

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

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 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.

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 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 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.