

## STAFF PAPER

November 2011

## IFRS Interpretations Committee Meeting

<b>Project</b>	<b>IFRIC 15 <i>Agreements for the Construction of Real Estate</i></b>		
<b>Paper topic</b>	Unit of account		
CONTACTS	April Pitman	<a href="mailto:apitman@ifrs.org">apitman@ifrs.org</a>	+44 (0) 20 7246 6492
	Daehyun Kim	<a href="mailto:dkim@ifrs.org">dkim@ifrs.org</a>	+44 (0) 20 7246 6493

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

**Objective of this paper**

1. In July 2008 the IASB issued IFRIC 15 *Agreements for the Construction of Real Estate* effective for annual periods beginning on or after 1 January 2009.
2. The Committee has received two submissions requesting clarification of the notion of ‘continuous transfer of a good’ that is expressed in paragraph 17 of IFRIC 15. This is discussed in paper 5A.
3. The Committee has also received a submission requesting clarification of the *unit of account* in determining continuous transfer in arrangements for the construction of multi-unit apartment blocks:

We ask the committee to clarify whether the unit of account, for determining whether control transfers continuously while construction takes place, is each individual apartment in a block of apartments or the entire block.

4. We have had many discussions with the firms concerning the notion of continuous transfer of a good. We think the question about what unit of account should be used for determining continuous transfer has been raised because there are two aspects of accounting for the construction of real estate – accounting for the revenue and accounting for the costs. Consequently, in addition to considering the

unit of account for continuous recognition of revenue, we will also discuss accounting for costs and the recognition of gross margin.

### **Structure of the paper**

5. The paper is organised as follows:
  - (a) Background
  - (b) Unit of account – cost
  - (c) Relationship of cost to sales price
  - (d) Unit of account – revenue
  - (e) Effect on the recognition of gross margin
  - (f) Significance of the unit of account in determining continuous transfer
  - (g) Can the unit of account for determining continuous transfer be the entire apartment block?
  - (h) Staff summary and conclusion

### **Background**

6. Unit of account questions typically arise when the level set for the unit of account affects the measurement of the element being addressed. In posing a question about the unit of account for determining when continuous transfer takes place, this links the unit of account issue with recognition.
7. The submitter questions whether selecting a different unit of account would give different answers to the question – does the good transfer continuously or at a point in time.
8. If the unit of account for determining whether control transfers continuously is each individual apartment then continuous transfer would be assessed apartment-by-apartment and buyer-by-buyer. If the unit of account for determining whether control transfers continuously is the entire apartment block then continuous transfer would be assessed for the entire apartment block and for all buyers of

apartments in the block. In that case, control would transfer to all buyers continuously, or not, and would transfer, or not, to all buyers at the same time.

### **Unit of account - cost**

9. We think one of the reasons this topic has been raised is because accounting for agreements for the construction of real estate must also address accounting for costs and the unit of account for accounting for costs is typically the entire apartment block.
10. When constructing an apartment block it is often not possible to measure the costs of individual apartments. Some surfaces will be shared – one apartment’s ceiling is another apartment’s floor. The cost of the shared surface will need to be allocated between both apartments.
11. Furthermore, the costs directly attributable to the construction of separate apartments may be inter-related. The vertical joists of the lower apartments may be thicker than the vertical joists of the topmost apartments, in order to support the higher floors. We think the costs of the stronger, lower joists are not entirely allocable to the lower floors.
12. Each apartment block will also include common spaces shared by all apartments such as the corridors and lift shafts. Some of these common parts may be substantial, such as lifts, underground car parks or landscaped gardens.
13. These costs are difficult to allocate to individual apartments. Should that allocation be done on the basis of relative selling price, cost, floor area or some other measure? For these reasons allocating costs to individual apartments will be difficult and the apartment block as a whole is generally the unit of account from a cost perspective.

### **Relationship of cost to sales price**

14. Before IFRIC 15 was issued, construction revenue was generally recognised in accordance with IAS 11 *Construction Contracts*. The contracts considered were

typically for a single constructed asset agreed with a single customer. The unit of account for both revenue and costs was typically the constructed asset as a whole.

