

## RECOGNISING REVENUE FROM THE CONSTRUCTION OF REAL ESTATE IN FINANCIAL STATEMENTS OF DEVELOPERS IN POLAND

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### ABSTRACT

*The core business of real estate developers is performance long term developer contracts (directly or by subcontractors), that include constructing and selling residential and non-residential real estates. The characteristic feature of such contracts is the construction of properties that are generally financed by the principal over the whole project, by way of contractually agreed advances, and then – after the investment process has been completed – the ownership right is transferred to the buyer. Due to no unequivocal regulations in scope of revenue recognition resulting from property development contracts until 31 December 2008 some developers recognised revenues on developer contracts in accordance with IAS 18 “Revenue” some used the method of revenues and expenses percentage-of-completion in accordance with IAS 11 “Construction Contracts”. The immediate aim of this paper is a comparative analysis of Polish and international rules adopted by property development companies when recognising revenue and outcome of development contracts and a presentation of the effect that IFRIC Interpretation 15 „Agreements for the Construction of Real Estate” has on the reporting of such companies.*



*real estate developers, IFRS, Poland, revenue recognition*

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## INTRODUCTION

The principal business activity of entities from the real estate development sector is the realisation of property development agreements consisting of the construction (directly or through subcontractors) and subsequent sale (or rental) of premises in commercial, entertainment, office, hotels or residential buildings. A characteristic feature of such agreements, usually performed over a period in excess of 12 months is that their realisation is financed by deposits paid by buyers with the title transferred to them after completion of the investment process. In many cases this involves entering into different types of agreements with buyers, often prior to completion of the construction of real estate. For example, companies that undertake the construction and sale of buildings and apartments start to market individual premises on the basis of a plan, i.e. while construction is still in progress, or even before it has begun. Such companies enter into agreements with the buyers and usually charge deposits, which are refundable only if they fail to build the real estate in accordance with the contracted terms. The balance of the purchase price is generally paid only on contractual completion, when the buyer obtains possession of the premises. Likewise, entities that undertake the construction of commercial or industrial real estate often enter into agreements with the buyers who are required to make partial payments before the date of contractual completion.

The analysis of solutions used by developers when recognising and estimating revenue from property development agreements showed that some entities recognise revenue at the time of transferring the property to a buyer (in accordance with IAS 18 *Revenue*) whereas others recognise it gradually over the duration of the construction of the real estate (in accordance with IAS 11 *Construction Contracts*) (Pokojska, 2009). It must be stressed that theoretically property development companies that report in accordance with the Accounting Act and National Accounting Standards (NAS) are not able to recognise sales revenue whilst the construction of real estate is in progress. NAS 3 *Unfinished Construction Services*, corresponding to IAS 11 *Construction Contracts*, specifies that this is not applicable in cases of constructions carried out by property development companies themselves in order to sell or rent the real estate (NAS 3, 2006; Lachowski & Stypułkowska-Molga, 2008).

The International Financial Reporting Interpretations Committee's (IFRIC) Interpretation 15 *Agreements for the Construction of Real Estate* is intended to standardize accounting solutions related to the accounting for sales transactions in the real estate sector by developers, who prepare their financial statements in accordance with international standards (Commission Regulation (EC), 2009: 5). The objective of this paper is a comparative analysis of Polish and international rules adopted by property development companies when recognising revenue and outcome of development contracts and a presentation of the effect that IFRIC

Interpretation 15 „Agreements for the Construction of Real Estate” has on the reporting of such companies. Within the framework of the above the following detailed tasks were set:

- Comparative analysis of Polish and international accounting standards relating to recognition of revenue from property development activities,
- Analysis and description of the accounting policy adopted by developers with respect to recognising revenue, costs and assets in financial statements prepared before the introduction of IFRIC Interpretation 15,
- Analysis of the subjects and objects of IFRIC Interpretation 15,
- Evaluation of the scope of changes in the present accounting policy following the adoption of IFRIC Interpretation 15.

