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Internal Market and Services DG

FREE MOVEMENT OF CAPITAL, COMPANY LAW AND CORPORATE GOVERNANCE

**Accounting**

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## **Endorsement of the Interpretation 15 *Agreements for the Construction of Real Estate***

### **Introduction, background and conclusions**

Attachment 1: Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

Attachment 2: Endorsement advice prepared by EFRAG

## **1. EFFECT STUDY**

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union (EU). The Commission Services together with the European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as analysis of effects of using the new accounting rules in the EU.

EFRAG has prepared an Effect Study for the Interpretation 15 *Agreements for the Construction of Real Estate* (attached). As the EFRAG Effect Study refers to the Endorsement Advice, we also included it in attachments.

This cover note contains background information, comments and a conclusion by the Commission Services.

## **2. BACKGROUND ON IFRIC 15**

### *Explanation of the issue*

In the real estate industry, construction companies, directly or through subcontractors, may enter into agreements with one or more buyers before construction is complete. Such agreements are widespread and may relate to residential, commercial or industrial developments. Construction often spans over more than one accounting period and may require progress payments.

For example, entities that undertake the construction of residential real estate sometimes start marketing and enter into agreements for the sale of individual units (apartments or houses) "off plan", i.e. 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.

### *Why the issue needed clarification?*

In existing IFRS, there is a divergence in practice in the identification of the applicable accounting standard to agreements for the construction of real estate. In some jurisdictions, the prevailing practice is to apply IAS 11 *Construction Contracts* and in others to apply IAS 18 *Revenue recognition*. This divergence in application can result in very different accounting.

When IAS 11 is applied, it results in the recognition of revenue as construction progresses. However if IAS 18 is applied, the recognition of revenue is only when the completed real estates is delivered to the buyer.

Therefore, there is uncertainty as to which standard, IAS 11 or IAS 18, should be applied to agreements for the construction of real estate. IFRIC 15 addresses these uncertainties.

The Interpretation clarifies the definition of a "construction contract" and by doing so, which agreements are subject to IAS 11. If an agreement does not comply with the definition of a

"construction contract", then it is subject to IAS 18. In the latter case, the Interpretation also provides three possible situations to be distinguished and offers guidance on how to account for revenue in each of these situations.

*How does IFRIC 15 suggest dealing with the issue?*

Current IAS 11 applies to agreements that meet the definition of a construction contract. Under IAS 11 a construction contract "is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use". This interpretation clarifies that 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).

If the agreement is within the scope of IAS 11 and its outcome can be estimated reliably, the entity recognises income by reference to the stage of completion of the contract activity.

In contrast, if the buyers have only limited ability to influence the design of the real estate, then the agreement is within the scope of IAS 18. In this case, three situations can be distinguished:

- If the agreement is for the rendering of services in accordance with IAS 18, revenue is recognised by reference to the stage of completion of the transaction using the percentage of completion method.
- If the agreement is in effect for the "brick-by-brick" sale of the real estate (if the entity transfers to the buyer control and the significant risks and rewards of ownership as construction progresses) revenue is recognised by reference to the stage of completion of the transaction using the percentage of completion method.
- If the agreement involves control and the significant risk and rewards of ownership of the real estate being transferred in its entirety at a single point in time, revenue is recognised in accordance with IAS 18 for the sale of goods only when the completed real estate is delivered to the buyer.

IFRIC 15 becomes effective for annual periods beginning on or after 1 January 2009, with earlier application permitted.

*IASB and EFRAG consultations*

The IASB carried out a consultation according to its due process. IFRIC published a draft Interpretation D21 *Real Estate Sales* on July 2007 and received 51 comment letters. IFRIC redeliberated on different issues of the Interpretation at three meetings. The final Interpretation was published in July 2008.

The majority of the commentators to the EFRAG consultation shared EFRAG's assessment of the costs and benefits associated with the implementation of this Interpretation. EFRAG also discussed the potential cost and benefits with its User Panel and this consultation did not identify any significant issues that should alter EFRAG's assessment of the cost and benefits expected to arise from implementing IFRIC 15.

### **3. EFFECT ANALYSIS**

#### *Main points identified in the EFRAG Effect Analysis*

##### Usefulness of accounting information provided in the financial statements

EFRAG's analysis concluded that IFRIC 15 will result in a reduction of divergence in practice, thereby enhancing consistency and comparability of the information provided.

The additional disclosures required by IFRIC 15 will allow users to have an improved understanding of the financial statements.

