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11 February 2019

Ms Sue Lloyd
Chair
IFRS Interpretations Committee
Colombus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Dear Ms Lloyd,

TENTATIVE AGENDA DECISION – OVER TIME TRANSFER OF CONSTRUCTED GOOD (IAS 23)

ISCA sought views on the above Tentative Agenda Decision from the ISCA Financial Reporting Committee which includes experienced technical accounting professionals from large accounting firms.

We note the IFRS Interpretations Committee ("Committee") conclusion that the entity should not capitalise borrowing costs under the described fact pattern and the Committee's below observation:

c. any inventory (work-in-progress) for unsold units under construction that the entity recognises is not a qualifying asset. In the fact pattern described in the request, this asset is ready for its intended sale in its current condition – i.e. the entity <u>intends</u> to sell the part-constructed units as soon as it finds suitable customers and, on signing a contract with a customer, will transfer control of any work-in-progress related to that unit to the customer.

We wish to highlight the following concerns we have regarding the Committee's observation (c) above.

1. Scope of the Tentative Agenda Decision is unclear

We note that the Tentative Agenda Decision is written for the construction of a residential multi-unit real estate development whereby revenue is recognised over time for the sale of individual units in the development. Hence, it is clear from the Tentative Agenda Decision that the property developer should not capitalise borrowing costs when revenue is recognised over time as the inventory (work-in-progress) is not a qualifying asset in accordance with paragraph 5 of IAS 23.

However, it is unclear whether the Tentative Agenda Decision also applies to similar situations where revenue for the sale of units is recognised at a point in time (for e.g., when control only passes on completion or handing over of units to customers).

Consider the example of two property developers – Entity A and Entity B. Entity A recognises revenue from the sale of uncompleted units over-time whereas Entity B recognises revenue from the sale of uncompleted units at a point in time. Assuming that neither Entity A nor Entity B has entered into any contract with a customer to sell a uncompleted unit during the financial year, and applying the principles in observation (c), Entity A would have expensed all borrowing costs incurred and Entity B would have capitalised all borrowing costs incurred.

The above would have implications for property developers who recognise revenue from the sale of units at a point in time and who have launched the development for sale prior to the completion of construction (i.e. pre-sales).

2. Conceptual challenge to differentiate between property developers who recognise revenue over time and those who recognise revenue at a point in time

In our view, it is conceptually challenging to differentiate between property developers who recognise revenue over time and those who recognise revenue at a point in time, because the pattern of revenue recognition may depend on the type of sales contract the developer enters into with the buyers of the units and it may not be known upfront which type of contract will be used for each sale.

Paragraph 5 of IAS 23 defines a qualifying asset as '...an asset that necessarily takes a substantial period of time to get ready for its <u>intended</u> use or <u>sale</u>.'

Once the inventory (work-in-progress) is ready for its intended sale, whether revenue is recognised over time or at a point in time under IFRS 15 should not have any bearing on whether that inventory (work-in-progress) is a qualifying asset under IAS 23.

We also do not agree with the Committee's observation (c) for the following reasons.

1. Pre-emption of method of revenue recognition

We would also like to highlight that the application of the principles in observation (c) would require the entities to decide upfront whether they will recognise revenue for the sale of the uncompleted units at a point in time or over time i.e. preempting the revenue recognition for future sales of the uncompleted units. Some entities may not be able to determine this at the start of construction of the units. If the principles in observation (c) were to be applied, does this mean that such entities should capitalise the borrowing costs incurred up until the point when the sales contract is signed?

2. Contrary to current market practice

In our view, inventory (work-in-progress) for unsold units under construction are qualifying assets for capitalising borrowing costs. It has generally been the market practice in the property development industry to capitalise borrowing costs into inventory (work in progress) because such inventories require a substantial period of time to be ready and are viewed as qualifying assets in accordance with paragraph 7 of IAS 23. The current reading of paragraph 5 of IAS 23 focuses on the substantial period of time to get [the asset] ready. The following part of that sentence is being interpreted as just outlining the two general purposes for which assets can be constructed: either for own use or for eventual sale. If the interpretation is now changing such that the key focus is whether the asset is ready for sale, it will mean that almost all assets being constructed in the normal course of business for eventual sale will not qualify for capitalisation of borrowing costs as most developers have been and will be selling uncompleted construction if a buyer is being identified.

The Tentative Agenda Decision, if finalised, would have a significant impact on the property development industry as it is contrary to the current market practice. The outcome would be that the property developers would see higher gross profit margins when the units are eventually sold in later years as borrowing costs have already been expensed during the construction period. This would result in comparability issues among entities.

3. Presentation of margins for projects will differ and usefulness of financial reporting may deteriorate

If the Committee's agenda decision is to be interpreted as being applicable only to construction where revenue is being recognised over time, the margins shown for similar projects where the only difference is the pattern of revenue recognition, will be different. For projects where revenue is being recognised over time, the project margin (revenue less cost of goods sold) will be better as compared to projects where revenue is being recognised at a point in time, as the capitalised borrowing costs are being added to the cost of goods sold for such cases compared to higher finance cost being shown for the projects with revenue being recognised over time. It is unclear how such different treatment would enhance the usefulness of financial reporting. We believe that the intention of IAS 23, especially in its amendment in 2007 to require the capitalisation of borrowing costs (i.e. removal of the option to expend borrowing costs when incurred) is to faithfully present all cost necessarily incurred to get the asset ready (BC 9).

Hence, we urge the Committee to look into the existing definition of qualifying asset under paragraph 5 of IAS 23 "Borrowing Costs" whereby "A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale" and the implications arising from the current rationale provided for its agenda decision.

We would also ask the Committee to clarify the scope of the agenda decision, in particular if it is intended to be applicable to situations where revenue is being recognised over time only.

Should you require any further clarification, please feel free to contact myself or Ms Felicia Tay, Manager, Corporate Reporting & Ethics (CoRE), from ISCA via email at jumay.lim@isca.org.sg or felicia.tay@isca.org.sg respectively.

Yours faithfully,

Ju May

Ju May, LIM
Deputy Director
Corporate Reporting & Ethics (CoRE)