financialreporting

| BY DR NORDIN ZAIN |

New era of financial reporting for developers

Managers of property developers should brace themselves for a change in the way revenue is recognised on projects, once the Malaysian Accounting Standards Board adopts the International Financial Reporting Interpretation on how property developers should account for their real estate development.

The impact of the new standard on property developers in Malaysia would be more significant than those in developed countries, where most property developments are based on the build-first, buy-later concept as opposed to buy-first and build-later system practised in most developing countries.

Currently, property developers have been using a local standard developed for the Malaysian property industry since the 1980s. Under FRS 201 Property Development Activities, revenue from property development activities is recognised progressively based on the stages of completion. The new interpretation issued by the International Financial Reporting Interpretations Committee (IFRIC), IFRIC 15, on real estate sales, however, sets out assessment criteria which will likely require developers to change their accounting treatment from recognising revenue using the percentage of completion method (that is, as construction progresses, by reference to the stage of completion of the development) to recognising revenue at a single time (that is, at completion upon or after delivery). This is because most of the developments today will almost certainly fall under the category in which revenue can only be recognised once the property is completed and delivered to the customers.

Such a requirement would result in developers having to change their revenue recognition policy, where revenue will be deferred until a project is completed.

This radical change was made in response to criticisms from international investors and analysts that the current financial statements were inconsistently presented as well as being overly aggregated.

When contacted, a large public-listed property developer said it had been using the percentage of completion method to satisfy both the reporting standard and Inland Revenue Board (IRB). The company said the current practice of progressive recognition of revenue does reflect the progress of work on the ground. A one-off recognition of revenue at the completion date will not only fail to match the progress of work done but will also give rise to significant fluctuations in the company's earnings.

ABDUL GHANI ISMAIL/THE EDGE

IFRIC 15 sets out assessment criteria which will likely require developers to change their accounting treatment

Bigger players, which have a number of projects annually, would not be affected much, but the smaller ones will suffer from wild fluctuations in earnings during the years of construction.

Given that this is an international standard and Malaysia's commitment to converge, the listed company is prepared to comply but also hopes that the IRB will adopt the same basis for company taxation; otherwise, developers will not only have to pay taxes first before recognising the revenue in the year of assessment, but also will have to prepare two sets of accounts.

Currently, the IRB bases its tax treatment on the percentage of completion method — it assesses the developer based on its progressive estimated profit. The IFRIC 15 principles, when adopted, would create a conflict with the IRB's ruling of March 13, 2006, which stipulated that the percentage of completion method should be the only basis of profit recognition in all forms of property development and construction contract activities. Where a developer prepares its accounts on a completion of contract method, the IRB requires the developer to compute his income tax liability for the year of assessment by using the percentage of completion method, or the progressive payments basis to determine and declare estimated profits annually.

In other words, deferring profits until development is completed is not permissible. Any losses will only be given a relief when the project is completed and when the amount can be ascertained accurately.

It is clear that a major area that needs to be addressed before IFRIC 15 is adopted in Malaysia is the tax base used to compute the income tax liability for property developers. It would appear that developers would be open to the idea of adopting IFRIC 15 so long as the IRB would be prepared to change its position on the tax treatment.

The cost to developers is clear, but the benefit seems questionable as the consequential change would merely change the timing in which the revenue would be recognised, and hence the tax implication.

It remains to be seen how strong the reactions of other developers will be to the new standard and whether a conclusive solution with the IRB is in sight before the international standard is adopted in Malaysia. Judging by the wave of convergence worldwide, it appears that the property development industry in Malaysia will likely embrace the new era of financial reporting but will have to bear with two sets of accounts to satisfy different regulatory bodies. E

Dr Nordin Zain is an executive director at Deloitte Malaysia. He specialises in advising companies on IFRS implementation and Islamic accounting standards. He can be contacted at myinsight@deloitte.com.