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International
Accounting Standards
Board

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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: **Interpretation X *Real Estate Sales (CLEAN)***

The staff prepared Interpretation X below to illustrate its drafting suggestions set out in agenda papers 2B, 2C and 2D. The staff will update this document in the light of the redeliberation of the proposals in D21 *Real Estate Sales*. Some paragraphs will also need to be renumbered.

References

- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 11 *Construction Contracts*
- IAS 18 *Revenue*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- IFRIC 13 *Customer Loyalty Programmes*

Background

1 Entities that undertake real estate development may enter into agreements to sell the real estate before they have completed its construction.

2 Such agreements are widespread in residential real estate developments. Developers may start to market individual units (apartments or houses) 'off plan', ie while construction is still in progress, or even before it has begun. Each buyer enters into an agreement to acquire a specified unit when it is ready for occupation. Typically, the buyer pays a deposit that is refundable only if the developer fails

to deliver the completed unit in accordance with the contracted terms. The balance of the purchase price is generally paid only on contractual completion, when the buyer obtains possession of the unit.

3 However, real estate sale agreements may take other forms. For example, they may relate to commercial or industrial developments. They may involve the sale of the whole development to a single buyer. The buyer may be required to make progress payments between the time of the initial agreement and contractual completion. Construction may be complete before the sale agreement is reached.

4 This Interpretation provides guidance on when the selling entity should recognise revenue from the sale of real estate. Specifically,

(a) it clarifies whether sale agreements entered into before construction is complete should be regarded as construction contracts within the scope of IAS 11 or agreements for the sale of goods within the scope of IAS 18; and

(b) it revises guidance on applying IAS 18 to real estate sales in general.

Scope

5 This Interpretation shall be applied in accounting for revenue from the sale of real estate.

Issues

6 The Interpretation addresses:

(a) the meaning of the term ‘construction contract’ as defined in IAS 11 with respect to sales of real estate; and

(b) the requirements of IAS 18 with respect to:

(i) the conditions that must be met before the selling entity recognises revenue for the sale of real estate; and

(ii) the way in which the selling entity should recognise and measure any contractual obligations that remain when the conditions for recognising revenue have been met.

Consensus

Applicable standard

7 IAS 11 applies if the sale agreement meets the following definition of a construction contract set out in IAS 11: ‘a contract specifically negotiated for the construction of an asset or a combination of assets …’ IAS 18 applies if the sale agreement is instead an agreement for the sale of goods (completed real estate).

8 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.

9 Features that, individually or in combination, indicate that a real estate sale agreement meets the definition of a construction contract in accordance with IAS 11 include:

(a) the buyer being able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether it exercises that ability or not);

(b) the seller transferring 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. Indications that the seller transfers effective control and the significant risks and rewards of ownership of the work in progress in this way may include, for example:

(i) the construction takes place on land the buyer owns or leases before construction begins;

(ii) the buyer has a right to take over the work in progress (albeit with a potential penalty) during construction, eg to engage a different contractor to complete the construction;

(iii) in the event the agreement is terminated before construction is complete, the buyer retains the work in progress and the seller has the right to be paid for work performed (subject to buyer acceptance).

10 Conversely, features that in combination indicate that a real estate sale agreement is for the sale of goods (completed real estate) within the scope of IAS 18 include:

(a) the negotiation between buyer and seller primarily concerns the amount and timing of payments, with the buyer having only limited ability to specify the design of the real estate, eg to select a design from a range of options or specify minor variations to the basic design; and

(b) the binding agreement gives the buyer an asset (or an equitable interest in an asset) in the form of a right to acquire, use and sell the completed real estate at a later date, with the seller retaining effective control and the significant risks and rewards of ownership of the underlying work in progress until that date.

11 Under a single agreement, an entity may deliver goods or services in addition to a real estate sale. In accordance with paragraph 13 of IAS 18, such an agreement may need to be split into separately identifiable components including one for the sale of real estate. The consideration received or receivable shall be allocated by reference to the relative fair values of the services or goods delivered, when the amounts are separately identifiable. If separate components are identified, the entity applies paragraphs 8-10 of this Interpretation to the component for the real estate sale in order to determine whether the component meets the definition of a construction contract in accordance with IAS 11 or is for the sale of goods (completed real estate) within the scope of IAS 18. The combining and segmenting criteria of IAS 11 then apply to any component of the agreement that is determined to be a construction contract.

Applying IAS 18—revenue recognition

12 If a sale agreement is for the sale of goods, revenue shall be recognised when all the conditions in paragraph 14 of IAS 18 have been satisfied.

