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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: May 2007, London**

**Project: IAS 18 Real Estate Sales  
(Agenda Paper 3)**

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## **Introduction**

- 1 This project addresses transactions in which an agreement for the sale of real estate is reached before its construction is complete. The IFRIC is developing an Interpretation that:
  - interprets the definition of a construction contract in IAS 11, and
  - revises existing guidance on applying IAS 18 to real estate sales (Example 9 in the Appendix to IAS 18).
  
- 2 The IFRIC has considered draft text for the Interpretation at two previous meetings and approved in broad terms the form and content of most sections of the latest draft. However, it has not yet reached a consensus on one issue—the guidance interpreting the definition of a construction contract in IAS 11. This

paper therefore considers the issue again in the light of suggestions made by IFRIC members at the last meeting.

- 3 If the IFRIC reaches a consensus on the issue at this meeting, it will also be asked to approve the draft Interpretation for release for public comment.

## **Definition of construction contract**

### ***Outcome of March meeting***

- 4 At the March meeting, the IFRIC decided that the Interpretation should address all real estate sales. It should therefore give general guidance on which sale agreements are construction contracts (within in the scope of IAS 11 *Construction Contracts*) and which are instead agreements for the sale of goods (within the scope of IAS 18 *Revenue*). The IFRIC considered staff proposals that the guidance should be framed in terms of ‘indicators’—ie lists of features that indicate that an agreement is a construction contract. The draft text proposed by the staff was:

9	<p>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 if it requires the seller to provide construction services 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:</p> <ul style="list-style-type: none"><li>(a) the buyer being able to specify the 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);</li><li>(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);</li><li>(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</li><li>(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</li></ul>
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- 5 The IFRIC supported the proposal to frame the guidance in terms of indicators, and most IFRIC members expressed broad support for the indicators proposed by the staff. However, they suggested a number of changes to the indicators and directed the staff to reflect upon the suggestions and come up with revised proposals for this meeting.

***Suggested changes — staff analysis***

- 6 IFRIC members made the following suggestions during or after the March meeting:
- i) slightly strengthen indicator (a);
  - ii) keep only indicator (a) and tighten it substantially;
  - iii) re-write indicator (b) in terms of control and/or risks and rewards of ownership instead of ownership rights;
  - iv) change indicator (b) from an indicator to a requirement;
  - v) incorporate the notion that the classification depends on whether construction takes place on real estate that is already the property of the buyer;
  - vi) reconsider indicator (d), which could be interpreted by reference to the timing of progress payments, and hence be too easily satisfied;
  - vii) add a second list of features, ie those that would indicate that the agreement is instead an agreement for the sale of goods.
- 7 These suggestions are discussed further below and lead to a number of staff recommendations for revisions to the text. The IFRIC will not be asked to approve these revisions individually, because there is some interplay between them. Instead, the combined effect of all the revisions is shown the revised consensus (Paper 3(i) – not included in Observer Note). The IFRIC will be asked for its views on the revisions in their entirety after each one has been explained below.

*Suggestion (i)—Strengthen indicator (a)*

- 8 One IFRIC member suggested strengthening indicator (a) by adding the following underlined text:

(a) the buyer being able to specify the major <u>structural</u> elements of the design of the real estate before construction begins and/or <del>alter it</del> <u>specify major structural changes</u> while construction is in progress (whether it exercises that ability or not);
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- 9 These changes are included in the revisions to the consensus.

*Suggestion (ii)—Keep only indicator (a) and tighten it*

- 10 One IFRIC member suggested that a contract is ‘specifically negotiated’ for the construction of an asset if, and only if, the buyer negotiates or specifies major elements of the original design, ie before construction commences. Thus, indicators of a contract being within the scope of IAS 11 would be that the buyer:

- develops the design independently of the constructor and negotiates with the constructor for it to be built;
  - obtains an off-the-shelf design from a third party and invites the constructor to tender for the work; or
  - negotiates substantial physical characteristics of the asset with the contractor before the contract commences.
- 11 The IFRIC member further suggested that the other indicators proposed by staff (ie (b)-(d)) are not relevant to the assessment of whether a contract has been ‘specifically negotiated’. So they should be excluded from the consensus.

- 12 The staff note that the effect of changing the indicators to those suggested in paragraph 10 would be that IAS 11 would never apply to sales agreed after construction has commenced—even if the buyer takes control and the risks and rewards of ownership of the partially-completed real estate and the contractor provides construction services for the completion of the development.
- 13 The staff also note that the term ‘specifically negotiated’ need not necessarily mean that the buyer has specified, or been closely involved in specifying, the original design. It could instead mean that that the construction activity is being undertaken specifically for the buyer, ie it would not be undertaken in the absence of the contract with that buyer. Factors that might indicate that this is the case would include:
- a) the buyer being able to specify and/or change major structural elements of the design of the real estate; and
  - b) the construction taking place on land or partially-completed real estate that is already the asset of the buyer, ie over which the buyer already has control and the risks and rewards of ownership.
- 14 The staff will recommend not deleting indicators (b)-(d) entirely, or narrowing indicator (a) to encompass only specification of the original design.
- 15 IFRIC members will be asked whether they agree.

