same status as a Standard) because it would either be:
  - (a) unnecessary—typically because, in the Committee’s view, IFRS Standards provide enough information for a company to determine its accounting or because there is no evidence that a widespread accounting problem exists; or
  - (b) unhelpful—for example, introducing new or amended requirements might assist one company with a particular type of transaction, while raising questions for other companies with slightly different types of transactions.
7. To explain why it did not recommend standard setting, the Committee publishes an Agenda Decision.<sup>2</sup>
8. Importantly, Agenda Decisions often include information to help companies apply IFRS Standards—for instance, 12 of the 14 final Agenda Decisions published in 2017 include such information. They do so by explaining how the applicable principles and requirements in the Standards apply to the question submitted. This material does not have the (mandatory) status of the Standards but, as explained in the *Due Process Handbook*, it should be seen as ‘helpful, informative and persuasive’. Given their importance, Agenda Decisions are exposed for comment before finalisation.
9. Agenda Decisions are therefore an important tool in supporting high-quality and consistent application of IFRS Standards. They allow the Committee to respond to specific questions about the application of IFRS Standards in a timely manner, but also help to ensure that we maintain the principle-based nature of the Standards and encourage the appropriate use of judgement by others in their application. Feedback that we have received shows that many

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<sup>2</sup> Paragraph 5.22 of the *Due Process Handbook* explains Agenda Decisions, although it describes them as ‘rejection notices’. We plan to ask the DPOC to consider revising this description as part of the process of revising the *Due Process Handbook* because it fails to convey that in most cases Agenda Decisions are responsive to a stakeholder’s submission and do not simply ‘reject’ it.

stakeholders agree with this and support the use of Agenda Decisions. And the Board has recently exposed a proposal intended to reduce the costs for companies when they change their accounting policies as a result of Agenda Decisions.<sup>3</sup>

### **The Committee's objective in responding to questions**

10. In response to some comments received on the Trustees' 2015 *Review of Structure and Effectiveness*, the Committee has focussed on its responsiveness to application questions both in terms of timeliness and also by trying to provide as much support as possible for entities applying IFRS Standards, even when the Committee decides not to recommend standard-setting. This means that typically Agenda Decisions now are more informative than they were in the past.
11. However, this raises the question of how far the Committee should go in Agenda Decisions in responding to questions, particularly when they have highly-specific fact patterns. As acknowledged by the Committee and the Board, and noted in some of the comment letters received on some recent tentative Agenda Decisions, there are risks to providing answers to highly-specific fact patterns.
12. The main risk highlighted is that stakeholders might inappropriately analogise to the conclusion when the facts are similar but not the same (although this risk is not unique to Agenda Decisions—the same risk arises when the Board or Committee develops illustrative examples to accompany a Standard). There is also the risk that, in appearing to be open to answering highly-specific questions, the Committee might inadvertently undermine the appropriate use of judgement by others that is required when applying the principles-based framework of IFRS Standards. The Committee might also appear open to acting like a technical enquiry helpdesk.
13. In considering this question, the Committee and Board's view is that the objective of the material in Agenda Decisions is to help stakeholders obtain a common understanding of the

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<sup>3</sup> Exposure Draft *Accounting Policy Changes* proposing amendments to IAS 8 issued in March 2018.

requirements and their application—this is what ultimately helps to support consistent application of IFRS Standards around the world.

