

**Agreements for the Construction of Real Estate**

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*paragraphs*

**INT FRS 115**

***AGREEMENTS FOR THE CONSTRUCTION OF REAL ESTATE***

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Interpretation of Financial Reporting Standard (INT FRS) 115 *Agreements for the Construction of Real Estate* is set out in paragraphs 1–25. INT FRS 115 is accompanied by an information note and illustrative examples. The scope and authority of Interpretations are set out in the *Preface to Financial Reporting Standards*.

# INTERPRETATION OF FINANCIAL REPORTING STANDARD INT FRS 115

## ***Agreements for the Construction of Real Estate***

### **References**

- FRS 1 *Presentation of Financial Statements*
- FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- FRS 11 *Construction Contracts*
- FRS 18 *Revenue*
- FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- INT FRS 112 *Service Concession Arrangements*
- INT FRS 113 *Customer Loyalty Programmes*

### **Background**

- 1 In the real estate industry, entities that undertake the construction of real estate, directly or through subcontractors, may enter into agreements with one or more buyers before construction is complete. Such agreements take diverse forms.
- 2 For example, entities that undertake the construction of residential real estate may start to market individual units (apartments or houses) 'off plan', ie while construction is still in progress, or even before it has begun. Each buyer enters into an agreement with the entity to acquire a specified unit when it is ready for occupation. Typically, the buyer pays a deposit to the entity that is refundable only if the entity fails to deliver the completed unit in accordance with the contracted terms. The balance of the purchase price is generally paid to the entity only on contractual completion, when the buyer obtains possession of the unit.
- 3 Entities that undertake the construction of commercial or industrial real estate may enter into an agreement with a single buyer. The buyer may be required to make progress payments between the time of the initial agreement and contractual completion. Construction may take place on land the buyer owns or leases before construction begins.

### **Scope**

- 4 This Interpretation applies to the accounting for revenue and associated expenses by entities that undertake the construction of real estate directly or through subcontractors.
- 5 Agreements in the scope of this Interpretation are agreements for the construction of real estate. In addition to the construction of real estate, such agreements may include the delivery of other goods or services.

### **Issues**

- 6 The Interpretation addresses two issues:

- (a) Is the agreement within the scope of FRS 11 or FRS 18?
- (b) When should revenue from the construction of real estate be recognised?

## Consensus

- 7 The following discussion assumes that the entity has previously analysed the agreement for the construction of real estate and any related agreements and concluded that it will retain neither continuing managerial involvement to the degree usually associated with ownership nor 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 following discussion applies only to the part of the agreement for which revenue will be recognised.
- 8 Within a single agreement, an entity may contract to deliver goods or services in addition to the construction of real estate (eg a sale of land or provision of property management services). In accordance with paragraph 13 of FRS 18, such an agreement may need to be split into separately identifiable components including one for the construction of real estate. The fair value of the total consideration received or receivable for the agreement shall be allocated to each component. If separate components are identified, the entity applies paragraphs 10–12 of this Interpretation to the component for the construction of real estate in order to determine whether that component is within the scope of FRS 11 or FRS 18. The segmenting criteria of FRS 11 then apply to any component of the agreement that is determined to be a construction contract.
- 9 The following discussion refers to an agreement for the construction of real estate but it also applies to a component for the construction of real estate identified within an agreement that includes other components.

### **Determining whether the agreement is within the scope of FRS 11 or FRS 18**

- 10 Determining whether an agreement for the construction of real estate is within the scope of FRS 11 or FRS 18 depends on the terms of the agreement and all the surrounding facts and circumstances. Such a determination requires judgement with respect to each agreement.
- 11 FRS 11 applies when the agreement meets the definition of a construction contract set out in paragraph 3 of FRS 11: ‘a contract specifically negotiated for the construction of an asset or a combination of assets ...’ An agreement for the construction of real estate meets the definition of a construction contract when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not it exercises that ability). When FRS 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 in accordance with paragraph 5(a) of FRS 11 and paragraph 4 of FRS 18.
- 12 In contrast, an agreement for the construction of real estate in which buyers have only limited ability to influence the design of the real estate, eg 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 FRS 18.

### **Accounting for revenue from the construction of real estate**

#### *The agreement is a construction contract*

- 13 When the agreement is within the scope of FRS 11 and its outcome can be estimated reliably, the entity shall recognise revenue by reference to the stage of completion of the contract activity in accordance with FRS 11.

- 14 The agreement may not meet the definition of a construction contract and therefore be within the scope of FRS 18. In this case, the entity shall determine whether the agreement is for the rendering of services or for the sale of goods.

