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**International
Accounting Standards
Board**

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: 2 November 2006, London

Project: Real Estate Sales (Agenda Paper 3)

A Background

- 1 The IFRIC is undertaking a project on real estate sales. The objective of the project is to clarify when revenue from the sale of real estate should be recognised if an agreement for sale is reached before construction is complete.
- 2 The IFRIC decided that the project should address:
 - a) the identification of the applicable accounting standard (IAS 11 *Construction Contracts* or IAS 18 *Revenue*); and
 - b) if IAS 18 applies:
 - i) the criteria that must be met before revenue is recognised for the sale of real estate; and

- ii) the way in which the seller should recognise and measure any contractual obligations that remain when the criteria for recognising revenue have been met.

3 At its September meeting, the IFRIC reached tentative conclusions on these issues¹ and asked the staff to prepare the first draft of a pronouncement.

B Purpose of meeting

4 The purpose of this meeting is to obtain the IFRIC's comments on the draft pronouncement and, if possible, to approve it for publication. [The draft Interpretation (Paper 3(i) for the IFRIC) is not included in the observer note.] Particular matters that the staff will bring to the IFRIC's attention are discussed below.

C Type of pronouncement

5 The IFRIC's proposed guidance would:

- interpret the definition of 'construction contract' in IAS 11; and
- amend existing guidance on applying IAS 18 to real estate sales, ie Example 9 in the appendix to IAS 18.

6 The IFRIC could locate this guidance:

- a) all in Example 9 in the appendix to IAS 18, as an amendment to that example;
- b) partly in an Interpretation (that interprets only the IAS 11 definition) and partly in Example 9 in the appendix to IAS 18; or
- c) all in an Interpretation, with Example 9 being withdrawn.

¹ The tentative conclusions reached in September are reported on the IASB website (under 'IFRIC Projects \ IAS 18 Real Estate Sales').

- 7 The staff favour approach (c) on the grounds that (i) guidance will be most accessible to those involved in real estate sales if it is all located in one pronouncement and (ii) it is preferable to avoid interpreting IAS 11 within an appendix to a different Standard.
- 8 The staff have therefore drafted the guidance as an Interpretation that would supersede Example 9 of the appendix to IAS 18.
- 9 IFRIC members will be asked whether they are happy with this approach.

D Definition of a construction contract

- 10 IAS 11 defines a construction contract as “a contract specifically negotiated for the construction of an asset or a combination of assets...”. The IFRIC tentatively concluded in September that agreements for the sale of real estate would meet this definition only if they required the seller to provide construction services to the buyer’s specifications. The buyer need not specify every detail of the design, but must have control over whether and how construction progresses.
- 11 The description of a construction contract as one that requires services to be provided to the buyer’s specifications is consistent with the US GAAP definition of a construction-type contract². However, the staff have concerns about the use of the word ‘specifications’, which may be read in the narrow sense of technical design specifications, rather than in the wider sense of directions or instructions. [Examples of the possible consequences have been omitted from the observer note.]
- 12 The IFRIC could avoid misinterpretation by adding further clarification of the meaning of ‘specifications’. However, it might be preferable to use a word that is less open to misinterpretation in the first place. One possibility would be to replace ‘to the buyer’s specifications’ with something like ‘in accordance with the

² Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* applies to contracts in which the seller agrees ‘to perform a service to the buyer’s specifications’ (paragraph 12). Paragraph 14 clarifies that the Statement does not cover goods produced in a standard manufacturing operation, even if produced to the buyer’s specifications.

buyer's directions'. The staff have tried out this alternative wording in the draft Interpretation.

- 13 IFRIC members will be asked whether they agree with the change or would prefer to stay with 'specifications'.

E Typical residential sale agreements

- 14 At its September meeting, the IFRIC decided that the consensus should specifically address typical residential sale agreements, explaining why they are not construction contracts. Members suggested that the consensus could also identify other transactions that would be construction contracts, and explain why they were different.

- 15 The staff have attempted to address these points in paragraph 10 of the draft Interpretation.

- 16 IFRIC members will be asked whether they are happy with this paragraph of the draft Interpretation.

F IAS 18 revenue recognition criteria

- 17 Paragraphs 12 and 13 of the draft Interpretation provide guidance on applying IAS 18 revenue recognition criteria. They aim to reflect views expressed by IFRIC members at the last meeting. They:

- focus on the need for the risks and rewards of ownership of, and effective control over, the real estate to have been transferred to the buyer
- state that these criteria should be applied to the underlying real estate in its current partially-constructed state, not the buyer's right to acquire the completed real estate at a later date, and
- observe that typically agreements for the sale of units within a multiple-unit development do not transfer risks and rewards and control of the underlying real estate to the buyer.

- 18 IFRIC members will be asked whether they are happy with the extent and content of the guidance in these paragraphs.

G Guidance carried forward from Example 9

- 19 The draft Interpretation proposes to withdraw Example 9 from the appendix to IAS 18. There are three paragraphs of guidance in that example. So far, the IFRIC has identified deficiencies in only the first of the three paragraphs. It needs to consider whether it wishes to carry forward the other two paragraphs into the Interpretation.

- 20 The staff propose that the second paragraph of Example 9 should be carried forward.

[Note to observers—this paragraph states that:

In some cases, real estate may be sold with a degree of continuing involvement by the seller such that the risks and rewards of ownership have not been transferred. Examples are sale and repurchase agreements which include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such cases, the nature and extent of the seller's continuing involvement determines how the transaction is accounted for. It may be accounted for as a sale, or as a financing, leasing or some other profit sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.]

The staff have therefore included this guidance in the draft Interpretation. Minor amendments are proposed to make the guidance follow more logically from the paragraph that now precedes it.

- 21 IFRIC members will be asked whether they agree that the second paragraph of Example 9 should be carried forward into the draft Interpretation.

- 22 The staff are less certain about carrying forward the third paragraph of guidance from Example 9. This paragraph states that:

A seller also considers the means of payment and evidence of the buyer's commitment to complete payment. For example, when the aggregate of the payments received, including the buyer's initial down payment, or continuing payments by the buyer, provide insufficient evidence of the buyer's commitment to complete payment, revenue is recognised only to the extent cash is received.

- 23 [Paragraph omitted from observer note.]
- 24 The staff propose that this third paragraph of guidance should be omitted from the draft Interpretation. [Rest of paragraph omitted from observer note.]
- 25 IFRIC members will be asked whether they agree that the third paragraph of Example 9 should *not* be carried forward in its present form.
- 26 IFRIC members will be asked whether they agree that the issue should not be addressed at all in the Interpretation.
- 27 If IFRIC members would like the issue to be addressed, they will be asked what guidance they think should be given.

H Other matters

- 28 IFRIC members will be asked whether there any other matters they would like to raise for discussion.