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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: **March 2008, London**
Project: **D21 Real Estate Sales - Flowchart illustrating the interaction of IAS 18 and IAS 11 (Agenda Paper 3B)**

Introduction

1. At the January 2008 IFRIC meeting, the IFRIC directed the staff to develop a flowchart to illustrate the accounting for real estate sale agreements in accordance with IAS 18 and IAS 11, with the starting point being to consider the nature of the sale ('what has been sold?').
2. The staff prepared a flowchart set out in section 2 of this paper. In section 1, the staff explain the basis underpinning the flowchart. Finally, in section 3, the staff ask questions to IFRIC members about the flowchart and the following steps of the project.
3. The staff note that, so far, it has considered a single real estate sale agreement to focus the analysis and discussion and because it was a concern raised by a few respondents to D21. However, there may be combining issues when there are several real estate sale agreements with a single or several customers. Combining issues can be considered once consensus on the basic model is reached.

4. To facilitate the comments on the flowchart, the staff have numbered each box of the flowchart from 1 to 15.

Section 1 – Comments on the flowchart

5. The main comments on the flowchart are as follows:
 - The agreement being analysed is a sale agreement. That is, we are not trying to determine *whether* something has been sold, but *what* has been sold. This means that the relevant standard is IAS 18.
 - IAS 18 has to be applied at the first step of the process in order to identify any components within the agreement, even though part or all of the agreement may fall into IAS 11 at a later stage;
 - Determining the nature of the real estate sale agreement and whether IAS 11 or IAS 18 applies requires analysing the terms of the agreement and the surrounding facts and circumstances. Therefore, there is a need for an Interpretation because there is divergence in practice (some respondents to D21 believed the use of IAS 18 or IAS 11 was an accounting policy choice);
 - Whether the construction spans more than one accounting period does not affect the accounting. Therefore, there is a need for an Interpretation because there is divergence in practice (some respondents to D21 claimed that it was the relevant feature);
 - The definition of a construction contract plays an important role in determining the applicable standard and needs further application guidance;
 - When considering the implications of the ‘transfer of control and risks and rewards’ test, two possible views exist although they produce similar revenue recognition answers;
 - Application by analogy to other industries than real estate seems easier because the articulation and the rationale of an Interpretation based on the flowchart would be clearer than D21 and not industry specific.

Box 1: Identify multiple components

6. Real estate sale agreements may include the construction of real estate together with additional delivery of other goods or services (eg a sale of a land) and

therefore it may be necessary to segment a single contract into several components.

7. Whilst IAS 11 has specific criteria for contract segmentation, the guidance in IAS 18 is expressed only at a general level: the recognition criteria should be applied separately to identifiable components of a single transaction in order to reflect the substance of the transaction. The staff also noted that, with IFRIC 12 and IFRIC 13, the IFRIC clarified when contracts should be divided into components and how much revenue should be attributed to each component.

BC 31 of IFRIC 12 states that ‘... Although the contract for each service is generally negotiated as a single contract, its terms call for separate phases or elements because each separate phase or element has its own distinct skills, requirements and risks. The IFRIC noted that, in these circumstances, IAS 18 paragraphs 4 and 13 require the contract to be separated into two separate phases or elements, a construction element within the scope of IAS 11 and an operations element within the scope of IAS 18. Thus the operator might report different profit margins on each phase or element. The IFRIC noted that the amount for each service would be identifiable because such services were often provided as a single service. The IFRIC also noted that the combining and segmenting criteria of IAS 11 applied only to the construction element of the arrangement.’

BC 9 of IFRIC 13 states that ‘... In the IFRIC’s view, paragraph 13 [of IAS 18] 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.’

8. The flowchart is consistent with existing guidance. It illustrates that paragraph 13 of IAS 18 should be applied at the first step of the process in order to identify any potential multiple components (eg. construction of real estate, real estate sale, delivery of other goods or services) within a single contract.
9. At a later stage, the real estate sale agreement (or component) may fall within the scope of IAS 11 and the segmenting conditions of that standard would then apply.
10. At the January 2008 IFRIC meeting, the staff suggested adding a paragraph in the consensus that deals with segmentation and two paragraphs in the basis for conclusions. The staff still believes that this guidance on segmenting is necessary in the Interpretation because some respondents to D21 asked for clarification on that issue. Providing an illustrative example will also help.

