

The Regulation of Financial Reporting: IC 15 and Revenue Recognition for Malaysian Property Developers

Hashanah Ismail

Faculty of Economics and Management
Universiti Putra Malaysia
Malaysia

Abstract

This paper discusses the proposed IFRIC15 in the context of Malaysia's financial reporting convergence journey for companies in the property development sector. The deadline for full convergence was January 1, 2012. However, the road to convergence may not be fully realized with respect to property developers, in particular, as a result of the proposed new way of accounting for revenue recognition under IFRIC15. Based on data obtained from the annual reports of property developers, the study finds that revenue recognition policy disclosed in the annual reports of 113 property companies showed only 2 out of 133 companies have adopted the proposed method in IFRIC15. In addition the study sought the views of both preparers and auditors on the impact of IFRIC15. Both groups are of the view that the spirit of IFRIC15 is not aligned to current Malaysian business practice and compliance will reduce the fair presentation of business revenue from property development. Hence whilst convergence to one set of global standards for financial reporting can enhance the quality of financial reports of Malaysian companies it has to be tempered to suit local business models. The paper contributes to the current debate on convergence to IFRS and assessment of the benefits of convergence.

Introduction

Accounting policies are an important part of the information disclosed in the financial statements of firms to shareholders. The policies are described as being an integral part of the financial statements and this is explicitly stated in the footnotes to the financial statements. Accounting policies determine how assets and liabilities are recognized and measured in the balance sheet and it also determines how revenues and expenses flow through the income statement. Management decides on the accounting policies guided by the financial reporting framework in use and relevant to the reporting organizations concerned. This paper focuses on the choice of accounting policy on one particular item: revenues in a specific industry of property development where choice has been removed because of the adoption of a new standard, IC15. The new standard requires a different way of interpreting when revenue is deemed to be earned for property construction business. Revenue is typically the largest single item in the Income Statement and revenue growth trends are frequently used as indicators of firm performance by investors and get coverage in the financial press. Revenue growth, for example, was cited as one key indicator of performance of UEM Land and Encorp Bhd. (*Star Biz Week*, 15 December, 2012). Revenue recognition has been identified as one of the most difficult issues faced by standard setters and accountants and is one of the avenues used to manage earnings thereby misstating earnings reported (Altamura *et al.*, 2005).

There are two dedicated standards on accounting for revenue in Malaysia: FRS 118 and MFRS 111 on contract accounting. Given our principle-based approach to financial reporting practice, it is of interest to know how firms apply the recognition principle within the bounds of prudence and substance over form. Recent studies on accounting policy choice have focused on certain service industries such as the airline industry (Tan *et al.*, 2002) and software industry (Zhang, 2005) or looked at choice of a particular policy such as accounting for government grants (Forker and Green, 2000), use of LIFO or FIFO for inventory accounting (Gul, 2001), to expense or capitalize research expenditure (Ahmed and Falk, 2006). Since revenue is one of the biggest monetary items to be reported in the financial statement and is a major input in measuring a firm's performance via the earnings figures arrived at after deducting expenses from revenues for a reporting period, and predicting its future cash flows, revenue recognition becomes a critical issue faced by standard setters and accountants more so when MASB has announced in 2008 that by January 1 2012 accounting standards for non-private entities in Malaysia are to be fully converged to the International Financial Reporting Standards.

One critical component of revenue accounting under accrual basis accounting is the recognition of when revenue is deemed earned and flows through the financial statement. Although FRS 118 on revenue provides certain criteria for revenue recognition, it requires judgment on the part of preparers to decide “when” is it appropriate to recognize that revenue is deemed earned. Timing of recognition of revenue could result in revenues being recognized too early or too late causing revenue reported to be misleading. Leavitt (1998) has stated that one of the leading causes of earnings management is early recognition of revenue. In the journey to full convergence by 1.1.2012, revenue recognition has met a hiccup in IC 15 on revenue recognition for property developers in that completed contract should replace percentage of completion method to recognize property development revenue. Despite the importance of revenue recognition in general and revenue recognition timing in particular, there is little empirical research on accounting policy choice on revenue recognition, in particular, the mandatory change in accounting policy for revenue recognition imposed by migrating to a new reporting framework in Malaysia. Hence how do preparers and auditors view this new rule for revenue recognition in property development? By solely focusing on property development, this study removes any variable due to industry factor, thus resulting in a more powerful analysis of the study. This paper therefore makes a small contribution to the gap in the literature on revenue recognition policy of a specific sector when change in accounting policy is mandatory. The rest of the paper is structured as follows: literature on financial reporting framework is briefly described followed by the literature on accounting policy choice. The paper then describes how data was collected and analyzed. The paper then discusses the findings and finally concludes.