The Commission Services agree with the EFRAG analysis and conclude that IFRIC 15 will improve the overall quality of the financial information and therefore benefit users.

##### Costs for preparers and users

EFRAG's analysis gives an overview of the expected incremental costs for preparers and users. With regard to preparers, EFRAG concludes that IFRIC 15 will result in some incremental costs for preparers to categorise their existing and future agreements. These costs could be significant for some entities, but when considered overall, the costs will not be significant. For those companies required to change their accounting due to IFRIC 15, this will likely result in a reduction in ongoing costs more often than it will result in an increase, although in neither case are the cost changes likely to be significant.

Users and preparers will incur in some cost relating to reading and understanding IFRIC 15 but they are likely to be insignificant. Apart from this, IFRIC 15 will impose no additional burden on users.

EFRAG notes that the Interpretation will result in some incremental cost for preparers, but when considered overall they will not be significant. In some additional costs may occur for users, but these are likely to be insignificant. The Commission Services share this analysis.

### **4. OVERALL COST-BENEFIT CONSIDERATIONS AND COMMISSION SERVICES CONCLUSIONS**

On the basis of EFRAG's Effect Study, the Commission Services have considered the main costs and benefits of endorsing the IFRIC 15 and concluded that the benefits of adopting the interpretation outweigh the costs incurred.

The Commission Services believe that Interpretation will have positive cost-benefits effects and that it should therefore be endorsed in the EU without delay.

## **Attachment 1**

Effect study prepared by the European Financial Reporting Advisory Group  
(EFRAG)

## **The costs and benefits of implementing IFRIC 15 *Agreements for the Construction of Real Estate***

### **Introduction**

- 1 Following discussions in 2007 between the various parties involved in the EU endorsement process, it was decided that more extensive information than hitherto should be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of *IFRIC 15 Agreements for the Construction of Real Estate*.
- 2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of IFRIC 15, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing IFRIC 15 in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments and information received.

### *EFRAG's endorsement advice*

- 3 EFRAG already carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

### **A summary of IFRIC 15**

- 4 In the real estate industry, entities that undertake the construction of real estate directly or through subcontractors often enter into agreements of various forms with one or more buyers before construction is complete. For example, entities that undertake the construction of residential real estate sometimes start marketing and enter into agreements for the sale of individual

- units (apartments or houses) “off plan”—in other words, while construction is still in progress or perhaps even before it has begun.
- 5 In existing IFRS there are two standards that deal with revenue recognition—IAS 11 *Construction Contracts* and IAS 18 *Revenue*—and they can result in very different accounting results. There is uncertainty as to which of these standards should be applied to agreements for the construction of real estate. IFRIC 15 addresses those uncertainties.
  - 6 The Interpretation notes that within a single agreement an entity may contract to deliver goods or services in addition to the construction of real estate (for example, a sale of land or provision of property management services). Therefore, and in accordance with IAS 18, such agreements need to be split into separate components, including one for the construction of real estate, and each component accounted for separately.
  - 7 Then, to account for the construction of the real estate component, the entity should apply the guidance in IFRIC 15 to determine whether that part of the agreement is within the scope of IAS 11 or IAS 18.
    - (a) IAS 11 applies to agreements that meet the definition of a construction contract (“a contract specifically negotiated for the construction of an asset or a combination of assets ...”). IFRIC 15 specifies that an agreement for the construction of real estate meets the definition of a construction contract only 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 it exercises that ability or not).
    - (b) Conversely, an agreement for the construction of real estate in which buyers have only limited ability to influence the design of the real estate (for example, they are able only to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design) is within the scope of IAS 18.
  - 8 When the agreement is within the scope of IAS 11 and its outcome can be estimated reliably, the entity shall recognise revenue by reference to the stage of completion of the contract activity. This is often referred to as the percentage of completion (PoC) method. Under this method, revenue is recognised as the work progresses.
  - 9 When the agreement is within the scope of IAS 18, three different situations need to be distinguished:
    - (a) If the agreement is for the rendering of services, revenue is recognised by reference to the percentage of completion method described in the preceding paragraph.
    - (b) If the agreement is in effect for the brick-by-brick sale of the real estate, again revenue is recognised by reference to the percentage of completion method described in the preceding paragraph. IFRIC 15 explains that a ‘brick-by-brick sale’ is involved if the agreement is for the transfer of control and of the significant risk and rewards of ownership of the work in progress in its current state as construction progresses.

