Hong Kong Institute of
Certified Public Accountants
香港會計師公會

31 January 2005

To: HKICPA members
All companies listed in Hong Kong
All other interested parties

Draft Interpretation 24
Revenue –
Pre-completion Contracts for the Sale of Development Properties

Comments to be received by 8 March 2005

Issued by the Council,
Hong Kong Institute of Certified Public Accountants

The Hong Kong Institute of Certified Public Accountants' Council (Council) has issued for consultation Draft Interpretation 24 *Revenue – Pre-completion Contracts for the Sale of Development Properties*.

The Council invites comments on the Draft Interpretation from any interested party and would like to hear from both those who do agree and those who do not agree with the proposals contained in the Draft Interpretation. Comments should be supported by specific reasoning and should preferably be submitted in written form.

Comments are requested to be received by **8 March 2005** and may be sent by mail, fax or e-mail to:

Standards and Technical Department
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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

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<u>A specific matter raised for consideration</u>

Transitional Provisions

As set out in paragraph 2 of this Draft Interpretation, property developers currently adopt various policies for recognising revenue arising from pre-completion contracts for the sale of development properties and the stage of completion method is a commonly used policy. Upon the implementation of this Interpretation, property developers would no longer be allowed to use the stage of completion method to recognise revenue arising from such contracts. Given the changes involved, the following are three possible transitional provisions for adopting this Interpretation:

(1) Prospective application (1) – An entity shall be required to apply this Draft Interpretation prospectively to pre-completion contracts entered into on or after [the effective date of this Interpretation] with earlier application encouraged. Under this transitional provision, the entity shall be allowed to continue to account for pre-completion contracts entered into before [the effective date of this Interpretation] using the existing method of accounting.

(2) Prospective application (2) – An entity shall be required to apply this Draft Interpretation prospectively for accounting periods beginning on or after [the effective date of this Interpretation] with earlier application encouraged. Any adjustment arising on the initial application of this Draft Interpretation shall be recognised in the profit or loss for the year in which this Draft Interpretation is first applied.

(3) Limited retrospective application – An entity shall be required to apply this Draft Interpretation for accounting periods beginning on or after [the effective date of this Interpretation] with earlier application encouraged. Any effect of applying this Draft Interpretation shall be reported as an adjustment to the opening balance of the retained earnings of the accounting period in which this Draft Interpretation is first applied. The entity would be encouraged, but not required, to restate comparatives. However, if comparative information is not restated, that fact shall be disclosed.

If there is no transitional provision included in this Draft Interpretation, an entity would have to account for this Interpretation on the following basis:

(4) Full retrospective application unless impracticable – An entity shall be required to apply this Draft Interpretation for accounting periods beginning on or after [the effective date of this Interpretation] with earlier application encouraged. Any changes in accounting policies shall be accounted for in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* Accordingly, the entity shall be required to restate all the comparatives as if the new accounting policy had always been applied except to the extent that it is impracticable to do so.

The example on the next page illustrates the effect of these transitional provisions and the effect if there is no transitional provision included in this Draft Interpretation.

EXAMPLE

Assumptions:

For the purpose of illustration, the following assumptions are made:

- *the effective date of the Interpretation is 1 January 2005;*
- *the year end of the property developer is 31 December 2005; and*
- *the development commenced in the year 2003 and is completed in the year 2006.*

Fact:

A property developer, that had previously used the stage of completion method to account for revenue arising from pre-completion contracts for the sale of a development property, decides to recognise revenue arising from such contracts only when the development is completed ("the completion method") after the implementation of this Draft Interpretation.

The property under development contains 10 units and each unit is on sale for CU100.

	Units sold	Stage of completion
In year 2003	1	30%
In year 2004	3	40%
In year 2005	6	60%
In year 2006	0	100%

Prior to 1 January 2005, the property developer has already recognised 40% of the revenue arising from the pre-completion contracts entered into before 1 January 2005, totalling CU160 (i.e. 40% x 4 units x CU100), using the stage of completion method.

Effects:

Under prospective application (1) above, the developer would continue to account for the remaining 60% of the revenue arising from the pre-completion contracts entered into before 1 January 2005 using the stage of completion method. However, the developer would use the new completion method for all new pre-completion contracts entered into on or after I January 2005. Accordingly, in respect of the remaining 60% revenue arising from the pre-completion contracts entered into before 1 January 2005 totalling CU240 (i.e. 60% x 4 units x CU100), the developer would recognise CU80 (i.e. 60% x 4 units x CU100 – CU160) in the profit or loss for the year 2005 and CU160 (i.e. CU240 – CU80) in the profit or loss for the year 2006. The developer would also recognise 100% revenue arising from the pre-completion contracts entered into on or after 1 January 2005, totalling CU600 (i.e. 100% x 6 units x CU100), in the profit or loss for the year 2006 (i.e. year of completion). No restatement of comparatives is needed.