Literature Review

Accounting Standards in Malaysia

International Accounting Standards reached the Malaysian shores since 1978 when certain selected standards were incorporated as approved accounting standards in Malaysia. In 1997 accounting standards gained legal standing when the Financial Reporting Act created the Malaysian Accounting Standards Board (MASB) giving the Board the sole authority to issue and approve Accounting standards in Malaysia. In 2005 MASB standards were renamed Financial Reporting Standards (FRS) and in 2006 MASB introduced two categories of standards: one for private and another for non-private entities. A year later all FRS were made identical to the International Financial Reporting standards (IFRS) and in 2008 MASB announced that by 1.1.2012 the financial reporting standards will fully converge to IFRS. Thus MASB gave a warning three years in advance for affected organizations to prepare for full convergence. Beginning 1.1.2012 MASB has introduced a new reporting framework called the Malaysian Financial Reporting Standards Framework (MFRS framework) to reflect a new FRS-compliant framework. Until and unless organizations comply with the entire FRS approved, they cannot state that their financial reports are MFRS compliant. Despite the full convergence target date to be 1.1.2012, IC15 on *Agreements for the construction of Real Estate* issued by the London based International Accounting Standards Board (IASB) which superseded FRS 201 and FRS 204 suddenly threw a spanner in the convergence work because IC15 will change the accounting policy of property developers’ revenue recognition method from one of gradual stage by stage method to that of full recognition only when the project is completed.

The concern expressed by property developers was that it may not portray the essence of sell and build business model practiced by Malaysian property developers. IC15- *Agreements for the construction of Real Estate* is MASB’s reproduction of IFRIC 15 (International Financial Reporting Interpretations Committee on real estate development) from IASB. Initially IC 15 was to have been implemented beginning July 1st 2010 to standardized revenue recognition among property developers. It requires entities to determine whether the sale and purchases agreements are construction service contracts or sale of goods based on certain criteria. IC 15 also proposed that revenue is recognized only at the point the constructed goods are delivered to the customers. In Malaysia, property developers apply the percentage of completion method in recognizing revenue. Hence IC15 brings about a big change in revenue recognition and therefore turnover reported for property developers. The negative responses to the proposed IC 15 requirements resulted in a delay to the implementation date pushing it further to another two years to 2012 in order to give more time to the stakeholders to deliberate on the implications of IC15. In Malaysia property developers practice sell-then build construction properties. Before construction begins a plan is submitted to the relevant authorities. Models of the proposed construction are made and a launch to the public follows. The public buyers will pay cash upfront before the physical properties are completely built.

Such projects take longer than a year to complete so every year a certain portion of the project is measured in order to assess the sales and expenses of the partially completed projects or constructions. If IC15 is adopted, then no revenue can be reported every year until the year the project is completed.

In response to the concern by the property developers MASB made exception to this sector and allowed them to defer adopting MFRS in 2012. Thus the financial reporting framework in 2012 has a dual framework for non-private entities: one with full MFRS compliance and the other deferring adoption (called Transitional entities) and a vacuum with no definitive standard on when revenue should be recognized in the financial reports of property developers. Given this co-existence in a one year transitional deferment period, what is the view of the industry, specifically the auditors and the preparers on IC 15?

Empirical Literature

The move by many countries to converge to IFRS has produced challenges to the countries concerned. In Australia, Haswell and Langfield-Smith (2008) examined the IFRS adopted and found fifty seven defects in the Australian IFRS concluding that IFRS is a large catalogue of conceptual and technical deficiencies. Judge, Li and Pinkers (2010) examine the 132 countries which choose to adopt IFRS and the study concludes that national adoption of IFRS are motivated not by economic logic but more by social legitimization pressures. In a study on revenue recognition by property developers in the UK, Eccles, Holt and Fell-smith (2004) found that revenue recognition in the property sector is a real issue. The choice of revenue recognition has economic consequences and mirrors conflict between the property industry norms, regulators and standard setters. Theories offered to explain revenue recognition practice were legitimacy theory, political costs theory and costly contracting theory. In New Zealand, Kabir, Laswad and Islam (2010) examined the impact of IFRS on earnings quality and reported that total assets, liabilities and net profit significantly increase after the adoption of IFRS framework suggesting that absolute discretionary accruals are higher post convergence to IFRS.

Methodology

Data for the views of both preparers and auditors was obtained by interviews with 15 auditors and 15 preparers of financial reports of property developers on the proposed change brought about when IC15 is adopted. The respondents were selected from the Top 30 property developers ranked by the Edge Property Excellence Award 2010. These companies were selected based on consumers' views of both quantitative attributes of shareholders' funds, revenue, pre-tax profit and qualitative attributes of quality of products, innovation and creativity and value creation for buyers. In addition the 2010- 2011 annual reports of property developers were also analysed in respect of the selected revenue recognition policies, following Eccles et al. (2004).