- (c) If the agreement involves control and the significant risk and rewards of ownership of the real estate being transferred in its entirety at a single point of time, revenue is recognised only when the criteria in IAS 18 for a sale of goods have been met. This is sometimes referred to as 'completed contract accounting'.

### **EFRAG's initial analysis of the costs and benefits of IFRIC 15**

- 10 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing IFRIC 15, both in year one and in subsequent years.
- 11 On the basis of that initial assessment, EFRAG tentatively concluded that IFRIC 15 would improve the quality of the financial information provided and, as such, that its implementation would benefit users. The improvements include:
  - (a) a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided.
  - (b) allowing users to have an improved understanding of the financial statements by means of additional disclosures in the case of continuous transfer transactions.
- 12 EFRAG further tentatively concluded that the amendments to IFRIC 15 would:
  - (a) involve some year one and ongoing costs due to reading and understanding IFRIC 15, but those incremental costs are unlikely to be significant;
  - (b) result in some insignificant incremental costs for preparers in year one to categorise their existing agreements;
  - (c) for those entities required to change their accounting, likely result in a reduction in ongoing costs more often than it will result in an increase—although in neither case are the cost changes likely to be significant;
  - (d) result in an insignificant incremental cost to provide additional disclosures in the case of continuous transfer transactions;
  - (e) not result in a significant cost to apply the interpretation retrospectively. This is because the information will either be readily available or additional costs will not make unavailable information available;
  - (f) impose no additional burden on users (beyond that involved in understanding the implications of IFRIC 15); and
  - (g) all in all result in benefits that are likely to outweigh the costs.
- 13 EFRAG published its initial assessment and supporting analysis on 29 July 2008 and invited comment on it until 22 September 2008. The results of this consultation are summarised in the paragraphs below.

- 14 EFRAG received seven comment letters.
- (a) Three were supportive of EFRAG's assessments of the costs and benefits;
  - (b) One did not comment on EFRAG's evaluation of the costs and benefits but expressed support for EFRAG's recommendation to adopt IFRIC15 for use in Europe;
  - (c) One broadly agreed with the evaluation of the costs and benefits of IFRIC 15 but acknowledged that it had not carried out a detailed examination; and
  - (d) Two did not support EFRAG's evaluation of the costs and benefits of IFRIC 15.
- 15 The two comment letters that did not support EFRAG's evaluation argued that IFRIC 15 will:
- (a) result in less informative accounting information (because it will result in less PoC accounting) and, accordingly, in significantly reduced benefits for users. In addition, if a preparer, for internal management purposes, would like to monitor the business on a PoC accounting basis, it will result in additional costs to keep a supplementary accounting system;
  - (b) result in significant year one and ongoing costs for preparers to categorise their existing and future agreements; and
  - (c) not result in a reduction in divergence in practice as the criteria of IFRIC 15 are not clear.
- 16 In addition, EFRAG consulted its User Panel in August 2008 on its view on percentage of completion accounting. This consultation did not identify any significant issues that should alter EFRAG's assessment of the costs and benefits expected to arise from implementing IFRIC 15.

#### **EFRAG's final analysis of the costs and benefits of IFRIC 15**

- 17 Based on its initial analysis, the comment letters received in response to that analysis and input from EFRAG's User Panel members, EFRAG's final analysis of the costs and benefits of IFRIC 15 is presented in the paragraphs below.

#### *Reading and understanding IFRIC 15*

- 18 Every change that is made to IFRS needs to be read and understood by preparers and users so that they can determine whether the change has any effect on them and, if it does, what that effect is. Normally the cost involved in doing this is insignificant compared to the other costs involved and to the benefits. EFRAG has considered whether that is also the case for IFRIC 15.
- 19 Although the scope of IFRIC 15 is limited to agreements for the construction of real estate, determining whether application by analogy to other types of construction contracts might be appropriate will require judgement and consideration of the facts and circumstances surrounding such transactions. EFRAG believes that this is a question that many entities will be required to

answer for a wide range of construction contract transactions, resulting in some year one and ongoing costs for preparers. However, this is often the case with new standards and interpretations, and the costs involved tend not to be significant.

- 20 EFRAG's assessment is that reading and understanding IFRIC 15 will involve some year one and ongoing costs, but those incremental costs are unlikely to be significant.

*Costs and benefits arising from the main requirements*

- 21 In assessing the costs and benefits that might arise from implementing IFRIC 15, EFRAG has found it easiest to consider the disclosure requirements and transitional arrangements separately from the other requirements ('the main requirements'). Those main requirements are considered in paragraphs 22 to 26 below.