### **How the Committee applies this objective in Agenda Decisions**

14. In most cases, the Committee can meet this objective in its Agenda Decisions by pointing to and linking together the principles, requirements and Basis for Conclusions in IFRS Standards that are relevant for the particular question. This might include setting out the Board’s objective in developing particular requirements and the factors an entity needs to consider in applying those requirements in particular circumstances or to particular transactions. The additional context provided in such explanatory material can improve the understanding of the requirements without providing an answer to a specific fact pattern. In addition, the material is often relevant for a range of facts patterns or transactions with characteristics specified in the Agenda Decision. The first Agenda Decision in the appendix (page 6) illustrates this approach.
15. Generally, therefore, the Committee does not provide answers to highly-specific fact patterns.
16. However, at times it might be necessary for the Committee to go further to achieve the objective of a common understanding of the requirements and their application. One reason for doing so is because the Committee’s research highlights that the question is causing disruption in the implementation of a new Standard. Therefore, to achieve a common understanding it is necessary for the Committee to actually provide an answer to the specific fact pattern. To reduce the risk of inappropriate application of the Committee’s conclusion in such cases, the Agenda Decision clearly articulates the fact pattern and the factors that are relevant for consideration in reaching the particular conclusion.
17. Sometimes the Committee will think it is important to try to address a fact pattern in detail to support consistent application. However, the application of the requirements to a particular fact pattern will depend on factors that are difficult to assess based simply on the facts outlined in the Agenda Decision—such as assessing whether a contract is legally enforceable. This is a situation in which the Committee needs to be particularly careful that inappropriate analogies are not drawn. This question of legal enforceability was of particular importance in

a recent Committee discussion about IFRS 15. To avoid the risk of misapplication of the Agenda Decision, the Committee was careful to avoid opining on the legal enforceability of contracts. The Committee concluded that assessing legal enforceability requires consideration of a wider set of facts than could be specified in an Agenda Decision. Hence the Agenda Decision highlights the key judgements that need to be made in assessing legal enforceability, including consideration of legal precedent, but states as an *assumption*—rather than as a conclusion—that the contract is not legally enforceable. This Agenda Decision is included in the appendix starting on page 9.

### **Concluding observations**

18. The Committee needs to be flexible in its approach depending on the nature of the question. It also carefully considers stakeholder feedback on tentative (ie draft) Agenda Decisions about its approach in responding to questions.
19. Regardless of the specificity of the Committee’s explanatory material, it is important that an Agenda Decision is read as an extra piece of explanatory material that does not, and should not, replace an entity’s consideration of all the facts and circumstances relevant in determining how to appropriately account for its transactions. The material in Agenda Decisions, like illustrative examples in the Standards, do not provide answers per se but rather provide additional, helpful information to assist entities in applying IFRS Standards in their own circumstances.

## **Appendix—Two recent Agenda Decisions (provided as background information)**

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

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

#### ***Identifying performance obligations in the contract***

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

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

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

The assessment of the criteria in paragraph 27 requires judgement.

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

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

Paragraphs BC105, BC116J and BC116K note that the notion of ‘separately identifiable’ in paragraph 27(b) is influenced by the notion of separable risks (ie whether the risk an entity assumes to fulfil its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised goods or services). The evaluation of whether an entity’s promise is separately identifiable considers the relationship between the various goods or services

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within the contract in the context of the process of fulfilling the contract. Therefore, an entity considers the level of integration, interrelation or interdependence among the promises to transfer goods or services. Rather than considering whether one item, by its nature, depends on the other (ie whether two items have a functional relationship), an entity evaluates whether there is a transformative relationship between the two items in the process of fulfilling the contract.

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

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

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

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

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

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

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

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



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### **Agenda Decision published in March 2018—Revenue recognition in a real estate contract (IFRS 15 *Revenue from Contracts with Customers*)**

The Committee received a request about revenue recognition in a contract for the sale of a unit in a residential multi-unit complex. Specifically, the request asked about the application of paragraph 35 of IFRS 15, which specifies when an entity recognises revenue over time.

#### ***Identifying the contract***

An entity accounts for contracts within the scope of IFRS 15 only when all the criteria in paragraph 9 are met. One of these criteria is that it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. Accordingly, an entity applies the requirements in paragraphs 22–30 and paragraphs 35–37 discussed in this agenda decision only to contracts for which the criteria in paragraph 9 are met.

#### ***Identifying performance obligations in the contract***

Before applying paragraph 35, an entity applies paragraphs 22–30 in identifying as a performance obligation each promise to transfer to the customer a good or service that is distinct. The Committee has included explanatory information about the application of paragraphs 22–30 to real estate contracts in its Agenda decision ‘*Revenue Recognition in a Real Estate Contract that Includes the Transfer of Land*’ published in March 2018.

