STAFF PAPER

November 2018

IFRS® Interpretations Committee meeting

Project	Over time transfer of constructed good (IAS 23)		
Paper topic	Initial Consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the capitalisation of borrowing costs in relation to the construction of a residential multi-unit real estate development. Applying IFRS 15 *Revenue from Contracts with Customers*, the real estate developer recognises revenue over time for the sale of individual units in the development. The submission asks whether the real estate developer capitalises borrowing costs as part of the cost of the units.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. The paper includes:

   (a) background information;

   (b) summary of outreach;

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(c) staff analysis; and

(d) staff recommendation.

4. There are two appendices to this paper:

(a) Appendix A—Proposed wording of the tentative agenda decision; and

(b) Appendix B—Submission.

Background information

5. In the fact pattern described in the submission:

(a) a real estate developer (entity) constructs a residential multi-unit real estate development (building) and sells the individual units in the building to customers;

(b) the entity borrows funds specifically for the purpose of constructing the building and incurs borrowing costs in connection with that borrowing;

(c) before construction begins, the entity signs contracts with customers for the sale of some of the units in the building (sold units);

(d) the entity markets for sale the remaining units (unsold units). Accordingly, the entity intends to enter into contracts with customers for the unsold units as soon as it finds suitable customers; and

(e) the terms, and relevant facts and circumstances, of the contracts with customers are such that, applying paragraph 35(c) of IFRS 15, the entity transfers control of each unit over time and, therefore, recognises revenue over time. The consideration promised by the customer in the contract is in the form of cash or another financial asset.

6. Applying IAS 23 *Borrowing Costs*, an entity capitalises borrowing costs that are directly attributable to the construction of a qualifying asset as part of the cost of that

asset. Paragraph 5 of IAS 23 defines a qualifying asset as '...an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.'

7. Because the entity transfers control of each sold unit over time, the submitter asks whether the entity has a qualifying asset and, thus, whether it capitalises any directly attributable borrowing costs as part of the cost of the units. The submitter has identified three different views as follows:

   (a) capitalise borrowing costs on only the unsold units (View A);

   (b) capitalise borrowing costs on neither the unsold nor the sold units (View B); and

   (c) capitalise borrowing costs on both the sold and unsold units (View C).

8. Appendix B to this paper reproduces the submission and outlines arguments in support of each of these views.

Summary of outreach

9. We sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators and large accounting firms.

10. In the request we asked, in the participant's experience:

   (a) whether it is common for real estate developers to transfer control of units over time, and thus recognise revenue over time applying paragraph 35 of IFRS 15;

   (b) if such entities recognise revenue over time, whether they capitalise borrowing costs on (i) either the sold or unsold units; (ii) both the sold and unsold units; or (iii) neither the sold nor unsold units; and

   (c) if such entities apply differing reporting methods in capitalising borrowing costs, whether the application of these differing methods could have a material effect on the financial statements of those entities?

11. We received fifteen responses—seven from large accounting firms, six from national standard-setters and two from organisations representing groups of regulators. The

views received represent informal opinions and do not represent the official views of those respondents.

Findings from outreach

Prevalence

12. Some respondents said it was common in particular jurisdictions for real estate developers to recognise revenue over time for the sale of units. A number of these respondents also said entities in some other jurisdictions recognise revenue at a point in time. The different patterns of revenue recognition result from contractual and legal differences in each jurisdiction.

13. Other respondents said entities in their respective jurisdictions recognise revenue at a point in time, and not over time.

Accounting

14. Of those respondents who said it is common for entities in particular jurisdictions to recognise revenue over time, the majority said they had observed all three views described by the submitter (see paragraph 7 of this paper). A number of these respondents said they had observed entities within a jurisdiction applying the same reporting method (ie entities within a jurisdiction predominantly apply only one of the three views described by the submitter) but had observed diversity across different jurisdictions.

