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   Website: www.iasb.org

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 2009, London**

Project: **Accounting for Selling Costs of Real Estate Projects (Agenda Paper 5I)**

RELEVANT STANDARDS

- IAS 2 *Inventory*
- IAS 11 *Construction Contracts*
- IAS 16 *Property Plant and Equipment*
- IAS 18 *Revenue Recognition*
- IAS 38 *Intangible Assets*
- IFRIC 15 *Agreements for the Construction of Real Estate*
- SIC 32 *Intangible Assets – Web Site Costs*
- IFRIC agenda rejection (March 2006) *Subscriber Acquisition Costs in the Telecommunication Industry*
- IFRIC agenda rejection (November 2006) *Intangible Assets – Classification and accounting for SIM cards*

SUMMARY OF SUBMISSION REQUESTS

1. The IFRIC received two submissions requesting clarification about how a real estate developer should account for initial selling and marketing costs incurred during the construction period that are directly attributable to the specific real estate project.

2. In both submissions, following the guidance in IFRIC 15, the revenue recognition for the real estate construction project falls within the scope of IAS 18, not IAS 11.

3. The submissions specifically excluded general marketing costs from their requests for interpretive guidance. They listed the following examples of initial selling and marketing costs for clarification:
    - Advertising expenses for the project
    - Sales commission paid for selling the units
    - Fees paid to the bank to list the property to enable buyers to get mortgage

4. The submissions described the three accounting alternatives for those expenses:
   - *View 1* – Expense immediately as incurred in accordance with paragraph 16(d) of IAS 2's requirement for selling costs because there are no future benefits.
   - *View 2* – Capitalise until the year in which related revenue is recognized on the basis of matching principle in paragraph 95 of the *Framework* because IAS 2 and other IFRSs are not specific about when the selling costs are incurred.
   - *View 3* – Capitalise as inventory WIP those expenses that add to the property's future value and are specific to the project and expected to be recovered, e.g., bank fees to list the property; however, expense sales commission.

5. One submission noted that IAS 8 permits an entity to refer to the *Framework* to develop its accounting policies when IFRSs do not provide guidance on the specific issue. The submission also noted that US GAAP requires capitalization of selling costs of real estate projects when certain criteria in paragraphs 17-21 of SFAS 67 are met. The submitter believes, therefore, that IFRSs should also require prepaid selling and marketing costs in real estate projects to be capitalized when those costs are (a) incurred for specific real estate projects and (b) expected to be recovered.

6. Noting a lack of consensus and diversity in practice, the submissions requested IFRIC to clarify this issue. See Appendix A to this agenda paper for the original IFRIC agenda item requests.

STAFF RECOMMENDATION

7. For the reasons discussed below, the staff recommends that the issues in these two current IFRIC submissions should not be added to the agenda.

8. Proposed wording for the tentative agenda decision is set out in Appendix D to this agenda paper.

BACKGROUND

9. IAS 11 contains specific guidance on the recognition of revenue and associated expenses for construction contracts. The guidance in the recently issued IFRIC 15 clarifies that agreements to construct real estate in which buyers have only limited ability to influence the design of the real estate, e.g., to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, is an agreement for the sale of goods within the scope of IAS 18, and not within the scope of IAS 11.

10. Paragraph 14 of IAS 18 addresses the accounting for revenues from the sale of goods. IFRIC 15 clarifies that if the entity continuously transfers to the buyer control and the significant risks and rewards of ownership of the work in progress as construction progresses, meeting all criteria in paragraph 14 of IAS 18, the entity should apply the percentage-of-completion method. Therefore, the entity should recognise revenue and associated expenses by reference to the requirements in IAS 11.

11. However, if 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 time, such as at completion upon or after delivery, IFRIC 15 clarifies that the entity should recognise revenue only when all criteria for sale of goods in paragraph 14 of IAS 18 are satisfied. Therefore, revenues for such transactions are recognised at project completion date.

12. IFRIC 15 and IAS 18 are both silent about the accounting for related costs for construction of real estate projects that are not in the scope of IAS 11.

STAFF ANALYSIS

13. The staff thinks that the selling costs described in the current IFRIC submissions are incurred when the expenditure is made, that is, when payments are made or liabilities are recognised to suppliers for goods or services received.

