



**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](mailto:iasb@iasb.org) Website: [www.iasb.org](http://www.iasb.org)**

**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: May 2008, London**

**Project: D21 Real Estate Sales - Remaining outstanding issues (Agenda Paper 2B)**

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### **Introduction**

1. This paper addresses the remaining outstanding issues in respect of:
  - the scope;
  - the application of IAS 18;
  - the identification of a component for the sale of land;
  - disclosures;
2. For this purpose, this agenda paper refers to agenda paper 2C–Flowchart, agenda paper 2D–Draft interpretation and agenda paper 2E–Basis for Conclusions.

### **Staff analysis**

#### **1) Clarification of the scope**

3. In redeliberating the issue, the IFRIC noted that the notion of ‘real estate sales’ in D21 might create confusion and asked the staff to clarify the flowchart and the draft Interpretation in this respect.
4. The staff suggest clarifying that the Interpretation would apply to *agreements for the construction of real estate* because the primary issue of whether an agreement is within the scope of IAS 11 or IAS 18 only arises from agreements that include construction activities. Such agreements may or may not meet the definition of a construction contract. Because the primary issue is to identify which standard applies, it seems that the use of the term ‘agreements for the construction of real estate’ is more relevant than the term ‘real estate sale’.
5. One implication of this clarification is that the Interpretation would deal with all types of agreements involving the construction of real estate:
  - Construction contracts (IAS 11);
  - Agreements for the rendering of services (IAS 18);
  - Agreements for the sale of goods (IAS 18).
6. Going further, the staff also suggest naming the Interpretation: IFRIC X—*Agreements for the Construction of Real Estate*. In doing so, the title would be consistent with the proposed clarification of the scope and with the title of IFRIC 12—*Service Concession Arrangements*.
7. In addition, the staff acknowledge that the terms ‘developer’ and ‘seller’ that appeared at several places in previous drafts (including D21) could be confusing. Therefore, the staff suggest removing these terms wherever they appear and make it clear in the scope section that the Interpretation gives guidance on the accounting for revenue and associated expenses by *entities that undertake the construction of real estate*. In the Interpretation, there would be only two parties: the entity that undertakes the construction of real estate and the buyer.
8. Paragraph 4 of agenda paper 2D states that ‘this Interpretation applies to the accounting for revenue and *associated expenses...*’ (emphasis added). This is

because the Interpretation refers to the percentage of completion method of IAS 11 and to paragraph 19 of IAS 18 — both deal with ‘associated expenses’.

9. The revised draft Interpretation no longer refers to paragraph 9 of the Appendix to IAS 18. This latter would be removed at the same time as the Interpretation would be issued.

10. Do you agree with the staff analysis? Do you have any suggestions on the drafting proposed in:

- agenda paper 2D–Draft interpretation, paragraphs 4 and 5;
- agenda paper 2E–Draft basis for conclusions, paragraphs BC3-BC5.

## **2) Application of IAS 18**

### *2.1) ‘Continuous transfer’*

11. In the course of the project, the IFRIC identified features that indicate that the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in process in its current state as construction progresses (labelled ‘continuous transfer’ for ease of reference). In D21, these features were described as indicating that the seller was providing ‘construction services to the buyer’s specifications’ and the following indicators were listed in paragraph 9(b) as examples:

- (i) the construction taking place on land that is owned or leased by the buyer;
- (ii) 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;
- (iii) 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 performed (subject to buyer acceptance).

12. In France and in Belgium (and possibly other jurisdictions we are not aware of), such agreements are defined by law: a VEFA agreement (Vente en l’Etat Final

d'Achevement) is an agreement by which the seller immediately transfers to the buyer the rights of ownership of the floor area and existing work. Additional construction work becomes the property of the buyer as it is performed. Although such agreements may not meet the definition of a construction contract, it is common practice in these countries to recognise revenue by stage of completion using the percentage of completion method.

13. Many respondents to D21 believed that the indicator of 'continuous transfer' set out in paragraph 9(b) of D21 was relevant to determining the method of revenue recognition, although it is not a criterion for an agreement to be a construction contract in IAS 11. Therefore, the staff proposed at the January and March IFRIC meetings to carry forward this criterion (transfer of control and the significant risks and rewards of ownership of the work in process in its current state as construction progresses) and to strengthen the Basis for Conclusions. At the March IFRIC meeting, the IFRIC generally supported View 2 presented by staff:

Some agreements for the construction of real estate may not meet the definition of a construction contract and therefore be within the scope of IAS 18. 'However, because all the criteria for revenue recognition for the sale of goods in IAS 18 are met on a continuous basis, the percentage of completion method appropriately recognises revenue. The entity should refer to IAS 11 for application guidance because the requirements of that Standard are generally applicable to the recognition of revenue and the associated expenses for such a transaction.' [March 08 IFRIC Update]

14. [Paragraph omitted from observer note].
15. The staff also clarified how to distinguish between the different types of agreements for the construction of real estate within the scope of IAS 18. For that purpose, the staff identified:
- (1) Agreements for the rendering of services (when the entity is not required to acquire and supply construction materials, the agreement may be only an agreement for the rendering of services in accordance with IAS 18);
  - (2) Agreements for the sale of goods of two types:
    - (a) Agreements in which the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress as construction progresses;

- (b) Agreements in which the entity transfers to the buyer control and the significant risks and rewards of ownership of the real estate in its entirety at a single point of time (eg at completion, upon or after delivery).

16. The staff clarified in the revised draft Interpretation that construction activities often require the entity that undertakes the construction of real estate to provide services together with construction materials. However, the entity delivers to the buyer an asset in the form of real estate, either completed or in its current stage of completion. In these circumstances, such agreements are agreements for the sale of goods.
17. When agreements are for the sale of goods, the IFRIC concluded that they may result in the entity meeting all of the criteria for recognising revenue from the sale of goods set out in paragraph 14 of IAS 18 (including the transfer of control and the significant risks and rewards of ownership) continuously as construction progresses or at a single point of time (eg at completion, upon or after delivery), depending on facts and circumstances. For agreements with ‘continuous transfer’, the IFRIC also concluded that it is appropriate to recognise revenue as the criteria are met by reference to the stage of completion using the percentage of completion method.

## 2.2) *Single agreement for the delivery of multiple goods*

18. The staff think that the IFRIC’s conclusion on agreements with ‘continuous transfer’ (see above) is appropriate for a single asset but suggest clarifying in the Basis for Conclusions (see paragraph BC 27 of agenda paper 2E) that, in a single agreement for the delivery of multiple goods, each good to be delivered may be identified as a separately identifiable component and the recognition criteria set out in paragraph 14 of IAS 18 would apply to each good. If the entity transfers to the buyer control and the significant risks and rewards of ownership of *each separately identifiable good at different points of time*, the criteria for recognising revenue from the sale of goods may be met at different times. This view is consistent with IFRIC 13 that states in BC 9 that ‘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’. The staff points out that, in

substance, this situation is different from the ‘continuous transfer’ of the work in progress of a single asset and therefore justifies a different accounting treatment.

19. For example, an entity may enter into an agreement to construct 10 helicopters for a single buyer and deliver these helicopters as they are constructed (or in predefined installments). The entity may transfer to the buyer control and the significant risks and rewards of ownership of each helicopter upon delivery. In this case, the criteria for recognising revenue from the sale of goods set out in paragraph 14 of IAS 18 would be met at each delivery.
20. The staff believes that paragraph 14 of IAS 18 is already being applied in this way, so the Interpretation would not change practice. Although the agreement does not meet the definition of a construction contract or the criteria for ‘continuous transfer’, the staff is aware that the guidance in IAS 11 might be used to determine the portion of the total revenue and costs to be allocated to each individual helicopter delivered.

### *2.3) Application by analogy*

21. When the IFRIC reached its consensus and issued D21, one concern was not to change practice in industries other than real estate. However, the staff noted in the comment letters that respondents to D21 were concerned about the implications of the IFRIC’s conclusions for agreements that required the manufacture of goods to a customer’s specifications in industries other than real estate. The issue of application by analogy mainly arose because respondents were confused about how to apply indicators 9(a) and 9(b) (whether one was predominant, both were needed or only one was sufficient).
22. The staff think that the IFRIC’s conclusion reflected in the revised draft Interpretation has no major effect on IAS 11 (guidance on the definition of a construction contract) and appears to be a logical application of IAS 18. If applied by analogy, an Interpretation based on the revised draft would affect (or potentially affect) only agreements accounted for in accordance with IAS 11 that do not meet the definition of a construction contract as interpreted by the IFRIC and that do not result in a ‘continuous transfer’. In the staff’s view, if the result of the Interpretation

is to change inappropriate practice with respect to real estate sales, a similar result in other industries would also improve financial reporting.

#### *2.4) Questions to IFRIC members*

23. Do you agree with the staff analysis? Do you have any suggestions on the drafting proposed in:

- agenda paper 2C–Flowchart, boxes 11-17;
- agenda paper 2D–Draft interpretation, paragraphs 15-19
- agenda paper 2E–Draft basis for conclusions, paragraphs BC21-BC29

24. Do you believe that the notion of ‘continuous transfer’ as described in the Interpretation is a sound interpretation of IAS 18 paragraph 14?