Boxes 2-4: allocate the fair value of the consideration received or receivable to each component

11. The staff noted that BC 30 of IFRIC 12 and BC 12-14 of IFRIC 13 address the allocation of the fair value of the consideration received or receivable to the identified components.

BC 30 of IFRIC 12 states that ‘The accounting requirements for construction and service contracts are addressed in IAS 11 Construction Contracts and IAS 18. They require revenue to be recognised by reference to the stage of completion of the contract activity. IAS 18 states the general principle that revenue is measured at the fair value of the consideration received or receivable. However, the IFRIC observed that the fair value of the construction services delivered may in practice be the most appropriate method of establishing the fair value of the consideration received or receivable for the construction services. This will be the case in service concession arrangements, because the consideration attributable to the construction activity often has to be apportioned from a total sum receivable on the contract as a whole and, if it consists of an intangible asset, may also be subject to uncertainty in measurement.’

BC 13 of IFRIC 13 states that ‘IAS 18 does not prescribe an allocation method for multiple-component sales. However, its overall objective is to determine the amount the customer is paying for each component, which can be estimated by drawing on the entity’s experience of transactions with similar customers. Hence, the Interpretation requires the consideration allocated to award credits to be measured by reference to their fair value.’

12. Box 3 of the flowchart requires the fair value of the consideration received or receivable to be allocated to each identified component. However, no detailed guidance is given but rather a reference is made to existing guidance in IFRIC 12 and IFRIC 13.
13. The staff’s view is that the Interpretation should remind readers that such an allocation is required when components have been identified. However, it is not the purpose of the Interpretation to give further guidance on that issue and a reference to IFRIC 12 and IFRIC 13 should be sufficient.

Boxes 5 and 6: apply IAS 18 to non real estate sale components

14. The flowchart illustrates in these two boxes that, for instance, within a real estate sale agreement, there may be a property management services agreement that should be accounted for separately from the real estate sale component in accordance with IAS 18.

Box 7: consider directly related services together with the real estate sale component

15. The flowchart illustrates in this box that, in accordance with paragraph 4 of IAS 18 and paragraph 5(a) of IAS 11, services directly related to construction contracts fall within the scope of IAS 11. At a later stage, if the real estate sale agreement or component is regarded as a construction contract (Box 9), such services are already included in the agreement or component. If the real estate sale agreement or component is regarded as a sale of goods, such services may need to be separated in accordance with paragraph 13 of IAS 18.

Box 8: does the real estate sale agreement or component meet the definition of a construction contract?

16. The staff note that the real estate sale issue is a revenue recognition issue and therefore two standards need to be considered for an Interpretation: IAS 18 and IAS 11. In accordance with the hierarchy in IAS 8, there is no need to refer to the *Framework* because the transactions are clearly in the scope of one of these existing standards and the issue is which one applies. In addition the *Framework* and these two standards are not fully consistent. An Interpretation on a revenue recognition issue must first be consistent with IAS 18 and/or IAS 11 and, secondarily if possible with the *Framework*. Only the long-term project of the IASB and FASB on revenue recognition can merge IAS 11 and IAS 18 into one principle-based standard that is consistent with the *Framework*.

17. The scope of an IFRS normally indicates whether a transaction is inside or outside its scope. IAS 11 applies in accounting for construction contracts in the financial statements of contractors. Therefore, it seems to the staff that a contract that meets the definition of a construction contract falls within the scope of IAS 11 (that was the IFRIC tentative view in D21). However, this definition is not altogether clear and IAS 11 does not distinguish between goods or services. On the other hand, IAS 18 identifies three transactions or events that fall within its scope (including the sale of goods and the rendering of services). Then IAS 18 gives examples of sale of goods and the rendering of services but with no definition.

18. Therefore, the staff concluded that, when determining the nature of the real estate sale agreement and the applicable standard, the first question that needs to be asked is whether the agreement meets the definition of a construction contract.

Boxes 8 to 10: the real estate agreement meets the definition of a construction contract

19. The IFRIC concluded in D21 (see paragraphs 9(a) and 10(a) and also BC 5(a)) that 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 only minor variations to the basic design is a contract for the sale of goods (completed real estate).

