



30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: 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: January 2008, London

**Project: D21 Real Estate Sales – Comment letter analysis -
Meaning of the term ‘construction contract’ (Agenda Paper 2B)**

Introduction

1. The key issue addressed in D21 is whether a real estate sale agreement entered into before construction is complete should be regarded as a construction contract within the scope of IAS 11 or an agreement for the sale of goods within the scope of IAS 18.
2. Most respondents (35 out of 51) to the draft Interpretation supported the IFRIC's proposal to develop an Interpretation.

‘First of all, we fully support the IFRIC in this interpretation, as it aims to clarify criteria for determining which revenues recognition principles apply to real estate sales’ [CL 17, French Real Estate Development Industry]

‘Overall, we support IFRIC proceeding with an interpretation on accounting for revenue from the sale of real estate to reduce divergent practices in this area. We agree with the guidance provided in Draft Interpretation D21. Furthermore, we support the principles-based guidance in D21, for the reasons stated in the Basis for Conclusions, which looks to the substance of a real estate sales agreement’ [CL 18, Canadian Accounting Standards Board]

3. However, many of them expressed concern with the current wording in D21 because they understood that either indicator 9(a) or 9(b) was preeminent, or that both needed to be applied. They urged the IFRIC to clarify paragraphs 8-10 of D21 on this matter.
4. Those who did not support D21 had different views on the meaning of the term ‘construction contract’. Some of them believed that this issue should be dealt with by the IASB within its joint project on revenue recognition with the US FASB.

Staff analysis

5. This paper addresses the following concerns expressed by respondents:
 - A need to clarify paragraphs 8-10 of D21;
 - The meaning of the term ‘construction contract’.

Section 1 - a need to clarify paragraphs 8-10 of D21

Clarify the articulation

6. The first sentence of paragraph 8 quotes the definition of a construction contract from IAS 11. The second sentence of paragraph 8 states that ‘A sale agreement meets this definition if it is an agreement for the seller to provide construction services to the buyer’s specifications’. Many respondents¹ were concerned by this sentence and its articulation with the rest of the consensus.

‘Based on paragraph 9 and the basis for conclusions, we believe we agree with the consensus reached by the IFRIC. However the last sentence of paragraph 8 which is central to that consensus is not consistent with our understanding of the consensus.’ [CL44, AFEP-MEDEF-ACTEO]

‘The last sentence of paragraph 8 is far too restrictive. We agree that contracts for custom-made assets fall within the scope of IAS 11 but we fully disagree that the scope of this standard shall be limited to such agreements.’ [CL16, Mazars]

‘Paragraph 9 of D21 provides indicators of when a construction contract approach should be applied and states that the indicators in paragraph 9(a) and

¹ E.g. CL16 Mazars, CL24, KPMG, CL 33 Accounting Standards Board, CL 35 Australian Accounting Standards Board, CL44 AFEP-MEDEF-ACTEO, CL45 BDO International

9(b) can be applied *individually or in combination*, implying that the presence of any one indicator is sufficient to make construction contract accounting appropriate. However paragraph BC5(b) identifies transfer of control and risks and rewards of ownership from the seller to the buyer as a key part of the rationale for percentage of completion accounting, implying that the presence of one or more of the indicators in 9(b) is a necessary condition for the application of construction contract accounting. We believe that this inconsistency needs to be resolved in the final interpretation.’ [CL24, KPMG]

7. The staff is of the view that it was not the intention of the IFRIC that one indicator set out in paragraph 9 of D21 should override the other. When discussing the definition of a construction contract, IFRIC members seemed to come at the question from two different angles. Some felt that the critical indicator was that the customer controlled the specification of the asset. Others disagreed and felt that the important feature was that the seller transfers to the buyer effective control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. For instance, the IFRIC discussed examples of off-plan sales in which the customer does not have any say in the design (the houses have already been designed) but from the moment of signing the sale agreement obtains substantial rights over the work in progress, which did amount to ownership. The wording in D21 aimed to accommodate both views. In other words, the IFRIC concluded that either 9(a) or 9(b) might on its own be sufficient basis for a judgement that the real estate sale agreement meets the definition of a construction contract (see the extract from the May 2007 IFRIC Update in the appendix to this paper).
8. The last sentence of paragraph 8 of D21 aimed to make a bridge between the definition of a construction contract and the features in paragraph 9 but instead has created confusion. Many respondents understood that this sentence implied that either indicator 9(a) or 9(b) was preeminent, or that both needed to be applied. In addition, some respondents² were concerned with the term ‘construction services’.

