



30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

**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: March 2007, London

Project: Real estate sales (Agenda Paper 4)

Background

- 1 This project addresses transactions in which an agreement for the sale of real estate is reached before its construction is complete. At its September 2006 meeting, the IFRIC reached tentative conclusions about the applicable accounting standard (IAS 11 *Construction Contracts* or IAS 18 *Revenue*) and how IAS 18 should be applied.¹
- 2 At its November 2006 meeting, the IFRIC decided that the output of the project should be an Interpretation that would both interpret the definition of a

¹ IFRIC September 2006 Agenda paper 3.

construction contract in IAS 11 and supersede existing guidance on applying IAS 18 to real estate sales (Example 9 in the Appendix to IAS 18).²

- 3 The IFRIC also considered text for the draft Interpretation—focusing in particular on the staff proposal in the draft that:

<p>9 IAS 11 defines a construction contract as ‘a contract specifically negotiated for the construction of an asset or a combination of assets...’. A sale agreement meets this definition only if it requires the seller to provide construction services in accordance with the buyer’s directions. The buyer need not specify all aspects of the design, but must have control over whether and how construction progresses.</p>

- 4 IFRIC members expressed concern with this wording—especially the statement that the buyer must have control over whether and how construction progresses. A particular concern was that it could be interpreted to define construction contracts more narrowly than the IFRIC intended, thus denying stage of completion accounting for genuine construction contracts of all types (not just real estate).
- 5 Some IFRIC members expressed support for describing a construction contract as one in which the seller provided construction services ‘to the buyer’s specifications’. But they accepted that further guidance may be needed to clarify the meaning of ‘to the buyer’s specifications’. For example, there may be circumstances in which an agreement for the sale of an entire partially-constructed development could include a contract for construction services to complete the development. The contract for the remaining construction services would be a construction contract, even though the buyer had not specified the original design.

² IFRIC November 2006 Agenda papers 3 and 3(i).

- 6 The IFRIC considered suggestions that:
- a) construction contracts could alternatively be described as contracts in which there is a continuous transfer of the risks and rewards of ownership of the real estate in its current state and condition;
 - b) rather than propose that the buyer must be able to control whether and how construction progresses, the draft Interpretation could list features that would be ‘indicators’ that contracts were specifically negotiated for construction services, rather than the sale of goods (completed real estate).
 - c) alternatively, the IFRIC could avoid making any general statements on the meaning of the term ‘construction contract’ by restricting the scope of the draft Interpretation to sales of units within multiple-unit real estate developments. The draft Interpretation could propose that whether a sale agreement was within the scope of IAS 11 or IAS 18 depended on whether it was (a) for the sale of the existing partially completed real estate in its current state and a contract for construction services for its completion; or (b) for the sale of the completed real estate once construction was complete.
- 7 The IFRIC asked the staff to:
- a) analyse these suggestions further for future discussion;
 - b) separately consider whether any of the text included in the Consensus section of the draft Interpretation could be moved to a separate section of implementation guidance;
 - c) re-present staff recommendations for deleting, amending or carrying forward into the draft Interpretation the existing guidance in Example 9 of the Appendix to IAS 18. These recommendations (which had been presented to the November meeting) could not be discussed until decisions had been reached about the scope of the draft Interpretation; and

- d) consider whether, in view of the long-term nature of some real estate development projects, the draft Interpretation should include specific transitional arrangements.

8 This paper addresses each of these requests.

C³ Changes to avoid narrowing the scope of IAS 11 too far

9 The staff have followed up the suggestions in paragraphs 5 and 6 by developing two alternative proposals. One proposal would replace the description of a construction contract with ‘indicators’. The other proposal would restrict the scope of the draft Interpretation.

Option 1 — Indicators of impairment

10 The staff have identified features of a contract that could indicate that it involves the provision of construction services, rather than the sale of goods. We have identified them from the discussion of the differences between agreements for the sale of units within multiple-unit real estate developments and construction contracts in the draft Interpretation (Paper 4(i))⁴. These indicators could replace the proposed requirement for the buyer to be able to control whether and how construction progresses:

³ There is no section B in the IFRIC paper either.