Results and Discussion

87% of responding auditors have attended seminars or workshops in readiness for the changeover in revenue recognition brought about by IC15 whilst only 60% of preparers have done so although both groups have attended workshops on convergence to International Financial Reporting Standards issued by IASB. Hence for both groups there are still members who have had no formal exposure to IC15. 75% of preparers identified insufficient knowledge as a potential major problem when IC 15 becomes mandatory. Respondents were invited to comment on which sections of the standard they were not happy with. 46% of auditors and 60% of preparers felt that IC15 has not considered the different local Malaysian business model of sell then build properties making the completed contract method of recognizing revenue as inappropriate. Bursa Malaysia requires that listed property companies must have a minimum land bank of 1000 acres (405 hectares) and must have an ongoing property developments projects to ensure enough earnings to sustain the company for the next five years after listing. Large property developers like Sime UEP are normally involved in developing townships over 500 acres spanning a period of more than 10 years (Ting, 2002). 93% of preparers felt that only adverse effect will result from migrating to IC 15 with auditors responding mixed positive and negative effects (67%). MASB did anticipate this response because when it issued the exposure draft in 2009 it did point out that it could have a significant impact on property developers given that it is the practice to sell units before construction is completed in Malaysia. In respect of timing of revenue recognition, preparers were unsure as to whether in the past it was wrong to use the percentage method all this while. IC 15 proposes using the completed contract method on the premise 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.

IC 15 lists three categories of agreements or contracts of sale:

- (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, ...*”

The question of which one then is applicable to the Malaysian property development industry and whether the work in progress belongs to the buyer or seller, legal ownership aside, still remains unanswered. In accounting, substance is more important than form. Respondents felt that the concept of “***continuous transfer of control, risk and reward***” introduced in IFRIC 15 is rather new and not easily understood by both preparers and auditors. 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. The consensus is IASB appears biased towards the completed method by making it tougher to apply paragraph 17. In sum both preparers and auditors interviewed are of the view that the uniqueness of property development practices and business model and its attendant accounting policies has not been adequately addressed by the standard setters. When asked if Malaysian property developers can be differentiated from other jurisdictions, the response is mixed as both completed and percentage of completion appear applicable

Can the circumstances in Malaysia be differentiated from those in other countries to justify the use of the percentage method? It is difficult to categorically claim that our practice meets the criteria of Paragraph 17 therefore the choice is select the alternative with less ambiguity, i.e. the completed contract method. This is the choice made by both MASB and MIA. It is the hope of respondents that the two bodies could issue a formal documentation of their views so that property developers get assurance that the completed method is indeed the right method. In other jurisdictions which have converged such as Singapore, the stand is to defer adopting IFRIC 15 pending efforts to correctly interpret the standard so that the outcome will be acceptable to all stakeholders. Hong Kong however, has adopted the completed method since 2005. Respondents would like the standard setters to gain a better understanding of the property development business in Malaysia 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. Suggestions were made that the standard setters consider comparing the solution process of other jurisdictions so that ultimately financial statements will indeed be useful for decision making by users. Although there is an option of not applying a specific accounting standard on the grounds that compliance will result in misleading financial statements, the accounting policies reviewed in the annual reports indicate that this option was not exercised. A notable exception in the annual reports was the early adoption of IC15 by Mutiara Goodyear which reported that: “*The adoption of IC15 resulted in a change in accounting policy which was applied retrospectively whereby the recognition of revenue from all property development activities of the group was changed from the percentage of completion method to the completed method.*” Unfortunately for the auditors they were removed for agreeing to the early adoption of the standard with the incoming auditors having the opposite opinion and the removal was initiated by shareholders. This is in contrast to an earlier view in 2010 when MASB announced the intention to adopt IC15, the President of the Malaysian Real Estate and Housing Developers Association (REHDA) gave a press release on June 11 2010 that “We are confident that as a result of the on-going consultations between REHDA and the accounting bodies as well as regulatory authorities, implementation issues surrounding the adoption of IFRIC 15 in Malaysia can be resolved in a manner which ensures that property development companies are not adversely affected.”

Conclusion

This paper reports on the current debate on the implications of full convergence to international financial reporting standards by non-private entities in Malaysia, in particular the challenges raised by IC 15 on revenue recognition for property developers.

The study reports on responses by auditors and preparers of financial statements to concerns raised about revenue recognition proposed in IC15. Both auditors and preparers are of the opinion that the ongoing controversy has created a “no definitive standard” environment instead of a clear uniform guidance on real estate revenue recognition. Both auditors and preparers share the same concern despite assurance from regulators that full convergence will benefit the industry. The road to convergence therefore needs to be tempered to suit local conditions; the guiding principle of substance over form should prevail.

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