EFRAG

European Financial Reporting Advisory Group

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 to 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 IFRC 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.

<u>Costs for preparers</u>

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).

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