#### ***Applying paragraph 35 of IFRS 15***

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

#### **Paragraph 35(a)**

Applying paragraph 35(a), an entity recognises revenue over time if the customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs. In a contract for the sale of real estate that the entity constructs, the Committee observed that paragraph 35(a) is not applicable because the entity’s performance creates an asset, ie the real estate, that is not consumed immediately.

#### **Paragraph 35(b)**

Applying paragraph 35(b), an entity recognises revenue over time if the customer controls the asset an entity’s performance creates or enhances as the asset is created or

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enhanced. Control refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

Paragraph BC129 explains that the Board included the criterion in paragraph 35(b) to ‘address situations in which an entity’s performance creates or enhances an asset that a customer clearly controls as the asset is created or enhanced’. Accordingly, the Committee observed that, in applying paragraph 35(b), an entity assesses whether there is evidence that the customer clearly controls the asset that is being created or enhanced (for example, the part-constructed real estate) as it is created or enhanced. An entity considers all relevant factors in making this assessment—no one factor is determinative.

In applying paragraph 35(b), it is important to apply the requirements for control to the asset that the entity’s performance creates or enhances. In a contract for the sale of real estate that the entity constructs, the asset created is the real estate itself. It is not, for example, the right to obtain the real estate in the future. The right to sell or pledge a right to obtain real estate in the future is not evidence of control of the real estate itself.

### **Paragraph 35(c)**

Paragraph BC131 explains that the Board developed a third criterion in paragraph 35(c) for recognising revenue over time because it observed that in some cases it may be unclear whether the asset that is created or enhanced is controlled by the customer. The underlying objective of the criterion in paragraph 35(c) is to determine whether the entity transfers control of goods or services to the customer as an asset is being created for that customer (paragraph BC143).

Applying paragraph 35(c), an entity recognises revenue over time if:

- a. the asset created by the entity’s performance does not have an alternative use to the entity; and
- b. the entity has an enforceable right to payment for performance completed to date.

Paragraph 36 specifies that the asset created does not have an alternative use to an entity if the entity is restricted contractually from readily directing the asset for another use during the creation of that asset or limited practically from readily directing the asset in its completed state for another use.

Paragraph 37 states that, to have an enforceable right to payment, at all times throughout the duration of the contract the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity’s failure to perform as promised. Paragraph B12 states that in assessing whether an entity has an enforceable right to payment, the entity considers the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect.

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The Committee observed that, although an entity need not undertake an exhaustive search for evidence, it would be inappropriate for an entity to either ignore evidence of relevant legal precedent available to it or anticipate evidence that may or may not become available in the future.

The Committee also observed that the assessment of enforceable rights as described in paragraph 35(c) is focussed on the existence of the right and its enforceability. The likelihood that the entity would exercise the right is not relevant to this assessment. Similarly, if a customer has the right to terminate the contract, the likelihood that the customer would terminate the contract is not relevant to this assessment.

### *Application of paragraph 35 to the fact pattern in the request*

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

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

- a. the real estate developer (entity) and the customer enter into a contract for the sale of a real estate unit in a residential multi-unit complex before the entity constructs the complex.*
- b. the entity's obligation under the contract is to construct and deliver the real estate unit as specified in the contract—it cannot change or substitute the specified unit. The entity retains legal title to the real estate unit (and any land attributed to it) until the customer has paid the purchase price after construction is complete.*
- c. the customer pays a portion of the purchase price for the real estate unit as the unit is being constructed, and pays the remainder (a majority) after construction is complete.*
- d. the contract gives the customer the right to an undivided interest in the land and the multi-unit complex under construction. The customer cannot cancel the contract, except as noted in ii. below, nor can it change the structural design of the complex or the individual unit. The customer can resell or pledge its right to the undivided interest in the land and the complex as the complex is being constructed, subject to the entity performing a credit risk analysis of the new buyer of the right.*
- e. the customer, and the other customers who have agreed to buy real estate units in the multi-unit complex, have the right to together decide to change the structural design of the complex and negotiate such change with the entity.*

