

[DRAFT] INTERPRETATION D21

Real Estate Sales

Comments to be received by 5 September 2007

INVITATION TO COMMENT

The Council on Corporate Disclosure and Governance (CCDG) invites comments on any aspect of this draft interpretation *Real Estate Sales*. Comments are most helpful if they indicate the specific paragraph to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing, so as to be received by 5 September 2007, preferably by email to: accounting_stds@acra.gov.sg or addressed to:

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DRAFT INTERPRETATION D21

Real Estate Sales

[Draft] Interpretation X *Real Estate Sales* ([draft] INT FRS X) is set out in paragraphs 1–18. [Draft] INT FRS X is accompanied by a Basis for Conclusions. The scope and authority of Interpretations are set out in paragraphs 2 and 7–17 of the *Preface to Financial Reporting Standards*.

References

- 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*
- ED INT FRS D20 *Customer Loyalty Programmes*

Background

- 1 Entities that undertake real estate development may enter into agreements to sell the real estate before they have completed its construction.
- 2 Such agreements are widespread in the context of residential real estate developments. Developers 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 to acquire a specified unit when it is ready for occupation. Typically, the buyer pays a deposit that is refundable only if the developer fails to deliver the completed unit in accordance with the contracted terms. Sometimes, the balance of the purchase price is paid only on contractual completion, when the buyer obtains possession of the unit.
- 3 However, real estate sale agreements may take other forms. For example, they may relate to commercial or industrial developments. They may involve the sale of the whole development to a single buyer. The buyer may be required to make progress payments between the time of the initial agreement and contractual completion. Construction may be complete before the sale agreement is reached.
- 4 This [draft] Interpretation provides guidance on when the selling entity should recognise revenue from the sale of real estate. Specifically,
 - (a) it clarifies whether sale agreements entered into before construction is complete should be regarded as construction contracts within the scope of FRS 11 or agreements for the sale of goods within the scope of FRS 18; and
 - (b) it revises guidance on applying FRS 18 to real estate sales in general.

Scope

- 5 This [draft] Interpretation shall be applied in accounting for revenue from the sale of real estate.

Issues

- 6 The [draft] Interpretation addresses:

- (a) the meaning of the term 'construction contract' as defined in FRS 11; and
- (b) the requirements of FRS 18 with respect to:
 - (i) the conditions that must be met before the selling entity recognises revenue for the sale of real estate; and
 - (ii) the way in which the selling entity should recognise and measure any contractual obligations that remain when the conditions for recognising revenue have been met.

Consensus

Applicable standard

- 7 FRS 11 applies if the sale agreement meets the definition of a construction contract in FRS 11. FRS 18 applies if the sale agreement is instead an agreement for the sale of goods (completed real estate).
- 8 FRS 11 defines a construction contract as 'a contract specifically negotiated for the construction of an asset or a combination of assets ...' A sale agreement meets this definition if it is an agreement for the seller to provide construction services to the buyer's specifications.
- 9 Features that, individually or in combination, may indicate that an agreement is for the seller to provide construction services to the buyer's specifications include:
 - (a) the buyer being 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 it exercises that ability or not);
 - (b) the seller transferring to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. Indications that the seller transfers control of the work in progress in this way may include, for example:
 - (i) the construction taking place on land that is owned or leased by the buyer;
 - (ii) the buyer having a right to take over the work in progress (albeit with a penalty) during construction, eg to engage a different contractor to complete the construction;
 - (iii) in the event of the agreement being terminated before construction is complete, the buyer retaining the work in progress and the seller having the right to be paid for work performed (subject to buyer acceptance).
- 10 Conversely, features that, individually or in combination, may indicate that an agreement is for the sale of goods (completed real estate) include:
 - (a) the negotiation between buyer and seller primarily concerning the amount and timing of payments, with the buyer having only limited ability to specify the design of the real estate, eg to select a design from a range of options or specify minor variations to the basic design;
 - (b) the agreement giving the buyer only a right to acquire the completed real estate at a later date, with the seller retaining control and the significant risks and rewards of ownership of the underlying work in progress until that date.

