

IFRIC 15 : Whose WIP is it ?

-One simple but critical question on application of IFRIC 15, a tough accounting rule, to the property development industry in Malaysia

By Goh Kean Hoe

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This is Part 1 of a 2-part article by Goh Kean Hoe on the issue of IFRIC 15. The title for Part 2 is IFRIC 15 : Getting it right

Looking at those buildings under construction and assuming that you have bought one unit from the property developer, the question is who owns the building under construction or work in progress(WIP), you or the property developer? In short, whose WIP is it? It may sound like a simple question with no trick and you can probably consult your lawyer or look into the Sale and Purchase Agreement(SPA) you signed for the answer. The answer to this question and other related issues, however, may shed some light into how the property developers in Malaysia should report the revenue in their financial statements in accordance with IFRIC 15. Can they continue to use Percentage of Completion Method(Percentage Method) or should they change to Completed Method?

IFRIC 15 means change? Were we wrong before?

Lately, IFRIC 15 has become a hot topic of discussion among the accountants and the leading property developers in Malaysia. IFRIC 15, with the title of 'Agreements For Construction of Real Estates' is an accounting interpretation issued by IASB(International Accounting Standards Board) in 2009 to clarify the existing accounting standards and to standardise the accounting practices in different countries for sale of uncompleted real estate. In Malaysia, MASB(Malaysian Accounting Standards Board) has adopted IFRIC 15 and issued it as IC Int 15 to be effective 1 July 2010 replacing the existing local standard, FRS201. Under FRS201, property developers in Malaysia have been using Percentage Method for decades to report the revenue from property development projects sold under 'Sell And Build' or 'Sell Then Build' system as regulated by the Housing Development Act(HDA). The commercial projects which are not regulated by HDA are usually also sold using the same system and practice and hence are treated the same way, accounting wise.

Suddenly, the property developers who need to apply IFRIC 15 (ie those listed companies) were in a state of shock when they were 'told' to change to Completed Method. The message to the market place by MASB as well as MIA(Malaysian Institute of Accountants) is that under IFRIC 15 property developers can only recognise the revenue(and hence the profit) in their financial statements when the construction is completed and the completed units are handed over to the purchasers. The leading audit firms have also indicated to their clients to

prepare for the fundamental change. According to them, Completed Method is the way to go under IFRIC 15. Their common stand is however not very surprising.

But why? The property developers affected by this are screaming 'why?'. Others such as analysts have found it difficult to comprehend the issue. We have hence seen furious remarks such as 'it is silly', 'it is crazy' 'it is a mistake' etc. The anger is understandable as the issue is about changing fundamentally about how an industry recognises the revenue from their businesses in their financial statements which affect directly the bottom line. Some ask 'Does that mean we were wrong to use Percentage Method all this while?' A general explanation given is that because property developers are selling goods and not providing construction services and hence revenue can only be recognised when the goods(ie the completed units) are delivered to the purchasers. This is the basic principle provided in IAS 18, the main accounting standard on revenue recognition.

Key question in IFRIC 15 : Para 17 or Para 18 ?

That may be true but it is not really what is provided in IFRIC 15. To be exact, IFRIC 15 categorises agreements that property developers enter with their customers/purchasers into 3 types as follows:

- 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 type a) and b) agreements, IFRIC 15 provided that the appropriate method is Percentage Method. For type c) agreements (sale of goods), which method shall apply depends further on whether the agreement meets the criterion set out in Para 17 or Para 18 of IFRIC 15 as follows.

'Para 17 : 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, if all the criteria in paragraph 14 of IAS 18 are met continuously as construction progresses, the entity shall recognise revenue by reference to the stage of completion using the percentage of completion method.'

'Para 18 : 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(eg at completion, upon or after delivery). In this case, the entity shall recognise revenue only when all the criteria in paragraph 14 of IAS 18 are satisfied.'

