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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **September 2006, London**

Project: **Real Estate Sales (Agenda Paper 3)**

A Introduction

1 At its March meeting, the IFRIC decided to undertake a project on real estate sales. The objective of the project is to clarify when revenue from the sale of real estate should be recognised if an agreement for sale is reached before construction is complete.

2 This paper is the first detailed analysis of the issues that the IFRIC decided to address in the project. The aim of the meeting is to reach a consensus on each of the issues, or identify any further arguments that need to be considered before a consensus can be reached.

3 The project could result in an Interpretation and/or amendments to the real estate example in the appendix accompanying IAS 18 *Revenue*. The format and scope of the output will be reconsidered once the consensus starts to take shape.

B Nature of the transactions

4 Diversity in practice has been reported primarily in the context of multiple-unit residential real estate developments, such as apartment blocks. The developers commonly start marketing the development before construction is complete (sometimes before it has even started). Buyers enter agreements to acquire a specific unit upon completion of the construction. The contracts typically require the buyer to pay a deposit, which is refundable only if the developer fails to complete and deliver the unit. The balance of the purchase price may be payable only when the buyer gains possession, which often coincides with the point at which legal title is transferred to the buyer.

5 However, other fact patterns also arise. For example:

- developments need not be residential—they could also be industrial estates or office towers;
- the whole development could be sold to a single buyer (eg a property investment company or fund);
- buyers may be required to make progress payments as construction progresses;
- legal title may transfer at different times, depending on national laws and practices.

C Issues addressed in this paper

6 The issues addressed in this paper are:

a) *the applicable accounting standard:* IAS 11 *Construction Contracts* or IAS 18 *Revenue*. **(Section D)**

b) *the revenue recognition requirements when IAS 18 applies.* This considers:

i) the circumstances in which the general revenue recognition criteria for sales of goods may be met in real estate transactions, and the extent to which there is a need for published guidance **(Section E);**

ii) whether, and in what circumstances, the sale could be regarded as comprising two components. The two components could be: (1) a sale of goods (the partially-constructed real estate); and (2) rendering of further services (to complete the construction and any other significant acts that the entity is obliged to perform) **(Section F)**

c) whether the IFRIC should include guidance on allocating revenue and expenses to real estate units within a multi-unit development. The method would depend on whether the development is accounted for as a whole, or individual sales contracts are accounted for separately. **(Section G)**

D The applicable accounting standard

7 The first area of divergence is the identification of the applicable accounting standard—IAS 11 *Construction Contracts* or IAS 18 *Revenue*. As detailed further in the appendix to the paper[1], practice has polarised as some national standard setters and industry bodies have provided guidelines that interpret IFRSs differently.

8 One view is that the sale agreements should be accounted for as construction contracts in accordance with IAS 11. In support of this view, it has been argued that:

a) pre-completion sale agreements do not necessarily meet the definition of construction contracts in IAS 11. However, their economic substance is that of contracts for construction of property, rather than contracts for the sale of goods or contracts for services other than construction. The typical features of a construction contract—land development, engineering and architectural design, and construction—are all present.

b) because many development projects span more than one accounting period, the rationale for the stage of completion method required by IAS 11—that it "provides useful information on the extent of contract activity and performance during a period"[2]—applies to property developments as much as construction contracts. If revenue were recognised only when the IAS 18 criteria for recognising revenue from the sale of goods were met, the financial statements would not reflect the entity's economic value generation in the period, and would be susceptible to manipulation.

1 Appendix omitted from observer note.
2 IAS 11, paragraph 25.

c) US GAAP requires a stage of completion method for recognising profit from sales of units in condominium projects or time-sharing interests[3]. Thus US GAAP acknowledges that such real estate sales have the same economic substance as construction-type contracts. Requiring developers to apply the IAS 18 revenue recognition criteria instead would create a new difference between IFRSs and US GAAP.