Costs for preparers

- 22 IFRIC 15 will require preparers to review their existing agreements for the construction of real estate in order to establish if they are in the scope of IAS 11 or IAS 18 and how to account subsequently for revenue. EFRAG understands that some preparers have developed some practices to determine whether or not a contract, or a part of a contract, can be accounted for using PoC accounting. The criteria of IFRIC 15 may for some entities require more judgement and hence increased costs. EFRAG assesses that these costs for some companies could be significant.
- 23 It will also be necessary for entities that have agreements that might be similar to agreements for the construction of real estate to review existing contracts to establish whether IFRIC 15 should be applied by analogy to them. This will involve additional year one work and therefore some additional year one costs.
- 24 For future agreements, this is less of an issue because it would have been necessary to consider how to account for the agreements in any case. However, for the reasons mentioned in paragraph 22, IFRIC 15 may for some entities require more judgement than hitherto and hence increased costs.
- 25 As a result of IFRIC 15, some entities will need to change the way they account for some or all of their agreements.
- (a) Some agreements previously accounted for using a percentage of completion (PoC) method will need to be accounted for using completed contract (CC) accounting. In principle, CC accounting is less demanding from a systems and estimation perspective and will therefore—in theory—reduce the costs preparers will incur in such cases. However, EFRAG's understanding is that some preparers may continue using percentage of completion (PoC) accounting for internal decision making purposes, in which case there will be no cost saving from the implementation of IFRIC 15; rather, the need to maintain two systems might increase costs. EFRAG's assessment is that these costs are unlikely to be significant, as tracking the information needed for CC accounting is a relatively simple task.

- (b) Some preparers will have to move, as a consequence of IFRIC 15, from CC accounting to PoC accounting. While this will result in setting up new tracking systems and applying a higher degree of judgement, EFRAG believes that on an overall level, considering all preparers subject to the implementation of IFRIC 15, these companies will be in the minority and as a result on an overall basis these incremental costs will not be significant.
- 26 In summary, EFRAG's assessment is that IFRIC 15 will result in some incremental costs for preparers in year one to categorise their existing agreements (including potentially analogous agreements). For entities having numerous non-standard contracts that have to be split into separately identifiable components, these costs could be significant. However, EFRAG believes that the costs for most entities – and when considered overall – will be insignificant. For those entities required to change their accounting, IFRIC 15 is likely to result in a reduction in ongoing costs more often than it will result in an increase—although in neither case are the cost changes likely to be significant.

Costs for users

- 27 EFRAG has also considered whether IFRIC 15 will in some way increase the burden on users of financial statements. Its view is that it will impose no additional burden on users (beyond that involved in understanding the implications of IFRIC 15, which is dealt with in paragraphs 18 to 20 above).

Benefits for preparers and users

- 28 EFRAG has concluded, for the reasons explained in EFRAG's Endorsement Advice Letter, that IFRIC 15 will result in a reduction in divergence in practice, thereby enhancing consistency and comparability of the information provided. This should be a benefit to all stakeholders.

*Additional disclosures*

- 29 IFRIC 15 requires preparers to provide additional disclosures in the case of so-called 'continuous transfer' transactions. These additional disclosures will result in additional ongoing publication costs, although that cost ought to be insignificant. Furthermore, the additional disclosures will also involve some additional year one and ongoing costs for preparers as they have to gather the required information as part of their financial statement preparation process. However, EFRAG's understanding is that generally all of the information needed to provide the additional disclosures will already be available within the entity. As a result, EFRAG's assessment is that again these costs ought to be insignificant.
- 30 EFRAG has also considered whether these additional disclosures will in some way increase the burden on users of financial statements. Its view is that the additional disclosures will impose no additional burden on users; rather, they will allow users to have an improved understanding of the financial statements.

*Transitional arrangements*

- 31 Entities are required to apply IFRIC 15 retrospectively. As explained above, EFRAG believes that, if a change in accounting is necessary, it will most often involve changing from PoC to CC accounting. EFRAG believes that doing this retrospectively will not cause a problem as the information needed should be readily available. On the other hand, where there is a change from CC to PoC accounting, either the information will be available—in which case no significant costs ought to be involved in implementing IFRIC 15 retrospectively—or it will not be available. If the information is not available, it appears to be unlikely that it can be established with hindsight; in such instances no additional cost will be incurred.