14. The staff identified two issues as being related to the requests:
    - *Issue 1* – Whether IFRSs provide guidance on the accounting of such costs.

- *Issue 2* – What is the appropriate accounting for such costs.

15. On *Issue 1*, the submission already noted the requirements of IAS 2, which requires selling costs of inventory be expensed when incurred.

16. The staff also notes other guidance in IFRSs such as IAS 16, IAS 38 and SIC 32 that discuss the criteria for capitalisation of costs as assets and internally generated intangibles. Those standards require an entity to expense selling costs (including advertising and promotional activities) of introducing a new product or service unless those costs can be directly attributed to preparing the asset for use.

17. Therefore, the staff believes that any conclusion on *Issue 2* that such costs for real estate projects should or may be capitalised must rest on analogies to other standards that discuss the costs of obtaining contracts with customers.

18. The staff believes that standards such as IAS 17 *Leases* (discussion of initial direct costs), IAS 18 (paragraph IE 14 on investment management fees), IFRS 4 *Insurance Contracts* (consideration of deferred acquisition costs) and IAS 39 *Financial Instruments: Recognition and Measurement* (paragraphs 9 and 43 on effective interest rate method considering transaction costs in amortised cost) may include relevant guidance. We also note that these standards have consistent requirements that the costs being considered be both incremental and directly related to the contracts in question.

19. Consequently, the staff does not believe it is necessary or appropriate to refer to the *Framework* to determine the accounting for such costs. However, we also note that the *Framework* generally considers matching to be the outcome of the proper recognition of assets and liabilities rather than a separate principle or objective. In particular, paragraph 95 of the *Framework* is explicit that application of this notion cannot result in the recognition in the financial statements of items that do not meet the definitions of assets and liabilities.

Previous IFRIC Agenda Decisions

20. The staff notes that the IFRIC previously considered two similar issues and that it declined to take those issues onto its agenda. The first issue related to how a mobile phone operator should account for telephone handsets which an operator provides free, or at a reduced price, to a customer. The second issue related to how a mobile phone operator should account for a SIM card for a new subscriber contract, whether it should be accounted for as an intangible asset in accordance with IAS 38 or as inventory in accordance with IAS 2.

21. The staff considers such subscriber acquisition costs – a mobile phone (or a SIM card) provided free or at a reduced price to the customer – to be similar to direct incremental selling costs to acquire customer contracts incurred during the construction of real estate projects.

22. Appendix B to this agenda paper includes extracts of the agenda decisions published in the March 2006 and November 2006 IFRIC Updates in respect of the two issues previously considered.

Current Active Board Project

23. The staff notes that the Board's Discussion Paper of *Preliminary Views on Revenue Recognition in Contracts in Customers* (published December 2008) discussed the capitalisation of costs in paragraphs 6.43-6.46. That document has a comment period ending in June 2009.

24. The staff notes that the DP states that the Board does not intend a new revenue recognition standard to include guidance on accounting for the costs associated with contracts with customers. Consequently, costs would be recognised as expenses when incurred unless they were eligible for capitalisation in accordance with other standards.

25. The DP specifically mentioned that significant contract origination costs might be affected by that preliminary view. See extracts in Appendix C.

ASSESSMENT OF THE AGENDA CRITERIA

26. In accordance with the IFRIC's due process, IFRIC members assess the proposed agenda item against the following criteria (the issue does not have to satisfy all the criteria to qualify for the agenda):

    (a) The issue is widespread and has practical relevance.

    (b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.

    (c) Financial reporting would be improved through elimination of the diverse reporting methods.

    (d) The issue can be resolved efficiently within the confines of existing IFRSs and the *Framework*, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRIC and its constituents to undertake the due process associated with an Interpretation.

    (e) It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis.

    (f) If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process.

27. The staff's view is that criteria (a), (b) and (c) are likely to be met. Many industries incur significant costs to acquire customers. IFRSs do not directly address such costs except for some of the narrow examples provided in the standards listed in paragraph 18 of this paper. In addition to requests previously submitted on the telecommunication industry, views are also mixed as to how IFRSs should apply to selling costs of real

estate projects. It is a more important issue after the recently issued IFRIC 15 clarified that many real estate construction contracts are no longer within the scope of IAS 11.