Applying FRS 18—revenue recognition

- 11 If a sale agreement is for the sale of goods, revenue shall be recognised when all the conditions in paragraph 14 of FRS 18 have been satisfied.
- 12 Two of the conditions require the entity to have transferred to the buyer the significant risks and rewards of ownership of, and effective control over, the goods sold. These conditions shall be applied to the underlying real estate in its current state, not to the buyer's right to acquire the fully constructed real estate at a later date.
- 13 In some cases, real estate may be sold with such a degree of continuing involvement by the seller that effective control and the risks and rewards of ownership are not transferred when the buyer obtains possession. Examples are sale and repurchase agreements that include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such cases, the nature and extent of the seller's continuing involvement determines how the transaction is accounted for. It may be accounted for as a sale, or as a financing, leasing or some other profit-sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.

Applying FRS 18—remaining obligations

- 14 The FRS 18 conditions for recognising revenue from the sale of the real estate may be satisfied before the entity has performed all of its contractual obligations to the buyer. If so, the entity shall recognise its remaining obligations in one of two ways:
- (a) to the extent that the entity has to perform further work on the real estate already delivered to the buyer (eg to remedy minor defects or complete internal decoration), it shall recognise an expense in accordance with paragraph 19 of FRS 18. The liability shall be measured in accordance with FRS 37.
 - (b) to the extent that the entity has to deliver further goods or services that are separately identifiable from the real estate already delivered to the buyer (eg some internal fittings or communal amenities), it shall treat the remaining goods or services as a separate component of the sale, in accordance with paragraph 13 of FRS 18. The fair value of the total consideration received and receivable from the buyer shall be allocated between the components already delivered and those not yet delivered. Consideration allocated to the goods or services not yet delivered shall be recognised as revenue only when the applicable revenue recognition conditions have been met for those goods or services.

Amendments to the appendix to FRS 18

- 15 This [draft] Interpretation supersedes the real estate guidance (Example 9) in the appendix to FRS 18.
- 16 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 [draft] Interpretation X *Real Estate Sales*.'

Effective date and transition

- 17 An entity shall apply this [draft] Interpretation for annual periods beginning on or after [date to be set at three months after the Interpretation is finalised]. Earlier application is permitted. If

an entity applies the [draft] Interpretation for a period beginning before [date to be set at three months after the Interpretation is finalised], it shall disclose that fact.

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

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, draft INT FRS X.

BC1 This Basis for Conclusions summarises the considerations in reaching its consensus.

Applicable standard

BC2 It has prepared this draft Interpretation in the light of divergent revenue recognition practices for sales of units within real estate developments. As explained in paragraph 2 of the draft Interpretation, developers often enter into agreements to sell the units while construction is in progress, or even before it has begun.

BC3 The main area of divergence concerns the identification of the applicable accounting standard. In some jurisdictions, the prevailing practice is to apply FRS 11 *Construction Contracts* and recognise revenue as construction progresses. In others, it is to apply the requirements for the sale of goods in FRS 18 *Revenue*, and recognise revenue only when the unit is delivered to the buyer.

BC4 In support of applying FRS 11 for all agreements entered into before construction is complete, it is argued that:

(a) the sale agreements are in substance construction contracts. The typical features of a construction contract—land development, structural engineering, architectural design and construction—are all present.

(b) FRS 11 requires a stage of completion method of revenue recognition for construction contracts. Revenue is recognised progressively as work is performed. Because many real estate development projects span more than one accounting period, the rationale for this method—that it ‘provides useful information on the extent of contract activity and performance during a period’ (FRS 11, paragraph 25)—applies to real estate development as much as it does to other construction contracts. If revenue is recognised only when the FRS 18 conditions for recognising revenue from the sale of goods are met, the financial statements do not reflect the entity’s economic value generation in the period and are susceptible to manipulation.

(c) US accounting standard SFAS 66 *Accounting for Sales of Real Estate* requires a stage of completion method for recognising profit from sales of units in condominium projects or time-sharing interests (providing specified criteria are met). Thus US generally accepted accounting principles (GAAP) acknowledge that such real estate sales have the same economic substance as construction-type contracts. International Financial Reporting Standards (IFRSs) can and should be interpreted in the same way to avoid unnecessary differences.