*The request also notes the following:*

- i. if the entity is in breach of its obligations under the contract, the customer and the other customers have the right to together decide to replace the entity or otherwise stop the construction of the complex.*
- ii. although the contract is irrevocable, courts have accepted requests to cancel contracts in particular circumstances, for example when it has been proven that the customer is not financially able to fulfil the terms of the contract (if, for*

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*example, the customer becomes unemployed or has a major illness that affects the customer's ability to work). In these situations, the contract has been cancelled and the customer has received most, but not all, of the payments it has already made to the entity. The entity has retained the remainder as a termination penalty.*

*The courts' acceptance of requests for cancellation provides evidence of legal precedent. This legal precedent is relevant to the assessment of the entity's enforceable right to payment as described in paragraph 35(c). It is assumed that the evidence of legal precedent is assessed as sufficient to indicate that the entity is not entitled to an amount that at least compensates it for performance completed to date in the event of cancellation for reasons other than the entity's failure to perform as promised.*

*It is also assumed that all the criteria in paragraph 9 are met and that the entity identifies a single performance obligation applying paragraphs 22–30.*

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

### **Paragraph 35(b)**

The entity's performance creates the real estate unit under construction. Accordingly, in applying paragraph 35(b) the entity assesses whether, as the unit is being constructed, the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the part-constructed real estate unit. The Committee observed the following:

- a. although the customer can resell or pledge its contractual right to the undivided interest in the land and multi-unit complex as the real estate unit is being constructed, it is unable to sell or pledge the part-constructed real estate unit itself before construction is complete.
- b. the customer has no ability to change the structural design of the real estate unit as the unit is being constructed, nor can it use the part-constructed real estate unit itself in any other way. The customer's right together with the other customers to decide to change the structural design of the complex does not provide the customer with the ability to direct the use of the real estate unit—this is because the customer requires the agreement of the other customers to negotiate changes to the structural design, and thus the customer does not have the ability to make those changes.
- c. the customer's right together with the other customers to replace the entity or stop the construction of the complex, only in the event of the entity's failure to perform as promised, is protective in nature and is not indicative of control.
- d. the customer's exposure to changes in the market value of the real estate unit may indicate that the customer has the ability to obtain substantially all of the remaining benefits from the unit. However, it does not give the customer the ability to direct the use of the unit as it is being constructed.

The Committee observed that there is no evidence that the customer has the ability to direct the use of the real estate unit as it is being constructed, and thus the customer does

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not control the part-constructed unit. Consequently, the criterion in paragraph 35(b) is not met.

In the Agenda decision '*Revenue recognition in a real estate contract that includes the transfer of land*' published in March 2018, the Committee discusses a fact pattern involving the construction of real estate for which it concludes the criterion in paragraph 35(b) is met.

### ***Paragraph 35(c)***

The entity cannot change or substitute the real estate unit specified in the contract with the customer, and thus the customer could enforce its rights to the unit if the entity sought to direct the asset for another use. Accordingly, the contractual restriction is substantive and the real estate unit does not have an alternative use to the entity as described in paragraph 35(c).

The entity, however, does not have an enforceable right to payment for performance completed to date as described in paragraph 35(c). This is because, in the fact pattern described in the request, there is relevant legal precedent indicating that the entity is not entitled to an amount that at least compensates it for performance completed to date in the event of cancellation for reasons other than the entity's failure to perform as promised. In the event of the courts accepting requests to cancel contracts, the entity is entitled only to a termination penalty that does not compensate the entity for performance completed to date.

Based on the fact pattern described in the request, the Committee concluded that none of the criteria in paragraph 35 of IFRS 15 are met. Accordingly, the entity would recognise revenue at a point in time applying paragraph 38 of IFRS 15.

The Committee concluded that the principles and requirements in IFRS 15 provide an adequate basis for an entity to determine whether to recognise revenue over time or at a point in time for a contract for the sale of real estate. Consequently, the Committee decided not to add this matter to its standard-setting agenda.