

6 December 2007

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

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, we have both a different understanding (compared to the IFRIC) on the issue on hand and of IAS 11; and we think the draft consensus is not internally consistent. We are also not convinced that the current drafting - which seems partly rather form driven - always allows entities to appropriately reflect economically different situations. We are also concerned about the implications were the consensus proposed to be applied by analogy to other circumstances and industries; we would have preferred the IFRIC to develop some generic guidance 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 appendix 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 – 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? The key issue here is whether the agreement is a construction contract as defined in IAS 11.
- 2 Under existing IFRS, a sale of goods is accounted for in accordance with IAS 18.14-19, the rendering of services is accounted for in accordance with IAS 18.20-28, and construction contracts are accounted for in accordance with IAS 11. We agree that there is currently uncertainty as to where the boundaries lie between these various requirements. We therefore support the IFRIC’s decision to attempt to bring greater clarity to the issue.
- 3 D21.8 proposes that a real estate contract is within the scope of IAS 11 if – and seemingly only 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”. D21.9 sets out features that individually or in combination may indicate that an agreement is within IAS 11, and some of those features seem to be about whether construction is to the buyer’s specification and some seem to be about whether a service is being provided.
- 4 We do not support this part of the proposed consensus, as we have a different understanding of the issue at hand and of IAS 11.
  - (a) Based on the arguments and language used in the Draft Interpretation, it appears to us that the IFRIC is trying to establish the boundary between “sale of goods” and “services” and use that to work out which contracts are in IAS 11 and which are not. However, we do not believe that IAS 11 is about construction services only, particularly as D21.BC5(b) explains that contracts for construction services tend to involve continual delivery (and therefore the continual transfer of risks and rewards). We think that IAS 11 is about the construction and handover/delivery of an asset. Although that will often involve continual delivery, it often will not because with some construction contracts the deliverable is at the end of the contract. (In these cases the requirement that there has to be final acceptance of the finished item by the buyer has the result in those contracts that little (if any) of risk and rewards are transferred to the buyer prior to final acceptance. In other words, regardless of whether partial acceptance has occurred previously, a specific “result” is owed by the construction company.) For that reason we think it is not very helpful to use the dividing line between the different types of sales included in IAS 18 (i.e. sale of goods and service) to distinguish between sale of goods (IAS 18) and construction contracts (IAS 11).
  - (b) Further, EFRAG’s understanding of IAS 11 is different from IFRIC’s. EFRAG believes that IAS 11 is about “customer driven”, contract based transactions. In particular, although EFRAG agrees with the statement in paragraph BC5(a) of D21 which says that, in an IAS 18-type contract, construction takes place independently of the sale agreement, we draw a different conclusion from it. We think it means that construction only takes place because there is a sale agreement in place. This is different from the IFRIC’s approach, which is based on the customer’s ability to specify key aspects of the asset being constructed.

In support of our understanding, we would point out 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. On the other hand, IAS 11.29 speaks about "the asset to be constructed" (emphasis added).

We discussed the boundary between IAS 11's construction contracts and IAS 18's sale of goods with our User Panel and the general view of panel members was that the buyer's specifications (and also the features identified in D21 in this connection) was of no importance to them, and therefore should not drive the accounting.

Having said that, we note that a lot of the wording in IAS 11 suggests that IAS 11 is actually about long-term contracts. For example, 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, the wording of IAS 11 generally is mainly about long-term contract accounting – all the examples mentioned in IAS 11.4 require a significant amount of time for construction - rather than construction to the customer's (ie the buyer's) specifications. Finally, we noted the objectives of IAS 11 and IAS 11.25 which indicate that the purpose of the PoC method is to account for long-term construction activities by aligning costs and revenue, in a way that, in case of long-term construction activities, it provides useful information to users. EFRAG believes that the IFRIC has not explained how D21 fits into the stated intentions of IAS 11.