⁴ The draft Interpretations presented to the IFRIC as papers 4(i) and 4(ii) are not available to observers.

9 IAS 11 defines a construction contract as ‘a contract specifically negotiated for the construction of an asset or a combination of assets...’. A sale agreement meets this definition ~~only~~ if it requires the seller to provide construction services ~~in accordance with the buyer’s directions. The buyer need not specify all aspects of the design but must have control over whether and how construction progresses.~~ to the buyer’s specifications. Features that, individually or in combination, may indicate that an agreement is for the provision of construction services to the buyer’s specifications, rather than the sale of goods (constructed real estate), would include:

- (a) the buyer being able specify major elements of the design of the real estate before construction begins and/or alter it while construction is in progress (whether it exercises that ability or not);
- (b) the buyer obtaining ownership rights over the work in progress as construction progresses (typically because the buyer owns the land to which the work in progress attaches);
- (c) the buyer having a right to take over the work in progress (albeit with a penalty) during construction, eg to engage a different contractor to complete the construction; and
- (d) the seller earning the right to be paid primarily on the basis of work performed (subject to buyer acceptance), rather than purely for the delivery of the finished goods

Option 2 — restricting scope of Interpretation

- 11 The alternative staff proposal is to restrict the scope of the draft Interpretation to sales of units within multiple-unit developments. It would then not be necessary to give a general interpretation of the meaning of the term construction contract that could be applied to all real estate sales.
- 12 The possible format and content of a restricted scope Interpretation is sketched in Paper 4(ii).
- 13 However, the staff believe that, as a consequence of restricting its scope, the Interpretation could not supersede the existing guidance on real estate sales in

Example 9 of the Appendix to IAS 18. This guidance is applicable to all real estate sales, not just sales of units within multiple-unit developments.

- 14 It could be argued that it is important the first paragraph of guidance in Example 9 is revised. It has been suggested that this paragraph can be interpreted in ways that are inconsistent with the requirements of IAS 18 itself. And, on the matters that the paragraph covers (revenue recognition and remaining obligations), the IFRIC has managed to identify better guidance to replace it (paragraphs 11 and 13 of the wider-scope Interpretation in Paper 4(i)). So if the IFRIC decides to issue a restricted draft Interpretation, it should also consider proposing new text to replace the first paragraph of Example 9 in the Appendix to IAS 18. Possible wording for the new text is sketched in Paper 4(ii).
- 15 [Paragraphs 15 and 16 omitted from observer note.]

Staff recommendation

- 17 The staff view is that both options are workable, and the decision will depend on whether the IFRIC regards the revisions to the description of construction contracts proposed in paragraph 10 as sufficient to avoid the risks of unintended consequences for construction contracts more generally. If so, the staff will recommend Option 1.

Questions for the IFRIC

- 18 IFRIC members will be asked whether they support either Option 1 (redrafting description of construction contracts to include ‘indicators’) or Option 2 (restricting scope of Interpretation and amending, rather than deleting, Example 9 of Appendix to IAS 18).
- 19 If the IFRIC favour Option 1, members will be asked whether they agree with the indicators proposed in the revised text following paragraph 10.
- 20 If the IFRIC favour Option 2, IFRIC members will be asked:
- a) whether they agree with the wording of the draft consensus addressing the applicable accounting standard; and
 - b) whether they agree with the amendments to Example 9 of the Appendix to IAS 18 proposed in Paper 4(ii).

D Moving application guidance to a separate section

- 21 At the last meeting, an IFRIC member suggested that the draft Consensus presented at the November meeting was too long. It included some application guidance that could be moved to a separate section.
- 22 This suggestion need be considered only if the IFRIC chooses Option 1 above, ie to retain the broad scope of the Interpretation.
- 23 The staff will recommend moving two paragraphs of text from the Consensus to a new section of Application Guidance.
- 24 IFRIC members will be asked whether they are happy with the move and the amendments to the text of the Application Guidance.

E Revisions to Example 9 of the Appendix to IAS 18

25 As part of this project, the IFRIC is reviewing the existing guidance in Example 9 of the Appendix to IAS 18.

26 There are three paragraphs of guidance in Example 9. The new guidance developed by the IFRIC would replace only the first paragraph. The IFRIC also needs to consider whether it wishes to retain the other two paragraphs. If it proceeds with a general Interpretation on real estate sales that supersedes Example 9 (Option 1), it would retain them by carrying them forward into that Interpretation. If it proceeds with the limited scope Interpretation that also amended Example 9 (Option 2), it would retain them simply by not proposing to amend them.