13 Two of the conditions require the entity to have transferred to the buyer the significant risks and rewards of ownership of, and effective control over, the goods sold. These conditions shall be applied to the underlying real estate in its current state, not to the buyer's right to acquire the completed real estate at a later date.

14 In some cases, real estate may be sold with such a degree of continuing involvement by the seller that effective control and the risks and rewards of ownership are not transferred when the buyer obtains possession. In that event, the continuing involvement of the seller will delay the recognition of revenue.

Interpretation X *Real Estate Sales*

Applying IAS 18—remaining obligations

15 The IAS 18 conditions for recognising revenue from the sale of the real estate may be satisfied before the entity has performed all of its contractual obligations to the buyer. If so, the entity shall recognise its remaining contractual obligations in one of two ways:

(a) to the extent that the entity has to perform further work on the real estate already delivered to the buyer, it shall recognise an expense in accordance with paragraph 19 of IAS 18. The liability shall be measured in accordance with IAS 37.

(b) to the extent that the entity has to deliver further goods or services that are separately identifiable from the real estate already delivered to the buyer, it shall treat the remaining goods or services as a separate component of the sale, in accordance with paragraph 13 of IAS 18. The fair value of the total consideration received and receivable from the buyer shall be allocated between the components already delivered and those not yet delivered. Consideration allocated to the goods or services not yet delivered shall be recognised as revenue only when the applicable revenue recognition conditions have been met for those goods or services.

Amendments to the appendix to IAS 18

16 This Interpretation supersedes Example 9 in the appendix to IAS 18.

17 The appendix to IAS 18 is amended as described below.

All of the text under the heading '9 *Real estate sales*.' is deleted.

New text is inserted under the heading as follows:

'This example was superseded by IFRIC X *Real Estate Sales*.'

Effective date and transition

18 An entity shall apply this Interpretation for annual periods beginning on or after [date to be set at three months after the Interpretation is finalised]. Earlier application is permitted. If an entity applies the Interpretation for a period beginning before [date to be set at three months after the Interpretation is finalised], it shall disclose that fact.

19 Changes in accounting policy shall be accounted for in accordance with IAS 8.

Illustrative Examples

These examples accompany, but are not part of, IFRIC X.

Example 1: Residential real estate development

IE1 An entity (the developer) is developing residential real estate and starts marketing individual units (apartments) while construction is still in progress. Buyers enter into a project agreement that gives them the right to acquire a specified unit when it is ready for occupation. They pay a deposit that is refundable only if the developer fails to deliver the completed unit in accordance with the contracted terms. The balance of the purchase price is paid only on contractual completion, when buyers obtain possession of their unit. Buyers are able to choose a design from a range of options provided by the developer or specify minor variations to the basic design they choose but they cannot specify or alter major structural elements of the design of their unit. In the jurisdiction, no rights to the underlying real estate asset transfer to the buyer other than through the agreement.

IE2 In this illustrative example, the terms of the agreement and all the surrounding facts and circumstances indicate that neither of the features set out in paragraphs 9(a) and 9(b) of this Interpretation is met. Therefore, the developer considers the agreement to be an agreement for the sale of goods in accordance with IAS 18 *Revenue*.

Example 2: Commercial real estate development

IE3 A developer buys a plot of land for the purpose of building commercial real estate. It designs an office block to build on the land and submits the designs to planning authorities in order to obtain a building permission. The developer markets the office block to potential tenants and signs conditional lease agreements. The developer markets the office block to potential investors and signs with one of them a conditional agreement for the sale of land and the construction of the office block. The total price is a multiple of the rent. The investor has the right to engage a new developer to complete the construction at anytime. However, the investor cannot put the land or the incomplete office block back to the developer. The developer receives the building permission and all agreements become unconditional.

IE4 In this illustrative example, the real estate agreement should be separated into two components: a component for the sale of land within the scope of IAS 18 (sale of goods) and a component for the sale of the office block. The developer then needs to consider whether the component for the sale of the office block meets the definition of a construction contract in accordance with IAS 11. The terms of the agreement with the investor and all the surrounding facts and circumstances indicate that the features set out in paragraphs 9(b)(i) and 9(b)(ii) of this Interpretation are both met. Therefore, it should consider the component for the sale of real estate to be a construction contract in the scope of IAS 11.

IE5 Alternatively, assume that the construction of the office block started before the developer signed the agreement with the investor. In that event, the real estate agreement should be separated into two components: a component for the sale of land and the work in progress of the office block in its current state within the scope of IAS 18 (sale of goods) and a component for the completion of the construction of the office block in the scope of IAS 11.