20. If applied by analogy to other industries than real estate, a few respondents to D21 claimed that D21 would change practice for industries such as aircraft or ship builders. However, the staff's view is that this guidance is useful because it helps distinguish between construction and the custom assembly of goods from predefined vendor options. In addition, the staff is not aware of significant divergence in practice in industries other than real estate.

Boxes 11: transfer of control and risks and rewards

21. The staff found that there was less support and more criticisms from IFRIC members and respondents to D21 on the 'control and risks and rewards' test. The main criticism was that IAS 11 does not require control and risks and rewards to transfer to the buyer as construction progresses for a contract to meet the definition of a construction contract.

22. The staff think that there are two possible views for real estate sale agreements in which the seller transfers to the buyer control and significant risks and rewards of ownership of the work in progress as construction progresses:

- View 1: such agreements should be considered to be construction contracts and fall within the scope of IAS 11;
- View 2: such agreements fall within the scope of IAS 18 (continuous sale of goods).

23. Supporters of View 1 note that IFRSs do not provide explicit guidance on determining whether an agreement 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. Therefore, the requirements of both IAS 11 and IAS 18 need to be considered for such a determination. They acknowledge that the transfer of control and risks and rewards is a criterion of IAS 18 but they point out that IAS 11 is the appropriate standard for such agreements because the percentage of completion method would recognise the economic benefits delivered to the buyer as work progresses. They would distinguish two real estate sale agreements that are different in nature: construction contracts and contracts for the sale of goods (completed real estate).

24. Supporters of View 2 believe that such agreements do not meet the definition of a construction contract and, in that event, should be regarded as sales of goods that occur as the work progresses. The definition of revenue (see paragraph 7 of IAS 18) and the criteria for revenue recognition for sale of goods (see paragraph 14(a) and 14(b) of IAS 18) are met on a continuous basis. They believe that in such circumstances the percentage of completion method appropriately recognises revenue in accordance with the requirements of IAS 18. In addition, they note that, for the rendering of services that are performed continuously, IAS 18 requires the use of the percentage of completion method and paragraph 21 of IAS 18 refers to IAS 11 for application guidance on the percentage of completion method. Supporters of View 2 would distinguish three real estate sale agreements that are different in nature: construction contracts, contracts for the sale of goods as the work progresses (continuous sale) and contracts for the sale of goods (completed real estate).

25. Under both Views, revenue and costs would be recognised by reference to the stage of completion. Both are consistent with the basis for using the percentage of completion method in SOP 81-1 *Accounting for Performance of Construction-*

Type and Certain Production-Type Contracts that states that ‘the business activity taking place supports the concept that in an economic sense performance is, in effect, a continuous sale (transfer of ownership rights) that occurs as the work progresses’.

26. However, under View 2, the segmenting, combining and disclosure requirements are those of IAS 18 and therefore are less restrictive than IAS 11 (View 1). In respect of disclosures, the staff acknowledge that there is a significant gap between IAS 18 and IAS 11 simply because the objectives of these standards are different. At the meeting of the International Accounting Standards Board with its Analyst Representative Group held in February 2008, analysts favoured the higher level of disclosures regardless of which standard applies in order to understand better the activity of real estate developers.
27. The staff has reflected these two Views in two different flowcharts. In the flowchart reflecting View 1, boxes 12 and 13 do not exist.