15. In applying IAS 11 to these single-unit contracts, many use cost incurred to date, as a proportion of the total costs of construction, as a proxy for measuring progress. Revenue is recognised, in effect, in accordance with a cost-based formula.
16. This method works well if the value attributed to each component of the constructed asset is equally valued by reference to the cost of constructing it and – when the entire constructed asset has one customer and one price – that is true. The pricing of the constructed asset’s various floors is blended into one overall price for the total constructed asset.
17. The situation is different, however, when the constructed asset is a multi-unit apartment block. In agreeing a sales price for each separate apartment with each individual customer the bargaining process takes into account qualitative factors that are specific to each apartment. In agreeing a single price for an entire constructed asset these characteristics are blended -when agreeing the individual sales prices of individual apartments, these factors are individually assessed by each buyer.
18. Take as an example an apartment block consisting of 40 apartments with four apartments on each floor. Assume each of the apartments is identical in terms of floor space, quality of fittings and construction costs. In building a single apartment block, for a single customer, the developer does not need to account for each part of the building separately or price each section separately.
19. When the apartment block consists of multi-units sold to individual buyers, however, the developer will be able to charge a customer buying an apartment on the top, 10<sup>th</sup>, floor more than a customer buying a basement apartment would be willing to pay. The 10<sup>th</sup> floor apartment is considered to be airier and benefits from a view.
20. Similarly, a buyer who selects an apartment on the fifth floor will prefer an apartment that looks over the sea or faces south to one that looks over a train station or faces north and the buyer will pay more for the favoured apartment.

21. This disconnect between cost and sales price makes accounting for the multi-unit transaction more difficult practically because a simple cost-to-cost percentage of completion is not a reasonable basis on which to allocate the revenue attributable to each apartment.

**Unit of account - revenue**

22. When sold separately, the revenue for each apartment can be measured explicitly by using the transaction price stated in the sales agreement. Each sales agreement is a separate legal contract, entered into independently by each customer, and bargained for separately by each customer. There is no interdependence between agreeing a price for apartment 1 and agreeing a price for apartment 40. Consequently, the unit of account for the measurement of revenue must be each individual apartment.
23. The unit of account could only be the entire apartment block for revenue recognition if the sales prices of the individual apartments were interlinked and each apartment had similar pricing characteristics. In our view the pricing of individual apartments cannot be done on a portfolio basis as each price negotiation is subject to a number of qualitative factors, specific to each apartment.
24. In our view the unit of account for revenue recognition is the individual contract with the individual buyer and this unit of account is measured directly at the sales price agreed with each individual buyer.

**Effect on the recognition of gross margin**

25. One consequence of a continuous transfer model in which revenue is recognised at the individual sales price, independent of allocated cost, is that different apartments may be sold at different gross margins. If revenue is recognised at an amount derived from a cost-based formula, as described in paragraphs 15- 16, the margin recognised is smoothed over all apartments.
26. On the other hand if the sales price is based on a number of subjective factors independent of cost, as described in paragraphs 17- 21, margin will vary between

apartments. In these situations sales of some apartments, such as those on the top floor, may result in a higher gross margin percentage than sales of less favoured apartments, such as the basement apartments.

27. This variation in margin between apartments in the same apartment block is troubling to many, especially those used to employing cost-to-cost percentage of completion to recognise revenue. In our view, however, the variation between apartments in margin achieved is a fair depiction of the individual bargains agreed with each buyer.

### **Significance of the unit of account in determining continuous transfer**

28. As discussed, we believe the measurement of revenue attributed to each apartment can be done directly – at the observable transaction price. Costs will need to be allocated.
29. The question posed by the submitter is what the unit of account should be for *determining* continuous transfer. As discussed in paper 5A, it is the nature of the individual sales agreement, and the control, risks and rewards that it confers on the buyer, that is the basis of any assessment of continuous transfer.
30. We think the question arises because some have expressed the view that an entity cannot recognise revenue for higher apartments until late in the construction process. They contend that completing apartment 1 doesn't transfer anything to the buyer of apartment 121. Therefore, if the unit of account is each apartment, nothing can transfer continuously to any buyer until construction begins on that apartment.
31. In a sell-and-build model in jurisdiction A discussed in paper 5A, a significant number of buyers are obtained before work commences. There are those who contend that revenue *can* be recognised continuously, for all apartments from contract inception, by identifying the unit of account as the apartment block as a whole.
32. These discussions are affected by two views relating to construction of multi-unit apartment blocks:

- (a) How are apartment blocks constructed in practice?
- (b) What is the significance of the timing of cash payments by the buyer?

***How are apartment blocks constructed in practice?***

- 33. Consider the construction of a five story building with four apartments on each floor. Many take the view that the construction of apartment one does not transfer anything to the buyer of apartment twenty. In our view, that ignores how apartment blocks are constructed.
- 34. Suppose it takes five months to complete the 20-unit apartment block. The construction generally does not proceed:
  - (a) Month 1 – complete apartments 1-4
  - (b) Month 2- complete apartments 5-8
  - (c) Month 3- complete apartments 9-12
- 35. Construction is more likely to progress as follows:
  - (a) Month 1 – foundations complete
  - (b) Month 2- steel framing complete
  - (c) Month 3 – roof, walls and windows complete
  - (d) Month 4 – cabling, plumbing, external finish complete
  - (e) Month 5- internal finish complete
- 36. If the assessment made is that control transfers continuously to the buyer, accounting for the apartment block would take into account that all apartments are 100% complete for foundations at month one; and all are 100 % complete for framing, walls, windows at month three.
- 37. Revenue would only be recognised on sold units. The costs allocated to the sold units would be recognised as an expense in cost of sales. Costs allocated to unsold units would be recognised as the developer’s work in progress until sold.