Paragraph 2 of Example 9

27 The staff will recommend that the second paragraph of Example 9 should be retained, on the grounds that it has widespread application and accurately reflects the requirements of IAS 18. The staff have therefore:

- a) included this guidance in the wider-scope draft Interpretation (paper 4(i)). Minor amendments are proposed (and marked) to make the guidance follow more logically from the paragraph that now precedes it; and
- b) omitted any proposal to amend the second paragraph of Example 9 from the restricted scope Interpretation (paper 4(ii)).

28 IFRIC members will be asked whether they agree that paragraph 2 of Example 9 should be retained.

Paragraph 3 of Example 9

29 The third paragraph of guidance in Example 9 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.

30 [Paragraph omitted from observer note.]

31 The staff will recommend that the third paragraph of Example 9 should be deleted without replacement, either by:

- a) *in a general real estate Interpretation that replaces Example 9 (Option 1), omitting the third paragraph from the draft Interpretation, or*
- b) *in a limited-scope Interpretation (Option 2), including the deletion within the proposed amendments to Example 9.*

32 The rationale could be that the specific issue addressed in the paragraph is not of widespread application. In most real estate sales, the seller is paid at the time of transfer of ownership, by either the buyer or a third-party lender. The more general need to consider whether “it is probable that the economic benefits associated with the transaction will flow to the entity” is the same for real estate sales as any other sales—there is nothing the IFRIC could usefully add to the existing requirement in paragraph 14(d) of IAS 18.

33 IFRIC members will be asked whether they agree that the third paragraph of Example 9 should *not* be retained in its present form.

34 They will also be asked whether they agree that the paragraph should be deleted entirely, rather than amended.

F Transitional arrangements

35 At its November 2006 meeting, the IFRIC noted the long-term nature of some real estate projects and asked the staff to consider whether the Interpretation should include any transitional arrangements.

36 Such arrangements would relax the general requirement for any changes in accounting policy to be applied retrospectively. They could require restatement only of contracts signed, or still in progress, after a specified date (for example the effective date of the Interpretation). They may be of benefit if the information required to restate older contracts is difficult to obtain or would be require estimates that cannot be made without hindsight bias.

37 However, for this Interpretation there may be little need (or demand) for any transitional arrangements. The staff think that most of the entities that change their accounting policies will be changing from ‘stage of completion’ to a form of ‘completed sale’ revenue recognition policy and:

- a) it is likely that, for all contracts still in progress or completed during the current or comparative periods, the entity will have the information required to move from stage of completion to sale of goods accounting.
- b) entities that applied the Interpretation prospectively would report reduced revenue in the periods immediately following the effective date. They would report revenue attributable only to the final stages of the old contracts completed during the period, and no revenue from the new contracts not completed during the period. This temporary dip in revenue would significantly impair comparability and could be difficult to explain to users.

- 38 An alternative to specific transitional arrangements, the IFRIC could specify a longer lead-in time. IFRIC Interpretations are usually effective for accounting periods beginning three months or more after the issue date. This period could be extended to, say, 6 months.
- 39 However, the staff not aware of any specific reasons why a longer lead in time would be necessary.

Staff recommendation

- 40 The staff will recommend that no specific transitional arrangements are included in the draft Interpretation and that the standard 3-month lead in time is proposed. If there is a need for any relaxations, it is likely that constituents will explain the reasons in their comments on the draft Interpretation. The IFRIC can then reconsider the matter before a final Interpretation is issued.

Question for the IFRIC

- 41 IFRIC members will be asked whether they agree.

G Letter from Swedish Construction Industry

- 42 IFRIC members will also consider a letter received from the Swedish Construction Industry regarding the conclusions tentatively reached by the IFRIC to date.
- 43 [Paragraphs 43 and 44 omitted from observer note.]
- 45 IFRIC members will be asked whether they have any comments on the letter that they wish to discuss in the meeting.