15. One respondent said entities predominantly apply View A (ie capitalise borrowing costs on only the unsold units) and another respondent said entities predominantly apply View B (ie capitalise borrowing costs on neither the sold nor the unsold units).

The effect of differing reporting methods

16. Six respondents said the application of differing reporting methods has or could have a material effect on the financial statements of entities affected. Other respondents either did not comment on, or said they did not have sufficient information to answer, this question.

Staff analysis

17. Paragraph 8 of IAS 23 states:

> An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

18. Accordingly, to determine whether to capitalise borrowing costs an entity must first determine whether it has a qualifying asset.

19. Paragraph 5 of IAS 23 defines a qualifying asset as 'an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.' Paragraph 7 gives examples of qualifying assets and states:

> Depending on the circumstances, any of the following may be qualifying assets:
>
> (a) inventories
>
> (b) manufacturing plants
>
> (c) power generation facilities
>
> (d) intangible assets
>
> (e) investment properties
>
> (f) bearer plants.
>
> Financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

20. The submitter asked whether, in the fact pattern described in the submission, the entity has a qualifying asset relating to all, some or none of the units. In analysing this question, we have first considered which assets the entity recognises, and then considered whether those assets meet the definition of a qualifying asset.

Assets recognised

21. Depending on the particular facts and circumstances, we think the entity might recognise one or more of the following assets:

    (a) **a receivable** for the sold units (applying IFRS 15)**.** The receivable represents the entity's right to consideration that is unconditional;

    (b) **a contract asset** for the sold units (applying IFRS 15)[1]. The contract asset represents the entity's right to consideration when it has transferred goods or services to a customer before the customer pays consideration or before payment is due (excluding any receivable); and

    (c) **inventory asset** generally for the unsold units under construction (applying IAS 2 *Inventories*). Inventory relating to the unsold units represents assets in the process of production for sale in the ordinary course of the entity's business[2]. The entity has not transferred control of the unsold units to customers, unlike the sold units. The entity might also have, for example, raw materials relating to sold units that it has acquired but is not yet using in constructing the building.

Do the assets recognised meet the definition of a qualifying asset?

Receivable

22. Paragraph 108 of IFRS 15 includes the definition of a receivable and states:

> A receivable is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration

[1] The entity might also recognise a contract liability. However, a contract liability is not an asset and would not be relevant in assessing whether and how the entity capitalises borrowing costs. Accordingly, we have not considered this further in our analysis.

[2] Applying the definition of inventory in paragraph 6 of IAS 2.

> is due… An entity shall account for a receivable in accordance with IFRS 9…

23. Paragraph 7 of IAS 23 specifically states that financial assets are not qualifying assets. Accordingly, the receivable is not a qualifying asset and the entity does not capitalise borrowing costs on any receivable it recognises.

Contract asset

24. Paragraph 107 of IFRS 15 states:

> If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable…

25. Appendix A to IFRS 15 defines a contract asset as:

> An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).

26. Paragraph 5 of IAS 23 states that a qualifying asset is 'an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.' IAS 23 does not explicitly specify whether a contract asset may (or may not) be a qualifying asset. In the fact pattern described in the submission, any contract asset represents the entity's right to consideration that is conditional on the entity's future performance (eg completing the construction of the unit). In other words, we think the intended use of the contract asset is to collect cash or another financial asset[3] —this does not, in our view, necessarily take a substantial period of time to get ready for its intended use. We think this is also the reason IAS 23 specifically states that a receivable is not a qualifying asset. Accordingly, we think a contract asset that represents a right to

[3] In the fact pattern described in the submission the consideration promised by the customer in the contract is in the form of cash or another financial asset.

receive consideration in the form of cash or another financial asset is not a qualifying asset.

