STAFF PAPER

March 2019

IFRS® Interpretations Committee meeting

Project	**Over time transfer of constructed goods (IAS 23)**		
Paper topic	Comment letters		
CONTACT(S)	Nicolette Lange	nlange@ifrs.org	+44 (0) 20 7246 6924

1. For ease of reference, this paper reproduces comment letters received on the tentative agenda decision published by the IFRS Interpretations Committee in September 2018 on ‘Over time transfer of constructed goods’.

Deloitte Touche Tohmatsu Limited
Hill House
1 Little New Street
London
EC4A 3TR

Phone: +44 (0)20 7936 3000
Fax: +44 (0)20 7583 0112
www.deloitte.com/about

Direct phone: +44 20 7007 0884
vepoole@deloitte.co.uk

6 February 2019

Sue Lloyd
Chair
IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
Canary Wharf
London
United Kingdom
E14 4HD

Dear Ms Lloyd

Tentative agenda decision – IAS 23 *Borrowing Costs*: Over time transfer of constructed good

Deloitte Touche Tohmatsu Limited is pleased to respond to the IFRS Interpretations Committee's publication in the November IFRIC Update of the tentative decision not to take onto the Committee's agenda the request for clarification on whether construction of a property for sale under terms that will qualify for recognition of revenue over time results in the entity having a qualifying asset into which directly attributable borrowing costs are capitalised.

We agree with the IFRS Interpretations Committee's decision not to add this item onto its agenda for the reasons set out in the tentative agenda decision.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 20 7007 0884.

Yours sincerely

Veronica Poole
Global IFRS Leader

MAZARS

Mrs Sue Lloyd
IFRS Interpretations Committee
Columbus Building,
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

La Défense, February 6, 2019

Tentative Agenda Decisions – IFRIC Update November 2018

Dear Sue,

MAZARS is pleased to comment on the various IFRS Interpretations Committee tentative agenda decisions published in the November 2018 IFRIC Update.

We have gathered all our comments as appendices to this letter, which can be read separately and are meant to be self-explanatory.

We would like to draw your attention to two issues that are worth considering:

- The tentative decision on physical settlement of contracts to buy or sell a non-financial item (see Appendix 2 to this letter) is contrary to the practice applied by large companies in the energy sector, and we think it necessary to undertake a comprehensive analysis of the issue and the rationale for their current practice before finalizing any decision;
- The issue of the accounting for the curing of a credit-impaired financial asset is not an easy one, and when diving into examples, it appears that there exist within IFRS 9 some unclear requirements or even inconsistencies between the definitions involved. We have tried to develop examples evidencing those difficulties, and we stand ready to present them and our concerns in a dedicated meeting with IFRS IC Staff / members.

Should you have any questions regarding our comments on the various tentative agenda decisions, or should you want us to participate in a meeting as proposed above, please do not hesitate to contact Michel Barbet-Massin (+33 1 49 97 62 27) or Edouard Fossat (+33 1 49 97 65 92).

Yours faithfully

Michel Barbet-Massin
Financial Reporting Advisory

Edouard Fossat

MAZARS

Appendix 3

Over time transfer of constructed good (IAS 23 Borrowing Costs*)—Agenda Paper 4*

We agree with the technical analysis conducted by the Interpretations Committee, leading to the conclusion that in the specific fact pattern described in the Agenda Decision, IAS 23 should not lead to any capitalization of borrowing costs.

We agree with the Interpretations Committee that neither receivables nor contract assets recognized according to IFRS 15 (i.e. relating to sold individual real estate units) are qualifying assets. We also agree that the management's intent regarding any unsold unit under construction is to sell it – still part-constructed – as soon as it finds a suitable customer, and that, applying IAS 23, should prevent any inventory (work-in-progress) from being a qualifying asset. That conclusion is obviously driven by the assumption that the expected contract with the suitable customer will trigger for revenue recognition overtime. Should the usual contracts for real estate sales not meet the criteria in IFRS 15.35(c), the conclusion would be reversed for both sold and unsold units under construction.

February 3rd 2019

IFRS Interpretation Committee

7 Westferry Circus

Canary Wharf

London

<u>Re: Tentative Agenda Decision – Over time transfer of constructed good</u>

Dear Committee members,

The Israel Accounting Standards Board welcomes the opportunity to comment on the IFRS Interpretation Committee's Tentative Agenda Decision on *over time transfer of constructed good* published in December 2018.

The tentative agenda decision states that "*any inventory (work-in progress) for unsold units under construction that the entity recognises is not a qualifying asset. In the fact pattern described in the request, this asset is ready for its intended sale in its current condition – i.e. the entity intends to sell the part-constructed units as soon as it finds suitable customers and, on signing a contract with a customer, will transfer control of any work-in-progress relating to that unit to the customer.*" We understand that the Committee's position as drafted in the tentative agenda decision is that inventory is not a qualifying asset when the entity <u>is able to</u> sell the inventory. When reading the tentative agenda decision it is not clear whether the intent to sell the current inventory is a factor in the analysis, as the tentative agenda decision does refer to the entity's intention "*i.e. the entity* ***intends*** *to sell the part-constructed units as soon as it finds suitable customers . . .*"

We would like to express two key concerns with respect to the tentative agenda decision:

- In our opinion, an approach under which inventory that the entity is able to sell is not a qualifying asset, regardless of an entity's business model will significantly reduce the possibility to capitalize borrowing costs on **all sorts of inventory**, although inventory is listed as an example of a qualifying asset (paragraph 7 of IAS 23). That is because an inventory can usually be sold at any stage of its construction process or manufacturing process. We believe that the decision whether inventory (work-in-progress) is ready for

14 Gruzenberg st., Tel-Aviv 65811, Tel ,972 3 5109977 .רח' גרוזנברג 14, ת"א 65811, טל
www.iasb.org.il , E-mail: iasb@iasb.org.il ,Fax. 972 3 5109988 .פקס

its **intended sale** and therefore can be a qualifying asset (according to IAS 23) should be based on the business model and intention of the entity, rather than on the ability to sell that inventory.

- It seems that the Committee's tentative decision links the definition of a qualifying asset to the revenue recognition model (point in time or over time). This linkage might raise various implementation challenges e.g the developer might be required to determine whether it would recognise revenue at a point in time or over time prior to signing a sale contract of any unit.

Various distortions might arise from application of the tentative agenda decision if the business model of an entity is disregarded such as entities that engage only with a single project of constructing units for sale would incur losses from expensing borrowing costs during stages in which revenue is not yet recognised.

The Committee's tentative agenda decision might also result in expensing borrowing costs incurred on land purchased for development, construction and sale of residential units. Developers usually buy land and begin an improvement and permits process (during which the developer receives a building permit, which includes the building rights). According to the Committee's tentative agenda decision, because the land can be sold in its current condition, the land might not meet the criteria of a qualifying asset.

We believe that the definition of a qualifying asset should be analyzed based on the business model and intention of the developer (i.e. the **intended** timing of beginning to sell units). Such an analysis would allow a developer to capitalise borrowing costs during the development stage and during construction until the point the developer plans to begin selling the units. If the developer's business model is to sell the units immediately after receiving a building permit, then the land would be a qualifying asset until that point, but if, for example, the developer's business model is to sell the units only after completion of 40 percent of construction, then the inventory (work-in-progress) would be a qualifying asset until that point. We would like to mention that the business model is also used in other IFRS standards such as IFRS 9 (for classification of financial assets) and IFRS 10 (for classification as an investment entity).

We would appreciate if the IFRS Interpretation Committee would consider our comments while concluding its agenda decision.

We appreciate the opportunity to provide our comments.

Sincerely,
Dov Sapir, CPA, Chairman
Israel Accounting Standards Board

14 Gruzenberg st., Tel-Aviv 65811, Tel ,972 3 5109977 .רח' גרוזנברג 14, ת"א 65811, טל
www.iasb.org.il , E-mail: iasb@iasb.org.il ,Fax. 972 3 5109988 .פקס

Accounting Standards Board of Japan (ASBJ)

Fukoku Seimei Building 20F, 2-2, Uchisaiwaicho 2-Chome, Chiyoda-Ku Tokyo 100-0011, Japan
Phone +81-3-5510-2737 Facsimile +81-3-5510-2717 URL https://www.asb.or.jp/en/

1 February 2019

Ms. Sue Lloyd
Chair of the IFRS Interpretations Committee
International Accounting Standards Board
Columbus Building, 7 Westferry Circus
Canary Wharf, London, E14 4HD
United Kingdom

Comments on the Tentative Agenda Decision Relating to
IAS 23 *Borrowing Costs* - Over Time Transfer of Constructed Good

1. The Accounting Standards Board of Japan (the "ASBJ" or "we") welcome the opportunity to comment on the IFRS Interpretation Committee (the "Committee")'s tentative agenda decision relating to IAS 23 *Borrowing Costs* — Over Time Transfer of Constructed Good, proposed in the November 2018 IFRIC Update.

2. This tentative agenda decision illustrates the thought process and interpretations of how the principles and requirements in IAS 23 would apply to a specific fact pattern. We believe that, as noted in the tentative agenda decision, the principles and requirements in IAS 23 provide an adequate basis to determine the appropriate accounting treatment for the specific fact pattern provided in the tentative agenda decision. However, we believe that the tentative agenda decision needs to consider the following matters.

3. The tentative agenda decision noted, as the basis for concluding that a contract asset is not a qualifying asset, that the intended use of a contract asset is to collect cash or another financial asset and that it does not necessarily takes a substantial period of time to get ready for its intended use or sale. However, we question if this reasoning is appropriate because some contracts require a substantial amount of time to get ready to collect cash or another financial asset. We believe that it is necessary to

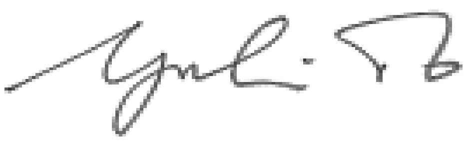
consider whether a contract asset is a qualifying asset, that is, an asset that necessarily takes a substantial period of time to get ready for its intended use or sale, by clarifying the nature of contract assets.