28. The staff's view is that criteria (d) (e) and (f) are unlikely to be met. Even though the staff does not think that resolving the issue would require interpreting the definition of assets set out in the *Framework* and its interaction with one or more IFRSs, the issue is not sufficiently narrow in scope to be capable of interpretation,. From the previous IFRIC Agenda Decisions, the staff thinks it is unlikely that the IFRIC will be able to reach a consensus on a timely basis. Finally, although the Board does not intend that the new revenue recognition standard to include guidance for the accounting of associated costs, the DP seems to imply that the Board will decide on the accounting for such costs when it finalises that standard.

STAFF RECOMMENDATION

29. For the reasons discussed above, the staff recommends that the issue in the two current IFRIC submissions should not be added to the agenda.

30. Proposed wording for the tentative agenda decision is set out in Appendix D to this agenda paper.

QUESTIONS TO THE IFRIC

31. Does the IFRIC agree with the staff recommendation?

32. Does the IFRIC have any comments on the draft wording (see Appendix D to this agenda paper)?

APPENDIX A – IFRIC AGENDA SUBMISSIONS (NOV 2008, JAN 2009)

Request 1 – Received in January 2009

With the help of IFRIC 15, we have come to a conclusion that the activity of constructing a building and selling flats to individual customers falls under IAS18 for this particular client.

Accordingly, no revenue will be recognised unless the building is completed and units are handed over to the customers.

The confusion is how we account for the following expenses:
a) Advertising expenses for the project;
b) Sales commission paid for selling the flats;
c) Fees paid to the bank to list the property to enable buyers to get mortgage.

Request 2 – Received in November 2008

Some of the real estate investment trusts (REITs) listed in the [**Deleted**] Stock Exchange contacted our Board for clarification on accounting of prepaid sales and marketing costs directly related with the real estate projects. According to their claims, briefly, although IAS 2[1] states that the selling costs should be recognised as expense when they incur, the selling and marketing costs[2] directly related with real estate projects should be deferred due to the generally accepted accounting principle called "matching principle", stated in the Framework paragraph 95. The main logic in this point of view is that;
a) The real estate projects last more than one accounting period,

b) Due to the requirements set in IAS 18 paragraph 14, the revenue arising from sale of a real estate project is recognised as the delivery is done, though the selling and marketing activities directly related with these projects are done at the beginning of the real estate projects, so there is material mismatch in the expenses and revenues of those projects and the profits of REITs at the beginning of the projects appear to be lower than the real economic situation and the profits of REITs as opposed to when the revenues of the real estate projects are recognised later appear to be higher than the real economic situation.

One can conclude, as the generally accepted *matching principle* necessitates that costs are expensed when related revenues are earned, selling costs that are for specific real estate projects and are expected to be recovered when related revenue is *accrued.* So the provision in the IAS 2 related with the selling costs should be also considered within *accrual and matching principles* and the selling costs that are for specific real estate projects and are expected to be recovered should be capitalised until related revenues *accrues*. But there is no consensus on the mentioned provision of IAS 2 among the REITs sector, auditors and literature.

---

[1] The properties held by mentioned REITs are recognized as inventory due to the type of their business.
[2] These selling and marketing costs are different than the general marketing costs in the sense that they are directly related with specific real estate projects.

Moreover IAS 8 paragraph 11 states that the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework can be applied when there is no specific provision in the related IFRS and other similar IFRSs. From here, it can be concluded that there is no specific provision in IAS 2 and other IFRSs on when the selling costs **incur**, so the matching principle related with the recognition criteria of expenses defined in the Framework can be applied.

On the other hand in the financial reporting standards set issued in USA by Financial Accounting Standards Board, there is a specific standard regulating costs and initial operations of real estate projects, called Statement of Financial Accounting Standards No.67 (SFAS 67). In the SFAS 67 paragraphs 17-21, it is clearly stated that the selling costs shall be capitalized when the requirements stated in the standard are not met.

In this context, we think that prepaid selling and marketing costs shall be capitalized as *"prepaid costs"* in the real estate projects as long as (i) those costs are incurred for specific real estate projects and (ii) are expected to be recovered. However, due to lack of consensus, we gently request a clarification on this issue.

