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Deloitte global IFRS leadership team

IFRS global office

Global IFRS leader
Ken Wild
kwild@deloitte.co.uk

IFRS centres of excellence

Americas
Robert Uhl
iasplusamericas@deloitte.com

Asia-Pacific

Hong Kong
Stephen Taylor
iasplus@deloitte.com.hk

Melbourne
Bruce Porter
iasplus@deloitte.com.au

Europe-Africa

Johannesburg
Graeme Berry
iasplus@deloitte.co.za

Copenhagen
Jan Peter Larsen
dk_iasplus@deloitte.dk

London
Veronica Poole
iasplus@deloitte.co.uk

Paris
Laurence Rivat
iasplus@deloitte.fr

Accounting for agreements for the construction of real estate

On 3 July 2008, the International Financial Reporting Interpretations Committee (IFRIC) issued IFRIC 15 **Agreements for the Construction of Real Estate**. The Interpretation addresses the accounting for revenue and associated expenses by entities that undertake the construction of real estate directly or through subcontractors. Agreements within the scope of IFRIC 15 are described as 'agreements for the construction of real estate', and may include the delivery of other goods or services. IFRIC 15 addresses two (related) issues:

- determining whether an agreement for the construction of real estate is within the scope of IAS 11 **Construction Contracts** or IAS 18 **Revenue**; and
- when revenue from the construction of real estate should be recognised.

The Interpretation provides some limited additional guidance on the distinction between 'construction contracts' (falling within the scope of IAS 11) and other agreements for the construction of real estate (falling within the scope of IAS 18). Agreements involving the construction of real estate will need to be examined carefully to determine whether they should be accounted for in accordance with IAS 11 or IAS 18. Entities most affected are likely to be those that undertake construction of multiple-unit developments.

For some agreements falling within the scope of IAS 18 and involving the supply of goods, the Interpretation has introduced a new concept, i.e. that IAS 18's revenue recognition criteria may be met 'continuously as construction progresses'. In such circumstances, revenue is recognised by reference to the stage of completion of construction, using the percentage of completion method.

IFRIC 15 is effective for annual periods beginning on or after 1 January 2009.

Background

Agreements for the construction of real estate take diverse forms, in part because the underlying substance of such agreements varies. While some agreements are for the provision of construction services, others are in substance for the delivery of goods (e.g. housing units) that merely happen not yet to be complete at the time of entering into the agreement. Thus, the underlying issue is that, whereas the percentage of completion method is appropriate for some agreements for the construction of real estate, for others revenue should be recognised only at the point that the constructed real estate is delivered to the customer. The Interpretation provides guidance as to how to determine which approach is appropriate in which circumstances.

The detailed guidance in IFRIC 15 (summarised below) is based on the assumption that the entity has previously analysed the agreement for the construction of real estate and any related agreements and concluded that any other criteria for revenue recognition are met. In particular, the entity must not retain continuing managerial involvement to the degree usually associated with ownership, and it must not retain effective control over the constructed real estate to an extent that would preclude recognition of some or all of the consideration as revenue. If recognition of some of the consideration as revenue is precluded, the detailed guidance in IFRIC 15 applies only to the part of the agreement for which revenue will be recognised. [IFRIC 15.7]

In some circumstances, agreements may need to be split into separately identifiable components, with each such component being accounted for separately. Where this is necessary for an agreement that includes the construction of real estate, the fair value of the total consideration received or receivable for the agreement is allocated to each component. The seller then applies the requirements of IFRIC 15 to any components for the construction of real estate in order to determine whether each component is within the scope of IAS 11 or IAS 18. [IFRIC 15.8]

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

Determining whether an agreement for the construction of real estate falls within the scope of IAS 11 or IAS 18 depends on the terms of the agreement and all the surrounding facts and circumstances, and judgement will be required with respect to each agreement. When IAS 11 applies, the construction contract also includes any contracts or components for the rendering of services that are directly related to the construction of the real estate. [IAS 11.5(a) & IAS 18.4]

If the contract under consideration meets the definition of a 'construction contract' in IAS 11, then the accounting for the contract is determined in accordance with that Standard. A construction contract is defined as 'a contract specifically negotiated for the construction of an asset or a combination of assets …'. [IAS 11.3] An agreement for the construction of real estate meets the definition of a construction contract when the buyer is able to specify:

[IFRIC 15.11]

- the major structural elements of the design of the real estate before construction begins; and/or
- major structural changes once construction is in progress (whether it exercises that ability or not).

