

XX October 2007

D21 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by
18 October 2007

Dear Sir/Madam,

Re: IFRIC Draft Interpretation D21 *Real Estate Sales*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IFRIC Draft Interpretation D21 *Real Estate Sales* (D21). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretation.

The IFRIC undertook this project to clarify when revenue from the sale of real estate should be recognised if an agreement for sale is reached before the construction of the real estate is completed.

D21 proposes that a real estate sale agreement will fall within the scope of IAS 11 *Construction Contracts* only if it is an agreement for the seller to provide construction services to the buyer's specification. D21 goes on to set out features that may indicate whether that is the case. It also provides some guidance on how to apply IAS 18 to agreements deemed to fall within the scope of IAS 18 and it moves and amends one of IAS 18's examples.

EFRAG supports the IFRIC in its efforts to provide interpretive guidance on the application of IAS 11 and IAS 18 to such transactions. However, we have several significant concerns regarding the proposals included in D21, in particular the implications were the consensus proposed to be applied by analogy to other circumstances and industries. We are also concerned about the implications were the consensus proposed to be applied by analogy to other circumstances and industries. For that reason, we would have preferred the IFRIC to develop some generic principles in connection with the difficulties that arise with construction contracts, instead of trying to cover the rather narrow area of real estate sales with potentially unintended consequences to other areas of "long-term contracting".

Our detail comments are set out in the appendices to this letter.

If you would like further clarification of the points raised in this letter, Thomas Oversberg or I would be happy to discuss the letter with you further.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1 – EFRAG’s detailed comments on IFRIC D21

D21, paragraph 8—Construction services to the buyer’s specification

- 1 The objective of D21 is to clarify how IFRS should be applied when a real estate developer enters into an agreement to sell real estate before its construction has been completed. In other words, should the transaction be accounted for as a construction contract in accordance with IAS 11 or as a sale of goods agreement in accordance with IAS 18.14?
- 2 The key issue here is whether the agreement is a construction contract as defined in IAS 11. D21 proposes in paragraph 8 that it is a construction contract if it is an agreement for the seller to provide construction services to the buyer’s specification. D21 then goes on to set out some features which may indicate that an agreement is “an agreement for the seller to provide construction services to the buyer’s specification”.

Construction services

- 3 IAS 11 defines a construction contract as “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.”
- 4 IFRIC D21, paragraph 8 states that an agreement to sell real estate before its construction is completed meets this definition only if it is an agreement for the seller to provide construction services to the buyer’s specifications. In other words, to be a construction contract as defined by IAS 11, two criteria have to be met.
 - (a) The agreement must be to provide construction services.
 - (b) The agreement must require those services to be provided in accordance with the buyer’s specifications.
- 5 EFRAG members were divided as to the significance of the reference to “construction services”. Some thought the reference was not very significant. However, some other EFRAG members were concerned that the use of the term “construction services” has the effect of limiting what is currently seen as the scope of IAS 11. In their view, IAS 11 is currently widely viewed as being a standard about the provision of a service combined with the delivery/handover of an asset, and this amendment would mean that IAS 11 would henceforth be about construction services only with no asset being involved. EFRAG members held strong views with respect to that point and we therefore thought it useful for the IFRIC’s understanding of the concerns, to include them in more detail in Appendix 2 to this letter.
- 6 In view of this uncertainty as to the significance of the phrase, EFRAG would encourage the IFRIC to either explain what its reasons are for using the phrase and what it believes the implications are of its inclusion or delete the term “services”. In any case, EFRAG would not support a limitation of the scope of IAS 11 in any manner.

Buyer’s specifications

- 7 As pointed out in paragraph 4 above, the second criterion identified by the IFRIC for a sale arrangement to be within the scope of IAS 11 is that the agreement must require those services to be provided in accordance with *the buyer’s specifications*.