*Conclusion*

- 32 Summarising the comments above, it is EFRAG's assessment that IFRIC 15 is likely to:
- (a) involve some year one and ongoing costs relating to reading and understanding IFRIC 15. These costs are likely to be insignificant;
  - (b) result in year one and ongoing costs for preparers to categorise their existing and future agreements. These costs could be significant for some entities, but for most companies in EU – and when considered overall - the costs will not be significant;
  - (c) result in a reduction in ongoing costs related to transaction recording more often than in an increase;
  - (d) involve users in no significant year one or ongoing incremental costs;
  - (e) result in improvements in the comparability, and therefore the quality, of the information provided.
- 33 EFRAG's assessment is that the benefits described in (c) and (e) are likely to outweigh the costs described in (a), (b) and (d).

Stig Enevoldsen  
**EFRAG, Chairman**  
**3 November 2008**

## **Attachment 2**

Endorsement advice prepared by EFRAG

Jörgen Holmquist  
Director General  
European Commission  
Directorate General for the Internal Market  
1049 Brussels

3 November 2008

Dear Mr Holmquist

**Adoption of IFRIC Interpretation 15 *Agreements for the Construction of Real Estate***

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of IFRIC Interpretation 15 *Agreements for the Construction of Real Estate* (IFRIC 15), which was issued by the IFRIC on 3 July 2008. It was issued as an Exposure Draft in July 2007 and EFRAG commented on that draft.

IFRIC 15 provides guidance on when revenue from the construction of real estate should be recognised. In particular, it provides guidance on whether an agreement is within the scope of IAS 11 *Construction Contracts* or IAS 18 *Revenue*. IFRIC 15 states that IAS 11 applies only to those agreements for the construction of real estate in which 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. Conversely, an agreement for the construction of real estate in which buyers have only limited ability to influence the design is an agreement within the scope of IAS 18. If an agreement is within the scope of IAS 18 but involves control and the significant risk and rewards of ownership of the real estate being transferred as work progresses or involves the rendering of services only, revenue is also generally recognised by reference to the percentage of completion method.

IFRIC 15 becomes effective for annual periods beginning on or after 1 January 2009, with earlier application permitted.

EFRAG has carried out an evaluation of IFRIC 15. As part of that process, EFRAG issued an initial evaluation for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

*EFRAG's Endorsement Advice Letter on IFRIC 15*

EFRAG supports IFRIC 15 and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IFRIC 15 and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen  
**EFRAG, Chairman**

## **APPENDIX BASIS FOR CONCLUSION**

*This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IFRIC Interpretation 15 Agreements for the Construction of Real Estate.*

*In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.*

*In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.*

- 1 When evaluating IFRIC 15 *Agreements for the Construction of Real Estate*, EFRAG asked itself four questions:
  - (a) Is there an issue that needs to be addressed?
  - (b) If there is an issue that needs to be addressed, is an Interpretation an appropriate way of addressing it?
  - (c) Is IFRIC 15 a correct interpretation of existing IFRS?
  - (d) Does the accounting that results from the application of the IFRIC meet the criteria for EU endorsement?
- 2 Having formed tentative views on the issues and prepared a draft assessment, EFRAG issued that draft assessment on 29 July 2008 and asked for comments on it by 22 September 2008. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

### **Is there an issue that needs to be addressed?**

- 3 EFRAG understands that there are various views on how the term "construction contract" used in IAS 11 should be understood in practice, and that this is resulting in scope uncertainties. EFRAG further understands that example 9 in the appendix to IAS 18 is being interpreted differently. Both uncertainties are resulting in a divergence in practice. EFRAG agrees that this diversity in the way entities account for the same types of transaction is undesirable and is an issue that needs to be addressed.