Interpretation X *Real Estate Sales*

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IFRIC X.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background

BC2 The IFRIC has prepared this Interpretation in the light of divergent revenue recognition practices for sales of units within real estate developments. As explained in paragraph 2 of the Interpretation, developers often enter into agreements to sell the units while construction is in progress, or even before it has begun. Real estate sale agreements may take other forms. For example, they may relate to commercial or industrial developments.

BC3 In July 2007, the IFRIC published for public comment the draft Interpretation D21 *Real Estate Sales*. In response to the proposals, 51 comment letters were received. In addition, in order to understand better the practical issues that would have arisen on implementing the proposed Interpretation, IASB staff met various interested parties, including representatives of the real estate industry.

BC4 Most respondents to D21 supported the IFRIC's proposal to develop an Interpretation. However, nearly all respondents expressed concern with some aspects of the proposals, some urging that the project should be passed to the International Accounting Standards Board to address the issue within its joint project revenue recognition with the US Financial Accounting Standards Board.

BC5 In its redeliberation of the proposals, the IFRIC concluded that it should continue its work because, given the limited scope of the project, it was by then better placed than the Board to deal with the issues in a timely way.

Scope

BC6 [to be completed]

Applicable standard

BC7 The main area of divergence concerns the identification of the applicable accounting standard. In some jurisdictions, the prevailing practice is to apply IAS 11 *Construction Contracts* and to recognise revenue as construction progresses. In others, it is to apply the requirements for the sale of goods in IAS 18 *Revenue*, and to recognise revenue only when the unit is delivered to the buyer.

BC8 In support of applying IAS 11 for all agreements entered into before construction is complete, it is argued that:

(a) the sale agreements are in substance construction contracts. The typical features of a construction contract—land development, structural engineering, architectural design and construction—are all present.

(b) IAS 11 requires a percentage of completion method of revenue recognition for construction contracts. Revenue is recognised progressively as work is performed. Because many real estate development projects span more than one accounting period, the rationale for this method—that it ‘provides useful information on the extent of contract activity and performance during a period’ (IAS 11, paragraph 25)—applies to real estate development as much as it does to other construction contracts. If revenue is recognised only when the IAS 18 conditions for recognising revenue from the sale of goods are met, the financial statements do not reflect the entity’s economic value generation in the period and are susceptible to manipulation.

(c) US accounting standard SFAS 66 *Accounting for Sales of Real Estate* requires a percentage of completion method for recognising profit from sales of units in condominium projects or time-sharing interests (providing specified criteria are met). Thus US generally accepted accounting principles (GAAP) acknowledge that such real estate sales have the same economic substance as construction-type contracts. International Financial Reporting Standards (IFRSs) can and should be interpreted in the same way to avoid unnecessary differences.

BC9 The IFRIC does not agree with these arguments. It takes the view that the applicable accounting standard depends on the nature of the sale agreement. Some agreements for the sale of units within real estate developments do not meet the IAS 11 definition of, and are distinguishable in substance from, construction contracts. They are instead contracts for the sale of goods (and perhaps additional services) for which IAS 18 is the applicable IFRS. Other agreements for the sale of real estate meet the IAS 11 definition of construction contracts.

BC10 The IFRIC noted that IFRSs do not provide explicit guidance on determining whether an 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. The IFRIC considered the requirements of both IAS 11 and IAS 18 and the typical features of agreements for the sale of real estate and noted that:

(a) IAS 11 defines a construction contract as ‘a contract *specifically negotiated* for the *construction* of an asset or a combination of assets …’ (emphasis added). An agreement for the sale of real estate in which the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether it exercises that ability or not) meets the definition of a construction contract. In contrast, an agreement for the sale of real estate in which construction takes place independently of the sale agreement and buyers have only limited ability to influence the design of the real estate, eg to select a design from a range of options specified by the seller, or to specify minor variations to the basic design is a contract for the sale of goods (completed real estate).

(b) the differences of substance between contracts for construction services and contracts for the sale of goods (completed real estate) justify different revenue recognition requirements. The terms of contracts for construction services tend to be such that there is a continual delivery (transfer of effective control and risks and rewards of ownership) from the seller to the buyer as construction progresses. For example:

- the land under construction is owned or leased by the buyer from the outset.
- the seller typically has no ownership claim to the work in progress (beyond perhaps a right of lien). The seller instead provides construction services and materials that become attached to the land as they are provided.
- the buyer typically has a right to take over the work in progress (albeit with a potential penalty) before construction is complete.
- the seller earns the right to be paid primarily on the basis of work performed (subject to customer acceptance) rather than purely for the delivery of finished goods.