- 8 EFRAG has reviewed D21 and existing IFRS for evidence that they provide support for this criterion in D21. We note that this appears to be the first reference in existing IFRS to IAS 11 applying only when the work is being done to the buyer's specifications. Even IFRIC 12 made no reference to such a criterion. As a result, EFRAG members have different views on this part of the paragraph 8 of D21.
- 9 Some EFRAG members believe that the 'buyer's specifications' criterion is one possible interpretation of the reference in IAS 11's definition of a 'construction contract' to a contract being specifically negotiated for the construction of an asset. In their view, D21's proposal is merely clarifying the type of negotiations to which IAS 11 is referring.
- 10 On the other hand, some EFRAG members believe that such an interpretation is not consistent with IAS 11. They note, for example, that in paragraph 25 of IAS 11 it is stated that the percentage of completion method "provides useful information on the extent of contract activity and performance during a period". Similarly, the paragraph on the objectives of IAS 11 states that the "nature of the activity undertaken in construction contracts [is that] the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting period". Furthermore, in their view the wording of IAS 11 generally is mainly about contract accounting rather than fulfilling a customer specific task.
- 11 However, assuming that the 'buyer's specifications' criterion *is* one possible interpretation of IAS 11's definition, EFRAG members had different views as to whether it was the most appropriate interpretation. In particular, although EFRAG agrees with the statement in paragraph BC5(a) of D21 that, in an IAS 18-type contract, construction takes place independently of the sale agreement, it disagrees on how best to operationalise that principle.
 - (a) Some EFRAG members believe that, although a 'buyer's specifications' criterion has its flaws, no better way of operationalising the principle described in (a) has been found. They therefore believe this part of the Interpretation is reasonable and should be supported.
 - (b) Other EFRAG members however believe a 'buyer's specifications' criterion is not the best way of operationalising the principle described in (a). For example:
 - (i) They are not convinced that the difference described in D21 is robust enough in practical terms to be used as the basis for determining which transactions should be dealt with by which standard. That is because, although it is easy to differentiate between construction activities that simply involve following the buyer's instructions and construction activities that are carried out independently of the buyer, those are the extremes and between those extremes it will often be much more difficult to identify real differences of substance. Therefore, the "buyer's specifications" criterion could result in economically similar situations being treated differently.
 - (ii) There could be unintended consequences if such an interpretation were to be applied to other areas where IAS 11 is currently applied. (see also paragraphs 23-28)

Question to our constituents:

EFRAG would particularly welcome your comments on the views expressed in paragraphs 8 – 11 above.

D21, paragraphs 9 and 10—Features that might indicate the existence of a construction contract

- 12 Having established in paragraph 8 the principle that IAS 11 applies only to agreements for the seller to provide construction services to the buyer's specifications, D21 then sets out in paragraph 9 two features which it proposes individually or in combination may indicate that an agreement is in the scope of IAS 11. Those features are that:
- (a) 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;
 - (b) the seller is transferring to the buyer control and the risk and rewards of ownership of the work in progress in its current state as construction progresses (i.e. continual delivery).
- 13 D21 also identifies in paragraph 10 two features that may indicate that the agreement is not within the scope of IAS 11 and should instead be treated as a sale of goods under IAS 18. Again, one of the features deals with the extent to which construction proceeds in accordance with the buyer's specifications (paragraph 10(a)) and the other deals with delivery and the transfer of control and risks and rewards of ownership (paragraph 10(b)).
- 14 As pointed out above, EFRAG has some fundamental questions with respect to the principle and assumptions of paragraph 8. However, even if EFRAG agreed with paragraph 8, we would have some significant concerns about the features. Our concerns relate primarily to the features (described in paragraphs 9(b) and 10(b) of D21) referring to continual delivery and continual transfer of control and of the risks and rewards of ownership, and how they relate to the other features—although we do also have one concern (see (a) below) about the features set out in paragraphs 9(a) and 10(a).
- (a) The features set out in paragraphs 9(a) and 10(a), with their references to negotiations and the extent of the buyer's involvement in specifying what is to be constructed and how it is to be constructed, seem an attempt to operationalise the principle established in paragraph 8. If the paragraph 8 principle is correct, we could agree with paragraphs 9(a) and 10(a). However, we do wonder whether replacing one undefined term ("specifically negotiated") with an equally vague term ("major structural elements of design") takes us very far forward.
 - (b) Although we agree that paragraphs 9(a) and 10(a) of D21 are an interpretation of the principle set out in paragraph 8, the features described in paragraphs 9(b) and 10(b), which refer to continual delivery and continual transfer of control and of the risks and rewards of ownership, seem to be based on an entirely different principle (relating to the transfer of control and risk and rewards). Certainly we see no link between carrying out work to the buyer's specifications and continual delivery. In our view they are completely different notions.
 - (c) As indicated under (b) it seems to us that there is not one but in fact two different principles underlying D21. The second principle is based on a "continuous sale" approach, which might or might not be helpful when discussing multi-unit real

