

IFRIC 15 *Agreements for the Construction of Real Estate*

Background

It is common practice for real estate developers to market their developments well before the start of any construction and this activity then continues throughout the construction period.

A typical 'off plan' arrangement will involve a buyer entering into a sales agreement with a developer to acquire a specific unit upon completion of construction. Often the buyer is required to pay a deposit, which is only refundable if the developer fails to deliver the unit as contracted.

Accounting for such arrangements is not consistent. Some real estate developers recognise revenue from these arrangements as construction progresses by reference to the stage of completion of the development, while others recognise revenue only when the completed unit is handed over to the buyer.

IFRIC 15 addresses this divergence in accounting treatment and clarifies when and how revenue and related expenses from the sale of a real estate unit should be recognised if an agreement between a developer and a buyer is reached before the construction of the real estate is completed. Furthermore, the interpretation provides guidance on how to determine whether an agreement is within the scope of IAS 11 or IAS 18.

This Interpretation supersedes the current guidance for real estate (Example 9) in the Appendix to IAS 18. It is applicable retrospectively for annual periods beginning on or after 1 January 2009.

Summary of proposals

Scope of the interpretation

The IFRIC has named the interpretation, '*Agreements for the Construction of Real Estate*', because the primary issue of whether an agreement is within the scope of IAS 11 or IAS 18 only arises from agreements that include construction activities. Although the interpretation is not intended to be applied outside the real estate industry, it may be applied by analogy to industries other than real estate in accordance with the IAS 8 hierarchy.

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

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 judgment with respect to each agreement. IAS 11 applies when the definition of a construction contract is met.

Let us assume an entity buys a plot of land with the intention of constructing an office block, the entity then markets the office block to potential buyers and signs an agreement for the sale and construction of the office block with one of the potential buyers. The buyer may

not put the land or the incomplete office block back to the entity. All the major structural decisions of the development are made by the entity - the buyer has little or no influence on the design.

This arrangement should be separated into two components:

- ▶ a component for the sale of land; and
- ▶ a component for the construction of the development.

The sale of land component is within the scope of IAS 18 and revenue is recognised when the criteria of paragraph 14 of IAS 18 are met. The construction component is less straight forward; the key question being whether the arrangement meets the definition of a construction contract in accordance with IAS 11. This depends on the terms of the agreement as well as all of the surrounding facts and circumstances, and requires judgment with respect to each agreement. The most important feature is whether the buyer is actually specifying the main elements of the structural design of the property. If this is not the case, then the definition of a construction contract is not met and the arrangement is accounted for under IAS 18.

The interpretation goes on to say that, when the arrangement is not a construction contract, but is an agreement for the rendering of services, then revenue can be recognised by reference to the stage of completion of the transaction using the percentage of completion method. This means the entity, in fulfilling this service does not acquire and supply the construction materials. This, in effect, means that again the requirements of IAS 11 are applicable to the recognition of revenue.

When an agreement involves providing services with the construction materials, this is considered a 'sale of goods'. In these cases, it is possible for a developer to recognise revenue by reference to the stage of completion if the risks and rewards of ownership are transferred to the buyer on a continuous basis. For example, if the agreement is terminated before construction is complete, the buyer retains the work in progress and the entity has the right to be paid for the work

performed, this might indicate that control is transferred along with ownership. Again, this would mean that the stage-of-completion principles in IAS 11 would apply.

Unfortunately, the Interpretation does not explain in detail how the continuous transfer concept works in practice. An entity will need to demonstrate that it will not retain either continuing managerial involvement to the degree usually associated with ownership, or effective control over the constructed real estate. This is highly subjective. For example, if an entity guarantees a return on the buyer's investment for a specified period, this may be a typical example where managerial involvement remains with the entity. In this case, recognition of revenue may be delayed.

Finally, when an entity transfers control and the significant risks and rewards of ownership of the real estate in its entirety only upon completion of the construction, then revenue will only be recognised when all the criteria of paragraph 14 of IAS 18 are met.

Disclosures

The IFRIC sets out that, if an entity applies the percentage of completion method because it met the 'continuous transfer' test, then the disclosure requirements of paragraphs 39 and 40 of IAS 11 apply. In this case, an entity shall disclose:

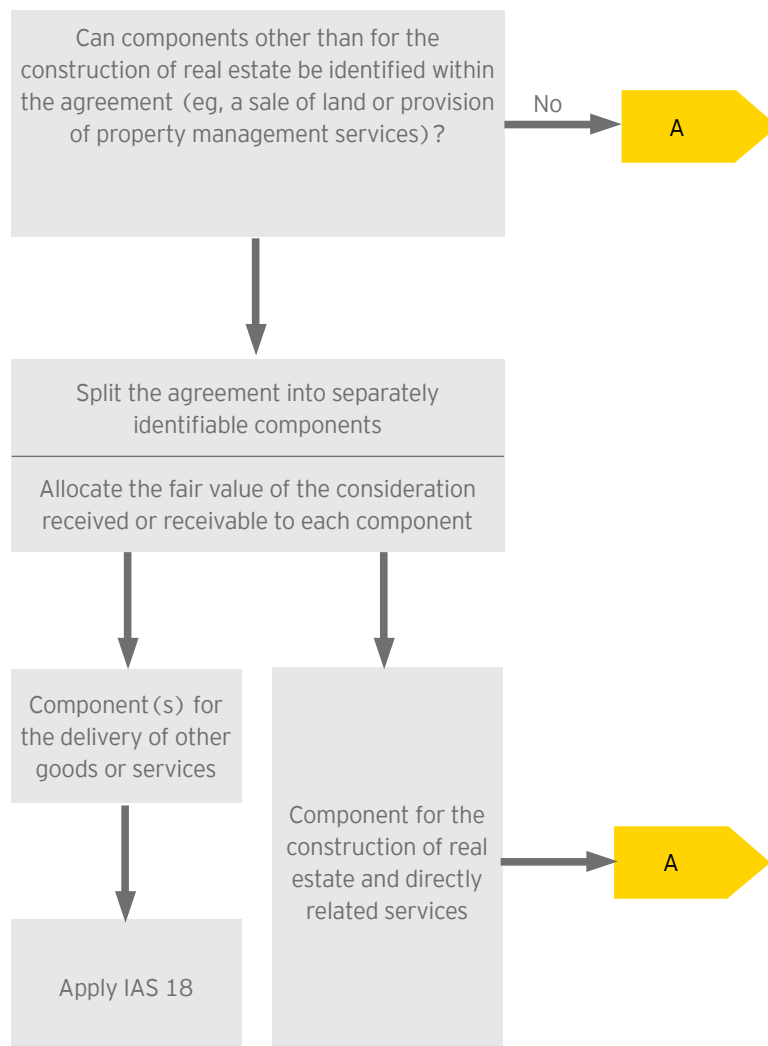
- ▶ How it has determined which agreements meet all the criteria in paragraph 14 of IAS 18 continuously as construction progresses;
- ▶ The amount of revenue arising from such agreements in the period; and
- ▶ The methods used to determine the stage of completion of agreements in progress.