4. We are not uncomfortable with the conclusion that a contract asset is not a qualifying asset for the fact pattern provided in the tentative agenda decision. Nevertheless, we believe another way to address this issue may be to amend paragraph 7 of IAS 23 and clarify that, similar to financial assets, a contract asset is not a qualifying asset, except for certain cases (such as when a contract asset is a qualifying asset as a result of applying paragraphs 19 and 22 of IFRIC Interpretation 12 *Service Concession Arrangements*), on the grounds that the intended use of a contract asset is to collect cash or a financial asset, just like the intended use of a receivable is to collect cash or another financial asset.

5. We also note that the tentative agenda decision states that "any contract asset that the entity recognises is not a qualifying asset". However, this statement is inaccurate because there are cases where a contract asset becomes a qualifying asset as a result of applying paragraphs 19 and 22 of IFRIC Interpretation 12. Therefore, we believe that it is necessary to clearly describe that the statement applies specifically to the fact pattern described in the request, similar to how the tentative agenda decision describes how it applies to inventory.

6. We hope our comments are helpful for the Committee's and the IASB's consideration in the future. If you have any questions, please feel free to contact us.

Yours sincerely,



Yukio Ono
Chairman
Accounting Standards Board of Japan

IKATAN AKUNTAN INDONESIA
(INSTITUTE OF INDONESIA CHARTERED ACCOUNTANTS)

Nomor : 0246/DSAK/IAI/II/2019 Jakarta, 6 February 2019

Ms. Sue Lloyd
Chair – IFRS Interpretations Committee
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Ms. Lloyd,

Re: Tentative Agenda Decision – Over time transfer of constructed good (IAS 23 *Borrowing Costs*)

The Indonesian Financial Accounting Standards Board (DSAK), as part of the Institute of Indonesia Chartered Accountants (IAI), is the national accounting standard-setter in Indonesia.

DSAK IAI is pleased to present our comments on the IFRS Interpretations Committee's (the Committee) tentative agenda decision regarding 'Over Time Transfer of Constructed Good (IAS 23 *Borrowing Costs*)'.

Our detailed response is attached in the Appendix to this letter below.

We hope that our comments could contribute to the Committee's future deliberations. Should you have further concerns regarding our comments, please do not hesitate to contact us at dsak@iaiglobal.or.id.

Yours sincerely.

Djohan Pinnarwan
Chairman
The Indonesian Financial Accounting Standards Board
Institute of Indonesia Chartered Accountants

APPENDIX – Comments on the Tentative Agenda Decision – Over time transfer of constructed good (IAS 23 *Borrowing Costs*)

The following summarises DSAK IAI preliminary views regarding the tentative agenda decision issued by IFRS Interpretations Committee (the Committee) regarding Over Time Transfer of Constructed Good (IAS 23 *Borrowing Costs*).

The Staff Paper Agenda Ref. 4 described the background and different possible views on capitalization of borrowing costs which are separated into:

1. View A: Capitalise borrowing costs on only the unsold units
2. View B: Capitalise borrowing costs on neither the unsold nor the sold units;
3. View C: Capitalise borrowing costs on both the sold and unsold units.

We found the Staff analysis in the Agenda Ref. 4 are well thought of and covering in-point references to applicable IFRS Standards to reach at the conclusion on View B, whereby borrowing costs are not capitalized on the unsold and sold units. We could not find any reasons to object to the Committee's conclusion based on currently effective IFRS Standards.

However, we have concerns on the unintended consequences of the Committee's conclusion. We are troubled by the fact that identical residential units under development being financed with borrowings would have different cost attributed to them depending on the manner in which revenues are recognized. There is clearly a diversity in implementation of revenue recognition and capitalization of borrowing costs (as explained in the Agenda Ref. 4 par. 12 - 15), as evidenced by results of the Staff's outreach. This diversity very possibly occurs because of previous IFRS Standards on revenue recognition, which differentiate the accounting treatments based on whether revenues are from the sale of goods or from rendering services, were in line with IAS 2 *Inventories* and IAS 23 *Borrowing Costs*. The underlying principles of revenue recognition under IFRS 15 which no longer differentiates revenue recognition from goods and services might not be in line with the underlying principles of IAS 2 *Inventories* and IAS 23 *Borrowing Costs*, which were largely based on differentiation of goods and services.

IAS 2 par. 10 states that 'The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.' These costs include borrowing costs, provided that provisions in IAS 23 are fulfilled.

IAS 23 par. 8 'An entity shall capitalize borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. ….' and IAS 23 par. 9 'Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset. …..'

GRHA AKUNTAN, Jalan Sindanglaya No. 1, Menteng, Jakarta 10310 - INDONESIA

Telp.: (62-21) 3190 4232 Hunting, Fax.: (62-21) 315 2076, E-mail: iai-info@iaiglobal.or.id, Home Page: http://www.iaiglobal.or.id

Both the provisions above are based on conclusion as described in BC9 of IAS 23:

> The Board concluded that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are part of the cost of that asset. During the period when an asset is under development, the expenditures for the resources used must be financed. Financing has a cost. The cost of the asset should include all costs necessarily incurred to get the asset ready for its intended use or sale, including the cost incurred in financing the expenditures as a part of the asset's acquisition cost. The Board reasoned that recognising immediately as an expense borrowing costs relating to qualifying assets does not give a faithful representation of the cost of the asset.

We think that the tentative agenda decision which concludes not to capitalise borrowing costs on the unsold or the sold units, on the ground of no qualifying assets, nullified the fact that inventory was involved in this case. We are of a view that the above provision does not cater actual practice in some of real estate activities, particularly in the fact pattern submitted to the Committee.

We strongly recommend the Committee to reconsider the conclusion, putting into account the consequences that might incur should the tentative agenda decision effective, and to conduct more in-depth analysis of the impact, as there might be unintended consequences resulting from the decision. As such, it would be more appropriate to refer this topic to the IASB.

Conclusion:

- We have concerns on the unintended consequences of the Committee's conclusion that the entity does not capitalize borrowing costs to sold or unsold inventories.
- We suggested the Committee to conduct more in-depth analysis on the impact and to ensure that any unintended consequences have been addressed appropriately. As such it would be more appropriate to refer this topic to the IASB.

******* END OF APPENDIX *******

GRHA AKUNTAN, Jalan Sindanglaya No. 1, Menteng, Jakarta 10310 - INDONESIA

Telp.: (62-21) 3190 4232 Hunting, Fax.: (62-21) 315 2076, E-mail: iai-info@iaiglobal.or.id, Home Page: http://www.iaiglobal.or.id

4 February 2019

Ms. Sue Lloyd
Chair – IFRS Interpretations Committee
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Sue

Tentative agenda decision
Over time transfer of constructed good (IAS 23 *Borrowing Costs*)

The Malaysian Accounting Standards Board (MASB) welcomes the opportunity to comment on the IFRS Interpretations Committee's tentative agenda decision (November 2018).

The fact pattern described in paragraph 5 of agenda paper 4 for the Committee's November 2018 meeting (AP 4) arises in a number of jurisdictions as noted in paragraph 12 of AP 4 and the content of the Committee's tentative agenda decision has the potential to significantly impact on the current accounting practices among property developers in those jurisdictions.

The MASB considers that the analysis of the requirements in IAS 23 *Borrowing Costs* in light of the requirements of IFRS 15 *Revenue from Contracts with Customers* is helpful. However, the MASB holds the following views.

(a) In responding directly to the issue posed, the Committee appears to confine itself to a narrow view on the way in which IAS 23 operates and has not taken into consideration an alternative view on the way in which IAS 23 functions. In the MASB's view, this alternative view is supported by the deliberations of the IASB on a cost-based measurement when IAS 23 was revised in 2007 (to require, rather than permit, capitalisation of borrowing costs). The tentative agenda decision would overturn a key aspect of the philosophy underpinning IAS 23 and, thus, a broader set of issues should be considered in a standard setting context by the IASB.

(b) The outcome of the analysis may be different if other relevant IFRS standards are also considered in conjunction with IAS 23 in developing the tentative agenda decision. The significance of the issue and its implications for the role of IAS 2 *Inventories* in determining the costs of inventories, and a cost-based measurement more generally, are matters that would be better considered in a standard setting context by the IASB.

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

The MASB considers that IAS 23, IFRS 15 and IAS 2 need to be analysed together in order to properly address which of the views outlined in paragraph 7 of AP 4 is appropriate. In respect of a property developer that progressively recognises revenue under contracts with customers and has work in progress that can be sold prior to its completion, paragraph 7 sets out the following possible views:

(a) capitalise borrowing costs on only the unsold units (View A);

(b) capitalise borrowing costs on neither the unsold nor the sold units (View B); or

(c) capitalise borrowing costs on both the sold and unsold units (View C).

In its tentative agenda decision, the Committee has effectively opted for View B through its analysis of IAS 23 and IFRS 15. However, the MASB is of the view that when the measurement requirements of IAS 2 and/or the broader requirements of IAS 23 are also considered, it would potentially alter the analysis in favour of View C.

The MASB's view is based on the reasoning noted below.

IAS 23 requirements

The MASB acknowledges the IFRS Interpretations Committee staff analysis in AP 4 that regards:

(a) the costs attributable to residential units under construction that are the subject of contracts with customers and represented by 'contract assets' that are not financial assets (customer receivables) to be assets that do not necessarily take a substantial period of time to get ready for their intended use or sale [AP 4.21 to 28]; and

(b) work in progress relating to unsold units under construction as not meeting the definition of a qualifying asset because they are ready for their intended sale in their current condition in the context of IAS 23.22 [AP 4.31].

In relation to point (a) above, the MASB regards costs to obtain contracts and costs to fulfil contracts with customers that are recognised as contract cost assets in accordance with IFRS 15.91 and 95 as representing that part of the physical qualifying asset constructed to date and is still recognised in the developer's financial statements. Financial assets (customer receivables) arise from billings made to customers. Contract assets that are not financial assets arise when the cumulative revenue recognised in profit or loss exceeds the sum of advance payments and billings to customers. The contract costs that are not yet customer receivables are akin to an inventory work-in-progress and the underlying physical asset is the relevant asset for the purposes of IAS 23. The transfer of control of a good or service noted in IFRS 15.35 is not a physical transfer of the underlying work in progress in the case of units under development and the application of IAS 23 should not be affected by the over-time nature of sales.

The MASB appreciates the Committee's view, but considers that IAS 23.22 to 25, when taken together, imply a solely 'physical' notion as the basis for determining

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

whether an asset is a qualifying asset. That is, the nature of a qualifying asset is determined by considering the time it will necessarily take to make it physically ready, and capitalisation of borrowing costs ceases once the relevant asset is physically capable of being used. The MASB notes the following concerns regarding the Committee's views on applying IAS 23 to over time transfers of goods.