Under prospective application (2) above, in the profit or loss for the year 2005, the developer would reverse the 40% revenue arising from the pre-completion contracts entered into before 1 January 2005, and which had previously been recognised in the profit or loss for the years 2003 and 2004 (i.e. CU160). The developer would then account for 100% revenue arising from all pre-completion contracts, totalling CU1000 (i.e. 100% x 10 units x CU100), in the profit or loss for the year 2006 (i.e. year of completion). No restatement of comparatives is needed.

Under limited retrospective application above, in the retained earnings brought forward as at 1 January 2005, the developer would reverse the 40% revenue arising from the pre-completion contracts entered into before 1 January 2005 (i.e. CU160). The developer would then account for the 100% revenue arising from all pre-completion contracts (i.e. CU1000) in the profit or loss for the year 2006 (i.e. year of completion). Restatement of comparatives is encouraged, but not required.

If there is no transitional provision introduced in this Draft Interpretation, the developer would, unless impracticable, make prior periods adjustments for the 40% revenue arising from the pre-completion contracts entered into before 1 January 2005 that had previously been recognised, in accordance with HKAS 8 (i.e. remove reported revenue in 2003: CU30 (i.e. 30% x 1 unit x CU100) and reported revenue in 2004: CU130 (i.e. 40% x 4 units x CU100 – CU30). The developer would then account for the 100% revenue arising from all pre-completion contracts (i.e. CU1000) in the profit or loss for the year 2006 (i.e. year of completion). Restatement of comparatives is required.

Council's preference is to have a transitional provision introduced in this Draft Interpretation. However, Council wishes to seek comments specifically on the three possible transitional provisions before determining whether or not to introduce a transitional provision in this Interpretation. If no transitional provision is introduced, the entity would have to apply HKAS 8 for any changes in accounting policies. Commentators are therefore encouraged to state their preference on these transitional provisions and, if possible, specify their reasons.

Taxation Impacts

Council is aware of the fact that these transitional provisions might have different taxation impacts. Accordingly, the HKICPA would consult with the Inland Revenue Department in respect of this in due course. However, commentators are requested to give their comments on the tax implications of these transitional provisions in their comment letters.

January 2005
Exposure Draft

Response Due Date
8 March 2005

Draft Interpretation 24

Revenue – Pre-completion Contracts for the Sale of Development Properties

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

REVENUE – PRE-COMPLETION CONTRACTS FOR THE SALE OF DEVELOPMENT PROPERTIES

(Response Due Date 8 March 2005)

CONTENTS

Interpretation 24 *Revenue – Pre-completion Contracts for the Sale of Development Properties* (SSAP-Int 24) is set out in paragraphs 1-9. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

References

- HKAS 18 (SSAP 18) *Revenue*
- HKAS 11 (SSAP 23) *Construction Contracts*

Background

1. Property development projects are usually long term projects. In many cases, property developers would enter into contracts to sell the properties in advance of the completion of the development. These contracts usually involve the payment of a deposit by the purchaser, which may be refundable only if the developer does not complete the development in accordance with the contracted timeframes and specifications, or if there is some other breach of a contractual condition or statutory obligation. The balance of the purchase price is normally paid at contractual settlement.

2. Property developers currently adopt various policies for recognising revenue arising from pre-completion contracts for the sale of development properties. The stage of completion method is a commonly used policy. Concern has been expressed as to whether the pre-completion contracts would satisfy the definition of construction contracts in HKAS 11 or SSAP 23, as appropriate, and, if not, whether the stage of completion method would be acceptable under Hong Kong Financial Reporting Standards. Concern has also been expressed, in the absence of authoritative guidance, that diverse or unacceptable practices would undermine the relevance, reliability or comparability of financial statements.

3. This Interpretation provides guidance on the applicable accounting standard and appropriate treatment for recognising revenue arising from the pre-completion contracts for the sale of development properties.

Scope

4. This Interpretation applies to the accounting of pre-completion contracts for the sale of development properties.

Issue

5. This Interpretation addresses the issue of how property developers shall recognise revenue arising from pre-completion contracts for the sale of development properties.

Conclusions

6. The pre-completion contracts for the sale of development properties do not meet the definition of construction contracts set out in HKAS 11 or SSAP 23, as appropriate, because the contracts in question are not specifically negotiated for the construction of the properties. Accordingly, these contracts fall outside the scope of HKAS 11 or SSAP 23, as appropriate, and, as a result, the stage of completion method as allowed under these Standards shall not be used to recognise revenue arising from such contracts.

7. Property developers shall apply HKAS 18 or SSAP 18, as appropriate, in recognising revenue arising from pre-completion contracts for the sale of development properties and, accordingly, recognise revenue only when all of the criteria specified in paragraph 14 of HKAS 18 or paragraph 13 of SSAP 18, as appropriate, are met.

Effective date

8. [To be inserted after consultation]

Transition

9. [To be inserted after consultation]