‘...we do not believe that IAS 11 is about construction services only, particularly as D21.BC5(b) explains that contracts for construction services tend to involve continual delivery (and therefore the continual transfer of risks and rewards). We think that IAS 11 is about the construction and handover/delivery of an asset. Although that will often involve continual delivery, it often will not

² E.g. CL13 Confederation of Swedish Enterprise, CL16 Mazars, CL50 EFRAG

because with some construction contracts the deliverable is at the end of the contract.’ [CL50, EFRAG]

9. Some respondents³ also pointed out that the interaction between paragraphs 9 and 10 is not altogether clear.

‘We suggest that the guidance given in §9 and §10 could be improved in order to make it possible to establish a clear hierarchy of characteristics that establish conclusively, which of IAS 11 and IAS 18 applies. At present it would seem possible for a contract to have features common to both §9 and §10 e.g. construction on buyer’s land but where the buyer only has limited ability to specify design. Where a contract has both features of §9 and §10, guidance is required as to how to decide whether IAS 11 or IAS 18 applies. We, therefore, suggest that the (draft) Interpretation should make it clear which indications represent conclusive evidence when either IAS 11 or IAS 18 is applicable so that the terms of §9 and §10 are mutually exclusive, or that features of IAS 11 are pre-eminent.’ [CL6, CNC]

10. The staff acknowledge that “individually or in combination” cannot be in both paragraphs 9 and 10. Because the IFRIC concluded that either 9(a) or 9(b) might on its own be sufficient basis for a judgement that the agreement is for construction services, “individually or in combination” should be deleted from paragraph 10. As a result of this clarification:

- either 9(a) or 9(b) might on its own be sufficient basis for a judgement that the agreement is for construction services;
- both 10(a) and 10(b) need to be met for a judgement that the agreement is for the sale of goods.

Clarify that judgement is required

11. Some respondents suggested that the Interpretation should clarify that judgment is required.

‘We recommend that the IFRIC precise that judgement is required...’ [CL16, Mazars]

‘This is not a black and white distinction, it is a spectrum – and judgement will be necessary in assessing where on that spectrum a contract lies.’ [CL42, Deloitte]

³ E.g. CL6 Conseil National de la Comptabilité (CNC), CL16 Mazars, CL17 French Real Estate Development Industry, CL44 AFEP-MEDEF-ACTEO

12. One respondent was also concerned that the indicators set out in paragraphs 9 and 10 could be seen as a ‘checklist’ (see CL32, PwC).

13. In addition, some respondents believed that determining whether a real estate sale agreement entered into before construction is complete should be regarded as a construction contract within the scope of IAS 11 or an agreement for the sale of goods within the scope of IAS 18 is an accounting policy choice.

‘We strongly object to the prescriptive and mandatory use of IAS 18 by all house builders and developers and support maintaining the existing policy choice between IAS 11 and IAS 18.’ [CL7, European Union of Developers and House Builders]

14. The staff recommend adding the following paragraph before the features listed in paragraphs 9 and 10 of D21: ‘Determining whether a real estate sale agreement entered into before construction is complete should be regarded as a construction contract within the scope of IAS 11 or an agreement for the sale of goods within the scope of IAS 18 depends on the terms of the agreement and all the surrounding facts and circumstances. Such a determination requires judgement’. With this paragraph, the Interpretation will make it clear that whether an agreement is within the scope of IAS 11 or IAS 18 is NOT an accounting policy choice.

15. This wording also refocuses on the key issue addressed in this section ‘Applicable standard’ and is consistent with the guidance on determining whether an entity is acting as a principal or as an agent that the Board tentatively decided⁴ to add to the appendix to IAS 18.

16. Question: does the IFRIC agree with the staff analysis in section 1 of this paper and the drafting suggestions set out in paragraphs 7-10 of agenda paper 2E?

Section 2 - the meaning of the term ‘construction contract’

17. IAS 11 provides little guidance on the meaning of the term ‘construction contract’. That Standard defines a construction contract as ‘a contract specifically negotiated for the construction of an asset or a combination of assets ...’ (emphasis added).

⁴ October 2007 IASB meeting

18. The IFRIC believed that, in the limited scope of a real estate sale, it could interpret these terms to reduce diversity in that industry. D21 paragraph 9 sets out features (indicators 9(a) and 9(b)) that, individually or in combination, indicate that a real estate sale agreement meets the definition of a construction contract in accordance with IAS 11.

19. Respondents to D21 had mixed views about these indicators. Like the IFRIC itself, some respondents supported 9(a) but not 9(b), or vice-versa. Some did not support any of them and had a wider view of what constitutes a construction contract.