- 5 We also think the consensus is internally inconsistent. In particular, if D21.8 is correct when it says that a real estate contract is within the scope of IAS 11 only if it is an agreement for the seller to provide construction services to the buyer's specification, it follows that the contract needs to be both a contract for construction services and a contract where construction is to the buyer's specification. (In other words, we think an implication of D21.8 would be that the consensus should require both d21.9(a) and D21.9(b) to be met; something no EFRAG member supports.) Yet D21.9 seems to state that it is sufficient for the contract to be a contract for services and it is also sufficient for construction to the buyer's specification. (In other words, under D21.9 it is enough for either (a) or (b) to be met.)
- 6 EFRAG is also very uncomfortable about the IFRIC developing such a narrowly-drawn interpretation on such a generic issue. We believe that, were the consensus in D21 to be applied generically, it would result in many contracts that are currently being accounted for in accordance with IAS 11 henceforth being accounted for as sales of goods. We think that means either that D21 conclusions are inconsistent with the general understanding of IAS 11 - and we are not aware of a widespread concern that IAS 11 is being misapplied - or that real estate sales are in some way different from other transactions. If the latter is the case, we think it is important that the IFRIC makes that clear and explains its reasoning. Our preference though would be for the IFRIC (or maybe the IASB) to approach the issues surrounding the "construction contracts" definition from a broader perspective and not based on real estate circumstances (see also our comments below on the scope of D21).
- 7 We think it is a pity that the Draft Interpretation does not clarify the unit of account, because we believe different conclusions could probably be reached depending on

whether the unit of account was e.g. the whole apartment block, the individual apartment, a contract or elements of a contract.

- 8 We also think it needs to be recognised that not all transactions involving e.g. partially completed assets are the same. In some cases the transaction is for the purchase of a completed asset; and in other cases the transaction is for the purchase of a partially completed asset and for the task to complete the asset. It is important that the consensus of D21 allows these economically different situations to be reflected differently.

#### **Buyer's specifications, and paragraphs 9(a) and 10(a)**

- 9 According to D21.8, for a sale arrangement to be within the scope of IAS 11, construction must be to *the buyer's specifications*. As said before, EFRAG believes that IAS 11 is about "customer driven", contract based, transactions; some EFRAG members believe that the 'buyer's specifications' criterion is *one* possible interpretation of this notion – at least for real-estate transactions. However, EFRAG members had different views as to whether it was the most appropriate interpretation.

- (a) Some EFRAG members believe that, although a 'buyer's specifications' criterion has its flaws, no better way of operationalising the principle in the circumstances of real-estate transactions described in D21.9(a) has been found. However, others believe it is not the best way of operationalising the principle described in D21.9(a). For example:

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 relatively 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.

- (b) All EFRAG members were concerned about the unintended consequences if D21's interpretation were to be applied to other areas where IAS 11 is currently applied. (see also paragraphs 22-24)
- (c) 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 term "specifically negotiated" in IAS 11. From a drafting perspective it remains unclear if the term "buyer's specification" should be read in a narrow sense of technical design specifications or not.

However, we do wonder whether replacing one undefined term ("specifically negotiated") with an equally vague terms ("buyer's specifications" and "major structural elements of design") takes us very far forward.

#### **Continual delivery, and paragraphs 9(b) and 10(b)**

- 10 We have some significant concerns about the features described in paragraphs 9(b) and 10(b) of D21, which refer to continual delivery and continual transfer of control and of the risks and rewards of ownership, and how they relate to the other features.