The main research hypothesis set prior to commencing the research is an assumption that the introduction of IFRIC Interpretation 15 has a significant effect on the accounting policy adopted by entities from the property development sector with regards to accounting for construction agreements. The research is based on annual and interim financial statements (mainly for the year 2009) of companies from the property development sector listed on the Warsaw Stock Exchange. The choice of entities researched is conditioned by the subjects and objects of the guidelines outlined in the Interpretation; IFRIC 15 applies to agreements for the construction of real estate, i.e. the subject of developers activities, whereas the reason for restricting the research to entities listed on the stock exchange is that only those companies are obliged to apply IFRS and associated interpretations.

## **1. SUBJECTS AND TOPICAL SCOPE OF IFRIC INTERPRETATION 15 AGREEMENTS FOR THE CONSTRUCTION OF REAL ESTATE**

Under the European Commission’s Regulation No 636/2009 of 22 July 2009 amending Regulation (EC) No 1126/2008, adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards the International Financial Reporting Interpretations Committee’s (IFRIC) Interpretation 15 (Commission Regulation (EC), 2009: 5) entities preparing individual or consolidated financial statement in accordance with IFRS/IAS are obliged to apply IFRIC 15 *Agreements for the Construction of Real Estate*, prepared by the International Financial Reporting Interpretations Committee, at the latest, as from the commencement date of their first accounting period starting after 31 December 2009. IFRIC 15 is an interpretation that contains guidelines on when revenue from the construction of real estate should be recognised in the accounts and helps to determine whether a construction agreement is within the scope of IAS 11 *Construction Contracts* or IAS 18 *Revenue*.

IFRIC 15 clarifies how to establish whether a given agreement is within the scope of IAS 11 or IAS 18 and sets out the principles of accounting for revenue and associated expenses by firms that undertake the construction of real estate directly or through subcontractors. It applies to agreements for the construction of real estate, which, in addition to the construction of real estate, may include the delivery of other goods or services. The Interpretation contains guidelines on splitting an agreement into separate components in order to establish the basis for revenue recognition. Subsequently, IAS 18 might be applied to one component of a contract and IAS 11 to another.

IFRIC 15 will result in a reduction of divergence in practice, thereby enhancing consistency and comparability of the information provided. The additional disclosures required by IFRIC 15 will allow users to have an improved understanding of the financial statements (European Commission, 2008; EFRAG, 2008).

## **2. HOW TO DETERMINE WHETHER AN AGREEMENT FALLS WITHIN THE SCOPE OF IAS 11 OR IAS 18**

In order to establish whether, under IFRIC 15, an entity should apply IAS 11 or IAS 18 in the accounting treatment of an agreement on the construction real estate, one has to first of all determine the structure of such an agreement, i.e. decide whether the agreement de facto contains one or more components. In many cases this involves splitting the agreements into individual components and accounting for each component separately. If required, the fair value of the total consideration received or receivable for the agreement is allocated to each component. The seller then applies the rules of IFRIC 15 to all separately identifiable components in order to establish whether they fall within the scope of IAS 11 or IAS 18.

Determining whether an agreement is within the scope of IAS 11 or IAS 18 requires subjective judgement on the part of management and depends on the terms of the agreement and all the surrounding facts and circumstances. According to IFRIC 15, IAS 11 applies when an agreement meets the definition of a construction contract, i.e. when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or is able to specify major structural changes once construction is in progress (whether he exercises that ability or not). Thus, an agreement constitutes an agreement for the construction of real estate when the buyer is able to identify the major structural elements before or during construction. For example: a production enterprise needing a new production hall specifies its exact requirements to a construction firm and once construction is in progress may monitor and change such requirements. In this case it is the buyer (the production enterprise) who determines the major elements of the design, therefore, in order to recognise, estimate and present revenue and results associated with the construction of such a production hall the construction firm applies IAS 11.