In contrast, if construction could take place independently of the agreement and 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), the agreement will be for the sale of goods or the rendering of services and within the scope of IAS 18. [IFRIC 15.12] The applicable requirements of IAS 18 will be determined by whether the agreement is an agreement for the rendering of services or an agreement for the supply of goods (see below).

Accounting for revenue from construction of real estate

Construction contracts (within the scope of IAS 11)

Where the agreement is a construction contract under IAS 11, and the outcome of the contract can be estimated reliably, revenue is recognised by reference to the stage of completion of the contract activity in accordance with IAS 11. IFRIC 15 has not introduced any new requirements or guidance that will affect such contracts.

Agreements for the rendering of services (IAS 18)

Where the agreement falls within the scope of IAS 18, and the entity is not required to acquire and supply construction materials, it may be only an agreement for the rendering of services. This may arise, for example, in arrangements where the customer acts in essence as its own general contractor and enters into agreements with individual suppliers for specific goods and services. Where the entity is responsible only for assembling materials supplied by others (i.e. it has no inventory risk for the construction materials), the agreement is an agreement for the rendering of services. [IFRIC 15.BC22]

In such circumstances, if the criteria in IAS 18.20 are met, revenue is recognised by reference to the stage of completion of the transaction using the percentage of completion method. The requirements of IAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction. [IFRIC 15.15 & IAS 18.21]

Agreements for the sale of goods (IAS 18)

An agreement for the construction of real estate will be an agreement for the sale of goods under IAS 18 if it involves the provision of services together with construction materials. For such contracts, the applicable recognition criteria are those set out in IAS 18.14.

The Interpretation focuses on the criteria that revenue can only be recognised when the entity has transferred to the buyer control and the significant risks and rewards of ownership of the goods, and distinguishes between circumstances in which these criteria are met 'at a single point in time' and 'continuously as construction progresses'.

If transfer of control and the significant risks and rewards of ownership of the real estate in its entirety occurs at a single point of time (e.g. at completion, upon or after delivery), revenue is recognised only when all the criteria in IAS 18.14 are satisfied. Assuming that all of the other criteria in IAS 18.14 are met, this will be upon the occurrence of that single critical transfer of control and the significant risks and rewards of ownership. [IFRIC 15.18]

The Interpretation also envisages that the entity may transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. In this case, if all of the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, revenue is recognised by reference to the stage of completion using the percentage of completion method. The requirements of IAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction. [IFRIC 15.17]

The idea that the criteria in IAS 18.14 can be met continuously as construction progresses is relatively new. In the Basis for Conclusions accompanying IFRIC 15, the IFRIC notes that agreements with 'continuous transfer' may not be encountered frequently. [IFRIC 15.BC26] Where an entity adopts such accounting, specific disclosures are required (see below), including how it determines which agreements meet all the criteria in IAS 18.14 continuously as construction progresses.

The Interpretation itself does not give further guidance on how to assess whether 'continuous transfer' is present, but some further commentary is included at IE3, IE8 and IE11 in the illustrative examples accompanying IFRIC 15. One of the important indicators of 'continuous transfer' appears to be that, 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 to date.

Disclosures

When an entity recognises revenue using the percentage of completion method for agreements that meet all the criteria in IAS 18.14 continuously as construction progresses (see above), the following disclosures are required:

[IFRIC 15.20]

- how the entity determines which agreements meet all the criteria in IAS 18.14 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.

For any such agreements that are in progress at the reporting date, the following disclosures are also required:

[IFRIC 15.21]

- the aggregate amount of costs incurred and recognised profits (less recognised losses) to date; and
- the amount of advances received.

Consequential amendments to the appendix in IAS 18

IFRIC 15 superseded the real estate guidance (Example 9) in IAS 18.

Additional guidance

IFRIC 15 is accompanied by an information note which, although not part of the Interpretation, summarises its requirements in the form of two flowcharts, which are reproduced in the Appendix to this newsletter for readers' convenience.