(a) The Committee has interpreted the words (emphasis added) in IAS 23.22 "*An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use* ***or sale*** *are complete …*" as meaning that the sale of an asset at any stage of physical development is a trigger for cessation of capitalisation. However, the MASB interprets the reference to 'sale' as merely indicating that an item that is physically completed might be used as inventory and sold rather than being property, plant or equipment used in the entity's business operations.

(b) The Committee has interpreted the words (emphasis added) in IAS 23.23 "*An asset is* ***normally*** *ready for its intended use or sale when the physical construction of the asset is complete …*" as meaning that sometimes physical completion is not required. However, the MASB interprets the use of 'normally' in the context of IAS 23.23 to mean that, sometimes, there might be subsequent minor physical modifications needed, but they do not affect the requirement that the construction of the asset must be complete before it is ready for its intended use or sale.

The Committee has ascribed a non-physical meaning to IAS 23.23 and 24, which the MASB considers may not have been the IASB intention when IAS 23 was promulgated. This is a fundamental aspect of IAS 23 and warrants consideration by the IASB, particularly since the Committee's view may have consequences in practice beyond the narrow issue currently being considered.

IAS 2 requirements

The MASB notes that under IAS 2, the cost of inventories comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition [IAS 2.10]. Those costs can include borrowing costs attributable to bringing the inventories to their present location and condition when they necessarily take a substantial period of time to get ready for their intended use or sale [IAS 23.5].

The MASB considers that the analysis of how IAS 23 should be applied to the 'over time transfer of constructed goods' should address the following:

(a) the requirement that inventories comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition [IAS 2.10];

(b) how costs are accumulated into inventories; and

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

(c) how costs to fulfil contracts are capitalised as contract costs (an asset) in accordance with IFRS 15.95.

Residential units under construction that are the subject of contracts with customers

The analysis in paragraphs 21 to 28 of AP 4 takes the view that the costs attributable to residential units under construction that are the subject of contracts with customers are represented by financial assets (customer receivables). The implication is that, once there is a contract with a customer, the residential units are never inventories – that is, every currency unit of cost incurred is instantaneously classified as a financial asset.

This is not a complete analysis because the first step in respect of the costs of development of residential units would be to recognise inventory (i.e. a development project) for all units under construction. When some units are sold to customers, a relevant (rateable) portion of the accumulated costs in inventory is then transferred to contract costs as an asset [IFRS 15.95] for the subsequent accounting in accordance with IFRS 15. Contract costs are recognised (amortised) as cost of sales consistent with the manner in which revenue is recognised in profit or loss. Units unsold remain as inventory within the scope of IAS 2.

For example, a highly-simplified representation of the relevant journal entries (assuming a profit component and that 50% of the residential units are sold and 50% remain unsold) might be:

Dr Inventories (project in progress)	CU200	
Cr Land, construction cost outflows		CU200
~ to accumulate land and development costs in project account		
Dr Contract costs	CU100	
Cr Inventories (project in progress)		CU100
~ to transfer cost of inventories to contract costs for units sold		
Dr Customer receivables	CU110	
Cr Contract liabilities		CU110
~ to recognise receivables on billings to customers		

Revenue and Cost Recognition in Profit or Loss:

Dr Contract liabilities	CU110	
Cr Revenue in profit or loss		CU110
~ to recognise revenue based on stage of completion		

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

Dr Cost of sales in profit or loss	CU100	
Cr Contract costs		CU100
~ to amortise contract costs asset as cost of sales		

The initial recognition of inventories provides the justification to include any relevant borrowing costs in the development project account (uncompleted development units in progress), which means they are consistent with measuring inventories as all costs of purchase, costs of conversion and other costs incurred in bringing them to their present location and condition under IAS 2.10. The MASB notes the Committee's view that the reference in IAS 23.22 to 'sale', in the context of IFRS 15, is that the sale takes place progressively and the Committee's view that the developer is providing construction services. However, in the circumstances outlined in the tentative agenda decision, the MASB considers that not all costs incurred would be included in cost of sales instantaneously. That is, there typically will be some project costs relating to unsold inventory carried as 'costs incurred to fulfil a contract' [IFRS 15.95], which would be disclosed as an asset [IFRS 15.128].

The MASB agrees that under IFRS 15.35, the sales of development units take place progressively, and notes this was the subject of thorough deliberation by the IASB. However, it is not clear that it is appropriate to view the meaning of IAS 23.22 through an IFRS 15 lens for the following reasons.

(a) IFRS 15 itself refers to IAS 2 in relation to determining the costs incurred in fulfilling a contract with a customer, as noted in IFRS 15.95:

> *95 If the costs incurred in fulfilling a contract with a customer are not within the scope of another Standard (for example, IAS 2 Inventories, IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets), an entity shall recognise an asset from the costs incurred to fulfil a contract only if those costs meet all of the following criteria: ...*

(b) The exhaustive due process conducted in developing IFRS 15 for revenue recognition purposes, understandably, did not involve considering all the potential impacts IFRS 15 might have on the treatment of borrowing costs in relation to inventories. (Borrowing costs are not referred to in the IFRS 15 Basis for Conclusions.)

(c) The tentative agenda decision addresses a fact pattern that includes five factors, two of which (in brief) are that: the entity intends to enter into contracts with customers for part-constructed units; and the entity's contracts with customers transfer control of units over time. However, intention is not a factor the IASB ordinarily relies on to determine an accounting treatment and the tentative agenda decision would affect even those inventories for which there are, as yet, no contracts with customers.

Units under construction that are available for sale to potential customers

AP 4 refers to 'work-in-progress' relating to unsold units [AP 4.31, 36 & 38]. There are some potential practical problems with this discussion.

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

A residential development might take, for example, three or more years from its inception to its completion. Throughout the course of the development, the developer may hold inventories that are in the process of being made ready for use (work in progress), but has yet to determine the manner in which the marketing and sale of units will be undertaken. The analysis in AP 4 does not address how IAS 23 applies to such cases. Nor does it adequately justify why the intention to market goods in a particular manner should be a trigger for either capitalising or not capitalising borrowing costs, particularly when it is evident from the promulgation of other IFRS standards[1] that intent is not supported as basis for determining accounting treatments.

Because of the narrow way in which the issue has been posed for the Committee to consider, the tentative agenda decision may raise as many questions as it might answer, including the following.

(a) Would a developer that is undecided about the manner in which units will be sold be required to capitalise relevant borrowing costs?

(b) If a developer initially intends to sell completed units once they are constructed and subsequently decides to market incomplete units (sell goods over time), would the developer cease capitalising, or possibly 'back-out' previously capitalised borrowing costs?

(c) In the circumstance where there is no enforceable right for payments and a developer recognises revenue only on completion and delivery of the units to customers, would borrowing costs be capitalised in contract costs under IFRS 15.95 as costs to fulfil contracts with customers?

In respect of (b), the Committee may be relying on there being an established pattern of practice for particular developers. However, conditions in the property market that affect marketing strategies often change during the development process.

The tentative agenda decision may also affect the current practice in some manufacturing industries that capitalise borrowing costs to specifically-designed machinery, equipment and vehicles for customers.

So long as the asset takes a substantial period of time to complete, the manner in which the asset is sold, whether by a forward sale or only on completion, does not change the underlying substance that the asset is a qualifying asset in accordance with IAS 23.

Other matters

Both IAS 2 and IAS 23 are standards that were written in the pre-IASB era. They have been more recently amended by the IASB, but the fundamental requirements

1 Notably IFRS 9 *Financial Instruments* - refer in particular to IFRS 9.BC4.21.

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

regarding inventory costing and the capitalisation of borrowing costs (now required rather than permitted) remain unchanged.

Unfortunately, IAS 2 and IAS 23 were written at a time when the decision-making process was not communicated in a Basis for Conclusions and the IASB and the Committee are left to surmise what the words in these older standards were intended to mean in particular situations.

The only IASB Basis for Conclusions in respect of these standards that is available to us relates to the 2007 removal from IAS 23 of the option to immediately expense all borrowing costs. Interestingly, that Basis for Conclusions places great weight on the faithful representation of the cost of an asset [IAS 23.BC9] and the comparability of costs attributed to all non-equity financed assets [IAS 23.BC10, BC11 & BC13].

The MASB observes that the Committee's tentative agenda decision would mean that identical residential units under development that are being financed with borrowings would not have comparable costs attributed to them, depending on the manner in which the units are sold. This is because, for example, under the tentative decision:

(a) units sold progressively under a contract entered into prior to construction commencing (and the related cost of sales) would never include any borrowing costs attributed to them as they only ever represent a receivable;

(b) units sold on completion would include borrowing costs.

This seems contrary to the IASB's reasoning in the Basis for Conclusions to the 2007 revision to IAS 23 as regards faithful representation and comparability. Accordingly, the reported performance would be less useful to investors and other financial statement users.

The MASB understands that the 2007 revision to IAS 23 was the last time the IASB considered cost-based measurement for inventories. The MASB is of the view that, given the possible conflict between the IASB's thinking at that time and the impact of the Committee's tentative agenda decision, the borrowing costs issue must be considered by the IASB, rather than the Committee.

The MASB appreciates that the Committee's view has formed in light of more recent IFRS standards, in particular IFRS 15. If the due process for IFRS 15 included consideration of the borrowing costs issue, and the view outlined by the Committee been proposed by the IASB in respect of goods sold over time, the MASB would have sought consistent measurement of inventories based their physical completion time regardless of whether revenue is recognised over-time or on completion.

For property developers, if borrowing costs are recognised as an expense when incurred (impact of the Committee's tentative agenda decision), the treatment might distort the reporting of performance of an entity as there will be a "mismatch" between the cost of sales and revenue recognised in profit or loss over time. Borrowing costs

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

would be front-loaded as an expense in profit or loss. The reported result is inconsistent with the information used to manage and monitor project revenues and project costs internally.

MASB conclusions

The MASB considers the Committee's tentative agenda decision would not be within the spirit of the requirements of IAS 2 and IAS 23 with respect to measuring the cost of 'over time transfers of constructed goods'.