25. Do you have any concern about application by analogy to industries other than real estate? Do you have any suggestions for drafting paragraph BC6 of agenda paper 2E–Draft Basis for Conclusions?

### **3) Identification of a component for the sale of land**

26. At the March IFRIC meeting, the IFRIC supported the first part of the flowchart dealing with the segmentation of the agreement (one component or multiple components?) but wanted to clarify whether the sale of land would be identified as a separate component within the scope of IAS 18 at the early stage of analysing the transaction or included in the real estate sale component and treated as a separate component at a later stage.

27. The staff think that the identification of a separate component for the sale of land must be undertaken when analysing any potential separate components. Therefore, the staff clarified in the Flowchart that a sale of land would be identified as a separate component at the early stage of analysing the transaction (see boxes 1 and 2 of the Flowchart set out in agenda paper 2C). In some cases, there may be a component for the sale of land separately identifiable (see Illustrative Example 1 in agenda paper 2F). In other cases, there may not be a component for the sale of land

that can be separately identified. For instance, in the US and Canada, a condominium is legally defined as the absolute ownership of a unit based on a legal description of the airspace the unit actually occupies, plus an *undivided interest in the ownership of the common elements* (which includes the land and actual building itself, all the driveways, parking, elevators, outside hallways, recreation and landscaped areas) which are owned jointly with the other condominium unit owners. In this case, the undivided interest in the ownership of the common elements does not give the buyer control and the significant risks and rewards of the land itself. Indeed, the right to the unit itself and the interest in the common elements are not separable.

28. In conclusion, the staff think that the segmentation issue is not specific to real estate. Therefore, the Interpretation should give only general guidance in accordance with IAS 18 and existing Interpretations (IFRIC 12 and IFRIC 13). However, because Example 1 illustrates a case of segmentation and Example 2 does not address this issue, the staff's view is that the Interpretation and the Basis for Conclusions should clearly state that the identification of a component for the sale of land should be undertaken when analysing any potential components. Depending on facts and circumstances, the entity may or may not conclude that such a component is separately identifiable from the component for the construction of real estate.

29. Do you agree with the staff analysis? Do you have any suggestions on the drafting proposed in:

- agenda paper 2C – Flowchart, boxes 1-7;
- agenda paper 2D –Draft Interpretation, paragraph 8;
- agenda paper 2E – Draft Basis for Conclusions, paragraphs BC9-BC13.



#### 4) Disclosures

30. The issue is whether, and to what extent, the Interpretation should require specific disclosures for agreements for the sale of goods in the scope of IAS 18 that meet the criteria for recognising revenue using the percentage of completion method. The staff note that this issue was not addressed in D21 because these agreements were considered to be construction contracts within the scope of IAS 11. Consequently, the disclosures of IAS 11 would have been required.
31. The staff are aware of two alternative views on this issue:
- View A: the Interpretation should require the same disclosures as IAS 11 (consistent with D21);
  - View B: the Interpretation should not require specific disclosures.
32. Supporters of View A think that the disclosures required by IAS 11 are designed to provide useful information when an entity uses the percentage of completion method. Therefore, when the criteria for recognising revenue from the sale of goods set out in paragraph 14 of IAS 18 are met continuously and the entity uses the percentage of completion method, it should provide the same disclosures as IAS 11 (see paragraphs 39–45 of IAS 11). These supporters also believe that applying View B would, in any event, lead the entity to disclose information about the major sources of estimation uncertainty in accordance with paragraph 125 of IAS 1 *Presentation of Financial Statements*. For these reasons, the Interpretation should either require the entity to provide the full disclosures of IAS 11 or include disclosures similar to those of IAS 11 (see paragraph 20 of agenda paper 2D and paragraphs BC30 and BC31 of agenda paper 2E).
33. Supporters of View B point out that, in the section on the rendering of services of IAS 18, paragraph 21 refers to IAS 11 only for guidance on the percentage of completion method and not for disclosures. They also note that the Interpretation would be based on the revenue recognition principles underpinning IAS 18 and would not introduce a new model or new principles. They conclude that requiring specific disclosures for agreements in the scope of IAS 18 beyond those already

required by IAS 18 would be a change of IAS 18 and would create an exception that may appear as rule-based.

34. The staff recommend View A because this view is consistent with the IFRIC's conclusion in D21.

35. Which view do you favor? View A or View B?

**5) Other issues**

36. Do you have any other outstanding issue you wish to discuss?