9 An alternative view is that pre-completion sales agreements typically do not meet the IAS 11 definition of, and are distinguishable in substance from, construction contracts. They are instead contracts for the sale of goods (and perhaps additional services), for which IAS 18 is the applicable standard. In support of this view, it can be argued that:

a) IAS 11 defines a construction contract as "a contract specifically negotiated for the construction of an asset or a combination of assets…". A contract meets this definition only if it requires the contractor to perform a construction service to the buyer's specification. If the developer retains control over whether and how the construction progresses (as is the case with a typical pre-completion contract for residential units), the sale agreements do not meet the definition. A buyer's ability to specify variations to the basic design (eg to replace a garage with an extra room, or to choose kitchen fittings) does not alter the overall nature of the contract.

b) there are important differences of substance between real estate sales and construction contracts as defined in IAS 11. The terms of construction contracts tend to be such that there is a continuous sale (transfer of control and ownership rights) to the buyer as construction progresses:

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3 FAS 66 Accounting for Sales of Real Estate, paragraph 37. The stage of completion method is applied if construction is beyond a preliminary stage, the buyer cannot require a refund of his deposit, sufficient units have been sold to assure that the property will not revert to rental property and sales prices are collectible.

- the contractor typically has no ownership claim to the work in progress (beyond perhaps a right of lien). Rather, the contractor typically performs work on land controlled by the other party and provides services and materials that become attached to the land as they are provided.

- the buyer typically has a right to take over the work in progress during construction (albeit with a penalty).[4]

The rationale for applying the percentage of completion method to construction contracts is not just that it recognises the extent of the entity's activity in the period. Rather, it also recognises the continuous transfer of control and ownership rights to the buyer as construction progresses. This continuous transfer typically does not occur in agreements for the sale of real estate units—control and ownership rights tend to pass at a single point in time, usually when the unit is ready for occupation. This is a difference of substance, which justifies the different accounting treatment required by IAS 18.

c) the revenue recognition requirements of IAS 18 are different from those of US standard, FAS 66 *Accounting for Sales of Real Estate*. These differences can be resolved only by harmonising the standards. They cannot be circumvented by arguing that sales that actually fall within the scope of IAS 18 should instead be accounted for in accordance with IAS 11.

10 [Paragraph omitted from the observer notes.]

11 The staff notes that it may be necessary to consider further the meaning of "to the buyer's specification" in paragraph 9a). It could be interpreted narrowly to exclude contracts in which a buyer accepts a pre-existing design or allows a third

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4 As discussed in the AICPA Statement of Position 81-1 Accounting for Performance of Construction-Type and Certain Production-Type Contracts, paragraph 22.

party (eg future tenant) to specify the details of the design. It could be argued that the important factor is not whether the buyer specified the original design or will specify every detail of the completion of the construction. Rather it is whether the buyer obtains overall control of whether and how construction progresses.

Staff recommendations

12 The staff will recommend that the draft Interpretation should:

a) propose that an agreement for the sale of real estate is within the scope of IAS 11 only if it meets the IAS 11 definition of a construction contract. Otherwise it is an agreement for the sale of goods within the scope of IAS 18;

b) propose that an agreement for sale meets the definition of a construction contract if it is a contract to provide construction services to the buyer's specification;

c) include additional guidance developing the ideas sketched in paragraph 9a) and 11.

IFRIC members will be asked whether they agree with the staff recommendation and the reasons for the recommendation out in paragraph 9.

E Guidance on IAS 18 requirements for the sale of goods

13 This section considers how the IAS 18 criteria for recognising revenue from the sale of goods would apply to agreements for the sale of real estate. It also considers the extent to which there is a need for application guidance on this topic.

IAS 18 requirements

14 The criteria for recognising revenue from the sale of goods are set out in paragraph 14 of IAS 18:

> *14 Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:*
>
> *(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;*
>
> *(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;*
>
> *(c) the amount of revenue can be measured reliably;*
>
> *(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and*
>
> *(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.*

Observations that could be included in guidance

15 The table below lists a range of observations that may be relevant to the assessment of whether each of the five conditions has been met for sales of real estate. The observations come from a wide range of sources.