APPENDIX B: PREVIOUS IFRIC AGENDA DECISIONS

IAS 18 *Revenue* – Subscriber Acquisition Costs in the Telecommunications Industry (March 2006)

The IFRIC considered how a provider of telecommunications services should account for telephone handsets it provides free of charge or at a reduced price to customers who subscribe to service contracts. The question was whether:

- the contracts should be treated as comprising two separately identifiable components, i.e. the sale of a telephone and the rendering of telecommunication services, as discussed in paragraph 13 of IAS 18 *Revenue*. Revenue would be attributed to each component; or
- the telephones should be treated as a cost of acquiring the new customer, with no revenue being attributed to them.

The IFRIC acknowledged that the question is of widespread relevance, both across the telecommunications industry and, more generally, in other sectors. IAS 18 does not give guidance on what it means by 'separately identifiable components' and practices diverge.

However, the IFRIC noted that the terms of subscriber contracts vary widely. Any guidance on accounting for discounted handsets would need to be principles-based to accommodate the diverse range of contract terms that arise in practice. The IASB is at present developing principles for identifying separable components within revenue contracts. In these circumstances, the IFRIC does not believe it could reach a consensus on a timely basis. The IFRIC, therefore, decided not to take the topic onto its agenda.

IAS 38 *Intangible Assets* – Classification and accounting for SIM cards (November 2006)

The IFRIC received a request for an Interpretation as to whether a mobile phone operator should account for a Subscriber Identity Module (or 'SIM card') as an intangible asset in accordance with IAS 38 or as inventory in accordance with IAS 2.

The IFRIC noted that the accounting for SIM cards before their delivery to customers or after connecting these customers to the network using such SIM cards was unlikely to be of practical or widespread relevance as the amounts involved were unlikely to be significant.

The IFRIC also noted that the accounting for SIM cards that had been delivered to customers is part of the question of which costs incurred by a mobile phone operator entering into a contract with a customer qualify for recognition as subscriber acquisition costs. The IFRIC had previously considered the treatment of subscriber acquisition costs in the telecommunications industry and, in March 2006, declined to take the issue onto its agenda.

The IFRIC therefore considered that the question of how SIM cards should be accounted for was a part of the issue that it had declined to take onto its agenda in March 2006. The IFRIC reaffirmed its March 2006 decision that the issue should not be taken onto its agenda.

APPENDIX C: RELEVANT EXTRACTS FROM DISCUSSION PAPER – PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS (DECEMBER 2008)

Chapter 6: Potential effects on present practice

Capitalisation of costs

6.43 The boards do not intend a new revenue recognition standard to include guidance on accounting for the costs associated with contracts with customers. Consequently, costs would be recognised as expenses when incurred unless they were eligible for capitalisation in accordance with other standards. Examples of costs eligible for capitalisation in other standards include inventory costs and software development costs.

6.44 Contracts with significant contract origination costs might be affected by that preliminary view. In some instances, those costs are often capitalised if they are deemed recoverable in subsequent periods. In other instances (see fn 20), an entity recognises the costs of obtaining a contract as expenses when incurred, but revenue is also recognised to offset them. As noted earlier, the boards' preliminary view is that revenue is recognised only when a performance obligation is satisfied. Hence, revenue would neither be recognised at contract inception nor offset any costs of obtaining a contract.

6.45 A common example of that potential effect is sales commissions and other marketing expenses associated with obtaining a contract. If those costs are not eligible for capitalisation in accordance with other standards, they would be recognised as expenses as incurred. Because no revenue would be recognised at contract inception (unless a performance obligation is satisfied), that may lead to the recognition of a loss when a contract is obtained.

6.46 Some note that an allocated transaction price approach could be modified so that rather than allocating the total transaction price to performance obligations, an entity could allocate that price less specified costs of obtaining the contract. Consequently, although some revenue would be recognised at contract inception, no profit would be recognised at that time. That approach would be similar to Implementation A of the IASB's proposed measurement approach in its discussion paper *Preliminary Views on Insurance Contracts*.

[Appendix D has been omitted from this Observer note]

fn 20 – See, for example, SFAS 51 *Financial Reporting by Cable Television Companies.*