The MASB is of the view that an alternative analysis is supportable and it is a valid interpretation of IAS 23 in conjunction with IAS 2 that borrowing costs would continue to be capitalised to inventories until they are physically completed, regardless of the way in which the units are being sold to customers.

The MASB considers each of the following points in their own right is a sufficient basis for referring this issue to the IASB.

~ The Committee's tentative agenda decision may fundamentally change the notion of what is meant by completion of a qualifying asset in a manner that was not intended when IAS 23 was promulgated. This may have consequences in practice beyond the narrow issue being considered by the Committee. If the IASB had explicitly identified the possible consequences of the requirements in IFRS 15 regarding borrowing costs and goods sold over time in the manner outlined by the Committee, the MASB (and probably other stakeholders) would have sought a consistent inventory measurement outcome. The IASB should address this issue through a full due process rather than the Committee's truncated due process.

~ The Committee's tentative agenda decision is not consistent with the cost-based measurement required by IAS 2, which involves inventories to be costed consistently without regard to the manner in which they might be sold. The view supported by the Committee is in contrast to the requirements of IAS 2.

~ The Committee's presumption about when capitalisation of borrowing costs must cease, which underpins the tentative agenda decision, is different from the MASB's view. The Committee's view is potentially inconsistent with the spirit of IAS 23, as implied by the IASB conclusions outlined in the Basis for Conclusions to the 2007 revision to IAS 23. In particular, compared with View C in AP 4, the Committee's view would lead to information that less faithfully represents the cost of inventories and is less comparable with other inventories and, therefore, is less useful for investors and other financial statement users.

The Committee's tentative agenda decision, if issued, would become part of IFRS literature and result in potentially significant changes to long-standing accounting practices and fundamentally affect the manner in which cost-based measures of inventory under IAS 2 are determined by property developers in many jurisdictions.

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

The MASB urges the Committee to not issue its tentative agenda decision. Instead, the MASB considers it would be appropriate for the Committee to refer the topic to the IASB. The IASB would be best placed to give full consideration to the broader issues raised by the tentative agenda decision about how IAS 2 and IAS 23 apply in light of earlier work on revising IAS 23.

The MASB would be happy to discuss and further clarify the matters raised in this submission. Please contact Tan Bee Leng [beeleng@masb.org.my] to coordinate any further input.

Yours sincerely

Mohamed Raslan Abdul Rahman
Chairman

Unit 13A-1, Menara MBMR, No. 1, Jalan Syed Putra, 58000 Kuala Lumpur.
Tel : (603) 2273-3100 Fax : (603) 2273-9400 Email : masb@masb.org.my Website : www.masb.org.my

ISCA INSTITUTE OF SINGAPORE CHARTERED ACCOUNTANTS

60 Cecil Street, ISCA House,
Singapore 049709
TEL +65 6749 8060
FAX +65 6749 8061
www.isca.org.sg

11 February 2019

Ms Sue Lloyd
Chair
IFRS Interpretations Committee
Colombus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Ms Lloyd,

TENTATIVE AGENDA DECISION – OVER TIME TRANSFER OF CONSTRUCTED GOOD (IAS 23)

ISCA sought views on the above Tentative Agenda Decision from the ISCA Financial Reporting Committee which includes experienced technical accounting professionals from large accounting firms.

We note the IFRS Interpretations Committee ("Committee") conclusion that the entity should not capitalise borrowing costs under the described fact pattern and the Committee's below observation:

c. any inventory (work-in-progress) for unsold units under construction that the entity recognises is not a qualifying asset. In the fact pattern described in the request, this asset is ready for its intended sale in its current condition – i.e. the entity <u>intends</u> to sell the part-constructed units as soon as it finds suitable customers and, on signing a contract with a customer, will transfer control of any work-in-progress related to that unit to the customer.

We wish to highlight the following concerns we have regarding the Committee's observation (c) above.

1. Scope of the Tentative Agenda Decision is unclear

We note that the Tentative Agenda Decision is written for the construction of a residential multi-unit real estate development whereby revenue is recognised over time for the sale of individual units in the development. Hence, it is clear from the Tentative Agenda Decision that the property developer should not capitalise borrowing costs when revenue is recognised over time as the inventory (work-in-progress) is not a qualifying asset in accordance with paragraph 5 of IAS 23.

However, it is unclear whether the Tentative Agenda Decision also applies to similar situations where revenue for the sale of units is recognised at a point in time (for e.g., when control only passes on completion or handing over of units to customers).

Consider the example of two property developers – Entity A and Entity B. Entity A recognises revenue from the sale of uncompleted units over-time whereas Entity B recognises revenue from the sale of uncompleted units at a point in time. Assuming that neither Entity A nor Entity B has entered into any contract with a customer to sell a uncompleted unit during the financial year, and applying the principles in observation (c), Entity A would have expensed all borrowing costs incurred and Entity B would have capitalised all borrowing costs incurred.

The above would have implications for property developers who recognise revenue from the sale of units at a point in time and who have launched the development for sale prior to the completion of construction (i.e. pre-sales).

2. Conceptual challenge to differentiate between property developers who recognise revenue over time and those who recognise revenue at a point in time

In our view, it is conceptually challenging to differentiate between property developers who recognise revenue over time and those who recognise revenue at a point in time, because the pattern of revenue recognition may depend on the type of sales contract the developer enters into with the buyers of the units and it may not be known upfront which type of contract will be used for each sale.

Paragraph 5 of IAS 23 defines a qualifying asset as '...an asset that necessarily takes a substantial period of time to get ready for its <u>intended</u> use or <u>sale</u>.'

Once the inventory (work-in-progress) is ready for its intended sale, whether revenue is recognised over time or at a point in time under IFRS 15 should not have any bearing on whether that inventory (work-in-progress) is a qualifying asset under IAS 23.

We also do not agree with the Committee's observation (c) for the following reasons.

1. Pre-emption of method of revenue recognition

We would also like to highlight that the application of the principles in observation (c) would require the entities to decide upfront whether they will recognise revenue for the sale of the uncompleted units at a point in time or over time i.e. preempting the revenue recognition for future sales of the uncompleted units. Some entities may not be able to determine this at the start of construction of the units. If the principles in observation (c) were to be applied, does this mean that such entities should capitalise the borrowing costs incurred up until the point when the sales contract is signed?

2. Contrary to current market practice

In our view, inventory (work-in-progress) for unsold units under construction are qualifying assets for capitalising borrowing costs. It has generally been the market practice in the property development industry to capitalise borrowing costs into inventory (work in progress) because such inventories require a substantial period of time to be ready and are viewed as qualifying assets in accordance with paragraph 7 of IAS 23. The current reading of paragraph 5 of IAS 23 focuses on the substantial period of time to get [the asset] ready. The following part of that sentence is being interpreted as just outlining the two general purposes for which assets can be constructed: either for own use or for eventual sale. If the interpretation is now changing such that the key focus is whether the asset is ready for sale, it will mean that almost all assets being constructed in the normal course of business for eventual sale will not qualify for capitalisation of borrowing costs as most developers have been and will be selling uncompleted construction if a buyer is being identified.

The Tentative Agenda Decision, if finalised, would have a significant impact on the property development industry as it is contrary to the current market practice. The outcome would be that the property developers would see higher gross profit margins when the units are eventually sold in later years as borrowing costs have already been expensed during the construction period. This would result in comparability issues among entities.

3. Presentation of margins for projects will differ and usefulness of financial reporting may deteriorate

If the Committee's agenda decision is to be interpreted as being applicable only to construction where revenue is being recognised over time, the margins shown for similar projects where the only difference is the pattern of revenue recognition, will be different. For projects where revenue is being recognised over time, the project margin (revenue less cost of goods sold) will be better as compared to projects where revenue is being recognised at a point in time, as the capitalised borrowing costs are being added to the cost of goods sold for such cases compared to higher finance cost being shown for the projects with revenue being recognised over time. It is unclear how such different treatment would enhance the usefulness of financial reporting. We believe that the intention of IAS 23, especially in its amendment in 2007 to require the capitalisation of borrowing costs (i.e. removal of the option to expend borrowing costs when incurred) is to faithfully present all cost necessarily incurred to get the asset ready (BC 9).

Hence, we urge the Committee to look into the existing definition of qualifying asset under paragraph 5 of IAS 23 "Borrowing Costs" whereby "A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale" and the implications arising from the current rationale provided for its agenda decision.

We would also ask the Committee to clarify the scope of the agenda decision, in particular if it is intended to be applicable to situations where revenue is being recognised over time only.

Should you require any further clarification, please feel free to contact myself or Ms Felicia Tay, Manager, Corporate Reporting & Ethics (CoRE), from ISCA via email at jumay.lim@isca.org.sg or felicia.tay@isca.org.sg respectively.

Yours faithfully,

Ju May

Ju May, LIM
Deputy Director
Corporate Reporting & Ethics (CoRE)

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: FRSC
Sent electronically through the IASB Website (www.ifrs.org)

11 February 2019
Sue Lloyd
Chair
IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Sue,

Tentative agenda decision – Over time transfer of constructed good

The Hong Kong Institute of Certified Public Accountants ("HKICPA") is grateful for the opportunity to provide you with views from our stakeholders on this Tentative Agenda Decision (TAD).

In response to this TAD, we reached out to our technical experts in accounting firms ('practitioners') and preparers in Hong Kong. Whilst agreeing with the treatment of the sold units in the TAD, some medium-large practitioners and preparers expressed concerns about the IFRS Interpretations Committee's tentative views in the TAD that borrowing costs are not captialised on work-in-progress relating to unsold units under construction. This comment letter summarises the concerns of these stakeholders.

Concerns that the TAD is contrary to the economics and the core principle of IAS 23 so far as unsold units are concerned

The Interpretations Committee considers that the unsold, partly-constructed units are ready for their intended sale in their current condition because the entity intends to sell those units as soon as it finds suitable customers and, on signing a contract with a customer, will transfer control of any work-in-progress relating to that unit to the customer. Consequently, the Interpretations Committee concludes that the units prior to sale do not meet the definition of a qualifying asset because they do not meet the criteria 'necessarily takes a substantial period of time to get ready for its intended use or sale'.

Our stakeholders are concerned that such a narrow interpretation of the definition of a qualifying asset in IAS 23 *Borrowing Costs* results in an outcome that does not make economic sense and undermines the core principle of IAS 23. They are also concerned that it could result in inconsistent, ever-changing outcomes for capitalising borrowing costs on otherwise identical units under construction, for example because of changes in management intentions. This might also provide an entity with opportunities to manipulate the accounting results based on intention.

