THE IFRS INTERPRETATIONS COMMITTEE PUBLISHES THREE IMPORTANT DECISIONS ON IFRS 15

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In recent months, the IFRS Interpretations Committee has received three referrals on the application of IFRS 15 to specific fact patterns in the real estate development sector.

The Committee finalised its positions during its March 2018 meeting and published three decisions all deciding not to add the matter to its standard-setting agenda.

These decisions are interesting on several grounds, apart from the formal responses in the individual cases:

- they are drafted in great detail with educational intent, since the Committee is well aware that the current period is critical (i.e. transition to a major standard that is unlikely to be fully mastered by everyone concerned);
- they provide valuable clarification on two major aspects of IFRS 15: identifying the performance obligations of the contract, and demonstrating the transfer of control over time.

In these respects, their scope extends far beyond the real estate development sector alone.

It should be noted that the Committee debated the relevance of responding to very specific questions to which the answers would be closely bound to the particular context in which they were asked. The Committee decided that it was important to respond, once again in light of the timetable and the recent entry into force of IFRS 15. The Committee is nevertheless aware that its role is not to provide answers to all the practical questions raised by the introduction of IFRS 15 when they relate to a context specific to a given jurisdiction. The Committee has also sought to word its answers in such a way that they cannot be improperly used in situations which would deserve a different analysis, given the different facts and circumstances.

Finally, the staff have noted in the agenda papers, in response to comments from some stakeholders following the publication of the related tentative agenda decisions, that the Committee had no need to question the relevance of the conclusion it had reached, in particular in the case where its analysis would lead to recognition of revenue at

completion and no longer as work progresses. The IASB has developed principles that must be applied in a consistent manner to all activities, even if this leads to a major change to current practices. The Committee therefore has no right to amend the principles defined by the IASB and considered that the existing provisions of IFRS 15 were sufficient to offer a response to the queries raised.

1. Sale before completion: is the land distinct from the building?

The Committee first discussed this question in November 2017. Eight responses were received as a result of the call for comments that followed the tentative decision not to add this matter to the agenda.

The contract in question relates to the sale before completion of a residential building to a single customer, and includes the sale of the land. The main question relates to the identification of the performance obligations in this contract.

The Committee first recalled the principles set out in IFRS 15, referring both to the relevant paragraphs of the standard (22-30) and to the Bases of Conclusion, all clarified during the publication of amendments to IFRS 15 in April 2016.

The Committee stressed that paragraph 27, which sets out the two conditions that must be met in order to conclude that a good or service is "distinct", requires the use of judgment:

(a) the customer can benefit from the good or service either on its own or together with other readily available resources (that is, the good or service is capable of being distinct);

(b) the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e. the promise to transfer the good or service is distinct within the context of the contract).

The Committee also recalled that assessing the distinct nature of a good or service "within the context of the contract" (the second condition) is influenced by the notion of separability of the risks relating to each of the services promised in the contract that the entity has promised to transfer.

Finally, the Committee stressed that an entity should evaluate whether there is a "transformative" relationship between the promised goods and services rather than considering whether one item depends on the other (i.e. demonstrating that two items have a functional relationship). The objective of the standard is to determine whether the nature of the promise made to the customer 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.

In the present case, the Committee conducted the following analysis:

- **First condition: can the land be considered distinct when taken in isolation?**

The Committee answered this question in the affirmative, observing that a customer could benefit from the land on its own by hiring another developer to construct the building on the land.

- **Second condition: is the land "distinct in the context of the contract"?**

To answer this question, the Committee considered the factors provided by paragraph 29 of the standard, indicating, as explained in the Bases of Conclusion, that these are just factors and not criteria, and that they are not necessarily relevant in every case.

The Committee concluded that, while there is a functional relationship between the land and the building, since the building cannot exist without the land, the transformative relationship has not been demonstrated; the risks assumed by the entity when it transfers the land to the customer do not seem inseparable from the risks assumed by the entity when it constructs the building. It also appears that the entity's performance in constructing the building would be the same regardless of whether it has previously transferred to the customer the land on which the building will be constructed.