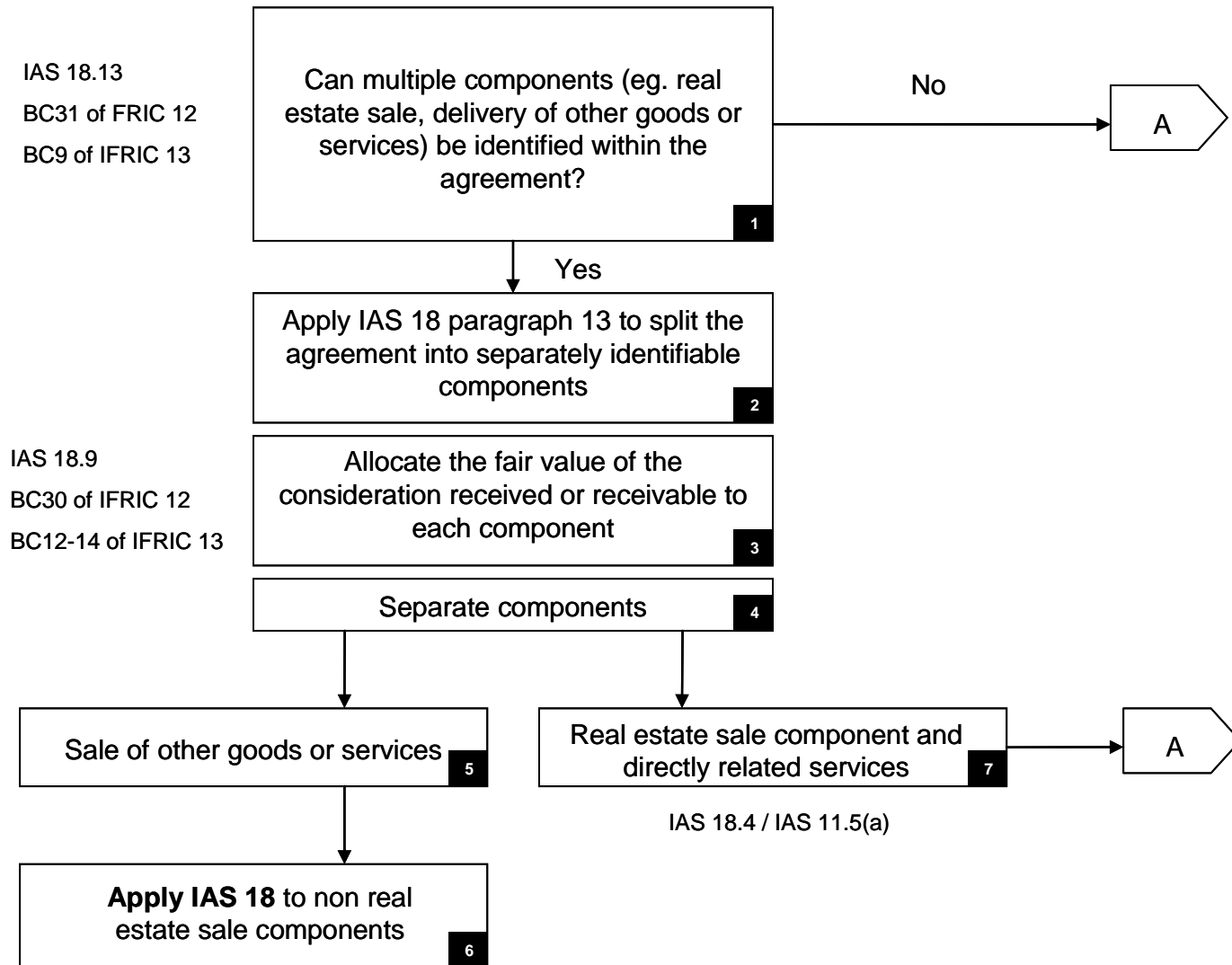
Boxes 14 and 15: sale of goods

28. When the real estate sale agreement or component does not meet the definition of a construction contract (Box 8) and does not transfer control and the significant risks and rewards of ownership of the work in progress to the buyer as construction progresses (Box 11), then it is a sale of goods (completed real estate). Revenue should be recognised when the conditions of paragraph 14 of IAS 18 for sale of goods have been satisfied.

