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

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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.