BC5 It does not agree with these arguments. It takes the view that the applicable accounting standard depends on the nature of the sale agreement. Some agreements for the sale of units within real estate developments do not meet the FRS 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 FRS 18 is the applicable standard. In reaching this view, It was noted that:

(a) FRS 11 defines a construction contract as ‘a contract *specifically negotiated* for the *construction* of an asset or a combination of assets ...’ (emphasis added). A contract for ‘construction’ is a contract to provide construction services to the buyer’s specifications, whereas agreements for the sale of real estate are often contracts for the sale of goods (fully constructed real estate)—construction takes place independently of the sale agreement and 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 seller, or to specify minor variations to the basic design.

(b) the differences of substance between contracts for construction services and contracts for the sale of goods (fully constructed real estate) justify different revenue recognition requirements. The terms of contracts for construction services tend to be such that there is a continual delivery (transfer of control and risks and rewards of ownership) from the seller to the buyer as construction progresses. For example:

- the land under construction is owned by the buyer from the outset.
- the seller typically has no ownership claim to the work in progress (beyond perhaps a right of lien). The seller instead provides construction 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 (albeit with a penalty) before construction is complete.
- the seller earns the right to be paid primarily on the basis of work performed (subject to customer acceptance) rather than purely for the delivery of finished goods.

The rationale for applying the stage of completion method to construction contracts is not just that it recognises the value of the entity's activity in the period. Rather it also recognises the economic benefits that the entity has delivered (via continuous transfer of control and risks and rewards of ownership) to the buyer as construction progresses. This continuous transfer is often not a feature of agreements for the sale of real estate units—control of the unit tends to pass from seller to buyer at a single point in time, usually when the unit is ready for occupation.

(c) differences exist between IFRSs and US GAAP requirements for revenue recognition. They cannot be eliminated by interpretation. They are being addressed in a general project on revenue recognition being conducted jointly by the International Accounting Standards Board and the US Financial Accounting Standards Board.

BC6 It therefore believes that the application of FRS 11 should be restricted to contracts that meet that standard's definition of a construction contract. It further proposes that a construction contract meets this definition only if it requires the seller to provide construction services to the buyer's specifications. To help clarify the difference between construction contracts and contracts for the sale of completed real estate, the consensus also lists typical features of each. These features draw from the discussion in paragraph BC5.

Withdrawal of Example 9 in the appendix to FRS 18

BC7 Having concluded that FRS 18 is the applicable standard for many transactions involving the sale of real estate before construction is complete, it considered whether it was clear *how* FRS 18 should be applied.

BC8 It was decided that the requirements of FRS 18 are not wholly clear. The main source of concern is the first paragraph of guidance on real estate sales (Example 9) in the appendix to FRS 18:

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 such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue. In either case, if the seller is obliged to perform any significant acts 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 been completed.

- BC9 It was accepted that this guidance could be interpreted in ways that are inconsistent with the requirements of FRS 18. For example, it could be read to suggest that binding agreements for the sale of real estate units (which can give the buyers a form of equitable interest) are sufficient to transfer the risks and reward of ownership of the real estate to the buyers. It could also be read as prohibiting recognition of any revenue until all substantial acts required under the contract have been completed, ignoring the possibility that the contract could include two or more separately identifiable components.
- BC10 It was therefore decided to review the first paragraph of guidance in Example 9, reconsidering in particular (i) the conditions that must be met before revenue can be recognised and (ii) the consequences of these conditions being met before the entity has completed all of its contractual obligations to the buyer. It also took the opportunity to review and refine the other guidance (ie the second and third paragraphs) in Example 9.
- BC11 It was concluded that guidance on recognising revenue from real estate sales is most accessible to readers of FRSs if it is located in a single pronouncement. It has therefore included the proposed new guidance on applying FRS 18 within this draft Interpretation and proposes the withdrawal of Example 9 from the appendix to FRS 18.

