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INFORMATION FOR OBSERVERS

IFRIC meeting: **May 2008, London**

Project: **D21 *Real Estate Sales* – Draft basis for conclusions Agenda Paper 2E)**

The staff redrafted the Draft Interpretation and this Basis for Conclusions in accordance with View 2 on which the IFRIC agreed at the March meeting. The staff welcome comments on these redrafting proposals.

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.

BC2 The IFRIC released draft Interpretation D21 *Real Estate Sales* for public comment in July 2007 and received 51 comment letters in response.

Scope

BC3 Agreements for the construction of real estate are widespread and may relate to residential, commercial or industrial developments. Construction often spans more than one accounting period, may take place on land the buyer owns or leases before construction begins and agreements may require progress payments.

BC4 The main area of divergence in practice 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 completed real estate is delivered to the buyer.

BC5 The IFRIC considered whether the scope of the Interpretation should be confined to agreements for the construction of real estate. It concluded in D21 that the scope should be limited to the request received to clarify the requirements of IAS 18 with respect to 'real estate sales' because that was the area identified as having the most diversity in practice. In redeliberating the issue, the IFRIC took the view that the notion of 'real estate sales' in D21 might create confusion and clarified that this Interpretation applies to 'agreements for the construction of real estate'. The primary issue of whether an agreement is within the scope of IAS 11 or IAS 18 arises only when agreements include construction activities. Such agreements may or may not meet the definition of a construction contract.

BC6 The IFRIC noted that respondents were concerned about the implications of the IFRIC's conclusions for agreements that required manufacture of goods to a customer's specifications in industries other than real estate. The IFRIC reconsidered the scope of the Interpretation after it had redeliberated its conclusions with respect to agreements for the construction of real estate. It concluded [to be completed after May meeting].

Issue

BC7 The issue is when should revenue from the construction of real estate be recognised? In International Financial Reporting Standards (IFRSs), two Standards deal with accounting for revenue: IAS 18 and IAS 11. Because many agreements involve the construction or manufacture of an asset to meet customer's specifications, the IFRIC was asked to clarify how to determine whether an agreement for the construction of real estate is a construction contract within the scope of IAS 11.

Consensus

BC8 The nature and extent of the entity's continuing involvement with the item sold determines how the transaction is accounted for. It may be accounted for as a sale, or as a financing, leasing or some other profit sharing arrangement.

Because the issue addressed in this Interpretation is a revenue recognition issue, the Interpretation assumes that the entity has previously analysed the agreement for the construction of real estate and any related agreements and concluded that it will not maintain continuing involvement with or managerial control over the constructed real estate to an extent that would preclude recognition of some or all of the consideration as revenue. This assumption, that the entity would recognise revenue at some point and the issue was one of timing, was implicit in D21 but was not clearly stated. In response to comments received, the IFRIC clarified that an entity must have concluded that the arrangement will result in the recognition of revenue to be within the scope of the Interpretation.

BC9 Some respondents to D21 asked the IFRIC to provide guidance on agreements with multiple components so the Interpretation would cover the more complex transactions that often occur in practice.

BC10 In its redeliberations, the IFRIC noted that, in addition to the construction of real estate, an agreement may include the delivery of other goods or services (eg a sale of land or provision of property management services). In accordance with paragraph 13 of IAS 18, such an agreement may need to be split into separately identifiable components, including one for the construction of real estate. Because IAS 18 is the standard that sets out requirements for revenue recognition in general, the IFRIC decided to consider the issue in the context of IAS 18, that is, an entity should first determine whether an agreement that includes the construction of real estate also includes other components that do not need further analysis.

BC11 The IFRIC noted that IFRIC 12 *Service Concession Arrangements* and IFRIC 13 *Customer Loyalty Programmes* already provide useful guidance on determining whether a single agreement should be divided into components and, if so, how to allocate the fair value of the consideration received or receivable to each component (see paragraph 13 of IFRIC 12 and paragraphs 5-7 of IFRIC 13). Therefore, the IFRIC concluded that this Interpretation should include only a reminder that such identification and allocation are required.

BC12 Regarding the issue of whether and when there is a separately identifiable component for the sale of land, the IFRIC concluded from the existing guidance that the identification of a component for the sale of land should be undertaken when analysing any potential components. In addition, 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.

BC13 The IFRIC noted that respondents were uncertain whether an entity applying D21 would follow the guidance on segmenting and combining contracts in IAS 18 or that in IAS 11. The approach adopted in the Interpretation makes it clear that the specific criteria for contract segmentation in IAS 11 are applied only after the entity has concluded that the agreement is within the scope of that standard.

Determining whether the agreement is within the scope of IAS 11 or IAS 18

BC14 One view is that IAS 11 applies to all agreements for the construction of real estate. In support of this view, it is argued that:

(a) these 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 (provided 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. IFRSs can and should be interpreted in the same way to avoid unnecessary differences.