- (a) We are not quite sure what is intended with paragraph 9(b), because it is difficult to understand the principle behind the word “might” and the phrase “individually or in combination”.
- (i) On the one hand, it could be concluded that the continuous transfer of risk and rewards feature simply confirms that IAS 11 includes construction contracts that have such a continuous transfer of control and risk and rewards of ownership. We accept that this might not have been clear before.
  - (ii) On the other hand, EFRAG believes that IAS 11 is also applicable to transactions which do not have a “continuous sales” feature. This is because 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. We think that 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. We thus believe that the question of a continuous sale is of no overarching importance when discussing the application of the Percentage of Completion (PoC) method. This view seems to be acknowledged by the references to “might” and “individually or in combination”; such references suggest 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 states that a continuous delivery of ownership and risks and rewards of ownership is the underlying principle of the PoC method and by this of IAS 11.
- Finally, EFRAG believes that there are “continuous sale” transactions in connection with construction activities which are not in the scope of IAS 11 but rather IAS 18. This would particularly be the case for transactions where the contract is signed after construction started, as EFRAG believes that IAS 11 implicitly assumes that the negotiations take place before construction starts.
- (b) Besides these fundamental questions, we also have a number of more detailed concerns about the features set out in paragraphs 9 and 10:
- (i) 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) seem to point in one direction whilst the features set out in paragraphs 9(b) and 10(b) (which are about whether there is continual delivery) could be read to point in the other. For example, in some jurisdictions the buyer might first acquire from the seller a piece of land, being part of a bigger development project (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 house-design from a range of options offered to any buyer participating in the development project (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).)
  - (ii) 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 with one party, while the ownership of the building might be with another party. In any event, it seems unclear to us, why the situation of the buyer leasing the piece of land, e.g. for 1 year, should be equal to the case, where the land is owned by the buyer.

- 11 In summary: the concern is that the proposed approach might 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 guidance that is applied consistently throughout the interpretation. This should be done in a generic manner, outside the real estate question at hand. 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*

- 12 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 clarity<sup>1</sup>. 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.

- 13 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. Nonetheless, we believe that IAS 18 is sufficiently clear on these issues that preparers, auditors and users will not necessarily miss the “guidance” included in this paragraph.

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<sup>1</sup> 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.”

Having said that, 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 as we find the wording included in the basis of conclusions (paragraphs 7-16) ambiguous.

*Second and third paragraph of Example 9 in IAS 18*

- 14 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.
- 15 EFRAG would have appreciated if the IFRIC could review the wording of incorporated second paragraph (now paragraph 13 of D21), as several EFRAG members thought the wording was confusing.

**D21, paragraphs 14—IAS 18 and the remaining obligation**

- 16 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.
- 17 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 and believe that it raises questions on the conclusion reached in IFRIC 13. For example, what is the principle that is being used to differentiate between “internal decoration” and “internal fittings”? The phrase “separately identifiable” is used, but what does this mean in this case? Do you mean “separable”, and if so, why? We think there is a suggestion in the current draft that the underlying principle seems to be to a certain extent based on significance of the outstanding obligation, yet a similar argumentation was not followed in IFRIC 13. EFRAG encourages the IFRIC to stipulate its principle more clearly and would suggest to move any examples into an application guidance, in order to avoid the impression of creating rules or detailed guidance in the consensus.

18 For the reasons we have already explained, and because we noted that this is now for the third time that the IFRIC has considered the question (i.e. in IFRIC 12, IFRIC 13 and D21), we 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**

19 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

20 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 could be read to indicate that it 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 and strongly encourage the IFRIC to do so.

21 We also note that paragraph 4 points out that the Draft Interpretation aims to provide guidance on whether *pre-construction* sales contracts are IAS 11 or IAS 18 contracts. The specific circumstances of such contracts seem to be subsequently ignored or at least not obviously considered. We noted for example, that in particular in multi-unit real estate sales, where the sale of all units has taken place before construction has started, the outcome of an accounting in D21 is less than satisfactory. We are also not certain, how D21 will help in *pre-completion* contracts (multi unit real estate) situations, i.e. where units are sold throughout the construction period and how the features are useful in these circumstances.

### *Application by analogy*

- 22 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.
- 23 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, then it ought to include in the Interpretation (as it did in IFRIC 10, paragraph 9) a statement that it is not to be applied by analogy.
- 24 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 might result in unintended consequences. For example, if the principles and features are applied to machinery, road or ship construction activities, they will often 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 11<sup>2</sup>. 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.

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<sup>2</sup> Ship and road construction activities are specifically mentioned in IAS 11.4 as an example of construction contracts.