

Rådet för finansiell rapportering

RFR-rs 2007:3

International Financial Reporting Interpretation Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

IFRIC D 21 Real Estate Sales

We appreciate the opportunity to respond to the International Financial Reporting Interpretation Committee's Draft Interpretation D 21, *Real Estate Sales* (D 21 below). This letter represents the view of the Swedish Financial Reporting Board.

Summary

The Swedish Financial Reporting Board does not support the consensus of the D 21.

The project started out with the aim of solving the issue of various accounting practices being applied in accounting for agreements related to sale of units of residential real estate, before the real estate is completed. The Draft Interpretation now goes, as we understand it, far beyond the initial intention.

The interpretation proposed in D 21 of the definition of what should constitute a construction contract is much more restrictive than the definition given in IAS 11. The stage of completion accounting approach to revenue recognition creates in many situations more relevant financial information, than the approach in IAS 18 for the sale of goods. Based on the narrow interpretation, the D 21 rules out the use of stage of completion revenue recognition for sale of units of residential real estate developments and limits the possibility to use IAS 11 for other types of contracts in the construction industry, as well as limiting the use of IAS 11 in other industries. D 21 could reduce the applicability of IAS 11 for industries such as engineering and telecom.

In our view the D 21 is not in line with the Objectives stated in IAS 11. D 21 would create a gap in the logic of revenue recognition for long-term contracts, between IAS 11 and the stage of completion revenue recognition for rendering of services according to the approach in IAS 18 for services.

The Draft also proposes that the first paragraph of example 9 in the Appendix to IAS 18 should be deleted, taking away the concept of equitable interest in a property being vested in the buyer before legal title passes. This would lead to postponing the reporting of many real estate sales, primarily in the Construction and Real Estate industries in Sweden and other countries creating financial statements clearly less relevant.

Companies with long-term projects, which have been using IAS 11 under a broader interpretation than the one proposed in D21, will continue to use stage of completion accounting for management purposes. The D 21 would create unwarranted differences between segment reporting and financial statements when IFRS 8 Operating Segments is implemented.

D 21 would create a new IFRS/US GAAP difference and disregards long standing developments of reporting for sales of residential real estate units.

To implement such significant changes (as D21 would require) just a few years prior to that a new converged revenue recognition standard is expected to be effective, would most likely result in costs that outweighs benefits.

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D 21 and the objectives and basic principles governing application of IAS 11

We are concerned with how the IFRIC is interpreting the objective and basic principles of IAS 11.

Our understanding is that the IFRIC primarily focuses on whether a contract is for the production or construction of something specifically specified by a buyer (see discussions in BC 4 to BC 6), rather than on the Objectives of the standard, as they are stated in IAS 11: *"The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed."* *'Underlining is our emphasis'*

The prime objective of IAS 11 is to provide principles for relevant financial reporting in situations where the undertaking by a seller is to construct/produce something that takes a considerable time to fulfill. The IAS 11 was created to solve severe relevance problems caused by using completed contract/goods type revenue recognition principles, for contracts that takes a considerable time to fulfill.

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 is the definition of a construction contract according to IAS 11. This definition does not include any clear requirement as to the asset being something that is to be constructed according to a specification where the buyer must have had the possibility to "specify the major structural elements of the design" (D 21, para 8 and 9). There is no reason to interpret the concept of a construction contract under IAS 11 as narrow as the IFRIC proposes. IAS 11 should be applicable to binding contracts with customers to construct/produce an asset or assets that take considerable time to fulfill. If the same asset is produced for one or many with the same structural specification is not a concern relevant in determining if IAS 11 should or should not be applied to fulfill the objectives of IAS 11.

The Draft asserts - with no further explanation or discussion that *'the rationale for applying the stage of completion method to construction contracts is not just that it recognises the value of the entity's activity in the period. Rather it also recognises the economic benefits that the entity has delivered (via continuous transfer of control and risks and rewards of ownership) to the buyer as construction progresses.'* (BC5(b), last paragraph). *'Underlining is our emphasis'* The IFRIC hereby, as we understand it, proposes to introduce *'continuous transfer of control and risks and rewards of ownership'* as key circumstances in determining if IAS 11 is applicable. The IFRIC also, proposes to introduce 'the buyer having a right to take over the work in progress (albeit with a penalty) during construction, eg to engage a different contractor to complete the construction' as a key circumstances in determining if IAS 11 is applicable. We find no justification in the IAS 11 for these interpretations and adding these new restrictions to the use of IAS 11 is contrary to the Objective of IFRS 11.

The IFRS has in IAS 18 principles for accounting for rendering of services which are used for revenue recognition of short- and long-term service contracts. Through IAS 18 we have stage of completion accounting, which provides principles almost identical with IAS 11 for revenue recognition of service contracts. IAS 18 does not include anything like the application restrictions discussed above, which the IFRIC now is proposing to introduce in the Draft interpretation of IAS 11. What the IFRIC D 21 would create is a situation where construction-type contracts, which in substance have characteristics that are very similar to long-term contracts for rendering of services that shall be reported based on IAS 18 for services, would not be allowed to be reported based on stage of completion. This would create a logical gap in IFRS revenue recognition and would reduce the value of IFRS financial standards to preparers and users.

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Applying revenue recognition at one single point in time for projects of the complexity contained in construction contracts (with or without sales of real estate) conveys a misleading notion of objective precision. In our view the stage of completion approach, expressing the degree of contract fulfilment at each point of time, is much more in line with the basic business rationale of the construction industry and is the base for financial reporting that presents a true and fair view of entities in this industry.