BC15 A second view is that IAS 11 applies only when the agreement meets the definition of a construction contract. When the agreement does not meet the definition of a construction contract, the agreement is within the scope of IAS 18.

BC16 The consensus reflects the second view. In reaching this consensus, the IFRIC noted that:

(a) the facts that the construction spans more than one accounting period and requires progress payments are not relevant features to consider when determining the applicable standard and the timing of revenue recognition;

(b) determining whether an agreement for the construction of real estate is within the scope of IAS 11 or IAS 18 depends on the terms of the agreement and all the surrounding facts and circumstances. Such a determination requires judgement;

(c) IAS 11 lacks specific guidance on the definition of a construction contract and further application guidance is needed to help identify construction contracts;

(d) differences exist between the IFRS and US GAAP requirements for revenue recognition in general and for construction contracts in particular. They cannot be eliminated by interpretation. They are being addressed in a general project on revenue recognition conducted jointly by the IASB and the US FASB.

BC17 The IFRIC noted that when IAS 11 applies, for accounting purposes, the construction contract also includes contracts for the rendering of services that are directly related to the construction of the real estate in accordance with paragraph 4 of IAS 18 and paragraph 5(a) of IAS 11.

BC18 In D21, the IFRIC concluded that an agreement for the construction of real estate would be within the scope of IAS 11 in two circumstances – if the agreement met the definition of a construction contract and/or if control and the significant risks and rewards of ownership of the work in progress in its current state transferred to the buyer as construction progresses. Many respondents pointed out that IAS 11 does not require 'continuous transfer' for the use of the percentage of completion method, only that the contract be a 'construction contract'. The IFRIC clarified in the consensus that IAS 11 applies only when the agreement meets the definition of a construction contract and carried forward into the Interpretation the guidance in paragraphs 9(a), 10(a) and BC5(a) of D21.

BC19 In addition, many respondents asked the IFRIC to provide guidance to distinguish between construction contracts that meet the definition included in D21 and other agreements for the manufacture of goods to a customer's specifications. The IFRIC concluded that the most important distinguishing feature is whether the customer is actually specifying the main elements of the structural design. In situations involving the custom manufacture of goods, the customer generally does not have the ability to specify or alter the basic design of the product. Rather, the customer is simply choosing elements from a limited range of options predefined by the seller. The IFRIC decided to include guidance to this effect in the Interpretation to help clarify the application of the definition of a construction contract.

Accounting for revenue from the construction of real estate

BC20 When the agreement is within the scope of IAS 11, the entity should apply the percentage of completion method in accordance with IAS 11.

BC21 When the agreement does not meet the definition of a construction contract, the agreement is within the scope of IAS 18. The IFRIC identified two types of agreements for the construction of real estate that are within the scope of IAS 18 and that are distinguishable in substance:

(1) Agreements for the rendering of services only;

(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).

BC22 The IFRIC noted that a customer may decide to act in essence as its own general contractor and enter into agreements with individual suppliers for specific goods and services. When the entity is responsible only for assembling materials supplied by others (that is, it has no inventory risk for the construction materials), the agreement is an agreement for the rendering of services. The IFRIC noted that, if the criteria in paragraph 20 are met, IAS 18 requires revenue to be recognised by reference to the stage of completion of the transaction using the percentage of completion method. IAS 18 then refers to IAS 11 and states that the requirements of IAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction.

BC23 The IFRIC also noted that construction activities often require an entity that undertakes the construction of real estate to provide services together with construction materials. However, the entity delivers to the buyer a real estate asset, either completed or in its current stage of completion. Therefore, the IFRIC concluded that the criteria in paragraph 14 of IAS 18 for recognition of revenue from the sale of goods should apply to such agreements.

BC24 As noted in BC16, the IFRIC agreed with respondents to D21 that IAS 11 does not require the entity to transfer to the buyer control and the significant risks and rewards of ownership of the work in process in its current state as construction progresses ('continuous transfer') in order to use the percentage of completion method, only that the contract be a 'construction contract'. In its redeliberations, the IFRIC noted that the criterion it included in paragraph 9(b) of D21 was actually one of the criteria in IAS 18 for recognition of revenue from the sale of goods. Although these agreements may not meet the definition of construction contracts, the IFRIC concluded that they may result in the entity meeting all of the criteria for recognising revenue from the sale of goods in IAS 18 (including the transfer of control and the significant risks and rewards of ownership) continuously as construction progresses, as opposed to at a single point of time (eg at completion, upon or after delivery).

BC25 The IFRIC concluded that if these criteria are met continuously, an entity should recognise revenue on the same basis (by reference to the stage of completion). Like paragraph 21 of IAS 18 for the rendering of services, the Interpretation refers entities to IAS 11 for guidance on applying the percentage of completion method. The IFRIC observed that this conclusion was 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:

> …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...