Indicator 9(a)

20. Respondents had mixed views about the relevance of indicator 9(a). Some respondents to D21 did not support paragraph 9(a) as an indicator of a construction contract. They had different views on the features of a construction contract and also argued that ‘the buyer’s specification’ is not a concept driven from IAS 11.

‘2.5 In our view, the meaning of “specifically negotiated” shall not necessarily be reduced to contracts for which the buyer may change the technical specifications. We strongly believe that “specifically negotiated” includes a concept of “unique” and non-fungible asset. Through this concept, it is clear that:

- A Mercedes limousine may be constructed for a specific client with specific options (colour, leather, TV set...) but remains a non-unique asset. Thus, it is clear that it is not a construction contract even if it was specifically negotiated between Mercedes and a specific client
- An apartment may be a unique penthouse and be subject to a specific commercial negotiation without the buyer being involved in its basic design.

2.6. The draft Interpretation introduces the concept that a “construction contract” is necessarily a contract for construction services to the **buyer’s specification**. This concept is not currently a feature of IAS 11 and will introduce a different revenue recognition principle according to whether the contract is to customer’s specification or not. We contest the validity of this distinction and recommend that contracts for the construction of assets should continue to give rise to revenue as work is performed irrespective of whether they are to customer’s specification.’ [CL6, CNC]

21. The staff argue that the notion of ‘unique and non-fungible asset’ is a very subjective feature. Rather, the buyer’s right to specify the design of the asset to be constructed is an integral part of the agreement and, therefore, is easier to

assess. The IFRIC already concluded that the construction of real estate that is subject to a specific commercial negotiation without the buyer being involved in the design would not, by itself, constitute a feature for a construction contract.

22. One respondent held another view:

‘...EFRAG’s understanding of IAS 11 is different from IFRIC’s. EFRAG believes that IAS 11 is about “customer driven”, contract based transactions. In particular, although EFRAG agrees with the statement in paragraph BC5(a) of D21 which says that, in an IAS 18-type contract, construction takes place independently of the sale agreement, we draw a different conclusion from it. We think it means that construction only takes place because there is a sale agreement in place. This is different from the IFRIC’s approach, which is based on the customer’s ability to specify key aspects of the asset being constructed.

...

...we note that a lot of the wording in IAS 11 suggests that IAS 11 is actually about long-term contracts. For example, in paragraph 25 of IAS 11 it is stated that the percentage of completion method “provides useful information on the extent of contract activity and performance during a period”. Similarly, the paragraph on the objectives of IAS 11 states that the “nature of the activity undertaken in construction contracts [is that] the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting period”. Furthermore, the wording of IAS 11 generally is mainly about long-term contract accounting – all the examples mentioned in IAS 11.4 require a significant amount of time for construction - rather than construction to the customer’s (ie the buyer’s) specifications. Finally, we noted the objectives of IAS 11 and IAS 11.25 which indicate that the purpose of the PoC method is to account for long-term construction activities by aligning costs and revenue, in a way that, in case of long-term construction activities, it provides useful information to users. EFRAG believes that the IFRIC has not explained how D21 fits into the stated intentions of IAS 11.’ [CL50, EFRAG]

23. The staff believe that the IFRIC had already discussed this view as noted in BC4 of D21 and held a different view (see BC5).

Indicator 9(b)

24. Respondents had mixed views about the relevance of indicator 9(b). The main criticism is that this indicator goes beyond the requirements of IAS 11.

‘...the indicative features introduced in paragraphs 9(b) and 10(b) relating to continual delivery and transfer of control and of risks and rewards of ownership seem to us to exceed what is contained in IAS 11’ [CL23, Swiss Holdings]

25. The staff acknowledge that the notion of transfer of effective control and the significant risks and rewards of ownership in indicator 9(b) is driven from IAS 18 and not IAS 11. The staff are of the view that it should be clarified in the basis

for conclusions that the IFRIC considered the requirements of both IAS 11 and IAS 18 and the typical features of agreements for the sale of real estate.

26. The staff also believe that it would be helpful to clarify, in the basis for conclusions, that indicator 9(b) may be a frequent feature in some commercial or industrial real estate developments. This would emphasise that the Interpretation addresses all sorts of arrangements and, depending on facts and circumstances, some would fall within IAS 18 (eg nearly all residential developments) and others within IAS 11 (eg some structured commercial or industrial developments).
27. One respondent believes that indicator 9(b) would be met in its jurisdiction because 'Buyers are able to immediately transfer and sell their equitable interests in the units at any time after purchase, indicating that they already own an asset which can be immediately converted into cash.' [CL2, Real Estate Developers' Association of Singapore (REDAS)].
28. The staff note that paragraph 10(b) and BC14 of D21 make the distinction between a right to acquire, use and sell the completed real estate at a later date and a right to control the underlying real estate in its existing partially-constructed state. However, this distinction can be clarified in the Interpretation and illustrated by an example (example 1) that would accompany the Interpretation.