If the analysis of an agreement for the construction of real estate indicates that buyers have only limited ability to influence the design of the real estate design – e.g. to select a design from a range of options specified by the entity, or to specify only minor variations to the basic design, then it is an agreement for the sale of goods within the scope of IAS 18. For example: a firm building residential premises has few types of house models within the framework of one construction undertaking. The extent to which a buyer may influence the design of the real estate is basically limited to selecting a model from amongst the ones offered by the construction firm and to perhaps indicating minor changes to the original design. Hence, the construction firm applies IAS 18 in order to recognise, estimate and present revenue and results associated with the construction of such a building.

### **3. TYPES OF REVENUE FROM THE CONSTRUCTION OF REAL ESTATE AND THE PRINCIPLES OF RECOGNISING SUCH**

As shown above the economic content of an agreement for the construction of real estate is decisive for applying IAS 18 or IAS 11 in the accounting treatment of such an agreement. By analysing the solutions outlined in IAS 18 and IAS 11 with respect to agreements for the construction of real estate we may indicate three types of revenues arising from such agreements and associated principles for the revenue recognition:

- 1) revenue from agreements for the construction of real estate
- 2) revenue from agreements for the rendering of services
- 3) revenue from the sale of goods.

#### **3.1. Revenue from agreements considered as agreements for the construction service**

If an agreement for the construction of real estate is within the scope of IAS 11 and its outcome can be estimated reliably, the entity (a construction company) shall recognise revenue by reference to the stage of completion of the contract activity in accordance with IAS 11.

Agreements within the scope of IAS 11 include:

- agreements for the rendering of a service involving the construction of an asset or a combination of assets which are strictly interrelated or interdependent in terms of design or technology or due to their functional purpose, final destination or usage,
- agreements for the construction of new objects as well as the reconstruction, renovation, extension or demolition of existing objects,
- agreements for the assembly of machines and equipment the installation of which lasts longer than one reporting period, e.g. power plant boilers.

Characteristic features of such agreements include:

- a custom-made product is generated as a result of a unique production with the conditions of realization determined by a detailed agreement entered by the parties,
- a relatively long period of their performance covering at least one balance-sheet date,
- services are financed by the buyer already during the performance of the agreement by means of an agreed schedule of advance payments,
- the system of determining the final price is usually complicated,
- the commencement of construction works is preceded by the construction of infrastructure,
- capital expenses, not corresponding directly to the part of revenue from rendering the service, are incurred before commencement of the service itself and such expenses have to be incurred and are charged to the agreement,
- services that are often rendered by subcontractors acting under instructions of the general contractor.

### **3.2 Revenue from agreements considered as agreements for the rendering of services**

As indicated earlier, according to the prerequisites of IFRIC 15, IAS 11 is applied to agreements for the construction of real estate when the buyer has the right to specify the major structural elements of the design before construction begins and when the seller transfers to the buyer control and significant risks and rewards of ownership of the work in progress in its current state as construction progresses. The last condition is met when construction takes place on land the buyers owns or leases. However, if the agreement does not meet the definition of a construction contract, then it should fall within the scope of IAS 18. In this case, the entity shall determine whether the agreement is for the rendering of services or for the sale of goods.

The agreement is an agreement for the rendering of services if the entity (a construction firm) is not required to acquire and supply construction materials. This situation may have place, when the buyer (client) acts as his own contractor and concludes agreements with individual suppliers of certain goods and services (including the construction firm). Then, the construction firm is responsible only for the assembly of materials delivered by suppliers and does not bear the risk associated with the stock of building materials. If the result of a transaction involving the rendering of services can be estimated reliably, revenue from the transaction should be recognized, considering the degree of realization of the transaction at the balance sheet date. According to § 20 IAS 18 the result of a transaction involving the construction and sale of real estate can be estimated reliably when all of the following conditions are met:

- the amount of revenue can be measured reliably,

- it is likely that the entity receives the economic benefits of the transaction,
- the degree of completion of the transaction at the balance sheet date can be measured reliably,
- the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

The recognition of revenue by reference to the stage of completion of a transaction, i.e. using the percentage of completion method, means that revenue has to be recognised in the accounting periods in which the services are rendered. As mentioned earlier, IAS 11 also contains a requirement that revenue is recognised in accordance with this method. Detailed guidelines contained in this requirement with respect to the use of the percentage completion method must be applied also to the recognition of revenue and expenses associated with a transaction that involves providing services (Winiarska, 2008: 50).

