



On the Horizon for IFRS

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IFRIC 15 issued to provide guidance on agreements for the construction of real estate

Introduction

On July 3, 2008 the International Financial Reporting Interpretations Committee (IFRIC) published IFRIC Interpretation 15, *Agreements for the Construction of Real Estate* (IFRIC 15). Applicable to entities that undertake the construction of real estate, IFRIC 15 provides guidance on the accounting for agreements to sell real estate before construction is complete. Such arrangements include *off plan* sales by real estate developers of apartments or houses (sales before completion or even before construction has begun). Diversity had arisen in practice from two different views as to the applicable revenue recognition standard:

- Some have considered *off plan* sale agreements to be construction contracts and accounted for them under IAS 11, *Construction Contracts*, with revenue being recognized by reference to the stage of completion as construction progressed

- Others have accounted for *off plan* sale agreements as sales of goods under IAS 18, *Revenue*, with revenue being recorded when control and the risks and rewards of ownership had been transferred to the buyer (typically when the unit is ready for occupation and handed over to the buyer)

The Interpretation applies to entities that undertake the construction of real estate directly or through subcontractors. Within the scope of IFRIC 15 are agreements, for the construction of real estate, which may include the delivery of other goods or services (for example, sale of land or provision of property management services.)

IFRIC 15 addresses an issue that has led to uncertainty and inconsistent application. IFRIC 15's analysis of how an agreement for the construction of real estate should be accounted for may lead to a change in the revenue recognition accounting policy for some entities.

Some entities that have viewed agreements for off plan sales of real estate as construction contracts will need to change their classification as a consequence of IFRIC 15's emphasis on the buyer's ability to specify the major structural elements of the design. Revenue needs to be recognized at a later point in time in accordance with IAS 18. However, despite the IFRIC's efforts in clarifying this area, judgment will continue to be required to determine the appropriate accounting.

components, which would be accounted for separately. The accounting for the real estate component follows the guidance in IFRIC 15.

IFRIC 15 addresses two issues concerning agreements for real estate sales before construction is complete:

- Whether the agreement is within the scope of IAS 11 or IAS 18
- When revenue from the construction of real estate should be recognized

Consensus

Determining whether an agreement for the construction of real estate is within the scope of IAS 11 or IAS 18 will depend upon the terms of the agreement and the surrounding facts and circumstances, which will require the exercise of judgment. IAS 11 will determine the accounting for revenue and related expenses if the agreement falls within its scope, which is determined by the level of control that the buyer may exercise over the design of the real estate.

If the agreement falls under IAS 11, the entity recognizes revenue by reference to the stage of completion of the contract. If instead the agreement falls within IAS 18, revenue and related expenses will be recognized based on whether the contract is for the provision of services or the sale of goods. Whether the agreement is for the provision of services or the sale of goods is determined by whether the entity provides materials in addition to construction services. If for the provision of services, revenue will generally be recognized using the percentage of completion method. If for the sale of goods, revenue will be recognized when the transfer of control and the significant risks and rewards of ownership have been

Issues addressed

IFRIC 15 notes that an agreement for the delivery of goods or services in addition to the construction of real estate may need to be split into identifiable

transferred to the buyer, whether that takes place continuously as construction progresses or at a single point in time.

Does IAS 11 apply?

IAS 11 applies when an agreement for the construction of real estate meets the following definition of a construction contract

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 (IAS 11.3).

This definition will be met 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 (irrespective of whether the entity exercises that ability or not).

If IAS 11 applies, revenue should be recognized by reference to the stage of completion of the construction, using the percentage of completion method.

An agreement in which construction could take place independently of the agreement and where buyers have only limited ability to influence the design of the real estate or can specify only minor variations to the basic design, will not meet the definition of a construction contract and should be accounted for under IAS 18.

Where the agreement is within the scope of IAS 18

An agreement that does not meet the definition of a construction contract falls within the scope of IAS 18. In that case it is necessary to consider whether the agreement is for the rendering of services or for the sale of goods.

Under IFRIC 15 an agreement may be considered for the rendering of services if the entity does not provide the construction materials. If the entity is required to provide both services and materials to fulfill its obligations, the agreement is deemed only for the sale of goods.

Agreement for the rendering of services

Where the agreement is only for the rendering of services, such as when the entity is not required to provide construction materials, revenue should be recognized by reference to the state of completion of the transaction, using the percentage of completion method in accordance with IAS 18.20. This method of revenue recognition is consistent with the requirements of IAS 11.