**Is an Interpretation an appropriate way of addressing it?**

- 4 As noted above, the diversity in practice results from uncertainties about the term "construction contract" and the meaning of the explanatory comments included in example 9 in the appendix to IAS 18. EFRAG is generally of the view that in cases where an inconsistency in accounting practice is caused by differing interpretations of one or more existing standards it will generally be appropriate to deal with the issue by means of an Interpretation.
- 5 EFRAG has considered whether it is premature for IFRIC to be developing guidance on how to account for the revenue arising from agreements for the sale of real estate bearing in mind that the IASB and FASB are jointly carrying out a comprehensive review of accounting for revenue and a discussion paper on the subject is due in 2008. It would, for example, be a particular concern were the Interpretation to require changes in accounting that the longer-term joint project might reverse, because that would place unnecessary burdens on preparers and users.
- 6 However, EFRAG recognises that the IASB's active agenda covers many aspects of accounting and that, if IFRIC is debarred from issuing Interpretations on all those aspects of accounting, its ability to clarify things that are unclear and causing problems will be severely restricted. EFRAG also notes that it will be several years before the joint IASB/FASB project will result in a standard and, if IFRIC could not act in the meantime, that would mean several years of diversity in accounting practice and a lack of comparability.
- 7 The Interpretation is amending IAS 18 by deleting one example included in the appendix to that standard. This could be considered to be outside the remit of an interpretation. However, as the appendix accompanies but is not part of IAS 18, it has not been endorsed for use in the EU so IFRIC 15 is not amending endorsed material. EFRAG further noted that the IASB has to approve IFRIC Interpretations.
- 8 Having taken the above considerations into account, EFRAG concluded that it was appropriate to resolve the uncertainties described above relating to accounting for real estate construction contracts by issuing an Interpretation.

**Is IFRIC 15 a correct interpretation of existing IFRS?**

- 9 EFRAG has considered whether IFRIC 15 is a correct interpretation of existing IFRS. In EFRAG's view, there were three issues that needed in this context to be considered particularly carefully.
  - (a) Issue 1—Drawing the line between IAS 11 and IAS 18 for the purposes of agreements for the construction of real estate.
  - (b) Issue 2—The recognition of revenue arising from agreements for the construction of real estate.
  - (c) Issue 3—The application of IFRIC 15 by analogy.

Each of these issues is discussed below.

*Issue 1—Drawing the line between IAS 11 and IAS 18 for the purposes of agreements for the construction of real estate*

- 10 The first issue involves determining whether an agreement to construct real estate is—for revenue recognition purposes—within the scope of IAS 11 (in other words, whether it meets IAS 11's definition of a 'construction contract' or not). The IFRIC noted that such a determination depends on the terms of the agreement and all the surrounding facts and circumstances and requires judgement.
- 11 Paragraph 3 of IAS 11 defines a construction contract as "a contract specifically negotiated for the construction of an asset or a combination of assets (...)". IFRIC 15 explains that an agreement meets the definition 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 (regardless of whether or not the buyer exercises that ability).<sup>1</sup>
- 12 EFRAG is aware that some commentators have to date been of the view that whether or not a contract is within the scope of IAS 11 should have more to do with the length of the contract (i.e. whether it is a long-term contract) than whether it is a contract in which the buyer has the ability to specify major structural elements of the design. However, EFRAG believes that the aforementioned paragraph 3 of IAS 11 is clear in this regard: the key issue is whether the agreement is a construction contract as defined, not the length of the contract. EFRAG further believes that whether or not the buyer has the ability—whether exercised or not—to specify the major structural elements of design is the appropriate feature when trying to differentiate between agreements for the construction of real estate that should be accounted for under IAS 11 and agreements for the construction of real estate that should be accounted for under IAS 18. EFRAG is therefore of the opinion that the guidance in IFRIC 15 represents a *possible* way of operationalising the term "construction contract" in the circumstances of real-estate transactions.
- 13 EFRAG has considered whether the guidance in IFRIC 15 addresses only the extreme cases, and as a result whether in other cases it will be more difficult to identify real differences of substance. For example, EFRAG is aware that some commentators are concerned that the IFRIC might have replaced one undefined term (IAS 11's "specifically negotiated") with an equally vague term ("major structural elements of design"). However, although EFRAG accepts that, despite IFRIC 15, there will remain some uncertainty in some cases, it believes that, in a principle-based accounting system, judgement will need to be applied and is preferable to bright line rules.

Conclusion

- 14 EFRAG believes that IFRIC 15 represents a reasonable interpretation of the term 'construction contract', as used by IAS 11.

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<sup>1</sup> Hereafter this will sometimes be referred to as "buyer's specifications".