*The agreement is an agreement for the rendering of services*

- 15 If the entity is not required to acquire and supply construction materials, the agreement may be only an agreement for the rendering of services in accordance with FRS 18. In this case, if the criteria in paragraph 20 of FRS 18 are met, FRS 18 requires revenue to be recognised by reference to the stage of completion of the transaction using the percentage of completion method. The requirements of FRS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction (FRS 18 paragraph 21).

*The agreement is an agreement for the sale of goods*

- 16 If the entity is required to provide services together with construction materials in order to perform its contractual obligation to deliver the real estate to the buyer, the agreement is an agreement for the sale of goods and the criteria for recognition of revenue set out in paragraph 14 of FRS 18 apply.

- 17 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 the criteria in paragraph 14 of FRS 18 are met continuously as construction progresses, the entity shall recognise revenue by reference to the stage of completion using the percentage of completion method. The requirements of FRS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction.

- 18 The entity may transfer to the buyer control and the significant risks and rewards of ownership of the real estate in its entirety at a single time (eg at completion, upon or after delivery). In this case, the entity shall recognise revenue only when all the criteria in paragraph 14 of FRS 18 are satisfied.

- 19 When the entity is required to perform further work on real estate already delivered to the buyer, it shall recognise a liability and an expense in accordance with paragraph 19 of FRS 18. The liability shall be measured in accordance with FRS 37. When the entity is required to deliver further goods or services that are separately identifiable from the real estate already delivered to the buyer, it would have identified the remaining goods or services as a separate component of the sale, in accordance with paragraph 8 of this Interpretation.

## **Disclosures**

- 20 When an entity recognises revenue using the percentage of completion method for agreements that meet all the criteria in paragraph 14 of FRS 18 continuously as construction progresses (see paragraph 17 of the Interpretation), it shall disclose:

- (a) how it determines which agreements meet all the criteria in paragraph 14 of FRS 18 continuously as construction progresses;
- (b) the amount of revenue arising from such agreements in the period; and
- (c) the methods used to determine the stage of completion of agreements in progress.

- 21 For the agreements described in paragraph 20 that are in progress at the reporting date, the entity shall also disclose:

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

- (b) the amount of advances received.

## **Amendments to the appendix to FRS 18**

- 22 This Interpretation supersedes the real estate guidance (Example 9) in the appendix to FRS 18.

- 23 The appendix to FRS 18 is amended as described below.

All of the text under the heading '9 *Real estate sales.*' is deleted.

New text is inserted under the heading as follows:

'This example has been superseded by INT FRS 115 *Agreements for the Construction of Real Estate.*'

## **Effective date and transition**

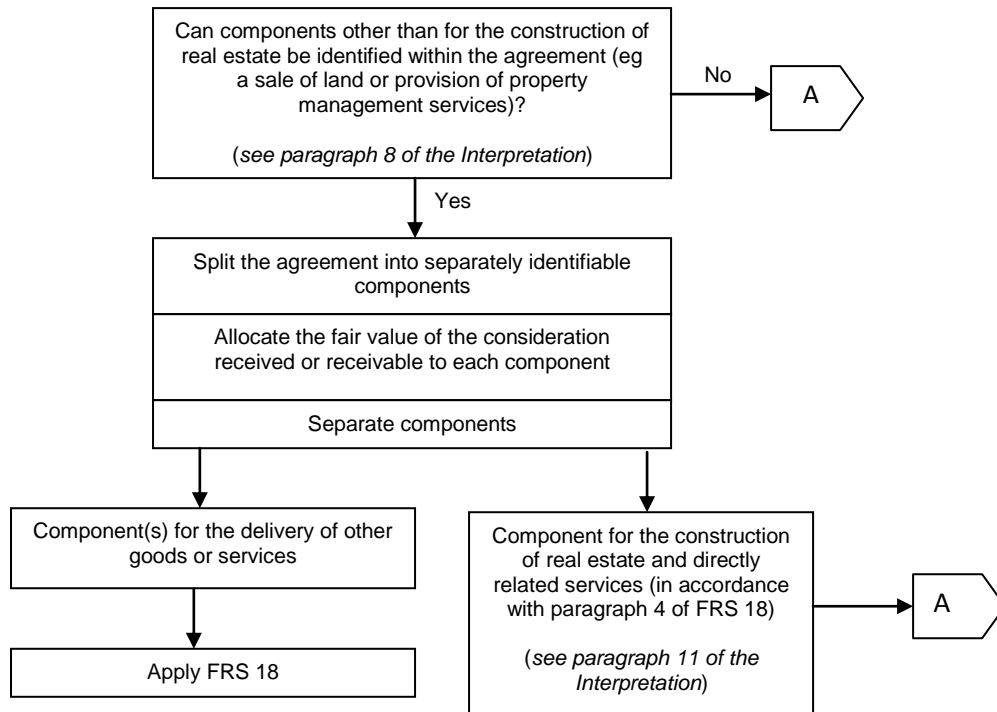
- 24 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the Interpretation for a period beginning before 1 January 2011, it shall disclose that fact.