Our stakeholders understand that IAS 23 is based on the principle that borrowing costs are capitalised as part of an asset that takes a substantial period of time to

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

construct/develop when borrowings finance the active development of that asset. Consequently, they think that an outcome where borrowing costs are not capitalised on units under construction simply because an entity intends to market those units prior to completion does not make economic sense.

Our stakeholders point out that the economic reality is:

- construction activity on the whole apartment building will continue until the building is physically complete, regardless of the marketing activity for the individual units; and
- the entity will be borrowing money to finance that construction activity for so long as the units within that building either:
  - have not yet been sold; or
  - have been sold but under contracts which did not require the buyer to pay substantial amounts of the consideration in advance of completion of the building and the units within it.

Our stakeholders note that generally, in our part of the world, in a single apartment building development project, revenue from the sale of apartments to retail customers might be either recognised at a point in time or recognised over time under IFRS 15.35(c), depending on the payment terms as chosen by the individual buyers (e.g. paid in full at the point of entering into a non-cancellable contract) and the enforceability of specific performance clauses in the individual contracts. For 'over time' contracts, the reduction in inventory for accounting purposes would generally only occur at the same time as a reduction in the financing required for the development. For all other sales prior to completion of the apartment building, revenue will be recognised at a point in time, being when the whole apartment building is finished and the individual apartment owners can take possession of their units and such units are beyond doubt qualifying assets during the period of active construction activity.

Our stakeholders do not consider it makes economic sense to decide whether to capitalise borrowing costs in relation to individual unsold units in an apartment building simply on the basis of whether eventually the revenue on a given unit will be recognised at a point in time or over time under IFRS 15 *Revenue from Contracts with Customers*.

Our stakeholders distinguish this scenario from one in which an entity would cease capitalisation of borrowing costs on unsold units because it is no longer financing their active development, for example where physical construction is complete and all that remains is decoration of the property to the customer's specifications.

Furthermore our stakeholders observe that the entity's intentions regarding the sale of unsold units within an apartment building may change over time. For example in response to changes in market conditions an entity might change its contract terms for the units being marketed to attract customers such that the contract no longer meets the criteria for revenue recognition over time. Consequently the units would no longer be ready for their intended sale and could now meet the definition of a qualifying asset.

Our stakeholders also expressed concern about how the TAD would affect similar scenarios that they have observed in practice:

- The facts are the same as those in the TAD except the contractual terms are only finalised between the entity and the individual customers when the payment method is agreed and the individual contracts are signed, which can occur at various stages of the construction. Until the contractual terms are finalised (ie the contract is undetermined), the entity is unable to determine whether the criteria in paragraph 35 of IFRS 15 for over time revenue recognition are met for each contract. Consequently from the date that development begins until the date the contract is signed the entity will not know whether it will ultimately transfer control of the unit over time or at a point in time. Our stakeholders question how to account for borrowing costs attributable to a unit under an undetermined contract at a reporting date, if the TAD were to be finalised in its present form.
- The facts are the same as those in the TAD except the borrowings are used as funding for both acquisition of the land/land use rights and constructing the building. The unit owner's share of the underlying land/land use right is only transferred to the customer upon completion of the construction and the contract. Even when the building costs of the partly-constructed unit are derecognised on sale, a portion of the related land/land use right may still remain in the balance sheet as fulfilment cost when measuring the entity's progress towards completion.

Conclusion reached by our stakeholders

Our stakeholders believe that the TAD's conclusion that the unsold units do not meet the definition of a qualifying asset is the result of an unduly narrow analysis of IAS 23 focused only on the words "ready for intended use or sale" taken out of context, and without due regard to the fact that these words were written a long time before the criteria in IFRS 15.35(c) were contemplated.

They are therefore concerned that the Interpretations Committee appears to be addressing the interaction of individual requirements in IAS 23 and IFRS 15 in a piecemeal fashion. They think the Interpretations Committee should think more broadly about how old standards like IAS 23 might need to be updated to reflect fundamental changes in new Standards against a range of scenarios, and that, without such broader analysis, the Committee should exercise greater caution before including additional commentary on such accounting matters in an agenda decision.

Consequently our stakeholders think that the Interpretation Committee should limit the TAD commentary to clarifying that:

- a receivable or contract asset is not a qualifying asset; and
- if an entity derecognises any inventory asset for the partly-constructed unit (because the entity no longer controls the unit) it would not have a qualifying asset.

They think the Interpretations Committee should not try to go further than this clarification in the TAD.

If you have any questions about the matters raised in this letter, please contact me, Michelle Fisher (mfisher@hkicpa.org.hk), Deputy Director, Standard Setting, or Joni Kan (jonikan@hkicpa.org.hk), Associate Director, Standard Setting. We would welcome an opportunity to discuss our stakeholders' comments further with the Interpretations Committee staff.

Sincerely,

Christina Ng
Director, Standard Setting Department

Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany

DRSC

ASCG • Zimmerstr. 30 • 10969 Berlin

Sue Lloyd
Chair of the IFRS Interpretations Committee
7 Westferry Circus, Canary Wharf
London E14 4HD

United Kingdom

IFRS Technical Committee

Phone: +49 (0)30 206412-12

E-Mail: info@drsc.de

Berlin, 06 February 2019

Dear Sue,

RE: The IFRS IC's tentative agenda decisions in its November 2018 meeting

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to comment on the tentative agenda decisions taken by the IFRS Interpretations Committee (IFRS IC) and published in the November 2018 IFRIC Update.

We agree with four of the tentative agenda decisions. However, in respect of two tentative agenda decisions we have concerns with the decision and the reasons cited, namely the tentative decisions on physical settlement of contracts (IFRS 9) and cloud computing (IAS 38).

Please find our detailed comments in the appendix to this letter. If you would like to discuss our views further, please do not hesitate to contact Jan-Velten Große (grosse@drsc.de) or me.

Yours sincerely,

Andreas Barckow

President

6th February, 2019

To,
Ms Sue Lloyd,
Chair, IFRS Interpretations committee,
IFRS Foundation,
London, UK

Dear Ms Sue,

Subject: Tentative Agenda Decision (TAD) Nov 2018 – Public Comments by Feb 6th, 2019

Thank you for giving us an opportunity to comment on the six tentative agenda decisions of IFRS Interpretation Committee published in Nov 2018. Our comments and concerns on TADs are given in the attachment and we hope you will find those useful and relevant. IFRIC Interpretation Committee is requested to consider our concerns appropriately to depict true and fair view and economic substance of the transactions/events.

The Institute of Chartered Accountants of India (the ICAI) , is the premier accounting body of India established way back 1949 as one of the primary building block of nation building, of Independent India. Over the last seven decades, the ICAI has grown in many professional areas and today it is second largest body of accountants in the World. The ICAI with its great vision and relentless mission to serve the public interest, domestic and global, has earned title of “Partner in Nation Building” in an emerging economy which is sixth largest by GDP and the fastest growing capital market in Asia.

Please feel free to contact CA. Vidhyadhar Kulkarni, Head, Technical Directorate, (email: vidhyadhar.kulkarni@icai.in or asb@icai.in) for any clarifications or discussion.

Thanking you,

Yours faithfully,

CA.S.B.Zaware,

Chairman, ASB, ICAI

New Delhi, India

Tentative agenda decision (TAD): Over time transfer of constructed good (IAS 23)

In the light of the specific facts and circumstances considered by the IFRS IC, some of the conclusions in the TAD appear to be fine. However, in view of the following concerns, we are unable to fully support the conclusions in the TAD.

1) IAS 11 replaced by IFRS 15 allowed capitalisation of borrowing costs under Percentage of Completion Method (POCM). This method of revenue recognition is similar to recognition of revenue over time. We draw your attention to paragraph 18 of IAS 11 that dealt with Contract costs and costs that are allocated as Contract costs -

   "Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include **borrowing costs**".

   In the absence of adequate discussion and deliberation about capitalisation of borrowing costs in the Basis for Conclusions of IFRS 15, it is not fully clear as to what has caused this significant change in the accounting treatment.

2) Logically, the methods and principles to determine costs to fulfill a contract under the two revenue recognition methods i.e. point in time and over time, should not be different. Cost accumulation principles should not be dependent basis outcome of revenue recognition methods.

3) The principle of capitalising interest arises from the physical activities and substantial Period of time required to complete assets. The customer has contracted to buy a constructed unit and not a right to obtain semi-constructed units.

4) In respect of unsold units, we believe the IFRS IC TAD needs reconsideration. In the specific facts and circumstances of the case, TAD conclusion may have some merits, but the TAD decisions become part of IFRS literature and are used to draw analogy to interpret the IFRS Standards. Therefore, there can be unintended consequences of incorrect application to other situation that appear similar but are practically different e.g. real estate developer may have many unsold units as work in progress and he has no intention to enter into contracts for these partly completed units until all the units are completely constructed and ready for use by the customers.

   In view of the above, we suggest IFRS IC not to issue this TAD, rather refer this matter to IASB for reconsideration of IFRS 15 principles in the context of borrowing costs.

COMITÊ DE PRONUNCIAMENTOS CONTÁBEIS
SAS Quadra 05. Bloco J. CFC
Brasília, Distrito Federal – Brazil
http://www.cpc.org.br

February 8, 2019

IFRS Interpretations Committee
Columbus Building
7 Westferry Circus
Canary Wharf
London
United Kingdom
E14 4HD

Reference: IFRS Interpretation Committee – Tentative Decision – Over time transfer of constructed good (IAS 23 Borrowing Costs)

The Comitê de Pronunciamentos Contábeis - CPC (Brazilian Accounting Pronouncements Committee)[1] welcomes the opportunity to respond to the IFRS Interpretation Committee – Tentative Decision – Over time transfer of constructed good (IAS 23 Borrowing Costs).

We are a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidance for Brazilian companies.

CPC believes that the conclusions on the fact pattern described in the tentative agenda decision will have a significant impact across many sectors, besides the real estate development entities, since different views under similar circumstances are being applied for a very long time. This can be an indication that the current wording of IAS 23 might not be sufficient clear when applied to those circumstances, and the resulting accounting consequences can be different of that intended under the general principles that IAS 23 was developed.