*Issue 2—The recognition of revenue arising from agreements for the construction of real estate*

- 15 IFRIC 15 states that, when the agreement is a construction contract, IAS 11 applies and, if the outcome of the contract can be estimated reliably, the entity shall recognise revenue by reference to the stage of completion of the contract activity.
- 16 IFRIC 15 states that, for contracts not falling within the scope of IAS 11, the accounting required by IAS 18 will depend on whether the agreement is an agreement for the rendering of services or an agreement for the sale of goods.
- 17 IFRIC 15 clarifies that, if the entity is not required to acquire and supply construction materials, the agreement may be only an agreement for the rendering of services. On the other hand, 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 for the sale of goods.
- 18 In case of an agreement for the rendering of services, IFRIC 15 explains that, if and when the outcome of the contract can be estimated reliably (in accordance with the criteria in IAS 18.20), IAS 18 requires revenue to be recognised by the stage of completion of the transaction. The IAS 11 requirements are generally applied to the recognition of revenue.
- 19 If the agreement is for the sale of goods, IFRIC 15 explains that two cases need to be differentiated:
  - (a) Agreements where the entity transfers to the buyer control and the significant risk and rewards of ownership of the work in progress in its current state as construction progresses (continuous transfer). In this case, if all the criteria in paragraph 14 of IAS 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 transaction is in effect a 'brick-by-brick' sale of the real estate.
  - (b) Agreements where the entity transfers to the buyer control and the significant risk and rewards of ownership of the real estate in its entirety at a single point of time. In this case, the entity shall recognise revenue only when all the criteria in paragraph 14 of IAS 18 are satisfied, i.e. at that single point in time, which will usually be at completion or upon delivery.
- 20 IFRIC 15 also provides guidance on the accounting to be adopted where the entity is required to perform further work on real estate already delivered to the buyer. It explains that, in such circumstances, the entity shall recognise an expense in accordance with IAS 18.19 and measure the liability in accordance with IAS 37. This situation is distinguished from the situation where the entity is required to deliver further goods or services that are separately identifiable from the real estate already delivered to the buyer, where the remaining goods or services to be delivered are treated as a separate component of the sale.

- 21 EFRAG believes that the IFRIC 15 guidance summarised in paragraphs 15 - 20 above is a correct interpretation of existing IFRS.
- 22 Some EFRAG members were concerned about structuring possibilities that might arise from the guidance in IFRIC 15 as to how to distinguish an agreement for the rendering of services from an agreement for the sale of goods (ie the guidance summarised in paragraph 17 above). However, the majority of EFRAG members believe that, while this might be the first time explicit guidance has been provided on the subject, IFRIC 15 is not the cause of any structuring possibilities that might now exist; if any such opportunities exist now, they had also existed before. They noted further that EFRAG in general is of the opinion that standards and interpretations should not be drafted with anti-abuse in mind. In their view the IFRIC 15 guidance summarised in paragraph 17 above is a reasonable interpretation of existing IFRS.
- 23 While all EFRAG members agreed that the continuous transfer model referred to in paragraph 19(a) above was a correct interpretation of the IAS 18, some EFRAG members thought the model was of little practical relevance because agreements for the construction of real estate would rarely if ever qualify for such accounting. The majority of EFRAG members however thought some transactions *would* meet the continuous transfer model requirements. They also noted that, while the concept looked new, it was always implicit in IAS 18.

#### Conclusion

- 24 Having considered the above arguments, EFRAG concluded that this aspect of the consensus is a reasonable interpretation of IAS 11 and IAS 18.

#### *Issue 3—Applying IFRIC 15 by analogy*

- 25 Although the scope of IFRIC 15 is in theory limited to agreements for the construction of real estate, some EFRAG members have doubts as to how effective such a scope limitation can be—or indeed should be—when the text that is being interpreted (IAS 11's definition of 'a construction contract') is of general applicability. Indeed, the IFRIC makes specific reference in the basis for conclusions (BC6) to the possibility of the guidance in IFRIC 15 being applied by analogy. EFRAG has therefore considered whether applying IFRIC 15 by analogy could result in inappropriate accounting.
- 26 A piece of IFRS literature should of course only be applied by analogy when it is applicable, and that will be a matter of judgement. Some EFRAG members believe there is a possibility that IFRIC 15 will be applied by analogy and, as result, what they consider to be a restrictive interpretation of what IAS 11 means by 'a construction contract' could be applied too broadly. Other EFRAG members were less concerned about this because application by analogy requires the transactions to be sufficiently similar to real estate transactions and, if the transactions are genuinely similar, there seems no reason to believe applying IFRIC 15 by analogy would create problems.
- 27 However, all EFRAG members believe that application by analogy is a question of judgment and of the facts and circumstances of individual

transactions and therefore cannot be answered universally for all types of arrangements.

#### Conclusion

- 28 Although some EFRAG members were concerned about the problems that might arise were IFRIC 15 to be applied incorrectly by analogy, other members were not concerned because that would in effect involve the misapplication of IFRS. All members agree that application by analogy is a question of judgment and of the facts and circumstances of individual transactions and therefore cannot be answered universally for all types of arrangements.