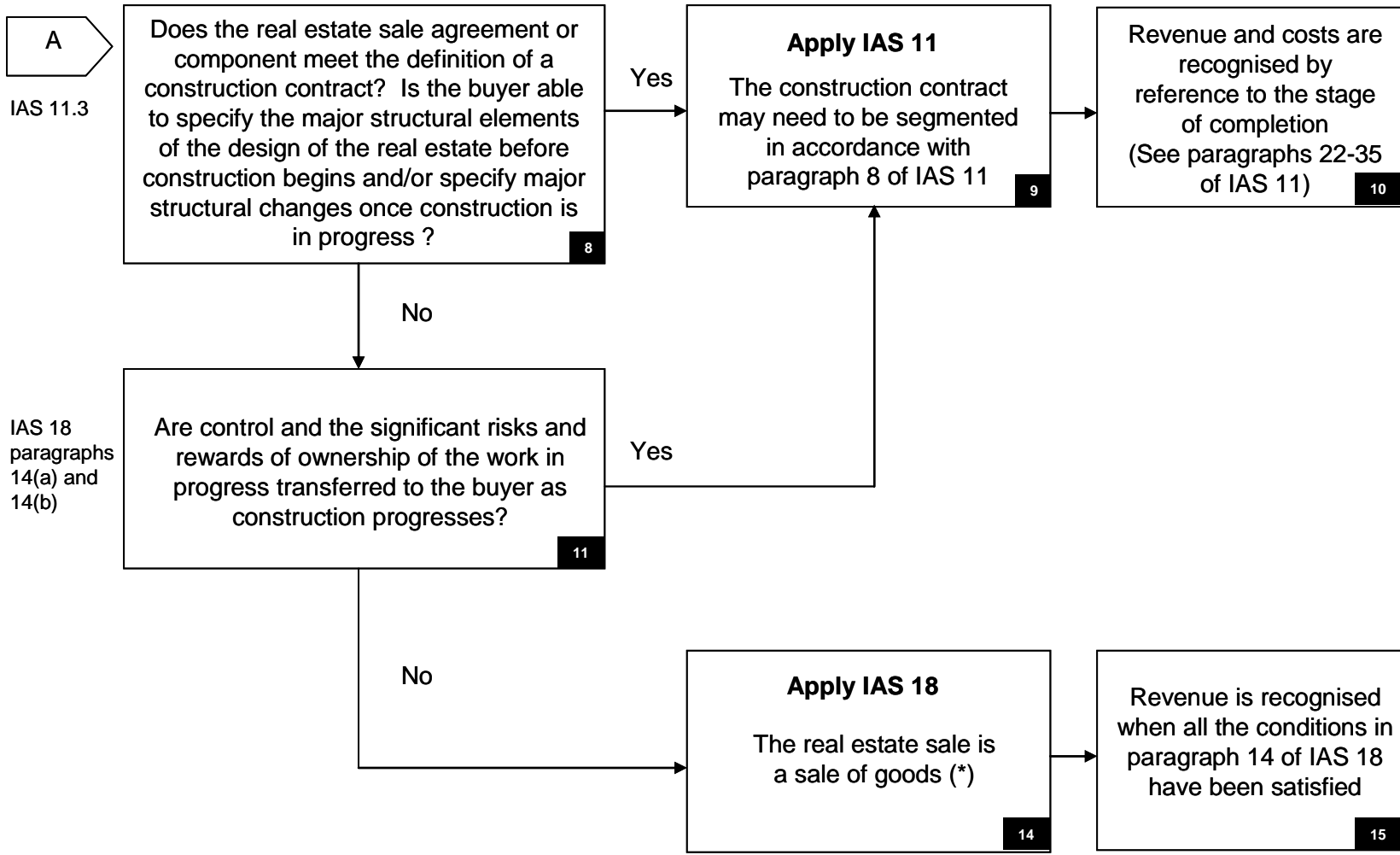
Other comments on the flowchart

29. The flowchart does not apply only to real estate sale agreements entered into before construction is completed. Rather, it applies to all real estate sale agreements regardless of the stage of completion of the construction.

Section 2 – Flowchart (analysis of a single agreement for the sale of real estate including construction)