27. Our view is also supported by the requirements in IFRIC 12 *Service Concession Arrangements.* IFRIC 12 specifically addresses the capitalisation of borrowing costs in respect of contract assets for an operator in a service concession arrangement. Applying IFRIC 12, an operator in a service concession arrangement recognises either a financial asset or an intangible asset for consideration it is entitled to in exchange for constructing or upgrading infrastructure. Paragraph 19 of IFRIC 12 states '…However, both types of consideration (ie financial asset and intangible asset) are classified as a contract asset during the construction or upgrade period in accordance with IFRS 15.'

28. Paragraph 22 of IFRIC 12 prohibits an operator in a service concession arrangement from capitalising borrowing costs to contract assets for which the nature of the consideration is a financial asset. This paragraph states:

> In accordance with IAS 23, borrowing costs attributable to the arrangement shall be recognised as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service)…

Inventory

29. Paragraph 7 of IAS 23 states that, depending on the circumstances, inventories may be qualifying assets.

30. In the fact pattern described in the submission, the entity transfers control of a unit to the customer over time and thus recognises revenue over time. Accordingly, when it signs a contract with a customer, the entity (a) would derecognise any inventory asset for the part-constructed unit sold (because it no longer controls the unit), and (b) may recognise a contract asset and/or receivable for consideration receivable from the customer. So, on signing a contract with a customer, the entity would not have an inventory asset for the unit and thus would not have a qualifying asset.

Unsold units

31. Before signing a contract with a customer, the entity would recognise as inventory any work-in-progress on the unsold unit. However, we think any such work-in-progress relating to unsold units under construction would not meet the definition of a qualifying asset. In the fact pattern described in the submission, the entity markets the unsold units for sale and intends to enter into contracts with customers for the unsold units as soon as it finds suitable customers. In other words, the unsold units are ready for their intended sale in their current condition and would not necessarily take *a substantial period of time* to get ready for such sale.

32. Proponents of View A in the submission (ie capitalise borrowing costs on the unsold units) support this view on the grounds that:

    (a) paragraph 10 of IAS 2 requires an entity to include in the cost of inventories, 'costs incurred in bringing the inventories to their present location and condition' (ie directly attributable costs). In their view, borrowing costs are directly attributable costs because the entity borrows funds (and incurs borrowing costs) specifically for the construction of the building.

    (b) although a unit can be sold before completion, the entity does not completely satisfy its performance obligation to transfer the unit to the customer until the physical construction is complete; and

    (c) paragraph 23 of IAS 23 states that an asset is 'normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue.'

33. We do not agree with this view. This is because:

    (a) paragraph 17 of IAS 2 specifically requires an entity to apply the requirements in IAS 23 when assessing whether to capitalise borrowing costs. The paragraph states 'IAS 23 *Borrowing Costs* identifies limited circumstances where borrowing costs are included in the cost of inventories.' Accordingly, we think an entity cannot capitalise those borrowing costs if it does not have a qualifying asset (as defined in IAS 23).

(b) IAS 23 requires an entity to capitalise borrowing costs on assets that necessarily take a substantial period of time to *get ready for* their intended sale, and not those for which an entity might transfer control (and therefore satisfy a performance obligation) over a substantial period of time.

(c) the use of the word 'normally' in paragraph 23 of IAS 23 indicates that the statement in that paragraph is not a rule. On signing a contract with a customer, the entity derecognises any inventory asset for the part-constructed unit because it no longer controls that unit. Accordingly, it no longer has a qualifying asset to which it could capitalise borrowing costs even though physical construction of that unit might not be complete.

Inventory acquired but not yet used in construction

34. We also think the entity would not capitalise borrowing costs on any raw material or other similar asset that the entity has acquired but is not yet using in constructing the building (for example, bricks that are not yet being used for construction). This is because the entity is not undertaking any activity on the material.

35. Paragraph 17 of IAS 23 states that an entity begins capitalising borrowing costs when, among other conditions, it '…undertakes activities that are necessary to prepare the asset for its intended use or sale'. Paragraph 19 of IAS 23 goes on to explain that 'such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place'.