estate sales. However, we would like to point out that IAS 11 makes no reference to the need for there to be continual delivery or a continual transfer of control or of risks and rewards. IFRIC's rationale here, as is set out in the last paragraph of BC 5(b) of D21, is that the reason IAS 11's percentage-of-completion approach is appropriate for certain contracts is because it enables the accounting to reflect the essence of those contracts, which is that they involve a continuous delivery of control and risks and rewards of ownership. This argument troubles us for two reasons:

- (i) According to D21, the existence of a continuous delivery of control and risks and rewards of ownership might indicate that the contract is an IAS 11-type contract, and a contract could be an IAS 11-type contract even if there is not a continuous delivery of ownership and risks and rewards of ownership. Paragraph BC5(b) however seems to suggest that a continuous delivery of ownership and risks and rewards of ownership is the underlying principle of IAS 11.
- (ii) We think that many of the contracts that are currently correctly treated as being within the scope of IAS 11 do not involve a continuous delivery of ownership and risks and rewards of ownership.

15 We also have a number of more detailed concerns about the features set out in paragraphs 9 and 10:

- (a) We believe that the features proposed and the status they have been given by D21 (they only "may" be an indication) will not help much in clarifying the issues addressed in the draft Interpretation.
- (b) We can envisage cases where the features set out in paragraphs 9(a) and 10(a) (which are about whether the agreement is to provide constructions services to the buyer's specifications) will point in one direction whilst the features set out in paragraphs 9(b) and 10(b) (which are about whether there is continual delivery) will point in the other. For example, the buyer might own the land (which might suggest, according to paragraph 9(b)(i), that the contract should be accounted for in accordance with IAS 11) but will still only be able to select a design from a range of options (which suggests, according to paragraph 10(a), that the contract should be accounted for under IAS 18). (We believe that this will be the case in a high number of domestic constructions (e.g. family homes).)
- (c) We are not convinced that D21.9(b)(i) is right to suggest that the question of who owns the land is necessarily relevant when considering who has control or the risk and rewards inherent in ownership of an apartment in a multi unit real estate building. We recognise that, in some jurisdictions, the person who owns the land will also own any constructions on that land, but it does not follow that just because that owner is the buyer the buyer will necessarily also have significantly all the risk and rewards of the constructions. Furthermore, in some jurisdictions, the ownership of land might be legally transferred a significant time after the construction started, or even has been completed, without having an impact on the ownership of the apartment.

16 The proposed approach seems to be form driven, focusing in too much detail on legal matters, while ignoring the substance of the transaction and the intentions of IAS 11 guidance. In our view, the key to getting the interpretation right is to have a clear unambiguous principle that is applied consistently throughout the interpretation. If that is done, it seems to us that it might not even be necessary to set out any features at all—because they do seem to be a rather complex way of addressing the issue.

D21, paragraphs 11-13—Example 9 in appendix to IAS 18

First paragraph of Example 9 in IAS 18

- 17 Having concluded that IAS 18 is the applicable standard for many transactions involving the sale of real estate before construction is completed, the IFRIC considered how IAS 18 should be applied to such transactions. It concluded that it was not “wholly clear” and that the first paragraph of example 9 in the appendix to IAS 18 is the main source of this lack of clarity¹. In particular:
- (a) The IFRIC thinks the paragraph can be read to suggest—incorrectly—that a binding agreement for the sale of real estate units (which can give the buyer a form of equitable interest) is sufficient to transfer the risks and reward of ownership of the real estate to the buyer.
 - (b) The IFRIC is concerned that the paragraph could be read—again incorrectly—to prohibit the 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.

The IFRIC is proposing that the best way of eliminating the risk of the paragraph being misread in this way is to delete the whole of the paragraph.

- 18 However, we believe that the paragraph, if read correctly, provides useful guidance in cases where, for example, the entry into the cadastral register (i.e. register of real estate property) is a pure formality. It also provides relevant guidance on a transaction type that involves the transfer of equitable and/or legal title to an uncompleted unit in a multi-unit real estate development—a type of transaction that is very common in some parts of Europe. Therefore we would prefer the paragraph to be retained and amended rather than deleted. In any case we believe it would have been helpful if the IFRIC would have explained in more detail, how the new guidance in D21 replaces the guidance of that paragraph.