#### *Conclusion*

- 29 Having taken into account all the arguments discussed above, EFRAG's view is that IFRIC 15 is, on balance, a reasonable interpretation of existing IFRS.

#### **Does the accounting that results from the application of IFRIC 15 meet the criteria for EU endorsement?**

- 30 Finally, EFRAG asked itself whether it believed that the information resulting from the application of IFRIC 15 would meet the criteria for EU endorsement; in other words, that:
- (c) it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
  - (d) it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be in the European interest to adopt the Interpretation.

- 31 EFRAG has previously concluded that the existing IAS 11 and IAS 18 meet the above endorsement criteria. Furthermore, for the reasons set out above, EFRAG has now concluded that IFRIC 15 is a reasonable interpretation of endorsed IFRS literature.

#### *Relevance*

- 32 According to the Framework, information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. EFRAG considered whether IFRIC 15 would result in the provision of relevant information; information that has predictive value, confirmatory value or both.
- 33 Some EFRAG members had concerns that IFRIC 15 might result in a loss of relevant information. Those EFRAG members note that the effect of IFRIC 15 would be that many real estate construction contracts are taken out of the scope of IAS 11; as a result, although they are currently accounted for using

percentage of completion (PoC), they will henceforth be accounted for using completed contract (CC) accounting, which could mean that relevant information is lost. The EFRAG members who had this concern noted that the continuous transfer model might have made up for this had it be of wide applicability, but in their view it will prove to be of limited practical relevance.

- 34 The majority of EFRAG members do not share the concerns, or at least not to the same degree. They believe that, although IFRIC 15 means that revenue will for some contracts be recognised later than at present and, as a result, the progress of the contract will not be reflected in the income statement in the same way, that does not mean that relevant information will be lost. In their view, the accounting prescribed by IFRIC 15 better reflects the economic substance.

#### *Reliability*

- 35 The Framework explains that information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. EFRAG considered whether the implementation of IFRIC 15 would result in reliable information being included in the financial statements.
- 36 EFRAG believes that the implementation of IFRIC 15 would raise no concerns about risk of error or bias. Some EFRAG members have concerns about the representational faithfulness of the information prepared in accordance with IFRIC 15 for the reasons set out in paragraph 33 above. However, the majority of EFRAG members do not share those concerns for the reasons set out in paragraph 34.

#### *Comparability*

- 37 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 38 The IFRIC's objective in issuing IFRIC 15 was to eliminate the cause of the current diversity in practice in the accounting treatment of agreements for the construction of real estate and thereby improve the comparability of the information provided in financial statements. EFRAG believes that IFRIC 15 will do that. In particular, IFRIC 15 reduces divergence in practice by clarifying the dividing line between contracts in the scope of IAS 11 and those that fall under IAS 18 and by providing guidance on how IAS 18 should be applied to different types of agreements for the construction of real estate falling within its scope. This increases comparability and ensures that users of financial statements compare like with like and are therefore not obscured by arbitrary accounting outcomes.
- 39 As explained in paragraph 13 above, IFRIC 15 will not eliminate all uncertainty as to whether an agreement is a construction contract as defined by IAS 11. A degree of judgement will continue to need to be applied. EFRAG nevertheless believes that the comparability criterion will still be met.

*Understandability*

- 40 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.
- 41 EFRAG concluded that the information that results from the application of IFRIC 15 is understandable as it is more comparable than hitherto, ensures that the accounting consequences of agreements for the construction of real estate are more evident than before, and better reflects the economic substance of the transactions involved. The information also provides meaningful information of related risk in the revenue recognition process. In addition, IFRIC 15 requires additional disclosure on so-called "continuous transfer" transactions, which ensures that complex matters are appropriately explained and reflected in the financial statements.

*True and Fair*

- 42 For the reasons set out above, EFRAG sees no reason to believe that IFRIC 15 is inconsistent with the true and fair view requirement.

*European Interest*

- 43 EFRAG has considered whether the benefits of implementing IFRIC 15 in the EU exceed the costs of doing so. Its assessment (as explained more fully in the Effects Study Report) is that, although implementation of IFRIC 15 would involve some incremental costs, they are likely to be outweighed by the benefits arising from its implementation.

*Conclusion*

- 44 After considering all the above arguments, EFRAG concluded that on balance IFRIC 15 satisfies the criteria for EU endorsement and EFRAG should therefore recommend its endorsement.