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28th February 2005

Standards and Technical Department,
Hong Kong Institute of
Certified Public Accountants,
4th Floor, Tower II,
Lippo Centre,
89 Queensway,
Hong Kong

Dear Sirs,

Re : Draft Interpretation 24 - Revenue
Pre-Completion Contracts for the Sale of Development Properties

We refer to your invitation for comment on the above Draft Interpretation.

We do not agree with the proposals contained in the Draft Interpretation for the following reasons :-

General principles under HKAS18

1. The recognition of revenue is governed by HKAS18 which by its terms applies to the sale of "goods". For this purpose, "goods" include land and other property held for resale. See paragraphs 1 and 3 of HKAS18.
2. Under paragraph 14 of HKAS18, revenue from the sale of property shall be recognised when all the following conditions have been satisfied :-
 - (a) The entity has transferred to the buyer the significant risks and rewards of ownership of the property.
 - (b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the property sold.
 - (c) The amount of revenue can be measured reliably.
 - (d) It is probable that the economic benefits associated with the transaction will flow to the entity.
 - (e) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

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Transfer of significant risks and rewards of ownership

3. In Hong Kong property under development is generally sold either under the Land Authority Consent Scheme or the Law Society Non-Consent Scheme. The form of the Agreement for Sale and Purchase (“ASP”) is prescribed. In either case, the terms of sale are similar.
4. As a matter of law, once an ASP is entered into, the buyer becomes the owner of the property in equity, subject only to payment of the balance of the purchase price.
5. A deposit is invariably payable upon the signing of the ASP. The terms of payment for the balance of the purchase price usually fall under one of the following categories :-
 - (a) Payable on completion.
 - (b) Stage payments in accordance with an agreed schedule or progress in construction.
 - (c) Full payment within a short time after the signing of the ASP. To finance such payment, the buyer would usually obtain a loan from a bank on the security of an “equitable mortgage”, i.e., a mortgage of the buyer’s interest in the property and in the ASP as security for the loan.
6. It is a standard provision of the ASP that the buyer is at liberty to (1) mortgage his interest in the property and in the ASP and (2) sub-sell his interest in the property. It is not uncommon for a buyer to sub-sell a property under development either at a profit or at a loss by what is commonly called a “confirmor transaction”.
7. The ASP, being a contract for the sale of land, is specifically enforceable. Damages are generally not considered a sufficient remedy. Each of the developer and the buyer can compel the other to perform the ASP. Neither the developer nor the buyer can elect to pay damages in lieu of selling or, as the case may be, buying the property, if the other party insists on performance.
8. Legally (in equity) and economically, the buyer becomes the owner of the property under development. The buyer can mortgage or sell his interest in the property. Any profits upon a sub-sale belong to the buyer and any loss would have to be borne by the buyer.
9. In the circumstances, the developer has transferred to the buyer the significant risks and rewards of the ownership of the property.

Continuing managerial involvement associated with ownership or effective control of property

10. Since the property is under development and is yet to be completed, the issue of continuing managerial involvement associated with ownership does not arise until after completion when the property is to be assigned to and possession taken over by the buyer.
11. The involvement of the developer is primarily directed at the construction of the property and in this respect its involvement is similar to that undertaken under a construction contract.
12. Once an ASP is entered into, the buyer becomes the beneficial owner of the property and the buyer is free to deal with the ownership of the property by way of an equitable mortgage or sub-sale. The developer has no further involvement with the ownership or control over the ownership.

Revenue can be measured reliably

13. The price and terms of payment are set out in the ASP. Progress of construction is a matter of fact and is usually certified by the authorised person appointed under the Buildings Ordinance.

Probable that the economic benefits will flow to the entity

14. The ASP is specifically enforceable. The purchase price must be paid in accordance with the terms of the ASP. In many cases, full payment of the balance of the purchase price is made shortly after the ASP. Economic benefits will flow to the developer once the ASP is entered into.

Costs can be measured reliably

15. Under both the Consent and the Non-Consent Schemes, before the developer can pre-sell a property under development, it must have entered into a construction contract for the completion of the development and demonstrated that it has the financial ability to complete the development in accordance with the terms of the ASP. The construction contract provides for the construction costs and an authorised person certifies the construction costs incurred.

Recognition of revenue under HKAS18

16. Since all the conditions in paragraph 14 of HKAS18 are satisfied where an ASP of a property under development is entered into, revenue should be recognised in accordance with the stage of completion method commencing from the date when the ASP was entered into.
17. In particular, paragraph 9 of the Appendix to HKAS18 provides as follows, in relation to real estate sales :-
- “Revenue is normally recognised when legal title passes to the buyer. However, in some jurisdictions the equitable interest in a property may vest in the buyer before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue. In either case, if the seller is obliged to perform any significant acts after the transfer of the equitable and/or legal title, revenue is recognised as the acts are performed. An example is a building or other facility on which construction has not been completed.”*
18. In Hong Kong, under an ASP of a property under development, the equitable interest in the property is vested in the buyer upon the signing of the ASP. The economic risks and rewards of ownership of the property are transferred to the buyer upon the signing of the ASP. The role of and the acts to be performed by the developer are to continue with the construction of and to complete the property. Revenue should therefore be recognised, in accordance with paragraph 9 of the Appendix to HKAS18, as and when construction progresses, on the stage of completion method.

Construction contracts and HKAS11

19. Upon the signing of an ASP, the legal (in equity) and economic ownership of the property is vested in the buyer. The buyer is free to mortgage or sell his interest in the property. The role of the developer is primarily the construction and completion of the development in accordance with the terms of the ASP. The ASP imposes construction obligations on the developer and the ASP is therefore similar to a construction contract.
20. Accordingly, the recognition of revenue in accordance with the stage of completion method applicable to construction contracts is consistent with the adoption of the same method of recognition for ASP of property under development.

Conclusions

21. We would submit that, for the reasons given above, on a proper interpretation and application of HKAS18, the stage of completion method should and can properly be used to recognise revenue arising from ASP of property under development.
22. To require recognition of revenue only after the development is completed as the only permissible way of recognition of such revenue is wrong in principle and is contrary to HKAS18.
23. Developers should not and cannot be precluded from recognising revenue using the stage of completion method. The HKICPA should not prescribe only one mode of recognition to the exclusion of all others. The HKICPA should only be concerned that the accounting policy adopted for the recognition of the revenue, consistent with HKAS18, is properly disclosed.

Yours faithfully,
For and on behalf of
Swire Properties Limited



Peter Kilgour
Finance Director