D 21 would create unwarranted differences between segment reporting and financial statements

Companies with long-term projects will continue to use stage of completion accounting for management purposes. The D 21 would create unwarranted differences between segment reporting and financial statements, when IFRS 8 Operating Segments is implemented, both due to restricting the use of IAS 11 and due to prohibiting recognition of revenue gain from sale of real estate, when the equitable interest in a property is being vested in the buyer before effective control has passed to the buyer.

Swedish construction companies have, in their capacity of developers as the D 21 was being drafted, in a letter to the IFRIC underlined that the percentage of completion method is the guiding principle for their own operating models. A consequence of the proposed interpretations in D 21 would be that preparers would have to add more information in the financial reports to overcome the reduced transparency and relevance the interpretation would cause. Proforma reporting may very well have to be added to the financial reports.

D 21 would in many situations delay revenue recognition of the sale of real estate

The first paragraph of Example 9 in the Appendix to IAS 18 reads; '*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.*' The Draft proposes that this paragraph should be deleted and as we understand the IFRIC, IAS 18 should be interpreted in way that precludes revenue recognition for sale of real estate even when the equitable interest in a property vests in the buyer, before the customer has taken effective control.

In countries like Sweden where substantially all risks and rewards of ownership of completed real estate, sold without any pre-conditions, passes to the buyer upon signing the contract, the D 21 would lead to delaying revenue recognition in a way that distorts financial reporting.

In case this consequence is not the intention of the IFRIC, clarifications are needed. It could be that we misinterpret the meaning of 'effective control' included in D 21 paragraph 12.

D 21 would create a new IFRS/US GAAP difference and disregards long standing developments of reporting for sales of residential real estate units

FAS 66: Accounting for Sales of Real Estate para .37 says as follows: '*If individual units in condominium projects or time-sharing interests are being sold separately and all the following criteria are met, profit shall be recognized by the percentage-of-completion method on the sale of individual units or interests:*

- Construction is beyond a preliminary stage.*
- The buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest.*
- Sufficient units have already been sold to assure that the entire property will not revert to rental property.*
- Sales prices are collectible*
- Aggregate sales proceeds and costs can be reasonably estimated.*

The accounting principles and criteria according to FAS 66 paragraph 37 are very similar to the accounting for principles for this type of development projects that have been advocated also outside the US in countries such as Sweden, Finland and France as well as other countries. Besides the fact that the

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stage of completion method has over time become the relevant principle for recognizing revenue for the sale of residential real estate units in a number of countries, it also has been explicitly considered by US GAAP as the one applicable.

The D 21 would create a new difference between IFRS and US GAAP in a situation where convergence is very important. We do not support creating any new GAAP differences, unless it is of great importance for the development of IFRS and that is in our view not the case here.

D 21 is not synchronized with ongoing developments

D 21 would result in significant changes in financial reporting for many companies in a situation where it may well be that they then would have to change principles again shortly, depending on what the IASB and FASB revenue recognition project concludes.

The D 21 proposes interpretations that delay revenue recognition. This is just going in the opposite direction compared to much of IASB's new standards and current proposals. It also is contrary to what has been suggested in the PAAinE Revenue recognition document recently published.

In our view, the issue with different interpretations between countries for the reporting of sale of real estate units, the issue the D 21 started from, is of less concern than the one that would be created by now forcing companies, based on D21, to change revenue recognition principles.

We believe the issues discussed in D 21 should rest until the IASB and FASB revenue recognition project is concluded.

The IAS 18 principles for goods would not capture the reality of sales of residential real estate units in a relevant manner

The SFAS 66 not only mentions sale of apartments, but also sale of the rights to use apartments on a time-sharing basis. This is only one of many examples of the complexities involved in accounting for sales of residential real estate units that users already have been addressing in discussions with IFRIC.

Sales of residential real estate units encompass such a wide range of contractual scenarios within countries, and between different countries, that it is doubtful whether the D 21 consensus would achieve the proposed standardisation of accounting practice among real estate developers.

Practical issues that should be considered

For companies like construction companies that today apply IAS 11, but based on D 21 would be required to use the IAS 18 approach for goods, for part of their businesses, the change would require substantial efforts such as:

- Re-design and implementation of new functionality in IT-systems and related processes/routines. For larger companies such systems are integrated (production, supply and accounting etc) and significant changes are both time consuming and expensive.
- Training of related staff. Note that in a construction company a large number of engineers, acting as project managers need to be trained as well as accounting staff on mid- and high levels. Therefore substantial training programs would be required.

In our view interpretations should not be issued by IFRIC just to get all preparers in line, where different interpretations exist among preparers, in a situation as the present, where an ongoing major IASB revenue recognition project, may in a few years lead to other solutions than the accounting model than the D 21 would establish, without carefully considering cost compared to benefits. Issuing the D21 may lead to that a number of companies will have to implement significant changes twice in a short period.

The Swedish Financial Reporting Board

Box 7680 103 95 STOCKHOLM

Tel: +46-8-50 88 22 79 Fax: +46-8-32 12 50

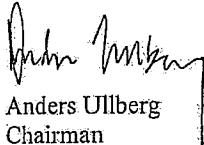
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If you have any questions concerning our comments please address our Executive member Carl-Eric Bohlin by email to: carl-eric.bohlin@radetforfinansiellrapportering.se

Stockholm, October 5, 2007
Yours faithfully,

THE SWEDISH FINANCIAL REPORTING BOARD



Anders Ullberg
Chairman