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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: **May 2008, London**

Project: **D21 *Real Estate Sales* – Illustrative examples (Agenda Paper 2F)**

Introduction

1. After the March IFRIC meeting, the staff received comments from IFRIC members on the illustrative examples. The main changes from the version presented at the March meeting are the following:

   - Example 2 (now Example 1) has been moved forward on the ground that it illustrates the main issues addressed in the revised draft Interpretation. See track changes next page.
   - Example 1 (now Example 2) now contains alternative facts patterns that lead to the use of the percentage of completion method (see paragraph IE7).
   - Example 3 carries forward the second paragraph of guidance from Example 9 in the appendix to IAS 18 and has been redrafted to give high level guidance and

alert entities that retaining continuing involvement may delay recognition of revenue. The staff did not intend to provide detailed guidance on that topic because it was not the question asked to the IFRIC at the first place.

Questions to the IFRIC

2. Do you believe these examples are useful and should accompany the Interpretation? If yes, do you have any drafting suggestions? If not, which one(s) should be deleted and why?

Illustrative Examples

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

Example 1

IE1 An entity buys a plot of land for the construction of commercial real estate. It designs an office block to build on the land and submits the designs to planning authorities in order to obtain building permission. The entity markets the office block to potential tenants and signs conditional lease agreements. The entity markets the office block to potential buyers and signs with one of them a conditional agreement for the sale of land and the construction of the office block. The buyer cannot put the land or the incomplete office block back to the entity. The entity receives the building permission and all agreements become unconditional. The entity then undertakes the construction of the office block.

IE2 In this illustrative example, the agreement should be separated into two components: a component for the sale of land and a component for the construction of the office block. The component for the sale of land is a sale of goods within the scope of IAS 18.

IE3 Because all the major structural decisions were made by the entity and were included in the designs submitted to the planning authorities before the buyer signed the conditional agreement, it is assumed that there will be no major change in the designs after the construction has begun. Consequently, the component for the construction of the office block is not a construction contract and is within the scope of IAS 18. The facts that the construction takes place on land the buyer owns before construction begins and that the buyer cannot put the incomplete office block back to the entity are indicators that 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. Therefore, because the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, revenue from the construction of the office block should be recognised using the percentage of completion method.

IE4 Alternatively, assume that the construction of the office block started before the entity signed the agreement with the buyer. In that event, the agreement should be separated into two components: a component for the sale of land and the partially constructed office block and a component for the completion of the office block. The entity should apply the recognition criteria separately to each component. Assuming that the other facts remain unchanged, the entity should use the percentage of completion method for the construction component as explained in IE3.

Example 2

IE5 An entity is developing residential real estate and starts marketing individual units (apartments) while construction is still in progress. Buyers enter into a binding sale 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 entity fails to deliver the completed unit in accordance with the contracted terms. Buyers are also required to make progress payments between the time of the initial agreement and contractual completion. The balance of the purchase price is paid only on contractual completion, when buyers obtain possession of their unit. Buyers are able to specify only minor variations to the basic design 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. Consequently, the construction takes place independently of the agreement for the construction of individual units.

IE6 In this illustrative example, the terms of the agreement and all the surrounding facts and circumstances indicate that the agreement is not a construction contract. The agreement is a forward contract that gives the buyer an asset in the form of a right to acquire, use and sell the completed real estate at a later date and an obligation to pay the purchase price in accordance with its terms. Although the buyer might be able to transfer its interest in the forward contract to another party, the seller retains control and the significant risks and rewards of ownership of the work in progress until the completed real estate is transferred. Therefore, revenue should be recognised only when all the criteria in paragraph 14 of IAS 18 are met (at completion in this example).

IE7 Alternatively, assume that, in the jurisdiction, the law requires the seller to immediately transfer to the buyer ownership of the real estate in its current state of completion and that any additional construction becomes the property of the buyer as construction progresses. This indicates that 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. Therefore, because the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, the entity should recognise revenue using the percentage of completion method taking into account the agreements signed with individual buyers and the stage of completion of the whole building.

Example 3

IE8 Agreements for the construction of real estate may include such a degree of continuing involvement by the seller that control and the significant risks and rewards of ownership are not transferred even when construction is complete and the buyer obtains possession. Examples are agreements in which the seller guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such circumstances, recognition of revenue may be delayed or precluded altogether. The Interpretation assumes the seller has reached the conclusion that it is appropriate to recognise revenue from the agreement and discusses how to determine the appropriate pattern of revenue recognition.