The rationale for applying the percentage of completion method to construction contracts is not just that it recognises the value of the entity’s activity in the period. Rather it also recognises the economic benefits that the entity has delivered (via continuous transfer of effective control and risks and rewards of ownership) to the buyer as construction progresses. This continuous transfer is often not a feature of agreements for the sale of residential real estate units—effective control of the unit tends to pass from seller to buyer at a single point, usually when the unit is ready for occupation. However, it may be a frequent feature in some commercial or industrial real estate developments.

(c) differences exist between the IFRS 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.

BC11 The IFRIC therefore believes that the application of IAS 11 should be restricted to contracts that meet that standard's definition of a construction contract. To help clarify the difference between construction contracts and contracts for the sale of goods (completed real estate), the consensus lists typical features of each. These features draw on the discussion in paragraph BC10. Paragraph 9 of the consensus lists two features that, individually or in combination, indicate that a real estate sale agreement meets the definition of a construction contract in accordance with IAS 11. On the other hand, paragraph 10 of the consensus sets out two features that, in combination, indicate that a real estate sale agreement is for the sale of goods (completed real estate) within the scope of IAS 18.

BC12 A Few respondents to D21 claimed that a binding agreement for the sale of real estate meets the definition of a construction contract. The IFRIC noted that a binding agreement for the sale of real estate—like other forms of binding customer order—gives the buyer an asset (or an equitable interest in an asset) in the form of a right to acquire, use and sell the completed real estate at a later date. The buyer controls this right and obtains risks and rewards associated with it, such as movements in the market value of the completed real estate. However, an agreement for the sale of a real estate unit typically does not give the buyer effective control of the underlying real estate in its existing partially-constructed state. The seller typically retains significant risks of ownership, such as construction risk and risk of damage or default. The seller also typically retains the right to use—ie continue development of—the work in progress. The seller is likely to retain these rights until the buyer obtains possession, usually at contractual completion.

BC13 Some respondents to D21 asked the IFRIC to provide guidance on agreements with multiple components so the Interpretation would cover more complex transactions that often occur in practice. The IFRIC noted that IFRIC 12 *Service Concession Arrangements* includes guidance on a similar issue. The IFRIC acknowledged that, in the context of this Interpretation, giving guidance on agreements with multiple components was likely to reduce diversity in practice.

BC14 In its redeliberations, the IFRIC noted that some real estate agreements include the construction of real estate together with additional delivery of goods or services (eg a sale of land). The IFRIC noted that IAS 18 requires its recognition criteria to be applied separately to identifiable components of a single transaction in order to reflect the substance of the transaction. IAS 18 paragraphs 4 and 13 require an agreement to be separated into its separately identifiable components and the IFRIC noted that one of those components may be a construction contract within the scope of IAS 11. The consideration received or receivable is allocated among the components by reference to the relative fair values of the services or goods delivered, when the amounts are separately identifiable. The IFRIC concluded that an entity should apply paragraphs 8-10 of this Interpretation to a component for a real estate sale in order to determine whether the component meets the definition of a construction contract in accordance with IAS 11 or is for the sale of goods (completed real estate) within the scope of IAS 18. The combining and segmenting criteria of IAS 11 then apply to the construction contract component of the agreement.

Withdrawal of Example 9 in the appendix to IAS 18

BC15 Having concluded that IAS 18 is the applicable standard for many transactions involving the sale of real estate before construction is complete, the IFRIC considered whether it was clear *how* IAS 18 should be applied.

BC16 The IFRIC decided that the requirements of IAS 18 are not wholly clear. The main source of concern is the first paragraph of guidance on real estate sales (Example 9) in the appendix to IAS 18:

> Revenue is normally recognised when legal title passes to the buyer. However, in some jurisdictions the equitable interest in a property may vest in the buyer before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue. In either case, if the seller is obliged to perform any significant acts after the transfer of the equitable interest and/or legal title, revenue is recognised as the acts are performed. An example is a building or other facility on which construction has not been completed.

BC17 The IFRIC accepted that this guidance could be interpreted in ways that are inconsistent with the requirements of IAS 18. For example, it could be read to suggest that binding agreements for the sale of real estate units (which can give the buyers a form of equitable interest) are sufficient to transfer the risks and reward of ownership of the real estate to the buyers. It could also be read as prohibiting recognition of any revenue until all substantial acts required under the contract have been completed, ignoring the possibility that the contract could include two or more separately identifiable components.