*Suggestion (iii)—Re-write indicator (b) in terms of control / risks and rewards of ownership*

- 16 Indicator (b) discussed in March was 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).
- 17 The staff had taken this wording from US Statement of Position 81-1<sup>1</sup>, in which it had been used in the discussion of the rationale for the stage of completion method of accounting. However, as IFRIC members pointed out at the March meeting, the term ‘ownership rights’:
- is not widely used in IFRSs;
  - is not defined, and could be interpreted to mean legal title. Contracts could therefore be drawn up in such a way as to allow them to be interpreted as conveying ‘ownership rights’ that have little commercial effect in practice.
- 18 IFRIC members suggested replacing ‘ownership rights’ with ‘control’ or ‘risks and rewards of ownership’. The staff will suggest that both terms should be included, as they are both conditions in IAS 18 for recognising revenue from the sale of goods. The rationale for the stage of completion method of accounting is that there is a continuous sale, so the conditions should be the same.
- 19 These changes are included in the revisions to the consensus.

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<sup>1</sup> Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, paragraph 22.

*Suggestion (iv)—change indicator (b) to a requirement*

- 20 During the March meeting, an IFRIC member suggested that indicator (b) should instead be a requirement, on the basis that, if control and risks and rewards of ownership of the work in progress transfer only at the end of the construction, rather than continuously as construction progresses, the contract must be for the sale of goods, not provision of construction services.
- 21 The staff gained the impression at the last meeting that most IFRIC members would be more comfortable sticking with indicators. Hence the staff will not recommend changing indicator (b) to a requirement.
- 22 However, the staff will suggest that there is a case for—and ready way of—giving greater weight to indicator (b) than it has at present. Indicators (c) and (d) can be viewed as sub-indicators of (b): a buyer’s ability to take over the work in progress and engage another contractor may indicate that the buyer controls the work in progress; a seller’s right to be paid for performing work may indicate that it is continuously transferring control of benefits to the buyer.
- 23 So, the list of indicators could be restructured, with indicators (c) and (d) becoming as ‘sub-indicators’ of the indicator (b). This would help to ensure that these ‘sub-indicators’ would be taken into consideration only if they had commercial effect, ie if they contributed to an overall conclusion that the buyer had control and the risks and rewards of ownership of the work in progress.
- 24 The indicators have been restructured in this way in the revised consensus.

*Suggestion (v)—construction takes place on real estate that is already the property of the buyer*

- 25 During the discussions at the March meeting, IFRIC members noted that the nature of a contract (construction services or sale of goods) could be identified by considering whether, applying IAS 16 *Property, Plant and Equipment*, the real



estate on which the construction was taking place would be recognised as the property of the buyer.

- 26 The staff have attempted to reflect this notion in the consensus and Basis for Conclusions.

*Suggestion (vi)—reconsider indicator (d)*

- 27 IFRIC members expressed concerns about indicator (d). One concern was that the entity's right to be paid for partially-completed real estate would be tested only in the event of non-completion, ie default. Another was that the reference to the 'right to be paid' might be interpreted as applying to the payment schedule: progress payments would be seen as an indicator that the contract was a construction contract.
- 28 Indicator (d) is not intended to refer to progress payments. It is intended to refer to the entity's rights to either receive payment, or keep amounts already received, if construction is not completed (for whatever reason). The staff think that this is a relevant indicator of whether the partially-completed real estate becomes an asset of the buyer as construction progresses or only on contractual completion.
- 29 A possible solution would be to retain indicator (d) but make it clearer that it does not refer to progress payments. Additional text to this effect is included in the revised consensus.

*Suggestion (vii)—have two lists of indicators*

- 30 An IFRIC member suggested that the consensus could have two lists of indicators: the first being the existing list of indicators that a sale agreement is a construction contract (to which IAS 11 would apply); and the second being a new list of indicators that the sale agreement is instead an agreement for the sale of goods (to which IAS 18 would apply).
- 31 As the IFRIC member pointed out, the second list of indicators could be useful for sale agreements that contained some but not all of the features of a construction contract. The second list would help people judge whether such agreements were closer to construction contracts or sales of goods.
- 32 To be useful, the indicators in the second list would have to do more than just add ‘not’ to the indicators in the first list. The staff have proposed text for the IFRIC’s consideration in the revised consensus.

***Question for the IFRIC***

- 33 IFRIC members will be asked whether they are happy with the changes discussed above.

## **Other revisions to the draft Interpretation**

34 A number of other revisions to the draft Interpretation are proposed by the staff.

35 They are explained in the draft itself.

### ***Question for the IFRIC***

36 IFRIC members will be asked whether they are happy with the other proposed revisions to the draft Interpretation.

## **Vote to approve draft Interpretation**

37 If no substantial issues arise from the matters discussed above, the IFRIC will be asked to vote to approve the draft consensus.