### **3.3 Revenue from agreements considered as agreements for the sale of goods**

If the agreement for the construction and transfer of real estate requires that the entity (a construction firm) provides certain services together with construction materials, then generally, the agreement is an agreement for the sale of goods and the criteria for recognition of revenue from the sale of goods apply. According to § 14 IAS 18 revenue from the sale of goods shall be recognised when all of the following conditions have been satisfied:

- o the entity has transferred to the buyer the significant risks and rewards of ownership of the goods,
- o the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold,
- o the amount of revenue can be measured reliably,
- o it is likely that the entity receives the economic benefits of the transaction,
- o the costs incurred or to be incurred by the entity in respect of the transaction can be measured reliably.

An assessment as to when the entity has transferred to the buyer the significant risks and rewards of ownership requires an examination of the circumstances of the transaction. In most cases, the transfer of risks and rewards of ownership coincides with the transfer of legal title or the physical transfer of goods to the buyer. This is the case in most retail sales. In other cases, however, the transfer of risks and rewards of ownership will take place at a time different from that of the transfer of legal title or the physical transfer of goods.

The entity may transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. The condition of transferring to the buyer control and the significant risks and rewards of ownership is met when, for example, the buyer is entitled to take over the property during its construction or when, in case of terminating the agreement before the completion of construction, the buyer retains the property under construction and the seller is entitled to consideration for the works performed. In this case, the entity shall recognise revenue by reference to the stage of completion using the percentage of completion method.

Thus, in case of agreements within the scope of IAS 18 and relating to the supply of goods, IFRIC 15 introduces a new solution, whereby the revenue recognition criteria outlined in IAS 18 may be applied continually, in line with the progress of construction. It is worth stressing that in practice agreements on the construction of real estate which assume the continual transfer of control, significant risk and rewards to the buyer during the construction are rather rare and if an entity adopts such principles of accounting for revenue, it must disclose additional information (KPMG, 2010).

#### **4. POLISH ACCOUNTING STANDARDS RELEVANT FOR PROPERTY DEVELOPMENT ACTIVITIES**

Polish accounting is regulated by the Accounting Act of 29 September 1994. The Minister of Finance has also issued several regulations covering specific accounting areas such as financial instruments, consolidation, accounting for banks, insurance companies, investment funds and pension funds. Since 2002 the Accounting Act has been undergoing significant changes to bring Polish accounting principles closer to the International Financial Reporting Standards (IFRS).

In 2002 the Accounting Standards Committee was established. Since that time until now it has issued 6 National Accounting Standards (NAS) to implement the Act, NAS 3 *Construction contracts*. In matters not regulated by the Act or Decrees issued by Ministry of Finance an entity may apply National Accounting Standards. In the absence of relevant local regulations, the entity may apply International Financial Reporting Standards.

Poland's accession to the EU lead to the necessity of changing regulations and local practices in many fields of activities of business entities, changes in the reporting of banks and public companies, amongst others (Jaruga *et al.*, 2007; Krzywda & Schroeder, 2007). According to Art. 4 of the Regulation 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of International Accounting Standards, companies are obliged to prepare their consolidated financial statement in accordance with IFRS/IAS if their securities are



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admitted to trading on a regulated market of any Member State. The change in the Polish Accounting Act adopted in 2004 introduced regulations defining in more details the list of entities, which have the obligation or right to prepare financial statement in accordance with IAS/IFRS. The application criteria are summarized in the following table:

*Table 1. Subjective scope of entities which have the obligation or right to report in accordance with international standards*