In addition, three illustrative examples designed to assist in the application of the Interpretation accompany IFRIC 15.

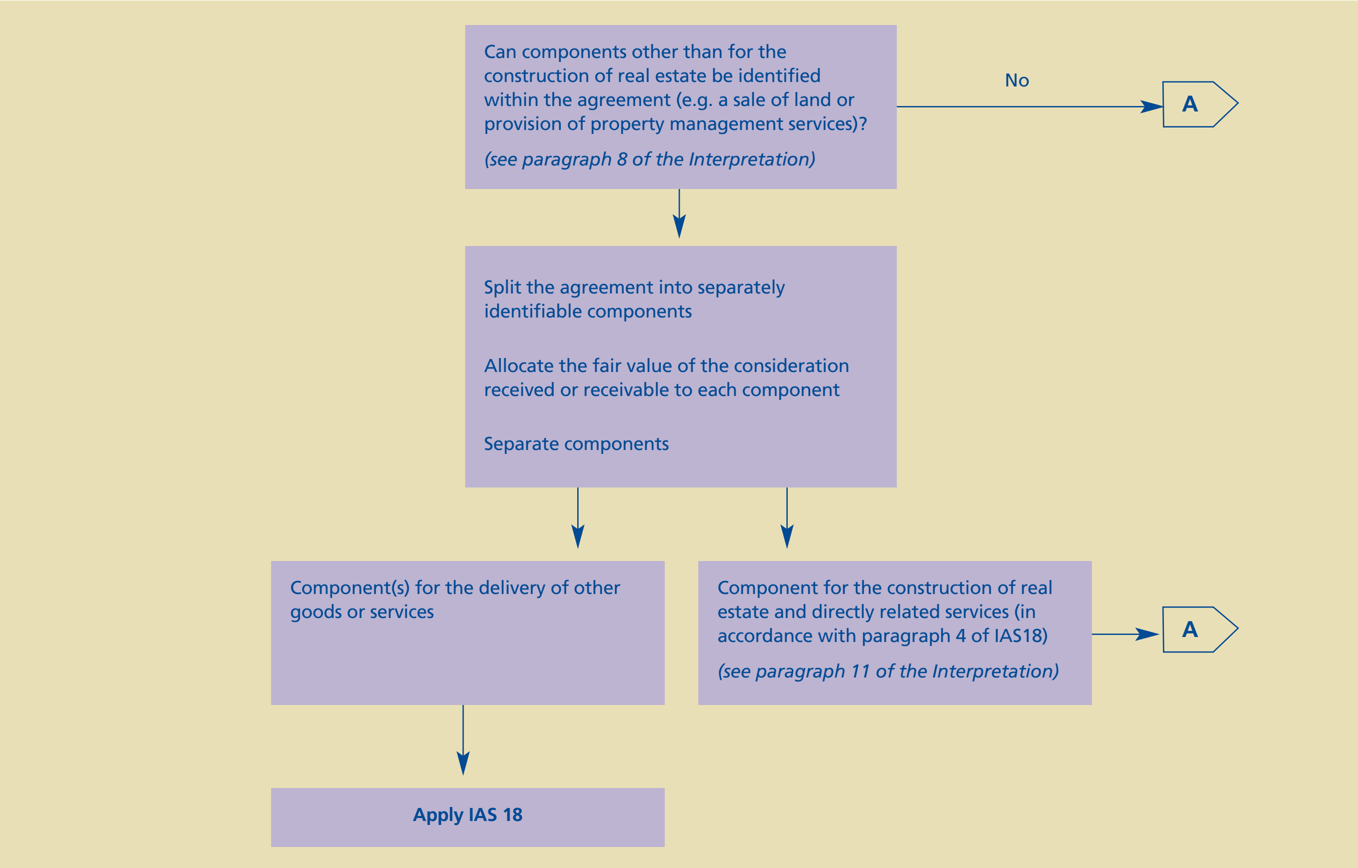
Effective date and transition

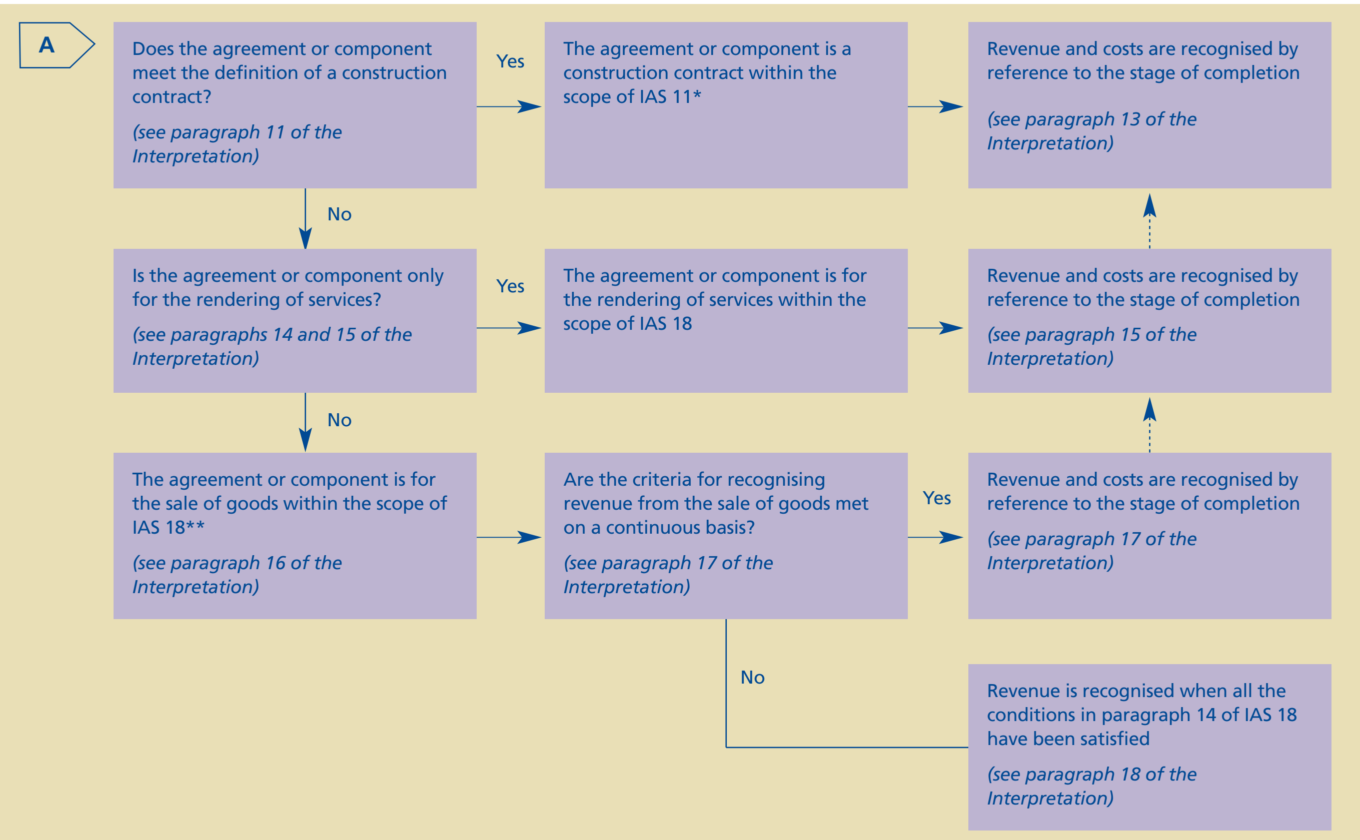
IFRIC 15 is effective for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the Interpretation for a period beginning before 1 January 2009, that fact should be disclosed.

Changes in accounting policy resulting from the adoption of the Interpretation are required to be accounted for retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Therefore, entities will be required to re-examine and, where applicable, retrospectively restate the revenue recognition for agreements that are in progress as at the opening date of the earliest period presented for comparative purposes.

Appendix

Analysis of a single agreement for the construction of real estate





* The construction contract may need to be segmented in accordance with paragraph 8 of IAS 11
** Directly related services may need to be separated in accordance with paragraph 13 of IAS 18

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