Impact

Many real estate developers will have to revisit revenue recognition for their developments.

Although the IFRIC clarifies when the percentage of completion method can be used, it is unlikely in many jurisdictions that many arrangements will meet the necessary criteria. Therefore, such arrangements will result in deferring recognition of revenue (and therefore profit) until construction is complete.

Diagram: Analysis of a single agreement for the construction of real estate *



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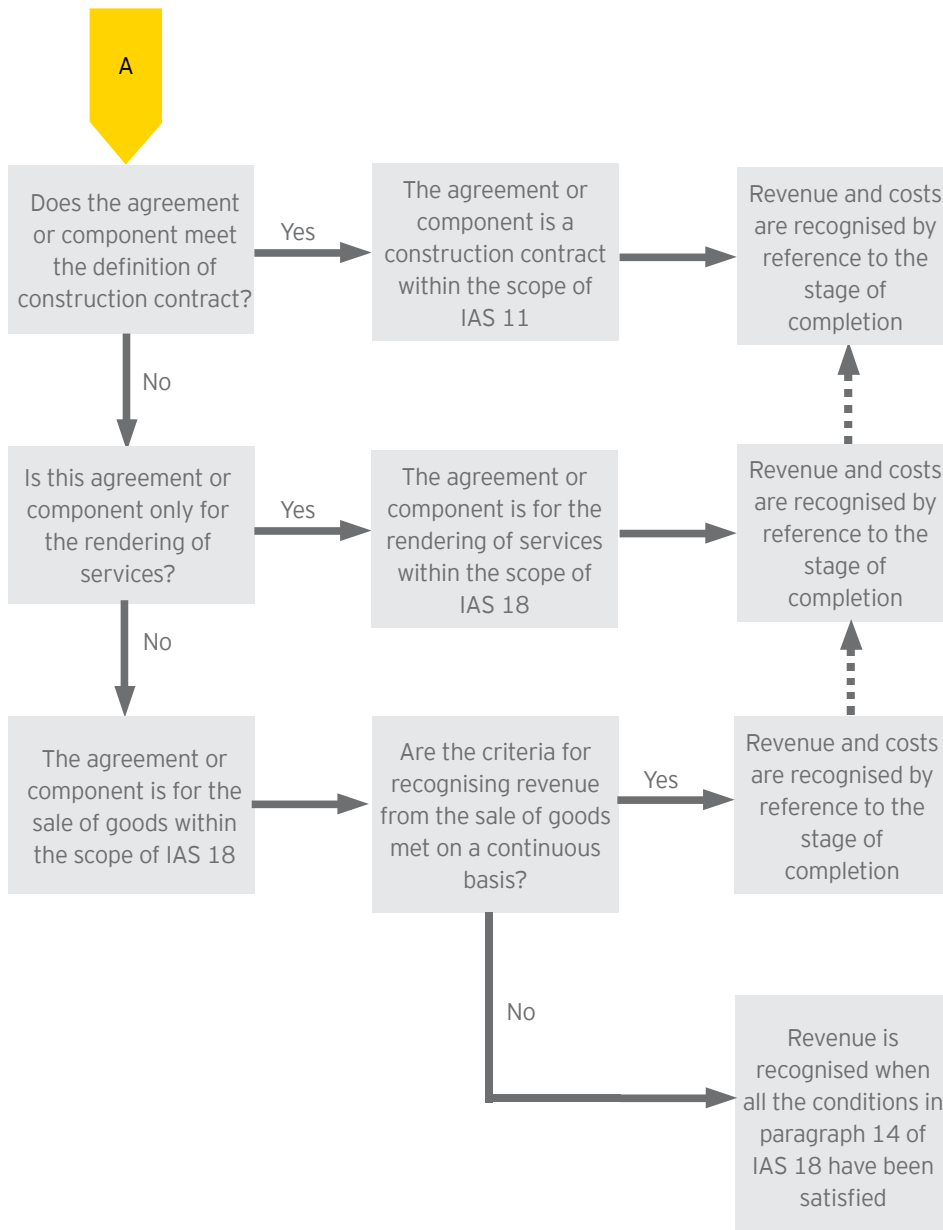
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* Source: IASCF: IFRIC Interpretation 15, Agreements for the Construction of Real Estate