	IAS 18 Requirement	Observations
(a)	The entity has transferred to the buyer the significant risks and rewards of ownership of the goods.	• The timing of the transfer of risks and rewards depends on the terms of the sale agreement. • A binding pre-completion sale agreement may transfer some risks and rewards of ownership to the buyer. For example, an unconditional fixed price sale agreement transfers the risks and rewards of changes in market prices. • However, the developer may retain other risks until the sale is completed and the buyer obtains possession and/or legal title. (Such risks might include loss from damage, or rights of the buyer to cancel the contract, eg if the real estate is not delivered by the developer in accordance with the contractual terms.) • The developer may retain risks and rewards of ownership after the buyer obtains possession or legal title. This might be the case if, for example, the sale incorporates a repurchase agreement or the developer guarantees the rental income for a specified period.
(b)	The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.	• IAS 18 does not give any guidance on the meaning of effective control. • Control is not defined in the current *Framework*. However, control of an entity is defined in IAS 27 in terms of 'power to govern … so as to obtain benefits…' • The working definition of an asset being developed by the Board in its Conceptual Framework project defines control as the 'ability to direct, manage or have power over..'.[5] • Control over real estate could be defined as arising from the right to use (ie occupy or let), sell or otherwise exploit the real estate. • If real estate is still in the course of construction and is unavailable for use, control arises from the power to determine whether and how construction will be completed. • In which case, the developer is likely to retain effective control until the buyer obtains possession and/or legal title.

5 IASB meeting July 2006, Agenda Paper 3A 'Definition of an Asset', paragraph 24.

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	IAS 18 Requirement	Observations
(c)	The amount of revenue can be measured reliably.	The amount of revenue is typically fixed when the sale agreement is reached. This requirement will typically not impact the timing of revenue recognition.
(d)	It is probable that the economic benefits associated with the transaction will flow to the entity.	This criterion may be satisfied only if the entity has evidence of the buyer's ability and commitment to complete payment. The entity might need to consider: • the size of the initial deposit and subsequent stage payments already received from the buyer. • whether the buyer has received an offer of finance from a third-party lender or, if the entity is going to finance the sale itself, the results of credit checks. (Often the sellers do not undertake any form of credit check at the time of the sale agreement. Such checks are of limited value if completion will not occur for some time.) • whether there has been any downturn in economic conditions since the sale agreement, which might make the buyer unable or unwilling to settle the contract. The amount of revenue recognised would be restricted to the amount that it was probable that the entity would receive.
(e)	The costs incurred or to be incurred in respect of the transaction can be measured reliably	The costs of real estate development often change as a result of alterations in design or unforeseen complexities. The developer is typically exposed to these changes as the sales price is typically fixed when the sale agreement is reached. This criterion might therefore prevent revenue from being recognised at an early stage of development. However, for contracts of this type, the other revenue recognition criteria are unlikely to be met at that stage anyway.

16 It could be argued that the most important observations of those listed above are those regarding control. A typical pre-completion contract does not transfer effective control of the real estate to the buyer. The developer retains control over whether and how construction progresses and, until the sale is completed, the buyer has no rights to use (ie occupy or let) the real estate he has agreed to buy. A typical pre-completion contract is like any other customer order—the entity agrees to deliver goods at a future date and the customer agrees to pay for them on specified terms. Delivery occurs when the sale is completed and the buyer obtains possession of his unit of real estate.

17 IAS 18 places little emphasis on the requirement for the entity to have relinquished effective control over the goods sold. There is no further reference to control in IAS 18 itself or in the real estate example in the appendix accompanying IAS 18. Hence, it could be argued that, if the control criterion is an important factor in the determination of when to recognise revenue from sales of real estate, it should be mentioned in the Interpretation.

18 By the time the buyer has obtained possession it could be argued that, in many real estate sales, the other conditions for recognising revenue will also have been met. The most notable exceptions might be:

- sales in which the developer retains significant risks or rewards of ownership, eg via a repurchase agreement or guarantee of the rental yield for a specified period.
- sales that are financed by the developer rather than the buyer or a third-party lender. As the developer would not have received the full amount of the consideration, it would need to consider the buyer's ability and commitment to complete payment.

These two matters are already discussed in the second and third paragraphs of the real estate example in the Appendix to IAS 18.

Staff recommendations

19 The staff will suggest that the Interpretation (and/or revised guidance in the Appendix to IAS 18) could

a) note that, when IAS 18 is applied to sales of real estate, revenue should be recognised only when all of the conditions set out in paragraph 14 of IAS 18 have been met;

b) include guidance (perhaps by proposing to expand the guidance in the Appendix to IAS 18):

   i) highlighting the need for effective control to have passed to the buyer

   ii) noting that effective control often transfers to the buyer only when the sale is completed, with the buyer obtaining possession of his unit

   iii) identifying circumstances that might prevent full revenue recognition at that time. These could be the circumstances identified in paragraph 18 (which are already discussed in the Appendix to IAS 18).