36. When the entity uses the material in constructing the building, the material becomes part of either work-in-progress (ie inventory) or the contract asset/receivable. As discussed in paragraphs 22–33 of this paper, in our view any receivable, contract asset or work-in-progress asset does not meet the definition of a qualifying asset in IAS 23.

In what circumstances could there be a qualifying asset?

37. In the fact pattern described in the submission, before construction begins the entity markets for sale the units in the building. If, instead, the units would be marketed for sale (and sold) only at a particular point in the future (for example, when construction is at a particular stage of completion) and that point in the future is after a substantial

period of time, then the units may meet the definition of a qualifying asset—ie in that situation, the entity may conclude that the units necessarily take a substantial period of time to get ready for their intended sale. However, this assessment would depend on the particular facts and circumstances, which are different from those in the submission.

Staff conclusion

38. Based on our analysis, we think that in the fact pattern described in the submission the entity does not have a qualifying asset and, accordingly, does not capitalise borrowing costs in relation to the construction of the building. This is the case for both:

    (a) any receivable or contract asset. Paragraph 7 of IAS 23 specifies that a receivable is not a qualifying asset and, in our view, the contract asset does not necessarily take a substantial period of time to get ready for its intended use or sale; and

    (b) any inventory (work-in-progress) asset in relation to unsold units because the asset is ready for its intended sale in its current condition.

39. We also think that the entity does not capitalise borrowing costs on any raw material or other similar asset that the entity has acquired but is not yet using in constructing the building. This is because there is no activity being undertaken on that material.

Question 1 for the Committee
Does the Committee agree with our analysis of the requirements in IAS 23, summarised in paragraphs 38-39 of the paper?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[4]

40. Based on our analysis, we think the requirements in IAS 23 provide an adequate basis for an entity to determine the borrowing costs eligible for capitalisation in the fact pattern described in the submission.

Staff recommendation

41. On the basis of our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 40 of this paper), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend it publish an agenda decision that explains how an entity applies the requirements in IAS 23 to the fact pattern described in the submission.

42. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

[4] Paragraph 5.16(b) of the *Due Process Handbook*

Appendix A—Proposed wording of the tentative agenda decision

Over time transfer of constructed good (IAS 23 *Borrowing Costs*)

The Committee received a request about the capitalisation of borrowing costs in relation to the construction of a residential multi-unit real estate development (building).

In the fact pattern described in the request:

(a) a real estate developer (entity) constructs the building and sells the individual units in the building to customers;

(b) the entity borrows funds specifically for the purpose of constructing the building and incurs borrowing costs in connection with that borrowing;

(c) before construction begins, the entity signs contracts with customers for the sale of some of the units in the building (sold units);

(d) the entity markets for sale the remaining units in the building (unsold units). Accordingly, the entity intends to enter into contracts with customers for the unsold units as soon as it finds suitable customers; and

(e) the terms, and relevant facts and circumstances, of the contracts with customers are such that, applying paragraph 35(c) of IFRS 15 *Revenue from Contracts with Customers*, the entity transfers control of each unit over time and, therefore, recognises revenue over time. The consideration promised by the customer in the contract is in the form of cash or another financial asset.

The request asks whether the entity has a qualifying asset as defined in IAS 23 and, therefore, capitalises any directly attributable borrowing costs.

Applying paragraph 8 of IAS 23, an entity capitalises borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Paragraph 5 of IAS 23 defines a qualifying asset as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Accordingly, the entity assesses whether, in the fact pattern described in the request, it recognises an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Depending on the particular facts and circumstances, the entity might recognise a receivable, a contract asset and/or inventory in the fact pattern described in the request.

The Committee concluded that the entity does not capitalise borrowing costs, observing that:

(a) any receivable that the entity recognises is not a qualifying asset. Paragraph 7 of IAS 23 specifies that financial assets are not qualifying assets.

