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# Balancing An Accounting Problem

The IFRIC 15 debate is still raging. It's time to work together to resolve it

**By Goh Kean Hoe**

LATELY, IFRIC 15 has become a hot topic among accountants and leading property developers in Malaysia. Developers here have been using the percentage method for decades to report revenue from projects sold under the sell-and-build system. Naturally, they were shocked when 'told' to change to the completed method.

(IFRIC 15 is an interpretation issued in July 2008 by the International Financial Reporting Interpretations Committee to cover agreements for the construction of real estate. The document is meant to standardise accounting practice across jurisdictions for the recognition of revenue among real estate developers for sales of units before construction is complete.)

The message to the marketplace from the Malaysian Accounting Standards Board (MASB) and Malaysian Institute of Accountants (MIA) is that under IFRIC 15, property developers can only recognise the revenue when the construction is completed and the completed units are handed over to the purchasers. The top audit firms have also indicated to their clients to prepare for this fundamental change.

The developers are perplexed. Some ask: 'Does that mean we were wrong to use the percentage method all this while?'

A general explanation is that property developers are selling goods and not providing construction services. Hence, revenue can only be recognised when the goods are delivered to the purchasers.

## Which paragraph?

That may be true, but to be exact, IFRIC 15 lists three categories of agreements:

- (a) The agreement is a construction contract;
- (b) The agreement is for rendering of services (only); and
- (c) The agreement is for sale of goods (services plus materials)

For types (a) and (b), IFRIC 15 says the appropriate method is the percentage method. For type (c), the applicable method depends on whether the agreement meets the criterion set out in paragraph 17 or paragraph 18 of IFRIC 15.

Paragraph 17 says: ‘The entity may transfer to the buyer control and significant risks and rewards of ownership of the work in progress in its current state as construction progresses. In this case, ....’;

Paragraph 18 says: ‘The entity may transfer to the buyer control and significant risks and rewards of ownership of the real estate in its entirety at a single point of time (e.g. at completion, upon or after delivery). In this case, ...’;

So which paragraph should apply to the Malaysian property development industry? Whose WIP (work in progress) is it?

But the answer is more than just about the legal ownership of the properties or WIP. In accounting, substance is more important than form. In fact, the concept of ‘continuous transfer of control, risk and reward’ introduced in IFRIC 15 is rather new and obviously, not well or easily understood even by accountants.

IFRIC 15 acknowledges that circumstances that meet the criterion of paragraph 17 may not exist frequently. In addition, IFRIC 15 requires an entity to disclose how it determines which agreements meet that criterion. It seems that the International Accounting Standards Board (IASB) is biased towards the completed method by making it tougher to apply paragraph 17.

Noting that the draft of IFRIC 15 (issued in 2007) might not have addressed the industry practice in Malaysia, I included a suggestion in my letter for IASB/IFRIC ‘to examine various typical sales agreements on uncompleted real estate and categorise them as much as possible (or by way of examples)’. IASB did take into consideration many of the comments and concerns raised, and yet, did it fall short of addressing adequately our unique circumstances?

## Percentage vs completed

Can the circumstances in Malaysia be differentiated from those in other countries to justify the use of the percentage method?

Based on my observation, the general view is that there are either equally strong arguments for both methods and any difference could be just a fine line, or there is no a clear answer due to lack of specific guidance in IFRIC 15 for our unique circumstances.

Since the MASB and MIA have taken the view that the completed method is the way to go under IFRIC 15, it will be useful if they issue a formal document putting forward their views, with the basis and arguments, so as to convince the property developers and the doubters that this is the correct way.

To conclude that we do not meet paragraph 17 and hence, the completed method shall apply, is an easier task, but the important consideration is if the financial statements will still provide a true and fair view of the financial position and performance of the developers.

It is understood that the Real Estate and Housing Developers Association (Rehda) recently submitted a memorandum to the MIA and other relevant bodies about their view, which is biased towards the percentage method.

The objective of IFRIC 15 is to clarify existing standards and to standardise the accounting practice worldwide. Singapore converged to IFRS (international financial reporting standards) in 2005. However, it has yet to adopt IFRIC 15 and is still trying to find ways and means to interpret it correctly and in such a way that it can be accepted by all stakeholders. Meanwhile, the percentage method continues to be used there. Hong Kong, on the other hand, has switched to the completed method since its convergence to IFRS in 2005.

In my view, for Malaysia to solve this issue and to make sure we get it right, we must go through a due process as follows:

- a) To understand thoroughly IFRIC 15 and also related accounting standards ie IAS 18 and IAS 11 as well as the upcoming new standard on revenue recognition. This may necessitate consulting the IASB on unclear areas.
- b) To understand exactly the property development business and to critically review the industry practices, laws and the terms of the typical sale and purchase agreements in order to understand completely the relationship between the developers and their customers. The relevant substance must be identified and given due consideration.
- c) To compare with other countries such as Singapore, Hong Kong, Australia, Britain and the United States on the industry practices and laws and the accounting treatments.

## Remember the objective of financial statements

We must consider two more factors. First, we cannot totally ignore the unique characteristics of this industry- that real estate is an immovable asset and that the construction element can be undertaken by another engineering firm so long as the design and specifications are available.

Second, the ultimate objective of financial statements is to provide useful and relevant information for users to make economic decisions. Hence, it must be true and fair, and reflect the economic and business activities and events that happened during the reporting period, including any value added or destroyed.

Another point is that many may not be aware that our Companies Act and the FRS 101 (on presentation of financial statements) actually provide that if applying an accounting standard or interpretation will not result in true and fair financial statements, the directors should not apply it. I suspect many companies may consider making use of this provision.

Finding a good solution to this issue is by no means an easy task. It is important that the MASB, MIA and Rehda pool their resources to resolve this. Since the real estate laws and practices in Singapore and Malaysia are quite similar, it may not be a bad idea for the two countries to cooperate on this matter. Will accountants in Malaysia, and perhaps in Singapore as well, have the same opinion on an accounting issue for once?

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