IFRIC members will be asked whether they agree with the analysis of the requirements of IAS 18 (paragraphs 16 - 18) and recommendations (paragraph 19).

They will also be asked whether there any other matters that they think should be addressed in the guidance.

F Incomplete performance

20 In some circumstances, it might be argued that the conditions for recognising revenue from the sale of real estate are met before the developer has completed construction. For example the developer may still have to:

- complete construction of the unit purchased (eg undertake internal decoration or install fixtures); or
- construct communal amenities, such as swimming pools or garages.

21 The IFRIC has decided to address whether revenue should be recognised at that stage and, if so, how the remaining obligations would be accounted for. The question has arisen in the context of conflicting interpretations of the existing guidance in the Appendix to IAS 18. This guidance states that:

> Revenue is normally recognised when legal title passes to the buyer. However in some jurisdictions the equitable interest in a property may vest in the buyer before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In that case, <u>provided the seller has no further substantial acts to complete</u> under the contract, it may be appropriate to recognise revenue. In either case, <u>if the seller is obliged to perform any significant acts</u> after the transfer of the equitable interest and/or legal title, revenue is recognised as the acts are performed. An example is a building or other facility on which construction has not yet been completed.[6] (Emphasis added)

22 Constituents have argued that it is unclear whether, if there are further significant acts to be performed, any revenue can be recognised before they are performed.

Whether revenue can be recognised

23 The staff suggests that the criteria for recognising revenue from the sale of goods may be met even if some work remains outstanding. It can be argued that:

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6 IAS 18, Appendix, Example 9 Real estate sales

a) the need to finish minor tasks or construct communal facilities does not necessarily prevent the buyer from obtaining control and the significant risks and rewards of ownership of his own unit.

b) the developer's continuing presence on site does not necessarily constitute 'managerial involvement to the degree usually associated with ownership' or 'effective control over the goods sold'.

c) paragraph 19 of IAS 18 envisages circumstances in which revenue is recognised while there are contractual obligations remaining to be performed:

> Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; this process is commonly referred to as the matching of revenues and expenses. <u>Expenses, including warranties and other costs to be incurred after the shipment of the goods can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied.</u> However, revenue cannot be recognised when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of the goods is recognised as a liability. (Emphasis added.)

How the remaining obligations should be accounted for

24 The remaining performance obligations could be accounted for in two ways:

a) <u>applying paragraph 19 of IAS 18,</u> the expected costs of fulfilling the obligations could be provided for when the revenue from the sale of the real estate is recognised;

b) <u>applying paragraph 13 of IAS 18,</u> the outstanding work could be regarded as a 'separately identifiable component' of the sales contract. Some of the consideration received or receivable from the customer would be allocated to it. This revenue would be deferred and recognised when the developer carried out the activities.

25 It is necessary to decide which paragraph to apply. The IFRIC has already addressed the issue in its project on customer loyalty programmes. It concluded 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 contract 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 install goods or 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.[7]

26 Applying this conclusion, it could be argued that:

a) to the extent that the remaining work is required to complete the construction of the real estate already delivered into the possession of the buyer, the costs should be provided for in accordance with paragraph 19 of IAS 18. Such work may include, for example, laying flooring or remedying defects identified when the real estate was certified as fit for occupancy;

b) to the extent that the remaining work represents goods or services that are separately identifiable from the construction of the apartment or house already delivered, it would be treated as a separate component, with some revenue being deferred until the goods are delivered or services performed. Such items might include, for example, construction services to create communal amenities.

c) the appropriate treatment will depend on the terms of the contract and judgement will be required. For example, in some sale agreements,

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7 Extract from paragraph BC7(a) of Draft Interpretation D[x] *Customer Loyalty Programmes*

fitting the kitchen could be viewed as part of the basic construction. However, in others it might be a separately identifiable service.

Staff recommendations

27 The staff recommends that:

a) to clarify the revenue recognition requirements in circumstances where construction is not quite complete, the IFRIC should propose new guidance to replace the existing paragraph of guidance on this issue in the Appendix to IAS 18.

b) on the basis of the analysis of the issues above, the guidance should:

i) acknowledge that the conditions for recognising revenue (as discussed in Section E) may be met before construction is complete;

ii) provide brief guidance to clarify how the remaining performance obligations should be accounted for;

iii) distinguish between work required to complete the construction of the real estate already delivered (when paragraph 19 would apply) and obligations to deliver separately identifiable goods and services (when paragraph 13 of IAS 18 would apply).

iv) briefly refer to examples to illustrate the differences, but emphasise the categorisation will be a matter of judgement and depend on the terms of the contract.

