

12 October 2007

Robert Garnett
Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London EC4M 6XH

commentletters@iasb.org

Dear Bob,

IFRIC Draft Interpretation D21 *Real Estate Sales*

Deloitte Touche Tohmatsu is pleased to comment on the International Financial Reporting Interpretations Committee's (the IFRIC's) Draft Interpretation D21 *Real Estate Sales* (referred to as the Draft Interpretation).

Whilst we support the IFRIC's efforts to provide clarification for transactions in which agreements for sale of real estate are reached before the construction is complete, we do not support the consensus as proposed in the Draft Interpretation as it does not clearly articulate the underlying principles and logic to distinguish a contract for the delivery of goods from that for the delivery of construction services. To assist the IFRIC in their re-deliberations of the Draft Interpretation we have articulated what we see as the relevant principles in Appendix A to this letter. The Appendix suggests some indicators to assist in distinguishing the characteristics of the delivery of goods from those of construction services. In our view, whether a contract is for the delivery of goods or for the provision of construction services is a spectrum in which judgement will need to be exercised in order to determine how a contract should be classified.

In Appendix B to this letter we have also highlighted some specific concerns in relation to the Draft Interpretation as it is currently drafted. We also note that a number of aspects of the Draft Interpretation are not clear and would benefit from modifications to the wording or the inclusion of additional guidance. We have provided detailed comments on each of these issues in Appendix B.

Whilst we believe that if principles are appropriately articulated in an Interpretation it is not necessary to limit the scope for its application, if the IFRIC proceed with the Draft Interpretation in its current form we strongly believe that the scope should be limited to address only pre-completion real estate contracts, and there should be explicit acknowledgement that other, different factors might need to be considered if similar issues arise for other types of contract.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0)20 7007 0907.

Sincerely,

A handwritten signature in black ink, appearing to read 'Ken Wild', written over a horizontal line.

Ken Wild

Global IFRS Leader

Appendix A

Proposed principles for distinguishing a contract for delivery of goods from delivery of construction services

Where a building is constructed on land that has not been, and will not become, an asset of the seller (or of a joint arrangement to which the seller is party), construction activity that takes place on that land will generally be the provision of a construction service, hence within the scope of IAS 11.

Where a property is prefabricated and then delivered, it will be necessary to apply the criteria below to decide whether the offsite construction activity is the delivery of a construction service or the production for the delivery of a good. But where construction activity takes place directly on someone else's land, and results in a structure that is irrevocably fixed to the land (so that it could not be transferred to another customer, only demolished), that onsite construction activity will be regarded as the provision of a construction service.

Otherwise, it is necessary to consider whether the characteristics of the contract as a whole mostly correspond to those of a contract for delivery of goods or those of a contract for construction services.

This is not a black and white distinction, it is a spectrum – and judgement will be necessary in assessing where on that spectrum a contract lies. Consider the following indicators and exercise judgement over how much weight to attach to each.

Characteristics of a contract for the delivery of goods:

- Important design features are driven by the seller, customers choose broadly from a range of pre-existing options.
- Overall construction activity of seller would not be affected by whether or not this customer entered into this contract (i.e., providing enough customers were identified or anticipated, the same construction activity would have taken place anyway).
- Contract is not for a specific item of property, or seller is entitled to substitute another similar property (e.g., an adjacent apartment in an apartment block).

Characteristics of a contract for delivery of construction services:

- Nature of constructed item is such that it could only be sold to someone other than the customer at significant disadvantage to the seller – for example:
 - the price might need to be reduced significantly;
 - further significant modification might be required; or
 - very infrequent demand could result in a significant delay before a sale occurs.
- Contract for supply of land is irrevocable regardless of any subsequent non-performance in respect of construction; i.e., irrespective of anything that may go wrong during the construction stage, the customer must still acquire the land and will still be obliged to pay for it.
- Contract permits the customer to request significant modifications of what is to be provided on an ongoing basis.
- Customer is entitled to terminate contract when only part performed, paying a reasonable price for work done to date (and for any other unavoidable costs of the supplier), but without suffering a penalty.

Appendix B

Detailed comments on D21 Real Estate Sales

Scope

Whilst we believe that if principles are appropriately articulated in an Interpretation it is not necessary to limit the scope for its application, we are concerned that the scope of the Draft Interpretation in its current form is too broad and will apply to a wider range of real estate contracts than is appropriate. On this basis, we are of the opinion that the scope of the Draft Interpretation should be narrowed to only address pre-completion real estate contracts to avoid any unintended consequences.

Further, we are concerned that the Draft Interpretation may be applied by analogy (through the IAS 8 hierarchy) to other contracts. We believe that the IFRIC should clarify that it may not be appropriate to apply the indicators outlined in the Draft Interpretation to other contracts, and that there may be other, more appropriate, indicators not listed in the Draft Interpretation that should be used to distinguish a contract for the delivery of goods from that for construction services. More specifically, we are concerned that the Draft Interpretation may be applied by analogy to other construction contracts as paragraph 6 of the Draft Interpretation states that it ‘... addresses the meaning of the term ‘construction contract’ as defined in IAS 11’. IAS 11 and IAS 18 are general standards and the term ‘construction contract’ also is quite general. Consequently, we are concerned that if the Draft Interpretation is applied by analogy then there may be certain unintended consequences. Therefore, we recommend that the IFRIC should specifically state that the factors identified in the Draft Interpretation should not be applied by analogy to other similar contracts (e.g. a bridge, building, dam, pipeline, road, ship or tunnel).