Third paragraph of Example 9 in IAS 18

- 19 The IFRIC proposes to incorporate the second paragraph of example 9 into the text of the Interpretation, but to exclude the third paragraph. That third paragraph states that if there is insufficient evidence of the buyer’s commitment to complete payment for the real estate, revenue shall be recognised only to the extent cash is received. IFRIC’s reason for omitting this paragraph is that it is not consistent in all respects with IAS 18.14(d), which states that one of the conditions that has to be satisfied for revenue from the sale of goods to be recognised is that it is probable that the economic benefits associated with the transaction will flow to the entity. We agree with IFRIC’s reasoning and decision to exclude the paragraph, but think it would have been preferable to have provided corrected guidance on what can be a difficult issue. Finally, EFRAG would have appreciated, if the IFRIC would have taken the time to review the wording of incorporated second paragraph (now paragraph 13 of D21), as several EFRAG members thought the wording was confusing.

¹ The first paragraph of example 9 says: “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 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.”

D21, paragraphs 14—IAS 18 and the remaining obligation

- 20 The conditions that IAS 18 requires to be met before revenue from the sale of the real estate shall be recognised may be satisfied before the entity has performed all of its contractual obligations to the buyer. The IFRIC has taken the view that it would be useful to provide guidance as to how, if the conditions have been met before all the contractual obligations have been performed, the remaining performance obligation(s) should be accounted for. As a result, paragraph 14 of D21 explains that IAS 18 requires the seller to recognise any outstanding performance 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 (for example to remedy minor defects or complete internal decoration), it shall recognise an expense in accordance with IAS 18.19. The liability shall be measured in accordance with IAS 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 (for example some internal fittings or communal amenities), it shall treat the remaining goods or services as a separate component of the sale, in accordance IAS 18.13. 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.
- 21 EFRAG agrees that the situations described in paragraph 14 of D21 are two economically different situations and that those situations should be accounted for differently. However:
- (a) we think the wording in the D21, paragraph BC 19 (in particular the use of the word “or” at the end of BC 19(a)) could be interpreted to mean that there is a free choice as to which accounting policy is applied. As that is not the intention, we suggest that the wording be improved; and
 - (b) we do not find the guidance provided in paragraphs 14(a) and (b) to be very helpful. Firstly, it does not seem to say anything new. Secondly, it does not clarify the things that are unclear at present. For example, what are ‘minor defects’ as opposed to more significant defects; and why is the completion of the internal decorations treated like a minor defect whilst completion of some internal fittings treated differently? To be useful, D21 needs to set out and explain the principle that it applied when developing these differences.
- 22 For the reasons we have already explained, we also think it would have been better had the IFRIC developed some generic guidance on how to distinguish between paragraph 14(a) and (b), rather than guidance focusing just on real estate sales.

D21, paragraph 5—Scope

- 23 The IFRIC proposes to apply D21 in accounting for revenue from all sales of real estate. This scope concerns us for two reasons:
- (a) Firstly, we do not think the Interpretation works well for all sales of real estate.
 - (b) We are also concerned about the Interpretation being applied more widely by analogy.

All sales of real estate

24 Although the proposed Interpretation is intended to be applicable to all sales of real estate, it appears to us that D21 was developed with a well defined multi-unit real estate sale in mind. The result is that, although IFRIC members suggested during their discussions that they did not intend to change the accounting treatment of real estate sales other than of multi-units, D21 will we believe have significant consequences for the accounting treatment of the construction of single (family) houses, not being part of a multi-property development, where the buyer is selecting from a range of available models and options. We understand that currently such contracts are generally accounted for by applying IAS 11; D21 would in many cases require them to be accounted for as sales of goods under IAS 18. It is not clear to us that the IFRIC has sufficiently considered the implications of this.

Application by analogy

25 Furthermore, although the scope of D21 is in theory limited to real estate sales, we have our doubts as to how effective such a scope limitation can be—or indeed should be—when the text that is being interpreted is of general applicability.