BC18 The IFRIC therefore decided to review the first paragraph of guidance in Example 9, reconsidering in particular (a) the conditions that must be met before revenue can be recognised and (b) the consequences of these conditions being met before the entity has completed all of its contractual obligations to the buyer. The IFRIC also took the opportunity to review and refine the other guidance (ie the second and third paragraphs) in Example 9.

BC19 The IFRIC concluded that guidance on recognising revenue from real estate sales is most accessible to readers of IFRSs if it is located in a single pronouncement. The IFRIC therefore included the new guidance on applying IAS 18 within this Interpretation and requested the Board to withdraw Example 9 from the appendix to IAS 18.

IAS 18—revenue recognition

BC20 Paragraph 11 of the Interpretation emphasises that, if IAS 18 applies, revenue from the sale of real estate should be recognised in accordance with the recognition conditions in paragraph 14 of that standard.

BC21 The IFRIC considered whether there was a need for further guidance to clarify how those conditions should be applied to real estate sales. It decided that it would be helpful to clarify whether and, if so, when a binding agreement for sale would transfer to the buyer the significant risks and rewards of ownership of, and effective control over, the real estate. Such guidance would help to counter any misunderstanding of the requirements of IAS 18 that has resulted from the guidance at present in Example 9 of the appendix to IAS 18.

BC22 The IFRIC noted that it is necessary to distinguish a right to acquire goods from the underlying goods themselves—paragraph 14 of IAS 18 requires the entity to have transferred to the buyer the significant risks and rewards of ownership of, and effective control over, the *goods sold*, not the right to acquire the goods. Hence, a binding agreement for the sale of a real estate unit is usually insufficient to satisfy the conditions for revenue recognition. Guidance explaining this aspect of paragraph 14 of IAS 18 is therefore proposed in paragraph 12 of the consensus.

BC23 The IFRIC noted that real estate may be sold with such a degree of continuing involvement by the seller that effective control and the risks and rewards of ownership are not transferred when the buyer obtains possession. In that event, the IFRIC concluded that the continuing involvement of the seller will delay the recognition of revenue. Paragraph 14 of the draft Interpretation carries forward the principles of the second paragraph of guidance from Example 9 in the appendix to IAS 18.

BC24 The Interpretation does not carry forward the third paragraph of guidance in Example 9. This paragraph states that if there is insufficient evidence of the buyer's commitment to complete payment for the real estate, revenue is recognised only to the extent cash is received. The IFRIC decided this guidance does not necessarily follow from the requirement in paragraph 14(d) for revenue to be recognised only to the extent that 'it is probable that the economic benefits associated with the transaction will flow to the entity'.

IAS 18—remaining obligations

BC25 Depending on facts and circumstances, the IFRIC noted that the remaining obligations would be accounted for in one of two ways:

(a) applying paragraph 19 of IAS 18, the expected costs of performing the obligations could be recognised as an expense when revenue is recognised from the sale of the real estate;

(b) applying paragraph 13 of IAS 18, the remaining work could be regarded as a 'separately identifiable component' of the sales contract. Some of the consideration received or receivable from the customer would be allocated to this component. This revenue would be deferred and recognised when the entity carried out the remaining work.

BC26 Some respondents to D21 were confused about the examples included in paragraphs 14(a) and 14(b) of D21. The IFRIC took the view that these examples were not essential to the understanding of the requirements of IAS 18 and therefore decided to delete them.

BC27 The IFRIC considered the circumstances in which each of the two methods would be appropriate when developing IFRIC 13 *Customer Loyalty Programmes*. It concluded that:

> … IAS 18 does not give explicit guidance. However, the aim of IAS 18 is to recognise revenue when, and to the extent that, goods or services have been delivered to a customer. In the IFRIC's view, paragraph 13 applies if a single transaction requires two or more separate goods or services to be delivered at different times; it ensures that revenue for each item is recognised only when that item is delivered. In contrast, paragraph 19 applies only if the entity has to incur further costs directly related to items already delivered, eg to meet warranty claims. In the IFRIC's view, loyalty awards are not costs that directly relate to the goods and services already delivered—rather, they are separate goods or services delivered at a later date…[1]

BC28 This conclusion has been followed as the basis for the requirements proposed in paragraph 15 of the Interpretation.

[1] IFRIC 13 *Customer Loyalty Programmes*, Basis for Conclusions paragraph BC9(a)