	<b>Standalone financial statements</b>	<b>Consolidated financial statements</b>
1. Entities listed on a regulated market in Poland or other European Economic Area (EEA) country	Choice	Required
2. Banks (other than those included in 1, 3 and 4).	Not permitted	Required
3. Entities that applied for permission to list on a regulated market in Poland or other EEA country.	Choice	Choice
4. Entities that are part of a group where the parent prepares consolidated financial statements in accordance with IFRS as adopted by EU.	Choice	Choice
5. Branches of a foreign entrepreneurs	Choice	Not applicable
6. Other entities	Not permitted	Not permitted

(Source: E&Y, 2011; The Polish Real Estate Guide, 2011; Jaruga, 2006)

As seen above, in Poland nowadays companies from the real estate development sector maintain their accounts in accordance with national and international regulations, namely:

- a) National regulations: Accounting Act and National Accounting Standard 3 *Unfinished construction services*,
- b) International regulations: IAS 11 *Construction contracts*” and *IFRIC Interpretation „Agreements for the Construction of Real Estate*.

The proper application of balance sheet law in service agreements requires referring to other standards, such as: IAS 1 „Presentation of financial statements”, IAS 18 „Revenue”, IAS 12 „Income taxes” and IAS 8 “Accounting Policies, Changes in Accounting Estimates and Errors” (Winiarska, 2008; Żyznowski, 2006).

Additionally some of the real estate sector entities may be obliged to use additional regulation, such as Stock Exchange regulations relating to the method of disclosing information about the results of long-term contracts as well. These regulations, however, must comply with the requirements of both, the national and international

reporting standards, which mean that they do not allow for introduction of different solutions but simply provide for a more detailed approach.

According to the Polish Accounting Act if a development project is considered as a long-term (construction) contract, then revenue from the performance of an unfinished service under the contract, carried out for a period longer than 6 months and significantly advanced as at the day of balance sheet, is established, as at the day of balance sheet, proportionally to the degree of completion, providing that such a degree as well as the total estimated costs of the performance of the service over the entire period of its realisation can be estimated reliably (Accounting Act, Art. 34a; Kalinowski, 2007). Detailed principles for establishing revenue and costs with respect to unfinished construction contracts as well as the principles for presenting and disclosing such information in financial statements are outlined in NAS 3, which is treated as the national counterpart of International Accounting Standard 11 "Construction Contracts" (NAS 3, 2006; Sobańska, 2004).

Applying NAS3 would permit developers to recognise revenue, costs and outcome associated with the performance of property development contracts whilst such contracts are in progress. However, Polish standards, similarly as the IFRIC Interpretation 15, do not leave any doubts that the discussed standard is not applicable to construction services performed by property developers themselves in order to sell or rent the real estate. In Polish legislation the activity of property development companies consisting of building and selling apartments is treated for accounting, reporting and tax purposes as a production activity. Therefore, a developer's revenue is the revenue from sale of a house or an apartment, constituting the product of development activities. The sale of a house or an apartment is accompanied by the sale of its appurtenant land, which at the time of purchase is recorded in the accounts as goods. Thus a property developer's revenue is mainly generated by sale of products and sale of goods (Czubakowska, 2009).

Currently, developers in many parts of the world, including Australia, China, Hong Kong and the UK, recognise revenue on sale of properties upon completion and delivery to customers. IFRIC 15 is not expected to change the accounting in these jurisdictions (PriceWaterhouseCoopers, 2009).

## **5. IMPACT OF IFRIC INTERPRETATION 15 ON THE FINANCIAL REPORTING BY DEVELOPERS APPLYING IFRS**

Analysis of consolidated financial statements of companies from the property development sector, listed on the Warsaw Stock Exchange, was carried out in order to assess the impact of IFRIC 15 on the applied accounting policies and principles of recognising and valuating revenue. The analysis was based mainly on consolidated financial statements for the first six months of 2009. The choice of entities researched was conditioned by the subjects and objects of the guidelines

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outlined in the Interpretation; IFRIC 15 applies to agreements for the construction of real estate, i.e. the subject of developers activities, whereas the reason for restricting the research to entities listed on the stock exchange is that only those companies are obliged to apply IFRS and associated interpretations. Table 1 contains information on accounting policies adopted by individual companies with respect to the estimation and recognition of revenue from construction contracts in their consolidated financial statements.