The Committee therefore concluded that the second condition of IFRS 15 is satisfied if the entity concludes that:

- its performance in constructing the building would be the same regardless of whether it also transferred the land, and
- it would be able to fulfil its promise to construct the building even if it did not also transfer the land (and vice-versa).

Therefore, although the Committee did not explicitly conclude that a sale before completion of land and a building in the same contract with a single customer must give rise to the recognition of two performance obligations, in practice its guidelines lead to this conclusion.

In its deliberations, the Committee stressed the fact that the conclusion of its analysis was closely related to the case in question.

In its decision not to add this matter to its standard-setting agenda, the Committee also considered the obligating event triggering the recognition of revenue for this contract. The analysis and the conclusion reached by the Committee are discussed at point 2.1. below.

2. Sale before completion: when should revenue be recognised?

The three agenda decisions published in March 2018 all relate, either directly or indirectly, to the analysis of the obligating event for the recognition of revenue.

In other words, these three decisions all help to clarify how to interpret the IFRS 15 requirements on the transfer of control to the customer, and in particular how to apply paragraph 35.

Readers will recall that, under this paragraph, 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 criteria is met:

a) the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs;

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;

c) the entity's performance does not create an asset that the entity could use in any other way, and the entity has an enforceable right to payment for performance completed to date, if the contract is terminated by the customer for reasons other than the entity's failure to perform as promised.

2.1. Sale before completion of a residential complex to a customer with immediate transfer of legal title to the land

This is the continuation of the question considered at point 1. above.

The background is as follows:

- The contract concluded between the entity and the customer is non-cancellable.
- At contract inception, the entity irrevocably transfers to the customer legal title to the land on which the entity will construct the building. The customer pays for the land immediately.
- Before the contract is signed, the parties agree upon the structural design and specification of the building (which may be subsequently amended at the request of either party, in accordance with the circumstances and conditions stipulated in the contract).

The customer is required to make milestone payments throughout the construction period. However, these payments do not necessarily correspond to the amount of work completed to date.

The Committee analysed the three (non-cumulative) criteria set out in IFRS 15 paragraph 35 in order to determine whether the transfer of control of the land, on the one hand, and the building, on the other, happens over time (this analysis must be conducted separately for each of the performance obligations in the contract). If this is not the case, the transfer of control takes place at a point in time.

In this instance, the Committee concludes that the transfer of control of the land takes place at inception, when the contract is signed.

The Committee finds that the criterion in paragraph 35(a) does not apply to the building, because the transferred asset is not consumed immediately by the customer. It then immediately concludes that the criterion in paragraph 35(b) applies, since the building is constructed on land that the customer controls. The customer therefore takes control of the building as it is being constructed. This practical illustration of the criterion in paragraph 35(b) is clearly envisaged by the standard's Bases for Conclusion.

2.2. Sale before completion of a real estate unit, where the customer has the right to an undivided ownership interest in the land and the residential complex under construction and where the case law as regards termination of the contract is not favourable to the entity

The Committee first discussed this question in November 2017. This raised other questions on IFRS 15 in the real estate development sector (discussed in November 2017 and also presented in this article). This decision is therefore the most detailed in terms of the texts on the transfer of control over time.

Forty responses were received as a result of the call for comments that followed the tentative agenda decision. Of these responses, 28 came from the real estate development sector in Brazil, the country in which the referral originated. The Brazilian regulator also responded, indicating that it disagreed with the legal interpretation of the case submitted. This illustrates the difficulty of the analyses to be conducted, and the risks of "extrapolating" from a position taken in a specific jurisdiction.

Following a lengthy reminder of the IFRS 15 requirements on the transfer of control over time, the Committee made two important observations. They enable us to understand the basis of the analysis in the case in question, and more generally, the appropriate way to apply IFRS 15.35(c) on the demonstration of an enforceable right to payment.