US GAAP and convergence

29. Some respondents claimed that D21 would create divergence with US GAAP. FAS 66 *Accounting for Sales of Real Estate* paragraph 37⁵ requires a stage of completion method for recognising profit from sales of units in condominium projects or time-sharing interests, thus acknowledging that such real estate sales have the same economic substance as construction-type contracts. The staff note that US GAAP is not internally consistent on this issue as FAS 66 does not seem to be consistent with the general guidance on construction-type contracts (SOP

⁵ The stage of completion method is applied if all the following criteria are met: construction is beyond a preliminary stage, the buyer cannot require a refund of his deposit, sufficient units have been sold to assure that the property will not revert to rental property and sales prices are collectible.

81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*).

30. The staff argue that, although the Interpretation would diverge from FAS 66, IFRS would remain internally consistent because the Interpretation would be based on the requirements of both IAS 11 and IAS 18. In addition, the staff note that BC5(c) of D21 states ‘differences exist between IFRSs and US GAAP requirements for revenue recognition. They cannot be eliminated by interpretation. They are being addressed in a general project on revenue recognition being conducted jointly by the IASB and the US FASB’
31. The staff is aware that the US real estate market recently experienced a number of buyers who, in the context of the fall of market prices, waived their deposits to escape from the sale. The staff believe this indicates that the Interpretation’s conclusion is appropriate for these types of real estate contracts.
32. The staff conclude that respondents did not raise new issues and therefore do not recommend amending D21.

33. Question: does the IFRIC agree with the staff analysis in section 2 of this paper and the drafting suggestions in paragraphs 10(b), BC9-BC12 and IE1-IE2 of agenda paper 2E?

Staff recommendation

34. The staff believe that many of the concerns expressed by respondents can be resolved by clarifying the wording of D21 (see agenda paper 2E).
35. There will remain, however, some concerns that cannot be resolved through clarifications because they relate to fundamentally different views on the interpretation of the definition of a construction contract (eg the wider view of construction contract shared by EFRAG and some real estate representatives).

36. Assuming that the Interpretation applies only to the sale of real estate, does the IFRIC agree with the staff analysis in this paper and the proposed clarifications set out in paragraphs 7-10, BC7-BC12 and IE1-IE2 of agenda paper 2E?

Appendix: Extracts from the May 2007 IFRIC Update

IAS 18 Revenue—Sales of real estate

The IFRIC considered a revised version of a draft Interpretation on real estate sales. It approved the draft Interpretation for release for public comment, subject to drafting changes.

The draft Interpretation would apply to all real estate sales. However, the consensus focuses on transactions in which agreements for sale are reached before construction of the real estate is complete. Among other issues, it addresses the applicable accounting standard. It provides guidance on determining whether the sale agreement is:

- a construction contract within the scope of IAS 11 Construction Contracts, or
- an agreement for the sale of goods within the scope of IAS 18 Revenue.

Before approving the draft Interpretation, the IFRIC considered revised text for this guidance. It confirmed its previous decision that the guidance should identify features that, individually or in combination, indicate whether an agreement is for the provision of construction services to the buyer's specifications (a construction contract) or the sale of goods.

The IFRIC considered proposals that the features of a construction contract would include:

- (a) the buyer being able to specify the major structural elements of the design of the real estate and/or specify major structural changes while construction was in progress (whether it exercises that ability or not);
- (b) the buyer obtaining control and the significant risks and rewards of ownership of the work in progress as construction progresses.

It also considered proposals that indications of (b) could include:

- that work in progress takes place on land that is already owned or leased by the buyer
- the buyer having the right to take over the work in progress during construction, eg to engage a different contractor
- in the event of the agreement being terminated before construction is complete, the buyer retaining the work in progress and the seller having the right to be paid for work done.

The IFRIC agreed with these proposals but asked the staff to revise the drafting:

- to avoid any impression that all of the above features would need to be present for a sale agreement to be classified as a construction contract—either (a) or (b) above might on its own be sufficient basis for a judgement that the agreement is for construction services rather than the sale of goods;
- to express the indicators in terms of the seller's, rather than the buyer's, rights and position; and

- to note that the references to work in progress are to the work in progress in its current state and condition.

The IFRIC also approved the rest of the draft Interpretation, subject to drafting changes. The next step will be to inform the Board that the IFRIC has reached a consensus.

Provided that the Board does not object, the draft Interpretation is expected to be released for public comment by the end of June.