**Table 2. Accounting policy with respect to recognising revenue  
from construction contracts**

	<b>Companies</b>	<b>Data sources</b>	<b>Accounting policy with respect to recognising revenue from construction contracts</b>
1	Globe Trade Centre	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.gtc.com.pl/web/pl/article/temporaryReports#">www.gtc.com.pl/web/pl/article/temporaryReports#</a>	IAS 18
2	ImmoEast AG	Consolidated financial statements for the period of three months ended on 31 January 2009 and consolidated financial statements for the year 2008 <a href="http://www.immoeast.at/polska/02ir/berichte.htm">www.immoeast.at/polska/02ir/berichte.htm</a>	IAS 18
3	Echo Investment	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.echo.com.pl/raporty_finansowe.php">www.echo.com.pl/raporty_finansowe.php</a>	IAS 18
4	Plaza Centers	Lack of information	-
5	Polnord	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.polnord.pl/relacje-inwestorskie">www.polnord.pl/relacje-inwestorskie</a>	IAS 11
6	LC Corp.	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.lcc.pl/raporty_okresowe">http://www.lcc.pl/raporty_okresowe</a>	IAS 18
7	Dom Development	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.domdevelopment.com.pl/roczne.html">www.domdevelopment.com.pl/roczne.html</a>	IAS 11

	Companies	Data sources	Accounting policy with respect to recognising revenue from construction contracts
8	Gant Development	Consolidated financial statements for the years ended on 31 December 2008 and 2009 <a href="http://www.gielda.gant.pl/CMS/raporty_gieldowe/raporty_gieldowe.html">www.gielda.gant.pl/CMS/raporty_gieldowe/raporty_gieldowe.html</a>	IAS 11
9	JW. Construction Holding SA	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://inwestor.jwconstruction.com.pl/pl/raporty_finansowe/raporty_polroczne_art7.html">http://inwestor.jwconstruction.com.pl/pl/raporty_finansowe/raporty_polroczne_art7.html</a>	IAS 11
10	Warimpex	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.warimpex.at/index.php?idcat=31&amp;channelang=3">www.warimpex.at/index.php?idcat=31&amp;channelang=3</a>	IAS 11
11	NFI Octava SA	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.octava.com.pl/rok_20092.php">www.octava.com.pl/rok_20092.php</a>	IAS 18
12	Orco Property Group	Consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.orcogroup.com/files/pressreleases/EN2009\OPG-annual_results-2008.pdf">www.orcogroup.com/files/pressreleases/EN2009\OPG-annual_results-2008.pdf</a>	IAS 18
13	BBI Development NFI SA	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.bbidevelopment.pl/index.php?option=com_content&amp;view=article&amp;id=33&amp;Itemid=33">www.bbidevelopment.pl/index.php?option=com_content&amp;view=article&amp;id=33&amp;Itemid=33</a>	IAS 18
14	Ronson Europe N.V.	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.ronson.pl/pwp/index.php?option=com_content&amp;task=view&amp;id=75&amp;Itemid=221">www.ronson.pl/pwp/index.php?option=com_content&amp;task=view&amp;id=75&amp;Itemid=221</a>	IAS 18
15	Triton Development	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008	IAS 11

