



13 February 2008

D21 Comment Letters
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

(By email: ifric@iasb.org)

Dear Sir/Madam,

IFRIC DRAFT INTERPRETATION D21 REAL ESTATE SALES

1. **We are responding to the IFRIC Draft Interpretation D21 Real Estate Sales (D21).**
2. The Accounting Standards Council of Singapore appreciates the efforts of the IFRIC to standardise accounting practice among Real Estate (RE) developers for sales of RE units, such as apartments or houses, “off plan”, i.e. before construction is complete. RE sales is an area which is highly relevant to Singapore.
3. The off plan RE market in Singapore involves the progressive transfer of risks and rewards during the construction period from the RE developer to the buyer. D21 would treat these RE sales as revenue only at the end of the construction period when title passes. Our comment letter sets out why we believe the proposed treatment sets out an overly simplistic analysis of the revenue recognition issues and why it would result in an accounting treatment that is inconsistent with the transfer of risks and rewards affecting the parties involved.
4. The sale of RE units by a RE developer in Singapore has certain characteristics of a multiple elements sale, comprising the transfer in equity of an undivided interest in land and the delivery of a completed RE unit after it has been constructed.
5. A typical RE unit in Singapore is sold with an allocated number of “share values” representing the proportionate entitlement to an undivided interest in the land. Changes in the market values of RE units are largely attributable to changes in the value of the underlying land. A buyer has immediate entitlement to the rewards of ownership of this land (and the RE unit under construction) through an equitable title system. Immediately after signing the Sales & Purchase (S&P) Agreement, a buyer can sell his equitable interest to realise any increase in the value of the unfinished RE.
6. A buyer also has immediate exposure to the risks of ownership, through a legally mandated system of progress payments and project account rules. Singapore law requires that the buyer and the RE developer agree on a standard schedule of progress payments so that the buyer

pays progressively for the cost of construction. Upon certain stipulated milestones in the construction being achieved as certified by a registered architect, the various instalment payments become payable. These instalment payments are required to be paid into a special project account and can only be withdrawn by the RE developer to pay for construction and related costs before completing the RE construction.

7. It is important to note that at any point of time during the construction period, the buyer would have paid a portion of the purchase price proportionate to the stage of completion. To the extent that the buyer has paid these amounts, he has a lien over the RE. The progress payments schedule is mandated by law to ensure that at any point of time during the construction period, neither the RE developer nor the buyer holds an unfair proportion of the total risk.

8. Through these arrangements, the progress payments schedule during the construction period has the effect of transferring ownership risks to the buyer progressively. If RE prices rise, the buyer is fully entitled to the increase in value as long as he is not in default of his payment obligations. If RE prices fall, the buyer is fully obliged to pay the entire contracted purchase price, failing which all progress payments already made by him would be forfeited and the RE developer would be free to resell the RE.

9. Banks that provide mortgage finance also take the view that the buyer whom they finance has ownership rights of the RE unit during the construction period - they finance the progress payments and take the related risks away from the RE developer in the knowledge that the equitable title is good collateral. It is also pertinent to note that the involvement of a bank in taking over the legally-mandated progress payments obligations effectively removes the credit risk faced by the RE developer.

10. There remains the issue of construction risks. The law to protect progress payments made by buyers ensures that, in practice, there is an observably low level of failure to complete construction. The obligation to construct a RE is, in form, that of the RE developer. In practice, the RE developer transfers the construction risk to a main contractor who undertakes the construction work. Whether the construction contract is effective in transferring the risks from the RE developer to the contractor is a matter of observable empirical evidence. The evidence points to an extremely low level of failure to complete construction. This arises because the law does not allow the contractor to be paid more than what a registered architect certifies to be payable, taking into account the stage of completion of construction work. Even if the contractor ceases construction work, a new contractor can take over the construction contract, with sufficient monies available in the project account to ensure that construction can resume.

11. Taken together, these various arrangements have the effect of the RE developer transferring all substantive risks and rewards of ownership to the buyer progressively during the construction period, and not at the end of the construction period, notwithstanding the fact that the RE developer is selling a good.

12. With these observations in mind, we are of the view that D21 does not fairly represent the financial performance of a RE developer. The anomalies that could arise have the potential to

confuse users of financial statements of RE developers. We set out the two following scenarios where there is such potential for confusion.