The question is which Para should apply to property development industry in Malaysia, Para 17(where Percentage Method shall apply) or Para 18(or where Completed Method shall apply). ‘Whose WIP is it ?’ is hence one key question in this respect. Other related questions to probe include:

- What happen if and when the project is abandoned?
- Can the purchasers take possession over the work in progress to complete it or otherwise?
- Assuming the work in progress is destroyed by Tsunami, whose loss is it?
- Can the purchasers sell the property to others when it is still a work in progress?

The concept of ‘continuous transfer of risk and reward and effective control’

But the answer being looked for is more than just about the legal ownership of the properties or WIP. In accounting, substance is more important than form. In this case, the accounting issue is centred on the timing and manner of transfer of significant risk and reward and effective control over the properties. However, this can be rather conceptual. In fact, the notion of ‘continuous transfer of control, risk and reward’ introduced in IFRIC 15 is a rather new accounting concept and obviously not well or easily understood even by accountants.

IFRIC 15 did acknowledge that circumstances that meet the criteria of Para 17 may not exist frequently. In addition, IFRIC 15 requires an entity who applies Percentage Method under Para 17 to disclose how it determines which agreements meet the criteria of Para 17. It seems that IASB is biased towards Completed Method by making it tougher or more stringent to apply Para 17.

It should be noted that IFRIC 15 was already issued as a draft (called D21 Real Estate Sales) for public comment way back in 2007. Because of my interest in this topic, i took time to review it and submitted a 4-page letter of my comments and suggestions to IASB. There were all together 51 comment letters submitted from various countries including one from MASB and one from the real estate association of Singapore. Noting that the Draft might not have addressed the circumstances of 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)’. The fact that IFRIC 15 has been redrafted to certain extent from the Draft with some significant changes show that IASB did take into consideration many of the comments and concerns raised in the 51 comment letters. But even that, did it still fall short of addressing adequately our unique circumstances?

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IFRIC 15 : Getting it right

-Due process is needed to interpret and apply IFRIC 15 rightly in Malaysia. Are the circumstances of our property development practice unique enough to justify use of Percentage Method?

By Goh Kean Hoe 22 July 2010

This is Part 2 of a 2-part article by Goh Kean Hoe on the issue of IFRIC 15. The title for Part 1 is IFRIC 15 : Whose WIP is it?

Whether applying IFRIC 15 to Malaysia scenario means that the property developers here can no longer use the Percentage Method in recognising the revenue from the property development projects and instead Completed Method should now be used depends on whether the circumstances in Malaysia meet the criterion set out in Para 17 of IFRIC 15. Can the circumstances in Malaysia be differentiated from other countries to justify use of Percentage Method? To answer this, there will be a need to study and consider carefully the terms in the typical SPA used in Malaysia as provided in the Housing Development Act(HDA) and other relevant facts and circumstances in order to determine if the property developers transfer the control and significant risk and reward of the properties in question to the purchasers on a progressive basis or at a single point of time.

Percentage Method vs Completed Method: Differences in views

Based on my observation, the general view about application of IFRIC 15 in Malaysia 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. However between the two methods, the general view is that the Percentage Method can better reflect the financial performance of the property developers and hence result in a more 'true and fair' financial statements. Since MASB and MIA have taken the view that the Completed Method is the way to go under IFRCI 15, it will be useful and appreciated if they could issue a formal document or paper putting forward their views with basis and arguments so as to convince the property developers and the doubters that this is the correct way moving forward. To conclude that we do not meet Para 17 and hence 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 property developers.

Obviously, the property developers do not think so. Finding themselves being pushed to a corner, they have, through their association, REDHA, recently submitted a memorandum to MIA and other relevant bodies about their view and interpretation of IFRIC 15 to Malaysia

scenario. Obviously, they are in favour of the status quo ie continue to use Percentage Method. IFRIC 15 is already effective by now. Will REDHA succeed? Will we have a sound and adequately documented consensus in due course?