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 to anticipate evidence that may or may not become available in the future. IFRS 15 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;
- the assessment of enforceable rights as described in paragraph 35(c) is focused on the existence of the right and its enforceability. The likelihood that the entity would exercise the right is not relevant to this assessment. For example, if a customer has the right to terminate the contract, the likelihood that it would do so is not relevant to the assessment required by IFRS 15.35(c).

These observations are fundamental, quite apart from the consequences they have for the particular case studied by the Committee.

The Committee also stresses that determining the obligating event for revenue recognition requires a case-by-case analysis, taking account of the jurisdiction in which the contract is enforceable. Conclusions may therefore vary from one situation to another, depending on the facts and circumstances.

In the present instance, the real estate development contract has the following characteristics:

- The real estate unit sold is specifically identified in the contract and cannot be substituted by the entity.
- 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.
- The customer pays a portion of the purchase price as the unit is being constructed, and pays the remainder (a majority) after construction is complete.
- 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.
- Nor can it unilaterally change the structural design of the complex or the individual unit. The customer, and the other customers who have agreed to buy real estate units in the same 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 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.

Furthermore:

- 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.
- 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 back most, but not all, of the payments it has already made to the entity. The entity has retained the remainder as a termination penalty.

In the view of the Committee, this last point provides evidence of legal precedent which is relevant to the assessment of the entity's enforceable right to payment as described in paragraph 35(c).

Having rapidly set aside the criterion of paragraph 35(a) which is not satisfied (see the remark in section 2.1. above), the Committee analyses the facts and circumstances in the light of the requirements of the criterion in paragraph 35(b). It concludes that:

- 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;
- the customer has no ability to change the structural design of the real estate unit as the unit is being constructed, as it requires the agreement of the other customers to negotiate changes to the complex;
- the customer's right together with the other customers to replace the entity or stop the construction of the complex solely in the event of the entity's failure to perform as promised, is protective in nature and is not indicative of control;
- 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.

For all these reasons, none of which takes precedence over the others, the Committee concludes that the criterion in paragraph 35(b) is not met.

Finally, therefore, the Committee analyses the factors to be taken into account to assess whether the criterion in paragraph 35(c) is met. The Committee first observes that there is a contractual restriction preventing the entity from redirecting the building to another customer. The Committee then considers whether there is a right to payment, and if it is enforceable. Given the legal precedent presented above, the Committee decided that the right to payment, although contractual, is not enforceable. This is because a court can accept a request to cancel the contract, so that the entity would only receive a termination penalty and not an amount corresponding to the transaction price of the performance completed to date.

The Committee therefore concluded that the transfer of control takes place at a point in time, rather than over time.

2.3. Sale before completion of a real estate unit: can the right to payment be assessed on an overall basis (i.e. taking account of sums obtained in the event of resale)?

The Committee first discussed this question in November 2017. Nine responses were received as a result of the call for comments that followed the tentative decision not to add this matter to the agenda.

In the present case, the customer pays 10% of the purchase price for the real estate unit at contract inception. The remainder is paid after construction is complete. The entity retains legal title to the real estate unit (and any land attributed to it) until the customer has paid the whole purchase price. The customer has the right to cancel the contract at any time. In this case, the entity is legally required to make reasonable efforts to resell the real estate unit to a third party. On resale, the entity enters into a new contract with the third party (the original contract is not novated to the third party). If the resale price to be obtained from the third party is less than the original purchase price (plus selling costs), the customer is legally obliged to pay the difference to the entity.

The question posed to the Committee is whether, in this case, the entity has an enforceable right to payment in application of IFRS 15.35(c). The Committee assumes that:

- the entity identifies a single performance obligation (i.e. no separation of the land and the building);
- the criteria 35(a) and 35(b) are not met;
- the first condition of paragraph 35(c) is met (i.e. no alternative use of the real estate).