Agreement for the sale of goods

Where the agreement is for the sale of goods, such as when the entity is required to provide services together with construction materials, the revenue recognition criteria described in IAS 18.14 apply. Revenue is recognized only when control and the risks and rewards of ownership have transferred to the buyer.

- *Continuously transferred:* In some cases control and the significant risks and rewards of ownership of the work in progress are continuously transferred to the buyer as construction progresses. Therefore, revenue should be recognized in accordance with the stage of completion of construction using the percentage of completion method (subject to meeting the other criteria set out in IAS 18.14). This method of revenue recognition is consistent with the requirements of IAS 11. IFRIC 15 does not provide any further guidance on how to determine if control and risks and rewards are continuously transferred to the

buyer. Paragraph BC24 notes that agreements that use the *continuous transfer* concept might not be frequently encountered.

- *Single point in time*: More typically control and the significant risks and rewards of ownership of the real estate will transfer to the buyer at a single point in time (for example, on completion or upon or after delivery of the real estate). In this scenario, IFRIC 15 specifies that revenue will only be recognized when that point in time is reached, subject to the other criteria in IAS 18.14 being met.

When the entity is required to perform further work on real estate already delivered to the buyer, a liability and an expense are recognized in accordance with IAS 18.19. The liability is measured in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. When the entity is required to deliver further goods or services that are separately identifiable from the real estate already delivered to the buyer, it would identify the remaining goods or services as a separate component of the sale in accordance with IFRIC 15.8.

Disclosures

When revenue is recognized using the percentage of completion method for agreements that meet all the criteria in IAS 18.14 continuously as construction progresses (see IFRIC 15.17), certain disclosures are required. If those agreements are in progress at the reporting date, additional disclosures are required.