***What is the significance to revenue recognition of the timing of cash payments by the buyer?***

38. Some contend that physical construction does progress apartment-by-apartment as described in paragraph 34.
39. If that is the case, revenue is recognised apartment-by-apartment if the assessment is made that control transfers continuously to the buyer. By this process apartments 1-4 are completed before apartments 5-8 are begun.
40. In paper 5A, the requirement for the buyer to pay in line with construction to date, throughout the construction process, is a factor in determining if continuous transfer takes place. If construction is deemed to take place apartment-by-apartment, many feel that revenue recognition should be constrained to only the payments relating to each apartment.
41. Those who hold this view have expressed concern that all buyers in the continuous transfer model pay at the same milestones throughout the apartment block process and that the buyers of apartment one will have only paid a small proportion of the total consideration due by the time apartment one is complete.
42. In our view, revenue isn't recognised as cash is received. IAS 18 states that revenue is recognised as control and the risks and rewards of ownership transfer to the buyer. The only constraint placed on revenue recognition is in IAS 18.14.d – it is probable that the economic benefits associated with the transaction will flow to the entity.
43. The contract structure, and the financing agreement, typical of jurisdiction A referred to in paper 5A, ensures that for those circumstances in which control is assessed to transfer continuously to the buyer, the buyer is required to pay. In the terms of IAS 18 it is, therefore, probable that the economic benefits will flow to the entity. Accounting for revenue on continuous transfer would not be constrained, therefore, by the amount of cash received to date.



**Can the unit of account for determining continuous transfer be the entire apartment block?**

- 44. As discussed in paper 5A the assessment of continuous transfer is made based on whether the rights of ownership and control of the good (ie work in progress) transfers to the buyer continuously as construction progresses. This assessment takes into account the rights of the individual buyer to register their interest in the work in progress or their ability to exercise their rights over the work in progress eg by borrowing money against the work in progress. In our view that assessment is made at the individual buyer level.
  
- 45. In the highly-regulated jurisdictions where continuous transfer is considered to occur, contract terms are typically specified by law and all buyers are likely to be in the same position regarding the transfer of control, whether continuous or at a point in time. If the assessment is that control transfers continuously to one, it will transfer continuously to all.
  
- 46. The buyers are all subject to the same contract terms and to the protection of the regulator. However, the individual buyers are not directly linked to each other in any way. They are not part of a defined consortium or joint venture nor do they collaborate.
  
- 47. Therefore, although any assessment for or against continuous transfer of control is likely to be identical for all buyers within an entire apartment block, the assessment itself will be done at the individual buyer level. Therefore, the unit of account for determining continuous transfer is the individual apartment, not the entire apartment block.

**Staff summary and conclusion**

**Summary**

- 48. In our view, the unit of account for determining continuous transfer to the buyer is the sales agreement with an individual buyer, for a specific apartment. As discussed in paper 5A, it is the nature of that individual sales agreement, and the control, risks and rewards that it confers on the buyer, that is the basis of any

assessment of continuous transfer. The revenue attributed to each unit is the sales price agreed with each individual buyer.

49. As discussed in paragraphs 45-47, we do not believe that the individual buyers are put into a collaborative relationship by the sales agreements common in jurisdiction A and discussed in paper 5a.
50. When only one customer is involved and an undivided block is being constructed, the costs associated with the sales contract are easily identified. When multiple units are constructed, accounting for costs become more complex and the costs of the entire apartment block need to be allocated to each individual unit. Some are concerned by this, but in our view it should be possible to do that cost allocation on a reasonable and systematic basis.
51. If revenue of each unit is measured directly, but costs are allocated, there is no direct link between costs and revenue. Consequently, the gross margin percentage recognised may differ between units. This concerns some commentators, but in our view this accurately depicts the nature of the individual sales contract agreed with each individual buyer.

### **Conclusion**

52. In our view the unit of account for determining when continuous transfer occurs is the element on which the assessment of transfer to the buyer is based – the individual sales agreement with each buyer. The unit of account in making that determination, therefore, is the individual apartment and not the entire apartment block.

**Question:**

Do the committee agree that the unit of account for determining if control transfers continuously to the buyer is the individual apartment/sales contract?