(b) any contract asset that the entity recognises is not a qualifying asset. The contract asset would represent the entity's right to consideration (that is conditioned on something other than the passage of time) in exchange for transferring control of a unit (Appendix A of IFRS 15). The intended use of the contract asset—to collect cash or another financial asset—is not a use for which it necessarily takes a substantial period of time to get ready.

(c) any inventory (work-in-progress) for unsold units under construction that the entity recognises is not a qualifying asset. In the fact pattern described in the request, this asset is ready for its intended sale in its current condition.

(b) paragraph 17 of IAS 23 specifies that an entity begins capitalising borrowing costs when, among other conditions, it undertakes activities that are necessary to prepare the asset for its intended use or sale. Therefore, the entity would not capitalise borrowing costs on any raw materials or similar assets that it holds but is not yet using in constructing the building.

The Committee concluded that the principles and requirements in IAS 23 provide an adequate basis for an entity to determine whether to capitalise borrowing costs in the fact pattern described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B—Submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

IAS 23 *Borrowing Costs* – Capitalisation of borrowing costs on assets being developed for sale for which revenue is recognised over time.

In [a particular jurisdiction], entities which operate in construction of residential buildings and sale residential units, apply IFRS 15.35(c) provisions and recognise revenue from the sale of residential units over time. The issue of whether or not borrowing costs should still be capitalised to the residential units' inventory once revenue recognition begins, is an issue we are dealing with. In addition, we've identified diversity in practice. We find it necessary and very much helpful if the committee would provide additional guidance that helps dealing with the issue.

More specifically and without expressing an opinion on each of the different views, there are three views to this issue:

View A – Only the inventory in progress of the unsold residential units should be treated as a qualifying asset

During the period when inventory is under development, the expenditures for the resources used must be financed. The cost of the inventory should include all costs necessarily incurred to get the inventory ready for its sale, including the costs incurred for financing the expenditures.

In accordance with this view, when a real estate developer recognises revenue over time, only the inventory of the unsold residential units represents a qualifying asset to which borrowing costs that are directly attributable to the acquisition of inventory (the land and the construction cost of the building), may be capitalised as part of the cost of that inventory. Regarding the sold units - in substance, the sold units are no longer meet the definition of inventory. Since revenue recognition has been started, these units should not be treated as a qualifying asset.

For example – a real estate developer builds a building of 10 residential units. 3 units have been sold. The progress measurement towards complete satisfaction of the performance obligation is 30%.

Under view A, only the inventory attributed to 7 residential units that haven't been sold yet, should be treated as a qualifying asset.

View B – The inventory cannot be "qualifying asset"

In accordance with this view, and for the purpose of the identification of the qualifying asset, the land, and the building cannot be divided to sold and unsold components and should be viewed together. Since revenue is recognised over time, revenue recognition begins, neither the sold nor the unsold residential units can be treated as a qualifying asset.

Furthermore, since the constructor markets the residential units, and the revenue recognition begins with the sale (according to the progress of satisfaction of performance obligation), the residential units (even those that haven't been sold yet) do not meet the conditions to "qualifying asset" ("A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale" – IAS 23). Accordingly, all borrowing costs should be expensed as finance expenses or costs of sales.

View C - The remaining inventory in progress of both sold and unsold residential units should be treated as a qualifying asset

In accordance with this view, the inventory of the unsold and sold residential units (the remaining in progress inventory of the sold units that still hasn't recognised as cost of sale) represents a qualifying asset to which borrowing costs should be capitalised. This view is based on the assumption that the remaining in progress inventory of the residential unit sold, is distinct and can be treated as a qualifying asset on its own.

In the example mentioned above, and under view C, the inventory attributed to seven residential units that haven't been sold yet, and the remaining inventory of the sold units (i.e. 70% of the costs of the three units) should be treated as a qualifying asset.

We would appreciate for further guidance on that issue, which, for our understanding, is common and controversial.