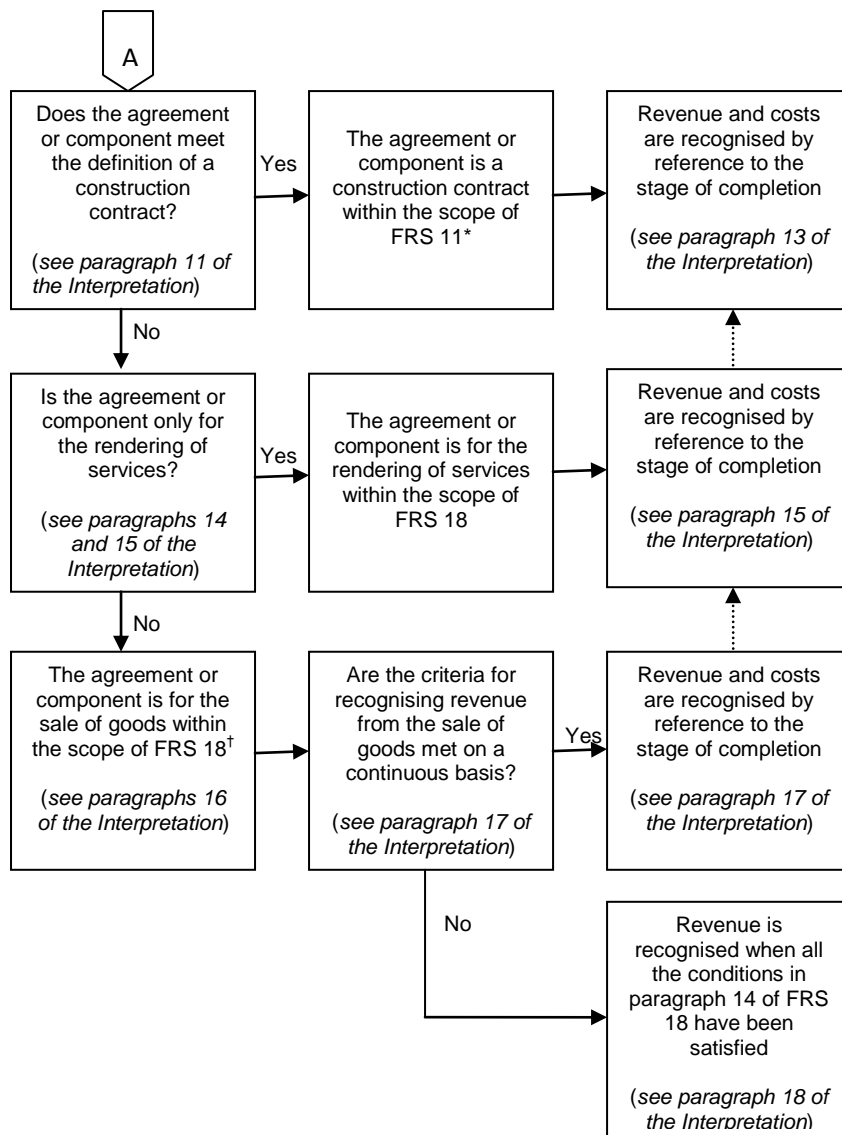
- 25 Changes in accounting policy shall be accounted for retrospectively in accordance with FRS 8.

## Information note

### Analysis of a single agreement for the construction of real estate

*This note accompanies, but is not part of, INT FRS 115.*





\* The construction contract may need to be segmented in accordance with paragraph 8 of FRS 11

† Directly related services may need to be separated in accordance with paragraph 13 of FRS 18