(A) A RE developer launches a RE project. It is fully sold within six months before construction commences. One of the RE units it sells is resold by one of the buyers for a gain. The first buyer collects his full capital gain in cash and has no legal obligations thereafter to the second buyer. During the construction period, the second buyer repeats this resale to a third buyer. Both the first buyer and the second buyer meet all the current requirements in IAS 18 *Revenue* to recognise the full amount of revenue but the RE developer that is responsible for delivering the “good” has not recorded any revenue under D21.

(B) A RE developer has fully sold a RE project. It has appointed a main contractor to undertake all construction activities. Complete with bank-backed performance guarantees, the RE developer has effectively transferred the delivery risk to the contractor. The RE developer is responsible for collecting progress payments from buyers, which go into a regulated trust account to be applied only to pay the contractor and construction-related costs during construction. The RE developer (typically nominally capitalised) and the contractor effectively have the same credit risk, both looking towards progress payments from buyers to fund the construction. IAS 11 *Construction Contracts* requires the contractor to recognise revenue on a progressive basis.

D21 however prohibits the RE developer from recognising any revenue during the construction period. This is clearly anomalous for two reasons: (i) the RE developer is not recognising revenue under D21 although it has effectively transferred out the construction risk but the contractor that bears the construction risk is progressively recognising revenue; and (ii) the RE developer and the contractor are both looking towards the same ultimate source of funding from the buyers and such funds are locked up in a regulated account but the contractor recognises revenue in the same pattern as the receipt of such funds. However, the RE developer who has direct access to and controls the funds, does not recognise such revenue under D21.

13. While we accept that the sale of a RE unit is the sale of a good as currently defined in IAS 18 *Revenue*, the accounting treatment of recognising revenue at the end of the construction period is inconsistent with the accepted market view of buyers, sellers, mortgagees and regulators that the risks and rewards of ownership are transferred significantly earlier than the date on which full legal title passes. Our view is that the approach to address revenue recognition for RE sales should be undertaken with a more fundamental examination of how the entity transfers the significant risks and rewards of ownership of the RE to the buyer, instead of the current approach.

14. Put more broadly, our view is that the “features” approach promulgated in D21 does not take into account the fact that RE developers in different countries operate under different legal and market rules. We suggest that it would be better for IFRIC to adopt a *principles-based* approach to address the revenue recognition issue for RE sales, instead of a *features-based*

approach that creates different accounting treatments depending on whether the sale is that of a good or a service.

15. If however it is decided that the interpretation be issued in keeping with its current structure, we propose changing paragraphs 9 and 10 of D21 in the following ways (changes marked in bold):

9. Features that, individually or in combination, may indicate that an agreement is for the seller to provide construction services to the buyer's specifications include:

(a) the buyer being able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether it exercises that ability or not);
(b) the seller transferring to the buyer control and/or the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. Indications that the seller transfers control **and/or the significant risks and rewards of ownership** of the work in progress in this way may include, for example:

- (i) the construction taking place on land that is owned or leased by the buyer;
- (ii) the buyer having a right to take over the work in progress (albeit with a penalty) during construction, eg to engage a different contractor to complete the construction;
- (iii) in the event of the agreement being terminated before construction is complete, the buyer retaining the work in progress and the seller having the right to be paid for work performed (subject to buyer acceptance);
- (iv) **the buyer having a right to the economic benefits associated with the work in progress during construction, eg to sell unilaterally without reference to the seller the equitable interests in the work in progress to another party;**
- (v) **the buyer having an obligation to finance the cost of construction and in fact does pay for the construction cost progressively during the course of construction.**

10. Conversely, features that, individually or in combination, may indicate that an agreement is for the sale of goods (completed real estate) include:

- (a) the negotiation between buyer and seller primarily concerning the amount and timing of payments, **with such payments being largely or entirely payable when construction has been completed;** ~~with the buyer having only limited ability to specify the design of the real estate, eg to select a design from a range of options or specify minor variations to the basic design;~~
- (b) the agreement giving the buyer only a right to acquire the completed real estate at a later date, with the seller retaining control and the significant risks and rewards of ownership of the underlying work in progress until that date.

16. We believe that there is also room to significantly improve D21 by providing examples to illustrate the application of the principles to different types of RE sales.

17. Should you require any further clarification, please kindly contact me.

Thank you.

Yours faithfully,

Dexter Tan
Secretary, Accounting Standards Council