Consensus

In relation to the consensus reached by the IFRIC, we share the concerns raised by the IFRIC staff in IFRIC November 2006 Agenda Paper 3 – observer note paragraph 11 that the term buyer’s ‘specifications’ may be misinterpreted ‘...to be read in the narrow sense of technical design specifications’. We believe that additional guidance should be included in the consensus to clarify how this term should be interpreted. For example, additional guidance could be provided in paragraph 8 of the Draft Interpretation stating that buyer’s specifications are the directions or instructions made to the seller.

We also believe that the IFRIC should provide further guidance as to the meaning of the term ‘major structural elements’. An understanding of this term is critical to analysing whether a contract is for the provision of construction services.

Further, IAS 11.3 states that a ‘construction contract is a contract specifically negotiated for the *construction of an asset*¹...’, whereas D21.BC5(a) explicitly places emphasis on the words *specifically negotiated* and *construction* without further consideration of whether the contract is for the *construction of an asset*. Therefore, we question whether sufficient emphasis is being put on whether a binding contract for the *construction of an asset* exists, rather than the degree to which a contract has been *specifically negotiated*.

¹ Emphasis added.

Features

Although we note that the Draft Interpretation states that the indicators could be considered either individually or in combination, we believe that the Draft Interpretation should also clearly articulate that the lists of indicators included within paragraphs 9 and 10 are not exhaustive.

Further, although we support the approach taken by the IFRIC to include indicators, we disagree with the inclusion of some of the indicators outlined in the Draft Interpretation. We are also concerned that the wording applied to articulate a number of the indicators is unclear and consequently may be misinterpreted. These are discussed below.

Features – construction services

We believe that paragraphs 9b and 10b should be split into two separate indicators as the notion of ‘control’ and ‘risks and rewards’ may not be the same and it is therefore confusing to present the two concepts within one indicator.

If the paragraphs are retained as one indicator, in our opinion, it is not currently clear whether the indicators in paragraph 9(b) relate to control and/or the transfer of risks and rewards of ownership. To prevent any confusion we suggest the following additional wording be included in paragraph 9(b):

‘the seller transferring to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. Indications that the seller transfers control and the significant risks and rewards of ownership of the work in progress in this way may include, for example:...

We also do not agree that the indicator in paragraph 9(b)(i) that ‘the construction taking place on land that is owned or leased by the buyer’ is necessarily an indicator that the seller has transferred control of the work in progress. Ownership of land is a legal formality which we do not believe to be a relevant indicator of whether a contract is for the delivery of construction services or not. Therefore, we recommend that the IFRIC focus on whether the land is an asset of the customer.

Further, the indicator in paragraph 9(b)(ii) that ‘...the buyer [has] a right to take over the work in progress (albeit with a penalty) during construction...’ appears to assume that a penalty will *always* arise when the buyer takes over the work in progress. This may not always be the case. Therefore, we recommend altering the wording of the paragraph to read as follows:

‘...buyer having a right to take over the work in progress (albeit with ~~the~~ a potential a penalty) during construction...’

Features – sale of goods

The indicator in paragraph 10(b) provided for an agreement for the sale of goods is ‘the agreement [gives] the buyer only a right to acquire the completed real estate at a later date...’. We believe that using the term ‘right to acquire’ may be misinterpreted to indicate that an amount may be required to be accounted for in accordance with paragraph 5 of IAS 39 *Financial Instruments: Recognition and Measurement*. It also implies that the buyer does not

have an *obligation* to complete the sale of real estate. We recommend altering the wording of the paragraph to read as follows:

‘an executory contract in which the agreement giving the buyer only a right has an obligation to acquire the completed real estate at a later date, with the seller retaining control and the significant risks and rewards of ownership of the underlying work in progress until that date.’

Applying IAS 18 – revenue recognition

Paragraph 14(a) makes reference to ‘minor’ defects, this reference is inappropriate because it is not uncommon for defects to be found upon completion that are not minor in nature; however, this would not necessarily delay the recognition of revenue.

Basis for conclusions

The comment in BC9 that Example 9 states that the appendix to IAS 18 could be read:

‘...as prohibiting 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’

Although we agree that this is a valid point, we do not consider that this is a ‘basis for conclusion’ for the current Draft Interpretation. We would recommend highlighting in the Basis for Conclusions the fact that the issue of segmenting contracts is not considered in the Draft Interpretation; rather it is considered in the larger revenue project.

We also note that there is no basis of conclusions on the transitional provisions debate. We believe that it would be useful to include some commentary that reflects the IFRIC discussion and conclusion that no specific transitional provisions were required, as noted in IFRIC March 2007 Agenda Paper 4 – observer note paragraphs 35-40, in particular paragraph 37.

In addition, we note that US GAAP guidance exists in SFAS 66 *Accounting for Sales of Real Estate*. It establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business. Although we understand that real estate transactions are complex and that SFAS 66 deals with the nature of the sale agreement we would like to better understand the IFRIC's rejection in BC5 and why the requirements of SFAS 66 are not considered further.