BC26 The IFRIC also identified agreements for the construction of real estate 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). The IFRIC reaffirmed its conclusion in D21 that these agreements are sales of goods within the scope of IAS 18. Such agreements only give 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 IFRIC concluded that revenue from such agreements should be recognised only when all the criteria in paragraph 14 of IAS 18 are satisfied.

BC27 The IFRIC noted that this conclusion is consistent with revenue recognition requirements for significant contracts for the delivery of multiple units of goods manufactured to the customer's specifications over more than one accounting period, such as subway cars. In such circumstances, the entity recognises revenue as individual units (or groups of units) are delivered. However, in contrast to the contracts described in BC24, control and the significant risks and rewards of ownership of the work in process do not transfer to the buyer as construction/manufacture progresses. This transfer takes place only on delivery of the completed units. Consequently, the entity in this case would apply the requirements of paragraph 14 of IAS 18 at that time; use of the percentage of completion method would not be appropriate.

BC28 In some circumstances an entity has to perform further work on real estate already delivered to the buyer. The IFRIC noted that IFRIC 13 *Customer Loyalty Programmes* already provides guidance on how to apply paragraphs 13 and 19 of IAS 18. Paragraph BC9 of IFRIC 13 states 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…

BC29 The IFRIC concluded that the Interpretation should provide similar guidance.

Disclosures

BC30 [If View A is followed: The IFRIC noted that the disclosure requirements of IAS 18 would not provide sufficient information for users about agreements that meet the criteria for recognising revenue from the sale of goods continuously (see paragraph 17 of this Interpretation). However, the disclosure requirements of IAS 11 are designed to provide useful information when an entity uses the percentage of completion method. The IFRIC [concluded that, when the criteria for recognising revenue from the sale of goods set out in paragraph 14 of IAS 18 are met continuously, the entity should provide the disclosures required by paragraphs 39–45 of IAS 11.

BC31 The IFRIC noted that this requirement was implicit in D21 because these agreements would have been included in the scope of IAS 11. In addition, for such entities it is probable that the estimates required to apply the percentage of completion method would require discussion in accordance with paragraph 125 of IAS 1. For greater certainty, the IFRIC concluded that it should specifically require the IAS 11 disclosures for these agreements.] [To be completed after the May meeting. See agenda paper 2B].

Changes from draft Interpretation D21

BC32 Most respondents to D21 supported the IFRIC's conclusion that it should develop an interpretation on this issue. However, nearly all respondents expressed concern with some aspects of the proposals or the possible application by analogy to industries other than real estate.

BC33 The most significant changes made from D21 in the light of comments received relate to:

(a) *scope*. D21 referred to 'real estate sales'. The IFRIC clarified that the Interpretation applies to agreements for the construction of real estate.

(b) *applicable standard*. D21 listed typical features, including 'continuous transfer', to help determine whether an agreement for the construction of real estate is within the scope of IAS 11 or IAS 18. The IFRIC concluded that only agreements that meet the definition of a construction contract are within the scope of IAS 11 and carried forward into the Interpretation the guidance in paragraphs 9(a), 10(a) and BC5(a) of D21 on when a contract satisfies that definition.

(c) *continuous transfer*. Many respondents believed that the indicator of 'continuous transfer' (the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses) set out in paragraph 9(b) of D21 was relevant, although not specifically included in IAS 11. The IFRIC took the view that when the criteria for recognising revenue from the sale of goods set out in paragraph 14 of IAS 18 are met continuously, it is appropriate to recognise revenue as the criteria are met. The IFRIC carried forward the criterion set out in paragraph 9(b) of D21 and concluded that the percentage of completion method appropriately recognises revenue in such circumstances. However, the IFRIC did not carry forward the features set out in paragraphs 9(b)(i)-9(b)(iii) of D21 on the basis that the criterion was sufficiently clear. Overall, the Interpretation and D21 provide similar revenue recognition conclusions for agreements with 'continuous transfer' but for different reasons.

(d) *multiple components*. Some respondents to D21 asked the IFRIC to address the issue of a single agreement with multiple components in order to cover the more complex transactions that often occur in practice. The requirements of IAS 18 in this respect have been included in the consensus and the issue is also addressed in an illustrative example.

(e) *disclosures*. D21 did not specify disclosures because 'continuous transfer' agreements were included in the scope of IAS 11 and its disclosure requirements would have automatically applied. [View A: Paragraph 20 of the consensus has been added to require the same disclosures when revenue from agreements for the construction of real estate is recognised using the percentages of completion method whether under IAS 11 or IAS 18] [To be completed after the May meeting. See agenda paper 2B]

(f) *illustrative examples*. D21 did not include illustrative examples. The IFRIC [decided] that illustrative examples should accompany, but not form part of, the Interpretation to help entities apply the Interpretation.

(g) [*flowchart*… if the IFRIC decides to include it in the Interpretation].