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	<b>Companies</b>	<b>Data sources</b>	<b>Accounting policy with respect to recognising revenue from construction contracts</b>
		<a href="http://tritondevelopment.pl/2009/PSr2009.pdf">http://tritondevelopment.pl/2009/PSr2009.pdf</a>	
16	Grupa kapitałowa TUP	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.tup.com.pl/cmsPlik/2890.pdf">www.tup.com.pl/cmsPlik/2890.pdf</a>	IAS 18
17	Reinhold	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.reinholdpolska.com/pl/raporty.php">www.reinholdpolska.com/pl/raporty.php</a>	IAS 18
18	Atlas Estate Limited	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.atlasestates.com/financial_statement.s.asp">www.atlasestates.com/financial_statement.s.asp</a>	IAS 18
19	Marvipol SA	Consolidated financial statements for the period of six months ended on 30 June 2009 and consolidated financial statements for the year ended on 31 December 2008 <a href="http://www.marvipol.pl/wersja-polska/dla-inwestorow/raporty-gieldowe/raporty-finansowe/2009/raport-polroczny.html">www.marvipol.pl/wersja-polska/dla-inwestorow/raporty-gieldowe/raporty-finansowe/2009/raport-polroczny.html</a>	IAS 18

(Source: survey based on data available on the Internet website of the Warsaw Stock Exchange as well as websites of individual companies from the property development sector)

From amongst 19 equity groups from the property development sector, listed on the Warsaw Stock Exchange, 18 were covered by the research (in case of one of them, financial statements for the researched periods were not available). Under the accounting policy applicable to the period covered by the study, in the majority of cases the risks and rewards, associated with the title to residential premises were transferred to the buyer at the time of signing a notary act. The costs of unsold premises were recorded under assets as work in progress or ready goods, depending on the degree of completion. Under the matching principles the costs of sold premises were recorded in the profit and loss account as costs at the time of recognising revenue. The present accounting policy adopted by those companies is compatible with the requirement of IFRIC 15, therefore the companies did not forecast any changes in this field.

Five of the analysed companies specified in their accounting policy that in the financial statements for the year 2009 as well as the previous ones the revenue from construction contracts was recognised on the basis of preliminary sale agreements and estimated in line with the progress of construction, on the basis of IAS 11. One of the companies, in its accounting policy provides the following justification for the choice of such a solution: “Work in progress is valued in accordance with IAS 11 „Construction contracts”. Based on previous experience of the Management Board it was found that the method of income and cost recognition described in this standard is the most suitable for the Company's business. Construction of a single project exceeds 12 months and the sale of apartments in residential developments consists of concluding numerous single contracts for the construction of apartments. If there is a probability that the total amount of costs of the developers' project shall exceed the total amount of the revenues anticipated for this project, the anticipated loss is then, according to the IAS 11, immediately disclosed as cost.” (see consolidated financial statements of Dom Development S.A. for the year 2008, page 7).

Following the introduction of IFRIC Interpretation 15 „Agreements for the Construction of Real Estate” all groups applying presently IAS 11 decided that for their subsequent financial statements they will change their accounting policy with respect to the recognition and valuation of revenue from construction contracts.

Under IAS 8 “Accounting Policies, Changes in Accounting Estimates and Errors” all changes in the accounting principles arising from the application of IFRIC 15 must be applied retrospectively. The retrospective use of a standard or interpretation involves restating the opening balance of each component of the equity, which becomes altered due to changing the accounting principles, for the earliest period presented in the financial statements as well as adjusting all data, which changes due to the change of accounting principles, in order to ensure the comparability of data for each accounting period covered by the statement.

Whenever IFRIC Interpretation 15 is applied for the first time it means that the methods used for recognising revenue with respect to ongoing agreements as at the date of opening the earliest period presented in comparable data, have to be verified and restated retrospectively. Subsequently, for accounting periods starting in 2009 at the latest, the companies recognise revenue and corresponding costs at the time of transferring to the buyer control and significant risks and rewards of ownership. The transfer of control and significant risks and rewards associated with the title to the object of sale takes place on the day of concluding the sale agreement in the form of a notary act, at the latest. In certain cases it is possible to recognise the outcome of a construction contract earlier, e.g. at the time of transferring premises on the basis of a protocol. However this is usually a subject to additional requirements, such as obtaining a legal permission, receiving 90-100% of the premises price from the buyer, a clear intent of both parties to

conclude the final agreement and a transfer of premises in the form of a notary act. Any payments received from the buyers prior to transfer of significant risks and benefits associated with the sale of premises are considered as the developers' liability and will be presented in the balance sheet.