Do you agree with the staff conclusions and recommendations?

G Allocation of costs and revenues

28 The final issue concerns revenue and cost allocation for multiple-unit real estate developments such as apartment blocks or housing estates.

29 Some units may be sold at lower prices than other similar units, for example if the entity operates a differential pricing strategy or is compelled to make some units available at readily affordable prices to meet social objectives. The question would be whether the profit recognised when each unit is sold should be determined by reference to the selling price and costs of that unit or the profitability of the development as a whole.

30 The IFRIC Agenda Committee proposed that the IFRIC consider including this issue in the project because it arises in real estate sales and guidance previously published (but no longer effective) lends support to a 'whole development' approach that is regarded by some as inconsistent with IFRSs.

31 This section outlines the issue using a simple example and considers whether the issue should be part of the project.

Facts of example

32 A real estate developer has constructed a residential development. To obtain planning permission for the development as a whole, the developer had to include 50 'affordable' apartments, which it was required to sell for $0.2 million each. The rest of the development comprises 90 houses that it expects to sell for $1 million each. Thus the total revenue is estimated to be (50 x $0.2 million) + (90 x $1 million) = $100 million.

33 Construction is nearing completion, at a total cost of $90 million. Thus the profit for the development as a whole is expected to be $10 million, ie an overall margin of 10%. Of the total cost of $90 million, $15 million was incurred to construct the affordable apartments and $75 million to construct the houses.

34 The developer has sold the affordable apartments. The issue concerns the measurement of the revenue and costs recognised in the income statement.

Alternative accounting treatments

View 1

35 The first view is that the development should be considered as a single project, with a 10% margin being recognised on each sale. This result could be achieved by allocating the total costs of the development to individual apartments and houses in proportion to their selling prices. When it sold the affordable homes, the developer would recognise revenue of $10 million and costs of $9 million.

36 In support of this view it could be argued that:

a) the development was undertaken as a single project, based on an assessment of its overall economic viability. The construction of affordable apartments was a condition of the permission to build the other houses. Their construction is so closely interrelated with the construction of the other houses that, to reflect the substance of the development, it needs to be considered as a single project with an overall profit margin.

b) the developer could have had other, non revenue-generating obligations imposed instead – eg to improve nearby roads or public services. These obligations would be treated as a cost of the development and allocated across the units in the development. Obligations to build affordable homes should be treated consistently.

View 2

37 The alternative view is that the apartments and houses should be accounted for individually. On selling the affordable apartments, the developer should recognise revenue of $10 million and the costs of $15 million incurred to build them, ie a loss of $5 million. In support of this view, it could be argued that:

a) although the economics of the development were assessed as a single project, the sales transactions themselves are not linked. The individual sales contracts, which are negotiated separately with unrelated parties, have not been negotiated as a single package. (There may not even be sale agreements in place for some of the units.) Hence, applying IAS 18, the revenue recognised from the sale of the unit should reflect the consideration received for that unit.

b) the costs recognised on the sale of each unit should be based on their inventory carrying value immediately before sale. This value should be measured in accordance with IAS 2 *Inventories*. Because each apartment or house will be sold separately, it should be accounted for as a separate item of inventory. IAS 2 requires each item of inventory to be measured at a cost that comprises the costs of purchase and costs of conversion. The costs of conversion include the costs directly related to each item plus an allocation of production overheads. Production overheads are allocated on the basis of use of production facilities. In other words, costs are allocated by reference to materials and production, not selling prices.

c) the substance of the transactions is not that they all generate the same margin. Rather it is that loss-making transactions have been undertaken to secure the right to profitable transactions. The financial statements should reflect this substance.

38 [Paragraphs 38-40 omitted from observer note.]

Staff recommendation

41 The staff will recommend that this issue is addressed in the project if the IFRIC members believe they could reach a timely consensus and that it needs to be addressed in the context of real estate sales.

IFRIC members will be asked for their views.