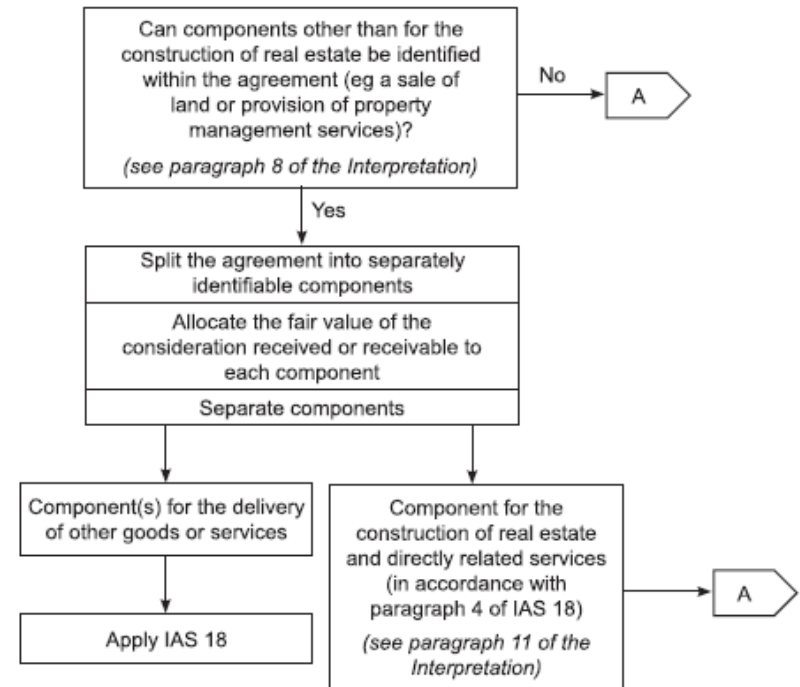
Flowcharts and illustrative examples

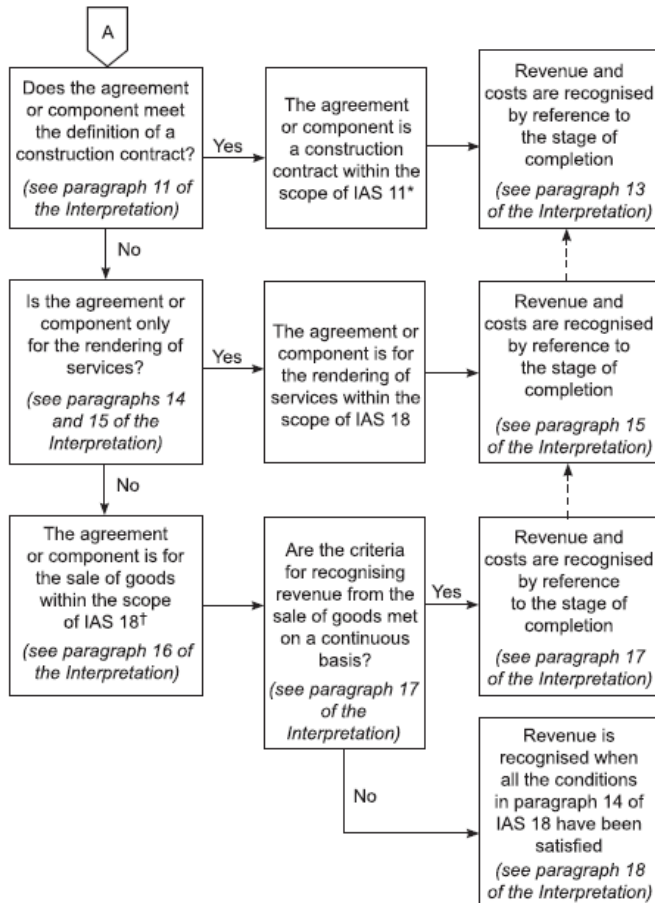
To assist preparers in applying IFRIC 15, flowcharts and illustrative examples accompany, but are not part of the Interpretation. The flowcharts, which provide an analysis of a single agreement for the construction of real estate, are presented below:

Information note

Analysis of a single agreement for the construction of real estate

This note accompanies, but is not part of, IFRIC 15.





* The construction contract may need to be segmented in accordance with paragraph 8 of IAS 11

† Directly related services may need to be separated in accordance with paragraph 13 of IAS 18

Effective date and transition

IFRIC 15 is effective for annual periods beginning on or after January 1, 2009. Early application is permitted if that fact is disclosed. Changes in accounting policy arising from the adoption of IFRIC 15 should be accounted for retrospectively in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

IFRIC 16 issued to provide guidance on hedges of a net investment in a foreign operation

Introduction

On July 3, 2008 the International Financial Reporting Interpretations Committee issued IFRIC Interpretation 16, *Hedges of a Net Investment in a Foreign Operation* (IFRIC 16), which provides guidance on the accounting for a hedge of the foreign currency risk arising from a net investment in a foreign operation. IFRIC 16 should not be applied by analogy to other types of hedge accounting.

Foreign operations are operations (subsidiaries, associates, joint ventures, or branches) whose activities are conducted in a currency other than the functional currency of the reporting entity. Investments in foreign operations create currency risk because exchange rate movements affect the reporting entity's functional currency equivalent of the foreign operation's net assets and results. The reporting entity might decide to hedge this currency risk by borrowing money in the foreign operation's functional currency or entering into foreign exchange contracts.

IAS 21, *The Effects of Changes in Foreign Exchange Rates* requires the reporting entity to translate the results and net assets of its foreign operations into its presentation currency (which need not be the same as its functional

currency). Exchange differences arising are reported in other comprehensive income until the foreign operation is disposed of.

IAS 39, *Financial Instruments: Recognition and Measurement*, permits but does not require, the reporting entity to apply a form of hedge accounting (referred to as net investment hedge accounting) to its investments in foreign operations, provided certain strict conditions are met. Net investment hedge accounting operates in a similar way to cash flow hedge accounting.

IFRIC 16 addresses various issues that have led to inconsistency in applying net investment hedge accounting in practice.

Issues addressed

The main issues addressed by IFRIC 16 are:

- The nature of the hedged risk
- The amount of the hedged item for which a hedging relationship may be designated
- Where in the group the hedging instrument may be held
- Reclassifications from equity to profit or loss on disposal of the foreign operation

Consensus

The following paragraphs summarize the main conclusions expressed in IFRIC 16's Consensus.

Nature of the hedged risk

IFRIC 16 clarifies that currency risk eligible for net investment hedge accounting relates to exposure arising between the functional currency of the foreign operation and the functional currency of any parent entity, which includes the immediate, intermediate, or ultimate parent entity. A higher level or

ultimate parent may also designate a hedge based on exposures arising between the functional currencies of a foreign operation and an intermediate parent.

Translation risks relating to exchange differences between the foreign operation's functional currency and the reporting entity's presentation currency are not eligible for hedge accounting.

Example: Functional and presentation currency

Parent entity P has a functional currency of GBP but presents its consolidated financial statements in euros. P has two subsidiaries E (euro functional currency) and J (Japanese Yen functional currency).