## Illustrative examples

*These examples accompany, but are not part of, INT FRS 115.*

### Example 1

- IE1 An entity buys a plot of land for the construction of commercial real estate. It designs an office block to build on the land and submits the designs to planning authorities in order to obtain building permission. The entity markets the office block to potential tenants and signs conditional lease agreements. The entity markets the office block to potential buyers and signs with one of them a conditional agreement for the sale of land and the construction of the office block. The buyer cannot put the land or the incomplete office block back to the entity. The entity receives the building permission and all agreements become unconditional. The entity is given access to the land in order to undertake the construction and then constructs the office block.
- IE2 In this illustrative example, the agreement should be separated into two components: a component for the sale of land and a component for the construction of the office block. The component for the sale of land is a sale of goods within the scope of FRS 18.
- IE3 Because all the major structural decisions were made by the entity and were included in the designs submitted to the planning authorities before the buyer signed the conditional agreement, it is assumed that there will be no major change in the designs after the construction has begun. Consequently, the component for the construction of the office block is not a construction contract and is within the scope of FRS 18. The facts, including that the construction takes place on land the buyer owns before construction begins and that the buyer cannot put the incomplete office block back to the entity, indicate that the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. Therefore, if all the criteria in paragraph 14 of FRS 18 are met continuously as construction progresses, the entity recognises revenue from the construction of the office block by reference to the stage of completion using the percentage of completion method.
- IE4 Alternatively, assume that the construction of the office block started before the entity signed the agreement with the buyer. In that event, the agreement should be separated into three components: a component for the sale of land, a component for the partially constructed office block and a component for the construction of the office block. The entity should apply the recognition criteria separately to each component. Assuming that the other facts remain unchanged, the entity recognises revenue from the component for the construction of the office block by reference to the stage of completion using the percentage of completion method as explained in paragraph IE3.
- IE5 In this example, the sale of land is determined to be a separately identifiable component from the component for the construction of real estate. However, depending on facts and circumstances, the entity may conclude that such a component is not separately identifiable. For example, in some jurisdictions, a condominium is legally defined as the absolute ownership of a unit based on a legal description of the airspace the unit actually occupies, plus an undivided interest in the ownership of the common elements (that includes the land and actual building itself, all the driveways, parking, lifts, outside hallways, recreation and landscaped areas) that are owned jointly with the other condominium unit owners. In this case, the undivided interest in the ownership of the common elements does not give the buyer control and the significant risks and rewards of the land itself. Indeed, the right to the unit itself and the interest in the common elements are not separable.

### Example 2

- IE6 An entity is developing residential real estate and starts marketing individual units

(apartments) while construction is still in progress. Buyers enter into a binding sale agreement that gives them the right to acquire a specified unit when it is ready for occupation. They pay a deposit that is refundable only if the entity fails to deliver the completed unit in accordance with the contracted terms. Buyers are also required to make progress payments between the time of the initial agreement and contractual completion. The balance of the purchase price is paid only on contractual completion, when buyers obtain possession of their unit. Buyers are able to specify only minor variations to the basic design but they cannot specify or alter major structural elements of the design of their unit. In the jurisdiction, no rights to the underlying real estate asset transfer to the buyer other than through the agreement. Consequently, the construction takes place regardless of whether sale agreements exist.

- IE7 In this illustrative example, the terms of the agreement and all the surrounding facts and circumstances indicate that the agreement is not a construction contract. The agreement is a forward contract that gives the buyer an asset in the form of a right to acquire, use and sell the completed real estate at a later date and an obligation to pay the purchase price in accordance with its terms. Although the buyer might be able to transfer its interest in the forward contract to another party, the entity retains control and the significant risks and rewards of ownership of the work in progress in its current state until the completed real estate is transferred. Therefore, revenue should be recognised only when all the criteria in paragraph 14 of FRS 18 are met (at completion in this example).
- IE8 Alternatively, assume that, in the jurisdiction, the law requires the entity to transfer immediately to the buyer ownership of the real estate in its current state of completion and that any additional construction becomes the property of the buyer as construction progresses. The entity would need to consider all the terms of the agreement to determine whether this change in the timing of the transfer of ownership means that the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. For example, the fact 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, might indicate that control is transferred along with ownership. If it does, and if all the criteria in paragraph 14 of FRS 18 are met continuously as construction progresses, the entity recognises revenue by reference to the stage of completion using the percentage of completion method taking into account the stage of completion of the whole building and the agreements signed with individual buyers.

### Example 3

- IE9 Determining whether the entity will retain neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the constructed real estate to an extent that would preclude recognition of some or all of the consideration as revenue depends on the terms of the agreement and all the surrounding facts and circumstances. Such a determination requires judgement. The Interpretation assumes the entity has reached the conclusion that it is appropriate to recognise revenue from the agreement and discusses how to determine the appropriate pattern of revenue recognition.
- IE10 Agreements for the construction of real estate may include such a degree of continuing managerial involvement by the entity undertaking the construction that control and the significant risks and rewards of ownership are not transferred even when construction is complete and the buyer obtains possession. Examples are agreements in which the entity guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such circumstances, recognition of revenue may be delayed or precluded altogether.
- IE11 Agreements for the construction of real estate may give the buyer a right to take over the work in progress (albeit with a penalty) during construction, eg to engage a different entity to complete the construction. This fact, along with others, may indicate that the entity transfers to the buyer control of the work in progress in its current state as construction progresses. The entity that undertakes the construction of real estate will have access to the land and the

work in progress in order to perform its contractual obligation to deliver to the buyer completed real estate. If control of the work in process is transferred continuously, that access does not necessarily imply that the entity undertaking the construction retains continuing managerial involvement with the real estate to the degree usually associated with ownership to an extent that would preclude recognition of some or all of the consideration as revenue. The entity may have control over the activities related to the performance of its contractual obligation but not over the real estate itself.