A due process is critical to get it right

The objective of IFRIC 15 was to clarify existing standards and to standardise the accounting practice worldwide but as it turns out IFRIC 15 has proven to be a tough nut to crack in terms of its understanding and application. Many jurisdictions find themselves trying to interpret the Interpretation for application in their respective countries. Singapore converged to IFRS in 2005 and has since adopted every new and revised standards and interpretations issued by IASB but has found it tough to adopt IFRIC 15. Until today, it has not adopted it 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 the stakeholders and affected parties. Meanwhile, Percentage Method continues to be used there. Hong Kong, on the other hand, has switched to 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 that include carrying out the following 3 tasks.

- a) To understand thoroughly IFRIC 15 in terms of its objective, the principles involved and the key criteria set out and also related accounting standards – IAS 18 and IAS 11. This may necessitate consulting IASB, the body that drafted the Interpretation on the unclear areas. Since IASB has just issued an Exposure Draft for a brand new standard on Revenue Recognition(called Revenue from Contracts with Customers) on 24 June 2010 which will eventually replace IAS 11 and IAS 18 and related interpretations(including IFRIC 15), it will also be necessary and important to find out what will be the treatment under this upcoming new standard.
- b) To understand exactly the business of the property developers and to critically review the industry practice, laws and the terms of the typical SPAs in order to understand completely the relationship between the property developers and their customers. In particular, we need to understand the roles and responsibilities between the 2 parties as well as their rights during the period when the properties are under construction. The relevant substance must be identified and given due consideration.
- c) To make comparison and contrast with selected other countries(such as Singapore, Hong Kong, Australia, UK, USA etc) on the industry practice and laws and the accounting treatment used. This will allow us to identify any significant differences that may justify the use of same or opposite accounting treatment between us and the comparable countries.

Remember the objective of financial statements

In addition, in arriving at the conclusion, we must not forget to consider 2 more factors as follows. Firstly, we must consider that the subject matter ie real estate, is an immovable asset. In addition, the construction element can be undertaken by another engineering firm so long as the design and specification are available. Although IASB is currently not in favour of treating property development as a specialised industry where a different accounting principle may apply, we cannot totally ignore the unique characteristics of this industry.

Secondly and as mentioned earlier, we must not forget that the ultimate objective of financial statements is to provide useful and relevant information for users to make economic decision. For this to happen, the financial statements must be true and fair and reflect the economic and business activities and events that happened during the reporting period. Any value added or destroyed during the period should be reflected in the financial statements one way or another. For instance, will the financial statements achieve this if it does not show any recognition of income and/or increase in the value of net assets when a project worth RM100 million has been fully sold and say, 90% completed before year end? The distortion in the periodical reporting under Completed Method must be seriously looked into.

Another point is that many may not be aware that our Companies Act and the accounting standard(FRS101) actually provided that if in a rare circumstance, applying an accounting standard or interpretation will not result in a true and fair financial statements, the directors should not apply it. I suspect any company will make use of this provision unless its auditors agree. As an alternative, some property developers are pondering the idea to enclose supplementary financial information prepared using Percentage Method for shareholders to understand better the 'true' position. This might be a way around it but it will be inefficient, messy and confusing.

It seems that finding a good solution to the issue created by IFRIC 15 is by no means an easy task. It is hence important that all relevant bodies including MASB, MIA and REDHA pull their resources together and work together to find the best and the most appropriate solution to this issue. The outcome must be published for understanding and consumption by the interested and affected parties. Since the real estate laws and practice in Singapore and Malaysia are quite similar, it may not be a bad idea for the 2 countries to co-operate or to work together on this issue. In fact, it will be odd if the interpretation and application of IFRIC 15 in both countries turn out to be different because of no co-operation. In addition, any outcome or consensus reached jointly by 2 countries will certainly carry more weight and will be more convincing to everyone including IASB. Will accountants in Malaysia and perhaps Singapore as well, have the same opinion on an accounting issue for once?

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