CPC urges the IFRS IC to analyze this issue in a more comprehensive project, allowing an intensive debate with stakeholders, instead of issuing an IFRS Interpretation Committee agenda decision. CPC believes that a Tentative Agenda Decision would not be the best alternative to clarify this issue; to the extent, it can create massive changes in current accounting practices without transition provisions and eventual reliefs.

***

[1]The Brazilian Accounting Pronouncements Committee (CPC) is a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies. Our members are nominated by the following entities: ABRASCA (Brazilian Listed Companies Association), APIMEC (National Association of Capital Market Investment Professionals and Analysts), B3 (Brazilian Stock Exchange and Mercantile & Future Exchange), CFC (Federal Accounting Council), FIPECAFI (Financial and Accounting Research Institute Foundation) and IBRACON (Brazilian Institute of Independent Auditors).

COMITÊ DE PRONUNCIAMENTOS CONTÁBEIS
SAS Quadra 05. Bloco J. CFC
Brasília, Distrito Federal – Brazil
http://www.cpc.org.br

If you have any questions about our comments, please do not hesitate to contact us at operacoes@cpc.org.br.

Yours sincerely,

Rogério Lopes Mota
Chair of International Affairs
Comitê de Pronunciamentos Contábeis (CPC)

COMISSÃO DE VALORES MOBILIÁRIOS
Rua Sete de Setembro, 111/2-5º e 23-34º Andares – Centro – Rio de Janeiro - RJ – CEP: 20050-901 – Brasil
Tel.: (21) 3554-8686 - www.cvm.gov.br

The Chairman of the IFRS IC
Ms. Sue Lloyd
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

6th February, 2019

REF: Committee´s Tentative Agenda Decision – *Over time transfer of constructed good (IAS 23 – Borrowing Costs)* - Agenda Paper 4, November 2018.

Dear Ms Lloyd

The Office of the Chief Accountant of the Securities and Exchange Commission of Brazil (CVM or "we"), welcomes the opportunity to comment on the tentative agenda decision (TAD) about the capitalisation of borrowing costs in a construction contract of real estate unit in a residential multi-unit complex in which revenue is recognised over time, according to IFRS 15. We are very concerned that such TAD conclusions for issuing a rejection notice might significantly conflict with current accounting practices in Brazil, although recognizing that a rejection notice does not have the authority of IFRS Standards[1].

[1] IFRS Foundation Due Process Handbook: "5.22 If the Interpretations Committee does not plan to add an item to its work programme it publishes this as a tentative rejection notice in the IFRIC Update and on the IFRS Foundation website and requests comments on the matter. The comment period for rejection notices is normally at least 60 days. After considering those comments the Interpretations Committee will either confirm its decision and issue a rejection notice, add the issue to its work programme or refer the matter to the IASB. Rejection notices do not have the authority of IFRSs and they will therefore not provide mandatory requirements but they should be seen as helpful, informative and persuasive. The IASB is not asked to ratify rejection notices".

The fact pattern described in the submission is related to a construction of a residential multi-unit complex in which the real estate developer (entity) markets real estate units to individual customers before construction begins, and thus signing contracts for the sale of some real estate units before and during construction. The entity borrows funds specifically for the purpose of constructing the building and incurs borrowing costs in connection of that borrowing. According to the staff paper, the terms, relevant facts and circumstances of the contracts with customers are such that the entity transfers control of sold units and recognises revenue over time applying IFRS 15.

The question raised by the submitter asks whether the entity has a qualifying asset and whether it capitalises any directly attributable borrowing costs as part of the costs of the units. The submitter also shows three different views related to the fact pattern described:

a) capitalise borrowing costs on only the unsold units;
b) capitalise borrowing costs on neither the unsold nor the sold units;
c) capitalise borrowing costs on both the sold and unsold units.

In summary, the staff analysis´ conclusion was that <u>the entity does not have a qualifying asset</u> and, therefore, <u>does not capitalise borrowing costs in relation to the construction of the building</u>. When dealing with unsold units (inventory), the staff reached such a conclusion based on the following reasoning:

> "… we think any such work-in-progress relating to unsold units under construction would not meet the definition of a qualifying asset. In the fact pattern described in the submission, the entity markets the unsold units for sale and intends to enter into contracts with customers for the unsold units as soon as it finds suitable customers. In other words, the unsold units are ready for their intended sale in their current condition and would not necessarily take *a substantial period of time* to get ready for such sale".

We have a different view from the conclusion reached by the staff in analysing the matter and we are very concerned with the potential consequences of the TAD, if confirmed, as we believe it will have the potential to result in significant change to current accounting practices of entities in the real estate industry, as well as in different business (i.e. construction contracts under the superseded IAS 11). We also believe that the staff conclusion has the potential to cause a significant departure from the fundamental aspects of IAS 2, IAS 16, IAS 23 and others standards that require a cost-based measurement approach of items recognised in financial statements. As such, the staff paper conclusion shows a narrow interpretation of the criteria established by IAS 23, giving more prominence to formal characteristics than to the rationale and intent of the standard´s requirements. In this aspect, we consider that the staff conclusion also lacks consistency with the Conceptual Framework for Financial Reporting.

Moreover, Exposure Draft ED/2018/2, Onerous Contracts-Cost of Fulfilling a Contract (Proposed amendments to IAS 37), clarifies in the modified paragraph 68 that "The cost of fulfilling a contract comprises the costs that **relate directly to the contract**." (emphases added). So, in order to analyze if a contract is onerous, not including borrowing costs in the concept of the unavoidable costs of fulfilling a contract could significantly undermine the estimation of a possible loss-making contract. Moreover, the earlier the sale the bigger the potential misstatement.

Taking the paragraphs 5 and 17-25 of IAS 23 together, it does not seem to us that the fact the entity is able to market units before or during construction is an adequate criterion under IAS 23 requirements to preclude unsold units from being qualifying assets. We understand that the meaning of "… substantial period of time to get ready for its intended use or sale" cannot be detached from the period in which the entity needs to perform activities (i.e. transformation or construction) in order to deliver the good as promised. In order words, according to our view of IAS 23´s objective, intended sale should be understood as preparing (constructing) the real estate unit to be delivered completed, regardless of whether the entity is able to market the unit before construction begins. Our reading of the aforementioned paragraphs also indicates that it is difficult to deviate from the notion of physical development/construction when referencing to the concept of qualifying asset and when taking into account the requirements to the commencement of capitalization in paragraph 17 of IAS 23, specially the one established in (c)[2]. In this circumstance, we observe that it is not appropriate to interpret IAS 23 using the lens for the IFRS 15, as the latter uses the concept of transfer of control while the intended sale in the former should be understood in terms of physical development to use or to deliver the item (the item is ready for its intended use or sale). This view is reinforced by paragraph 23 of IAS 23, when it states that the asset "… is normally ready for its intended use or sale when the physical construction of the asset is complete…". The term "normally" should be understood meaning that in some cases the asset is ready for its intended use or sale even though minor activities still remain to be performed (i.e. decoration, as described in paragraph 23 of IAS 23), considering that substantially all the activities have been completed.

IAS 23 operates in a cost-based measurement perspective, when requiring, rather than permitting, capitalisation of borrowing costs. In this regard, we consider that borrowing cost is a proper component of the cost of an item when directly attributable to the production or construction of a qualifying asset, the one that takes a substantial period of time to get ready for its intended sale, i.e. construct (prepare) the real estate unit to be delivered to the customer. Having in mind the substantial period of time to develop and deliver the unit, we consider that IAS 23 ultimate aim is to operationalise the principle of matching of cost with revenue, as stated in paragraph 5.5 of the Conceptual Framework for Financial Reporting (as issued in March 2018). Paragraph 4(b) of IAS 23 excludes from the scope of IAS 23 inventories that are manufactured in large quantities on a repetitive basis because of the cost and benefit analysis of the information provided otherwise capitalising borrowing costs. In this situation we understand that as the

[2] 17. An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:
(a) it incurs expenditures for the asset;
(b) it incurs borrowing costs; and
(c) it undertakes **activities** that are **necessary to prepare the asset** for its intended use or sale. (*emphases added*)

inventories are produced in large quantities and on a repetitive basis, the time period between the production and sale is probably very short, not justifying the procedures and controls developed by the entity to capitalise borrowing costs (it is a cost and benefit analysis exception). Does it make any sense capitalising borrowing costs if the period between capitalisation and the recognition as expense to match the revenue is very short?

Moreover, if we analyse paragraph 7 of IAS 23, in special the excerpt that says “[…] financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets”. As a result, we comprehend the concept of qualifying asset as encompassing the underpinning characteristic of taking a substantial period of time to be produced, that serves as the basis for capitalising borrowing costs in order to correctly present the cost of production and to satisfy the principle of matching of cost with revenue.

Besides, we have analysed at the previous IAS 11 – Construction Contracts (superseded by IFRS 15 and taken here as a reference because of the similarity of the contract´s nature) and found in paragraph 18 an explicit requirement to allocate borrowing costs to contracts under the scope of the aforesaid superseded standard. In this respect, we believe this rationale did not change with the adoption of IFRS 15. So, if the TAD is confirmed as posed, in our view, it will have the potential to cause unintended consequences far beyond the fact pattern described in the submission.

Considering what has been said, the Office of the Chief Accountant of CVM doesn´t agree with the conclusions of the TAD and understands that borrowing costs should continue to be capitalised to inventories (unsold units). In regard of sold units, although not recognised as an entity´s inventories, we also believe that borrowing costs are costs attributable to such contracts (in which units have been sold) and thus recognised in profit or loss <u>as part of the cost of the units sold</u> in light of not distorting the gross profit margin presented. In this way, not recognising borrowing costs as costs of the asset being constructed would impair the information being presented to users of financial statements because such procedure would not adequately portrait the financial performance of the entity. It would also undermine comparability of information between entities that choose to market real estate units in different ways, i.e. entities that choose to sell real estate units before or after their physical completion.

Finally, we again emphasise that the rationale of IAS 23 is to deal with an asset in formation, and not about the point in time when the contract is signed. In other words, the objective of IAS 23 is to help to account for the costs of an asset that takes a substantial period of time to be produced, independently if revenue is recognised at a point in time or over time. Moreover, if an entity satisfies its performance obligations over time, then there is a partial and continuous transfer of control (continuous sale) which only ends when the contract is completed and the entity achieves the intended sale, for purposes of application of IAS 23. Therefore, all costs for constructing and producing the asset, including borrowing costs that are attributable to the contract, should be recognised as cost of the contract. In our understanding, the IFRS IC is conditioning the accounting practice of cost capitalization on the accounting police of revenue recognition. This means that the method of revenue recognition over time does not qualify for the criterion of cost capitalisation established by IAS 23. According to the TAD conclusions, only the method of revenue recognition at a point in time would qualify for such cost capitalisation.