The main effect of changing the accounting policy with respect to construction contracts is that the sales revenue, costs of producing marketed goods and the ensuing gross financial result will be recognised much later than it had place when using the percentage of completion method. However, despite the fact that this change influences the value of revenue and costs assigned to each individual accounting period, it does not affect the profitability of construction contracts.

## **SUMMARY**

The main purpose of this paper was to assess the impact of IFRIC Interpretation 15 „Agreements for the Construction of Real Estate” on the reporting of construction companies with respect to recognising revenue, costs and assets arising from the performance of construction contracts. The analysis of interim reports indicates that IFRIC Interpretation 15 impacted the accounting policy currently applied with respect to construction contracts by approx. 30% of the researched property development companies. The main effect of changing the accounting policy will be that the sales revenue, costs of producing marketed goods and the ensuing gross financial result will be recognised much later than it had place when using the percentage of completion method. By impacting the principles of accounting for the revenue and cost of sale allocated to individual reporting periods this change will at the same time influence the principles of recording and estimating inventories (current assets). The costs of manufacturing current assets, incurred before the transfer of control and significant risks and rewards of ownership, shall be shown in the balance sheet under assets as inventories. Such costs include the usufruct right (land lease) or land, construction costs related to works carried out by subcontractors and other capitalised costs such as planning costs, design costs and other costs associated with the construction. As at the date of the balance sheet, inventories are valued at the lower of: manufacturing costs (purchase price) or net realisable value.

Taking into account the objectives of the Interpretation it must be assumed that the changes introduced by IFRIC 15 had the greatest influence on those entities from the property development sector, which up to this moment were recognising revenue from the sale of a real estate in accordance with IAS 11, and agreements entered by them did not meet the requirements of the “construction agreement” definition or the IFRIC 15 criteria relating to the percentage of completion method. However, it must be stressed that despite the fact that the guidelines outlined in the Interpretation are limited to the sale of real estate, they may affect other fields of

business activities and IFRIC Interpretation 15 may be applied by analogy to other situations (Frendzel *et al.*, 2009).

It must be also added that IFRIC Interpretation 15 did not make any changes to the accounting policy of companies reporting in accordance with the Polish accounting standards. According to NAS 3 the percentage of completion method of accounting for revenue during construction of real estate is not applicable to constructions carried out by property development companies themselves in order to sell or rent the real estate (NAS 3, 2006)

As pointed out previously, the principles relating to recognising revenue inclusive of revenue generated by developers are mainly contained in IAS 18, IAS 11 and IRFIC 15. At the moment IASB and FASB are working over a common draft standard ED 2010/6 “Revenue from Contracts with Customers” which would replace not only the abovementioned standards and interpretation but also IRFIC 13 “Customer Loyalty Programmes”, IRFIC 18 “Transfer of Assets from Customers” and SIC-31 “Revenue – Barter Transactions Involving Advertising Services”.

According to the draft standard revenue should be recognised when control over goods or services is transferred to a client and control is defined as “the ability to have the direct use of and receive the benefit from the good or service”. The draft indicates circumstances in which control is established and stresses the need for conducting a general assessment since all these circumstances are of equal importance. Such circumstances may include: an unconditional obligation to pay for a good or service, possession of legal title, physical possession, the design or function of the good or service is customer specific or others (IASB, 2010; FASB 2008)

Additionally it requires that an entity discloses its subjective judgments affecting the recognition and estimation of revenue, such as methods, data and assumptions used for evaluating liabilities and profits and establishing stand-alone selling prices for individual elements of a contract. For commonplace retail transactions, the proposed recognition model would cause little, if any, change in comparison to the presently applying standards. In some circumstances however, the solutions will differ from the existing ones since the overall aim of the proposed standard is to create a model which will permit to recognise revenue generated by economically similar transaction in a uniform way, regardless of their legal form and the sector, in which individual entities function.



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