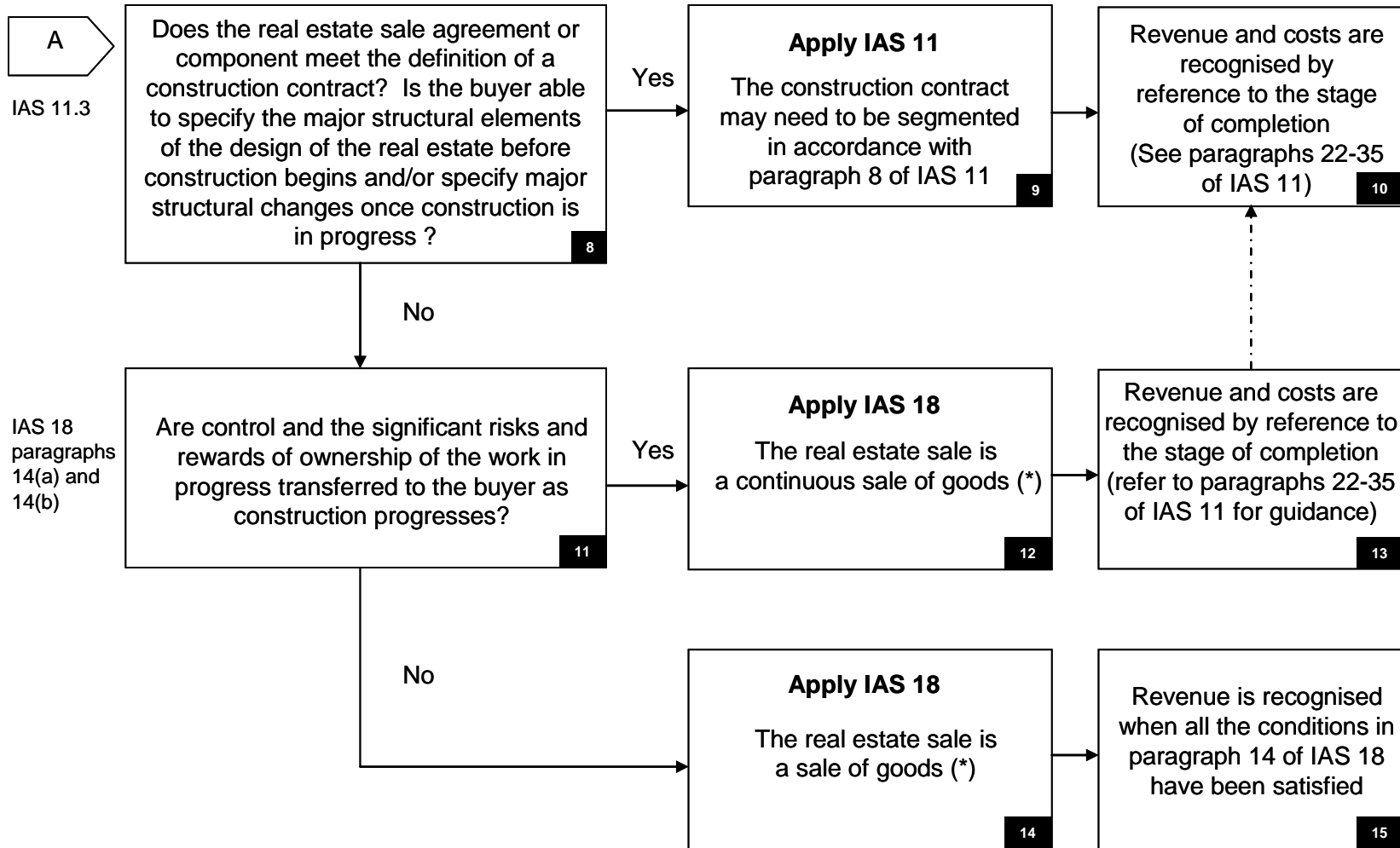


View 1



(*) Directly related services may need to be separated (IAS 18.13)

View 2



(*) Directly related services may need to be separated (IAS 18.13)

Section 3 – Questions to IFRIC members

30. In paragraphs 21-27 of this paper, the staff discussed two possible views for real estate sale agreements that do not meet the definition of a construction contract proposed in D21 but in which control and significant risks and rewards transfer continuously to the buyer. Which view do you support? View 1 (IAS 11 applies) or View 2 (continuous sale of goods under IAS 18)?
31. Does the flowchart describing the View you favour appropriately reflect that view? If yes, do you believe that application by analogy to other industries than real estate would be a significant issue? If not, do you have any suggestions on how to proceed with the flowchart and the project?
32. If View 2 is preferred, do you believe that the Interpretation should require further disclosures, such as those in IAS 11?
33. Do you believe that there may be combining issues when there are several real estate sale agreements with a single or several customers (see paragraph 3 of this paper)? How should the Interpretation cover them?
34. Do you believe the flowchart should accompany the Interpretation as an information note (as IFRIC 12 does)? If yes, the staff will include references to the flowchart with the final Interpretation.