P may designate the following currency risks in a net investment hedge based on functional currencies:

- GBP to euro currency exposure relating to E
- GBP to Yen currency exposure relating to J

Because P uses euros as its presentation currency, currency translation risks also arise on

- euro to GBP exchange differences on translation of P's financial statements
- euro to Yen exchange differences on translation of J's financial statements

Neither of these risks is eligible for hedge accounting. However, P can still designate based on the functional currency exposures relating to E and J, even though in E's case there will be no translation differences on consolidation.

The amount of the hedged item for which a hedging relationship may be designated

The amount of the foreign operation's net assets eligible for designation as the hedged item cannot exceed the carrying value of those net assets in the parent entity's consolidated financial statements. If a lower-level (intermediate) parent applies hedge accounting for a net investment in a foreign operation, the amount of the foreign operation's net assets eligible for hedge accounting by a higher or ultimate parent entity is reduced accordingly. In other words, an exposure to currency risk on a net investment in a foreign operation cannot qualify for hedge accounting more than once.

Where in the group the hedging instrument may be held

IFRIC 16 clarifies that the availability of hedge accounting in the consolidated financial statements is not affected by which group entity holds the hedging instrument. The designated hedging instrument (a derivative or non-derivative financial instrument) in a net investment hedge could therefore be held either by the parent itself or by another group entity.

Reclassifications from equity to profit or loss on disposal of the foreign operation

If the reporting entity disposes of its investment in the foreign operation, reclassifications from equity to profit and loss are required of

- The cumulative foreign currency translation reserve (FCTR) recorded on consolidation of the foreign operation in accordance with IAS 21; and
- If net investment hedge accounting has been applied, the cumulative change in the fair value of the hedging instrument to the extent that the hedge was effective. In accordance with IAS 39, this effective portion is recorded in other comprehensive income (equity). Any ineffective portion of the hedge is recognized immediately in profit and loss.

IFRIC 16 notes that the amount of the cumulative FCTR may differ depending on whether the reporting entity applies the direct or step-by-step method of consolidation described below.

The *direct method* is the method of consolidation in which the financial statements of the foreign operation are translated directly into the functional currency of the ultimate parent.

The *step-by-step method* is the method of consolidation in which the financial statements of the foreign operation are first translated into the functional currency of any intermediate parent(s) and then translated into the functional currency of the ultimate parent (or the presentation currency if different).

If the *step-by-step method* is used, the FCTR relating to the foreign operation in question will be determined at the level of that foreign operation's immediate parent, rather than the ultimate parent. However, IFRIC 16 permits (as an accounting policy choice) the reporting entity to reclassify from equity the amount that would have been included in the FCTR if the *direct method* had been applied.

Application guidance

IFRIC 16 includes an Application Guidance Appendix which provides a detailed example of how to apply the Interpretation's requirements. The Appendix is an integral part of IFRIC 16 and should be referred to when net investment hedging is applied.

Effective date and transition

IFRIC 16 is effective for annual periods beginning on or after October 1, 2008. Early application is permitted if that fact is disclosed.

On the adoption of IFRIC 16, retrospective application is not required. If entities have designated a hedge accounting relationship that is no longer permissible, hedge accounting is discontinued prospectively (in accordance with IAS 39's requirements on discontinuing hedge accounting).

Net investment hedge accounting is a relatively common form of hedge accounting that has existed for many years. The conclusions reached in IFRIC 16 seem uncontroversial and could be characterized more as clarifications rather than substantive changes.

The issue that may have the greatest impact in practice is that of the types of risk that qualify for net investment hedge accounting. Some preparers may have designated hedges based on presentation currency exposures (translation risk). The related translation differences affect other comprehensive income (equity). IFRIC 16 takes a robust, economic view of qualifying risk: a *functional-to-functional* exposure is regarded as economically substantive whereas a *functional-to-presentation* exposure is merely an accounting phenomenon.

AICPA

AICPA launches a new IFRS website

The AICPA recently launched a new IFRS website at www.ifrs.com. The website includes informational videos, explanatory material about IFRS, training programs, and links to various resources. Included on the new website are the following documents:

- [International Financial Reporting Standards \(IFRS\) - An AICPA Backgrounder](#)
- [IFRS Questions and Answers](#)
- [IFRS Primer for Audit Committees](#)

IFRS reference materials

IASB

IASB projects, meetings, and effective dates

See the [IASB website](#) for information on projects, meetings, and effective dates.