IFRS 15.37 and the clarifications in paragraph B9 of the application guidance state that an entity has an enforceable right to payment for performance completed at a given date if it is entitled to an amount that at least compensates it for completed performance if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised. An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the entity's costs to fulfill the performance obligation, plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract is terminated.

Relying on the provisions of IFRS 15, the Committee concluded that the existence of a right to payment in accordance with paragraph 35(c) must be assessed only in respect of the amount that the entity is entitled to receive under the existing contract with the customer relating to performance under that contract. Therefore, the consideration received by the entity from a third party cannot be compared with a payment for performance under the existing contract with the customer; it is consideration to which the entity is entitled relating to that resale contract.

In the event that the customer cancels the contract for reasons of convenience, the entity's entitlement to payment corresponds to the difference between the original selling price (plus costs to resell) and the resale price to a third party (where applicable). In practice, this means that the amount to which the entity is entitled does not correspond at all times throughout the duration of the contract to an amount that approximates the selling price of performance completed to date. This consideration may well be lower in the event that the real estate under construction is sold to another customer. The second condition of paragraph 35(c) is therefore not met. The revenue for the contract would therefore be recognised at a point in time, and not over time.

Some commentators disagree with this conclusion. They believe that the right to payment should be assessed overall (i.e. including the consideration received by the entity from both the first and second customers), without taking account of the way in which the entity is compensated and by whom. In its agenda paper, the Committee's staff indicated that it was not relevant to take both contracts into account in order to assess entitlement to payment, since they cannot be combined in application of the IFRS 15 principles on combining contracts. The staff also clarified that the important thing is not that the customer makes the payment directly to the entity, it is rather that the consideration to which the entity is entitled in the event of cancellation corresponds to the performance under the existing contract with the customer, and not the performance under another contract.

The important lessons to be learned from the Committee's positions on these three questions on situations encountered in the real estate sector form a useful addition to the guidance emerging from the work of the TRG. And it is easy to understand why the Committee should take up the baton now that the transitional phase is complete and the standard has finally (or perhaps already) come into effect. There is little doubt that the Committee will continue to receive queries about IFRS 15, given the many practical questions surrounding its application.

Key points

In March 2018, the IFRS Interpretations Committee issued a definitive position on three practical questions regarding the application of IFRS 15 to real estate activities resembling off-plan sales.

However, the scope of these decisions extends far beyond the real estate development sector alone, since they:

- Illustrate, through a practical example, how the clarifications to the standard issued in April 2016 should be applied in order to identify the performance obligations in a contract. The Committee stressed that the interdependence of two contract promises was not a sufficient basis on which to conclude that they formed a single performance obligation. An entity must demonstrate that there is a transformative relationship between the two promises, and the Committee explains how this relationship should be identified.
- Clarify how to assess the existence of an enforceable right to payment for performance to date in application of the criteria in paragraph 35(c) on the transfer of control over time. The Committee observed that:
  - Legal precedents should be taken into account, where these could affect the terms of the contract. For example, even where a contract is non-cancellable, where the courts agree to authorise cancellation by the customer for reasons other than the entity's failure to perform as promised, this should be taken into account, and the consideration to which the entity would then be entitled must be assessed. If the customer can cancel the contract by paying a mere termination penalty and not an amount corresponding to the transaction price of the performance completed to date, the criterion of paragraph 35(c) is not met. However, the Committee also states that it is unnecessary to extrapolate where there are no legal precedents.
  - That in assessing the amount to which an entity would be entitled in the event of early termination of the contract, only the consideration due from the customer under the existing contract should be taken into account. Therefore, entities should not take an overall approach which would also include consideration that the entity could receive in the event that the good were sold to another customer, where the first customer would only have to pay the difference between the initial selling price (+ the costs of sale) and the resale price.

Given the very recent entry into force of IFRS 15, the Committee has provided an unusual amount of detail regarding both the texts and the reasoning it has applied to reach its conclusions. A further reason to take a close look at the emerging guidance on this complex standard.

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