Request

If the TAD is confirmed as posed, we believe it will have the potential to disrupt the current accounting practice in cost-based measured assets. The TAD conclusion, if confirmed, will not also be consistent with the rationale and intent of current standards (i.e. IAS 2, IAS 16, IAS 23, IFRS 15 etc.) and the principles established by the Conceptual Framework for Financial Reporting. Considering this unintended widespread consequences, we urge the IFRS IC not to issue the TAD in relation to this matter. If the IFRS IC finds its TAD conclusion appropriate, we recommend referring this topic to the IASB because of the broader issues raised by the IFRS IC conclusion.

Finally, the Office of the Chief Accountant of the Securities and Exchange Commission of Brazil (CVM) highlights the importance of the role played by IFRS IC as the body responsible for ensuring consistent interpretation of international financial reporting standards in different jurisdictions. Nonetheless, if the IFRS IC confirms the rejection notice, we will consider whether, as a result of such conclusions, to issue guidance in order to clarify this matter. The objective of such guidance would be to contribute to the faithful representation of the information presented in financial statements by entities required to adopt CVM rules, as required by our corporate law.

Respectfully yours,

Paulo Roberto Gonçalves Ferreira
Deputy Chief Accountant

José Carlos Bezerra da Silva
Chief Accountant

Global Financial Reporting Collective
incorporating the Pacioli Initiative

globalfrcollective@gmail.com

4 February 2019

IFRS Interpretations Committee
IFRS Foundation
Columbus Building
7 Westferry Circus
Canary Wharf
London
E14 4HD
United Kingdom

The Global Financial Reporting Collective is pleased to offer its comments on the Tentative Agenda Decision—Over time transfer of constructed good.

We understand the conclusions reached by the Committee. However, not all of those contributing to this letter agree with the outcome.

We do all agree that the Committee is interpreting the words "intended use or sale" and that the Committee has concluded that if the entity intends to sell an asset being constructed as soon as it can, as indicated in the fact pattern, then the asset is in a state that is its intended use.

Although we also all agree that this is a valid interpretation, some of our group observed that IAS 23 defines a qualifying asset and refers to the acquisition, construction or production of a qualifying asset. Nowhere in IAS 23 does it say that the asset must be controlled or owned by the entity. They think it is possible to interpret IAS 23 as meaning that a qualifying asset could be an asset being constructed for another party. Paragraph 18 of IAS 23 has a reference to "any progress payments received" in relation to a qualifying asset. This is a term we would associate with contract payments on a construction contract, which implies that assets being constructed for others was anticipated by IAS 23.

These members of the group say that this would mean that borrowing costs could qualify for inclusion in the costs of an asset being constructed for another party and subsequently recognised as an expense on the same basis as other construction costs (which might be on completion). They think this would be a more consistent financial reporting outcome. They also couldn't find any reference in IFRS 15 that prevented borrowing costs from being contract costs. In fact, IFRS 15.97(d) says that contract costs include costs that are explicitly chargeable to the customer under the contract. If finance costs are chargeable to the customer, we cannot see what prevents them being included as contract costs. IFRS 15.95 states that an entity can recognise an asset from the costs incurred to fulfil a contract. It is not a **contract asset** as defined in IFRS 15, but it is an asset. The tentative Agenda Decision refers only to a contract asset and not to the asset referred to in IFRS 15.95.

We also considered the implications of this tentative Agenda Decision in conjunction with the Agenda Decision finalised in March 2018: Revenue recognition in a real estate contract (IFRS 15 *Revenue from Contracts with Customers*). We think the tentative Agenda Decision would mean that if there is a purchase agreement but the point at which the point-of-sale revenue has not been reached the borrowing costs cannot be capitalised. This is because, even though the sale has not "completed" the asset is in the state that seller intended it to be for sale.

We do wonder what would stop an entity stating that its intention is sell only completed assets, such as housing units, and capitalising borrowing costs until an actual sale is made. Management intent seems to be increasingly important in IFRS Standards.

Furthermore, if the actual intention is to sell on completion but the entity receives an offer and sells subject to completion can the entity continue to capitalise costs until the asset is complete and the sale is completed? That seems to be a logical outcome, but it could be that the tentative Agenda Decision would say otherwise. We know it is a different fact pattern to the one you received, but you have placed a lot of emphasis on "intended use or sale" and it has raised additional issues for us to think about.

To summarise, we think, on balance, that the tentative Agenda Decision is likely to lead to more consistent application of IAS 23 even if it raises additional questions.

Thank you for considering our comments.

Global Financial Reporting Collective

Global Financial Reporting Collective

4 February 2019

About the Global Financial Reporting Collective

The **Global Financial Reporting Collective** is a coalition of academics who support global financial reporting standards and who are motivated to help the IASB to develop high quality standards. The Collective does not have a jurisdictional base. It operates as a virtual, global network.

The Collective was established in 2018. In its initial phase it is managed by a small group of volunteers who analyse IASB proposals and collate comments into comment letters to the IASB. In the second phase the Collective plans to develop a website that will enable a broader range of academics, and practitioners, to provide analysis of proposals. Any comments and input received will not be attributed to an individual. We plan to provide mechanisms to allow individuals to make observations which can then be assessed on their merits, rather than be influenced by the reputation of the submitter—a blind review process.

The primary focus of comments from the Collective is on the clarity and internal and conceptual consistency of proposals, mainly informed from experience with teaching from IFRS Standards or applying them in practice. The Collective does not represent any sector and will not lobby on behalf of any entity or sector to support a particular view.

The purpose of the **Pacioli Initiative** is to make research and learning resources available to the broader community of people using global financial reporting standards. A portal for sharing these resources is being developed as part of the second phase of the Collective. We welcome any input on IFRS-related matters that could be helpful to those who teach or research in this area.

The Chairman of the IFRS IC
30 Cannon Street
London EC4M 6XH
United Kingdom
06 February 2019

REF: Committee´s Tentative Agenda Decisions, Over time transfer of constructed good (IAS 23 Borrowing Costs)

The ABRASCA - Brazilian *Association* of *Public Companies - is* an association which represents the listed companies in Brazil, such as real estate enterprises. We are deeply involved in the matter in order to better interpret and guide these companies on the subject of this letter.

Besides that, Abrasca is a member of the CPC - Brazilian Accounting Pronouncements Committee - a standard-setting body engaged in the study, development and issuance of accounting standards, interpretations and guidances for Brazilian companies.

After meetings and discussions by our technical group to analyse the issue, we would like to submit some comments on the *IFRIC Update* of November 2018, relating to the item *Committee's tentative agenda decisions Over time transfer of constructed good (IAS 23 Borrowing Costs) (Agenda Paper 4)*, with a view to clarifying some important issues before the international body issues its final decision.

Taking into account the remarks contained in the document of the IFRS Interpretations Committee, more specifically items 18, 26 and 30, about its definition of whether or not an asset qualifies for capitalization of loan charges, we would comment as follows:

1. The activity of real estate development in Brazil requires a substantial period of time for construction, which makes it necessary to obtain financing. In our jurisdiction there are specific lines of credit for this purpose, linked to the Financial Housing System, the primary source of funding for the sector. The financing agreement contains a direct attribution to the project, confirming our understanding that the asset qualifies under IAS-23 as a component of the cost of the property unit.

2. According to item 8 of IAS-23: *"An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.".* Therefore the composition of development costs must include the loan charges, as long as they are associated with the process of development of the undertaking; in other words, the costs are calculated at the outset – or as they are incurred – and must be measured, adjusted and settled throughout the period of construction of the whole development. This is the same procedure as for the other costs of the development (e.g. construction costs) which are estimated initially,

controlled, adjusted and finalized during the process of construction – irrespective of whether units of property are sold or not during the same period.

3. Since these are components of the production cost, they should be capitalized as inventory and written off to income when units of property are sold. This understanding is corroborated by item 7 of IAS-23: "Depending on the circumstances, any of the following may be qualifying assets: a) inventories; (…).

4. There is no difference in the formation of the cost of a unit of property intended or proposed to be sold during construction or after completion; and

5. Since these are construction cost items they must be matched with the corresponding sales receipts, as per *The Conceptual Framework for Financial Reporting (IASB – BV 2011 Blue Book)* item 4.50: *"Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Conceptual Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities."* Thus while there is no revenue from the sale of units in inventory, there cannot be costs related to these units in the income statement.

6. If we compare the preliminary decision of the Committee with the reality of the Brazilian market relating to the cost composition of a development or unit to be built and sold, or otherwise, during the construction period, we have the following comments to make:

   a. Qualifying asset: is an asset which necessarily requires a substantial period of time to be ready for use, this being defined at the time when a loan is arranged. The need for funds for the development of an undertaking (use and/or construction) is defined as provided for in Item 8 of IAS-23.

   b. Charges as a cost component of the development: eligible as a cost during the development period and allocated proportionately to the qualifying units while construction is in progress (Item 7 and 8 of IAS-23).

   c. Appropriation of charges to inventory or to the cost of presold units: if eligible for capitalization in the undertaking, divided between the units, the charges will be allocated to inventory until the unit is sold (Item 7 of IAS-23) and to the cost of units sold (result) after the sale is completed, thus respecting the accounting principles of cost appropriation in line with the appropriation of revenue (Item 4.50 of IAS-00). Note that the fact that the charges are considered as part of the cost of the unit produced is unrelated to the timing or manner of sale of the unit; they are simply a component of production cost.

7. We believe that our current procedures, described above, are in compliance with IAS-23 and illustrate the best practices of measurement of the cost of properties produced, with allocation to inventory or to the cost of sales (capitalization during construction). The procedures we currently follow do not create any distortion in sales margins, since the cost is appropriated to revenue, thus ensuring the correct allocation to all the units built, as per paragraph 5 above.

8. Any change in the rules for capitalization, along the line of the preliminary proposal of the Committee, will create distortions in production costs and consequently in the margins of the units of a single development as they are sold, and in addition will not represent the business and lending environment in the Brazilian market.