FRS 18—revenue recognition

- BC12 Paragraph 11 of the draft Interpretation emphasises that, if FRS 18 applies, revenue from the sale of real estate should be recognised in accordance with the recognition conditions in paragraph 14 of that standard.
- BC13 It was considered whether there was a need for further guidance to clarify how those conditions should be applied to real estate sales. It decided that it would be helpful to clarify whether and, if so, when a binding agreement for sale would transfer to the buyer the significant risks and rewards of ownership of, and effective control over, the real estate. Such guidance would help to counter any misunderstanding of the requirements of FRS 18 that has resulted from the guidance at present in Example 9 of the appendix to FRS 18.
- BC14 It was noted that a binding agreement for the sale of real estate—like other forms of binding customer order—gives the buyer an asset in the form of a right to acquire, use and sell the completed real estate at a later date. The buyer controls this right and obtains risks and rewards associated with it, such as movements in the market value of the completed real estate. However, an agreement for the sale of a real estate unit typically does not give the buyer control of the underlying real estate in its existing partially-constructed state. The seller typically retains significant risks of ownership, such as construction risk and risk of damage or default. The seller also typically retains the right to use—ie continue development of—the work in progress. The seller is likely to retain these rights until the buyer obtains possession, usually at contractual completion.
- BC15 It was noted that it is necessary to distinguish a right to acquire goods from the underlying goods themselves—paragraph 14 of FRS 18 requires the entity to have transferred to the buyer the significant risks and rewards of ownership of, and effective control over, the goods sold, not the right to acquire the goods. Hence, a binding agreement for the sale of a real estate unit is usually insufficient to satisfy the conditions for revenue recognition. Guidance explaining this aspect of paragraph 14 of FRS 18 is therefore proposed in paragraph 12 of the draft consensus.
- BC16 Paragraph 13 of the draft Interpretation carries forward (with only minor amendments) the second paragraph of guidance from Example 9 in the appendix to FRS 18. It took the view that this guidance has widespread application and accurately interprets the requirements of FRS 18.
- BC17 The draft Interpretation does not carry forward the third paragraph of guidance in Example 9. This paragraph states that if there is insufficient evidence of the buyer's commitment to complete payment for the real estate, revenue is recognised only to the extent cash is

received. It was decided this guidance does not necessarily follow from the requirement in paragraph 14(d) for revenue to be recognised only to the extent that 'it is probable that the economic benefits associated with the transaction will flow to the entity'.

FRS 18—remaining obligations

BC18 The draft Interpretation addresses situations in which the conditions for recognising revenue from the sale of real estate are met before the entity has performed all of its obligations under the sales contract. It was observed that such situations can arise if, for example, the buyer obtains possession before internal decoration has been completed or communal amenities have been built:

- (a) the need to finish minor tasks or construct communal amenities does not necessarily prevent the buyer from obtaining the significant risks and rewards of ownership of his or her individual unit.
- (b) a developer's continuing presence on the development site does not necessarily constitute 'continuing managerial involvement to the degree usually associated with ownership' of the buyer's individual unit.
- (c) paragraph 19 of FRS 18 clearly envisages circumstances in which revenue is recognised while there are contractual obligations still to be performed.

BC19 It was noted that the remaining obligations could be accounted for in one of two ways:

- (a) applying paragraph 19 of FRS 18, the expected costs of performing the obligations could be recognised as an expense when revenue is recognised from the sale of the real estate; or
- (b) applying paragraph 13 of FRS 18, the remaining 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 this component. This revenue would be deferred and recognised when the entity carried out the remaining work.

BC20 It had considered the circumstances in which each of the two methods would be appropriate when developing ED INT FRS D20 *Customer Loyalty Programmes*. It had concluded that:

... FRS 18 does not give explicit guidance. However, the aim of FRS 18 is to recognise revenue when, and to the extent that, goods or services have been delivered to a customer. In its view, paragraph 13 applies if a single transaction 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 meet warranty claims. In its 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... *T

BC21 This conclusion has been followed as the basis for the requirements proposed in paragraph 14 of the draft Interpretation.

* ED INT FRS D20 *Customer Loyalty Programmes*, Basis for Conclusions paragraph BC7(a)