26 It could perhaps be argued that the IFRIC needs to limit the scope of its Interpretations if its projects are to be manageable, and that therefore it is reasonable for the IFRIC to propose to limit the scope of D21 to the sale of real estate sales. EFRAG does not however accept that argument in this particular case. IAS 11 and IAS 18 are general standards and IAS 11's definition of a 'construction contract' is a generally applicable definition. Therefore, although it is perfectly reasonable that a clarification of IAS 11's definition could focus on issues that arise in the context of a particular type of transaction and could be expressed in language that is somewhat transaction-specific, the clarification cannot be transaction-specific. Therefore, the IFRIC should state that, a real estate sales agreement meets the IAS 11's definition of a construction contract "if it is an agreement for the seller to provide construction services to the buyer's specifications" only if it also believes that would be the case for any other sales agreement as well. If the IFRIC does not believe that would be the case but believes it is nevertheless essential to issue an Interpretation, the least it should do is include in the Interpretation (as it did in IFRIC 10, paragraph 9) a statement that it is not to be applied by analogy.

27 In the absence of such a statement, we think there is a significant probability that D21 will be applied by analogy in other circumstances and that could result in unintended consequences. For example, if the principles and features are applied to machinery, road or ship construction activities, they will result in a fundamental change in the accounting treatment of such activities, i.e. those activities would have to be accounted for as sales of goods under IAS 18, while currently they are accounted for under IAS 11². It is our understanding that the IFRIC did not, during the course of its deliberations, consider the implications of its narrowly-based interpretation of a generally-applied part of IAS 11 being applied by analogy.

28 In summary, because of the implications of the hierarchy and the likelihood of interpretations being applied by analogy, we believe that it would have been more helpful had the IFRIC developed some generic principles rather than simply address

² Ship and road construction activities are in fact specifically mentioned in IAS 11.4 as an example of construction contracts.

the rather narrow area of real estate sales in a way that could have potentially significant unintended consequences for other areas of “long-term contracting”.

Appendix 2 – Reasons why some EFRAG members do feel that the term construction services is limiting the scope of IAS11

- 1 As indicated, some other EFRAG members were concerned that the use of the term “construction services” has the effect of limiting what is currently seen as the scope of IAS 11.
- 2 In their view, IAS 11 is currently widely viewed as being a standard about the provision of a service and the delivery/handover of an asset, and this amendment would mean that IAS 11 would henceforth be about construction services only.
- 3 These EFRAG members pointed out:
 - (a) There is no explanation in D21 as to why the IFRIC believes IAS 11 applies only to contracts for construction services. For example, the first reference to the matter in the Basis for Conclusions is in paragraph B5(a) which first quotes IAS 11’s definition of a construction contract (see paragraph 4 above) and immediately states without further explanation that “a contract for ‘construction’ is a contract to provide construction services”.
 - (b) Such a restriction would appear not to be consistent with the wording of existing IFRS. For example:
 - (i) When discussing whether the construction of an additional asset shall be treated as a separate construction contract, IAS 11.10(b) refers to the “price of the asset”. If IAS 11 applies only to construction service contracts, they would have expected that reference to be to the price of the construction service.
 - (ii) The scope paragraph of IAS 18 explains that the standard applies to the sale of goods, the rendering of services (as well as the use by others of entity assets yielding interest, royalties and dividends). IAS 18.4 then attempts to explain the boundary between IAS 18 and IAS 11. It states that “some contracts for the rendering of services are directly related to construction contracts, for example, those for the services of project managers and architects. Revenue arising from these contracts is not dealt with in this Standard but is dealt with in accordance with the requirements for construction contracts as specified in IAS 11.” If all construction contracts involve only the rendering of services, the inclusion of the words “directly related” would be unnecessary; IAS 18.4 could simply say that “some contracts for the rendering of services are construction contracts...”.
 - (c) EFRAG notes that D21, paragraph BC5(b) explains that the IFRIC believes there is a difference of substance between a contract for construction services and a contract for the sale of goods and that difference of substance tends to be that in a contract for construction services there tends to be a transfer of control and of the risks and rewards of ownership as construction progresses. (See also our comments in paragraph 14 of Appendix 1 on that matter.) Members of the third group would agree with the first part of that statement, but identified a different difference, as explained above in Appendix 1, paragraph 5.
- 4 For the above reasons, those EFRAG members that believe the inclusion of the phrase “construction services” is significant do not support its inclusion.