In view of the above, we do not agree with the conclusions of the Committee and would respectfully ask you to reconsider them.

Yours truly,

Eduardo Lucano da Ponte
Executive President
ABRASCA - Brazilian *Association* of *Public Companies*

The Chairman of the IFRS IC
30 Cannon Street
London EC4M 6XH
United Kingdom
06 February 2019

REF: Committee´s Tentative Agenda Decisions, Over time transfer of constructed good (IAS 23 Borrowing Costs)

The Brazilian Association of Real Estate Developers (ABRAINC) represents 36 real estate developers of national importance that together account for a market share of approximately 60% in our jurisdiction. After meetings and discussions by our technical group to analyse the issue, we would like to submit some comments on the *IFRIC Update* of November 2018, relating to the item *Committee's tentative agenda decisions Over time transfer of constructed good (IAS 23 Borrowing Costs) (Agenda Paper 4)*, with a view to clarifying some important issues before the international body issues its final decision.

Taking into account the remarks contained in the document of the IFRS Interpretations Committee, more specifically items 18, 26 and 30, about its definition of whether or not an asset qualifies for capitalization of loan charges, we would comment as follows:

1. The activity of real estate development in Brazil requires a substantial period of time for construction, which makes it necessary to obtain financing. In our jurisdiction there are specific lines of credit for this purpose, linked to the Financial Housing System, the primary source of funding for the sector. The financing agreement contains a direct attribution to the project, confirming our understanding that the asset qualifies under IAS-23 and a component of the cost of the property unit.

2. According to item 8 of IAS-23: *"An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.".* Therefore the composition of development costs must include the loan charges, as long as they are associated with the process of development of the project; in other words, the costs are calculated at the outset – or as they are incurred – and must be measured, adjusted and settled throughout the period of construction of the whole development. This is the same procedure used for other development costs (e.g. construction costs) which are estimated initially, controlled, adjusted and finalized during the process of construction – irrespective of the sales of property units.

3. Since these are components of the production cost, they should be capitalized as inventory and written off to income when units of property are sold. This understanding

Associação Brasileira de Incorporadoras Imobiliárias – ABRAINC
Rua Iguatemi 448 – 14º andar – Itaim Bibi – São Paulo – CEP: 01451-010
Telefone: 11 2737-1400
www.abrainc.org.br

is corroborated by item 7 of IAS-23: “Depending on the circumstances, any of the following may be qualifying assets: a) inventories; (…).

4. There is no difference in the cost formation of a real estate unit to be sold during the construction or after its completion; and

5. Since these are construction cost items they must be matched with the corresponding sales revenue, as per *The Conceptual Framework for Financial Reporting (IASB – BV 2011 Blue Book)* item 4.50: *“Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Conceptual Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.”* Thus while there is no revenue from the sale of units in inventory, there cannot be costs related to these units in the income statement.

6. If we compare the preliminary decision of the Committee with the reality of the Brazilian market relating to the cost formation of a development or unit to be built and sold, during or after the construction period, we have the following comments to make:

    a. Qualifying asset: is an asset which necessarily requires a substantial period of time to be ready for use, this being defined at the time when a loan is arranged. The need for funds for the development of a project (use and/or construction) is defined as provided for in Item 8 of IAS-23.
    b. Charges as a cost component of the development: eligible as a cost during the development period and allocated proportionately to the qualified units while construction is in progress (Item 7 and 8 of IAS-23).
    c. Appropriation of charges to inventory or to the cost of presold units: if eligible for capitalization in the undertaking, divided between the units, the charges will be allocated to inventory until the unit is sold (Item 7 of IAS-23) and to the cost of units sold (result) after the sale is completed, thus respecting the accounting principles of cost appropriation in line with the appropriation of revenue (Item 4.50 of IAS-00). Note that the fact that the charges are considered as part of the cost of the unit produced is unrelated to the timing or manner of sale of the unit; they are simply a component of production cost.

7. We believe that our current procedures, described above, are in compliance with IAS-23 and illustrate the best practices of measurement of the cost of properties produced, with allocation to inventory or to the cost of sales (capitalization during construction). The procedures we currently follow do not create any distortion in sales margins, since the cost is appropriated to revenue, thus ensuring the correct costs allocation to all the units built, as per paragraph 5 above.

8. Any change in the rules for capitalization, as described at the preliminary proposal of the Committee, will create distortions in production costs and consequently in the margins of the sold units of the same development. In addition, it will not represent the business and credit environment in the Brazilian market.

In view of the above, we do not agree with the conclusions of the Committee and would respectfully ask you to reconsider them.

Yours truly,

Brazilian Association of Real Estate Developers (ABRAINC)

PDG Realty S.A Empreendimentos e Participações

To
The Chairman of the IFRS IC
30 Cannon Street
London EC4M 6XH
United Kingdom

Re:
IFRIC public consultation (Open for comment document) about the application of IAS 23 (CPC 20) to contracts for the sale of real estate units whose revenue is recognized over time.

PDG Realty S.A. Empreendimentos e Participações ("PDG"), a Brazilian real estate company, would like to comment on IFRIC Update November 2018, referring to the Committee's tentative agenda decisions over time transfer of constructed good (IAS 23 Borrowing Costs) (Agenda Paper 4) in order to clarify important issues for a final decision by IFRIC.

In light of the considerations contained in the IFRS Interpretations Committee document, specifically in items 18, 26 and 30, regarding the definition of qualifying asset eligible for capitalization of borrowing costs, we comment:

1. The real estate sector in Brazil uses the same procedure to evaluate whether a building qualifies for allocation of borrowing costs. This qualification is based on an evaluation of whether the loan is intended to support production (necessary for the development of the building) and when capitalization of these costs must begin (when the preparation of the project for use and/or construction begins), as well as when capitalization is not allowed (when construction is completed). We also point out that, in our jurisdiction, there are specific lines of credit for such production linked to the Housing Finance System, the main source of funding for the sector. This financing agreement is directly attributable to the building, which corroborates the understanding that it is a qualifying asset as defined in IAS-23 and that borrowing costs are part of the cost of the real estate unit; these assumptions are corroborated in the guidelines contained in IAS-23 on Borrowing Costs and perfectly in line with the reality of the Brazilian market.

2. Another important point for an appropriate understanding of the subject is that the cost of the building must include borrowing costs, as long as these are associated with the development of the building, i.e. regardless of whether the units of the building are sold, costs are calculated initially – or as they are incurred – and must be measured, adjusted and finalized during construction of the entire building. The same procedure is used for other costs of the building (e.g. cost of construction), which are initially estimated, controlled, adjusted and finalized during the building development process – regardless of whether unit sales are realized in the same period.

3. Since these are components of production costs, they must be capitalized in inventory and written off to profit of loss following the sale of the real estate units. This

understanding is supported by item 7 of IAS-23: “Depending on the circumstances, any of the following may be qualifying assets: a) inventories; (…).

4. There is no difference in the cost formation of a real estate unit to be sold (intention/purpose) during or after completion of construction.

5. Because they are part of construction costs, they should be matched with their respective sale revenue, in accordance with item 4.50 of The Conceptual Framework for Financial Reporting (IASB – BV 2011 Blue Book): “Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Conceptual Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.” Therefore, while there is no revenue related to the sale of inventory units, the cost related to these units will not be recognized in the income statement.

6. After comparing the preliminary understanding of the Committee with the reality of the Brazilian market regarding the composition of the costs of the building or unit to be developed and sold (or not) during the construction period, we would like to make the following points:

   a. Qualifying asset: It is identified and defined at the time the loan is taken out and its definition is based on the assumption that the funds are necessary for the development of the building (use and/or construction) - (Item 8 IAS-23).
   b. Borrowing costs as part of the cost of a building: They are eligible as a cost during the development of the property and allocated proportionally to all units of the building while it is under construction - (Items 7 and 8 IAS-23).
   c. Recognition of borrowing costs under inventories or cost of units sold: While eligible for capitalization to the property, divided between the units, borrowing costs will be allocated to inventories while the unit is not sold (Item 7 IAS-23) and to the cost of real estate units sold (profit or loss) after it is sold, thus respecting the accounting procedure of matching the recognition of costs to the recognition of revenue (Item 4.50 IAS-00). Please note that the fact that borrowing costs are considered as part of the cost of the resulting unit bears no relation to the timing or form of sale of the unit, but to their nature as a component of the production cost.
   d. We agree that borrowing costs should not be capitalized for finished units - as they are considered as a financial expense at this time; however, changing the Committee's understanding of the reality of the financial costs as a cost component of the unit and the controls on asset qualification, beginning and end time of capitalization, and allocation to inventory or profit or loss.

7. We understand that the above-mentioned procedures currently used in Brazil by PDG and other real estate companies represent the best practices for measuring the cost of developed real estate units, its allocation to inventory or cost of sale (capitalization during construction) and financial expense (after completion of construction). These procedures do not generate distortions in sales margins, since they guarantee the correct allocation to all developed units; any change in capitalization, as proposed by the Committee on a preliminary basis, will generate distortions in production costs and consequently in the margins of the units of the same building.

In light of the above, PDG Realty S.A. Empreendimentos e Participações does not agree with the conclusions of the Committee and kindly requests it to reconsider the matter.

Sincerely,

____

PDG Realty S.A Empreendimentos e Participações

POSITION PAPER

IASB Tentative Agenda Decision — Over time transfer of constructed good

WSBI (World Savings and Retail Banking Group)
ESBG (European Savings and Retail Banking Group)
Rue Marie-Thérèse, 11 - B-1000 Brussels

ESBG Transparency Register ID 8765978796-80

28.01.2019

WSBI

ESBG

WSBI-ESBG welcomes the opportunity to comment on the IFRS Interpretations Committee's tentative decision on over time transfer of constructed good.

We share the Committee's view and conclusions on this issue and agree that the existing principles and requirements in existing IFRS Standards provide an adequate basis for an entity to determine whether to capitalise borrowing costs.

About WSBI (World Savings and Retail Banking Institute)

(Boiler plate)

World Savings and Retail Banking Institute - aisbl
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99
Info@wsbi-esbg.org ■ www.wsbi-esbg.org

About ESBG (European Savings and Retail Banking Group)

(Boiler plate)

European Savings and Retail Banking Group – aisbl
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99
Info@wsbi-esbg.org ■ www. wsbi-esbg.org

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