

October 22, 2010

IFRS Foundation/IASB  
30 Cannon Street  
London EC4M 6XH  
Company No: FC023235

Dear International Accounting Standards Board,

Regarding the request for Comment Letters on the Exposure Draft (Revenue from Contracts with Customers) by October 22<sup>nd</sup> 2010, the Study Group of Korean Accounting Association on Revenue Recognition of Real Estate Industry has completed its review of the Exposure Draft with appropriate consultation and input from various interested parties.

Although we broadly agree with the outline of the Exposure Draft, we do have some recommendations to propose. While we appreciate the principle-based approach of IFRS, our view is that the draft fails to recognize the distinct characteristics of real estate business and contains several ambiguous or impractical provisions.

This Comment Letter has two parts:

- Part 1 contains proposals to incorporate the characteristics of the real estate industry relating to (1) paragraphs 26 & 27 on the customer's ability to direct the use of the goods and services for the remaining economic life; (2) paragraph 30(d) on customer-specific design, and (3) paragraph 32 on continuous transfer of goods and services.
- Part 2 explains Korea's real-estate regulations on the continuous transfer of control to the customers by reviewing (1) private company-driven construction development projects, (2) pre-sale contracts, and (3) important regulatory policies that affect the revenue recognition measures.

We hereby provide a detailed review and recommendations relating to specific paragraphs and examples in the Exposure Draft with the hope that they will be duly noted in the revision of the Exposure Draft.

Respectfully yours,

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Chairperson  
Study Group on Revenue Recognition of Real Estate Industry  
Korean Accounting Association

## **Part 1: Recommendations on the Exposure Draft**

Our view is that the IFRIC 15 does not sufficiently recognize the characteristics of the real estate industry and has been a source of confusion. We see similar problems in the Exposure Draft and propose the following recommendations:

### **1. Transfer of Control**

#### **1) Customer's ability to direct the use of good and service for its remaining economic life**

*(Paragraph 26) A customer obtains control of a good or service when the customer has the ability to direct the use of, and receive the benefit from, the good or service.*

*(Paragraph 27) The customer's ability to direct the use of a good or service (i.e., an asset) refers to the present right to use the asset for its remaining economic life or to consume the asset in the customer's activities.*

The definition of "the customer's ability to direct the use of the good or service" is not well articulated and not readily applicable to some practices, especially to real estate construction contracts. For example, if we strictly interpret it as it is currently written, unlike a manufactured good, the customer is unable to "direct the use of" or "consume" a work-in-progress in many real estate construction contracts.

Furthermore, the meaning of the "remaining economic life" is unclear. For real estate construction contracts, a property under construction may have two "remaining economic lives": One is the remaining construction period, and the other is the period after the construction is completed. If the "remaining economic life" refers only to the former, "the present right to use the asset" is not applicable to the real estate industry for the same reason as we described above: that is, the customer is unable to "direct the use of" or "consume" a work-in-progress. Our recommendation is to include both periods in the concept of "remaining economic life." We propose that the Exposure Draft include an explicit interpretation that states that the "remaining economic life" can mean "during or after the construction" in order to ensure applicability to the real estate industry.

#### **2) Customer-specific design**

*(Paragraph 30-d) The design or function of the good or service is customer specific.*

The definition of "customer-specific design," an important criterion for determining whether the customer has control, concerns only two factors: design and function. However, this is a very limited definition that ignores the characteristics of the real estate industry because there are other elements that have much greater impact on the value of a property such as place, view, floor, transportation, and school zone. These attributes are determined by the location of the property. The customer primarily considers the location rather than the design or the function when buying a house.

Therefore, we propose “location” as another critical factor to accompany “design or function” when determining whether a construction contract is “customer-specific.”

For manufacturers, “customer specific” means that the customer can make decisions about the design or the function of the product. But the same logic does not apply to real estate developers. Within an apartment complex, individual homes will sell at different prices depending on its location, and the customer can designate its location when entering into a contract. Although the design and function of the houses are alike, the fact that the customer chooses the location of the apartment makes it customer-specific. Therefore, we propose paragraph 30(d) to be changed to “The design or function or **location** of the good or service is customer specific” in order to reflect the characteristics of the real estate industry.

There are strong arguments in favor of a separate standard for construction contracts because the current Exposure Draft does not accommodate the important characteristics of construction contracts. We believe that, if the Exposure Draft heeded our proposals, it will gain greater acceptance and more successfully replace IAS 11.

## **2. Continuous Transfer of Goods or Services**

### **1) Continuous transfer**

*(Paragraph 32) When the promised goods or services underlying a separate performance obligation are transferred to a customer continuously, an entity shall apply to that performance obligation one revenue recognition method that best depicts the transfer of goods or services to the customer.*

How an entity determines its project to be a “continuously transferred” performance obligation is not clear in the Exposure Draft. It is our opinion that an explicit guideline or indicator enabling an entity to make such decisions is needed. One way of setting the guidance is “**unconditional progress payments.**” If there is an irrevocable construction contract and the customer must pay an initial deposit followed by non-refundable progress payments as the construction progresses, it would be safe to say that control is transferred continuously to the customer because a rational customer would not make non-refundable considerations unless control was transferred.

## **3. An Example of Percentage-of-Completion Method**

The Exposure Draft does not show an example of a situation using the percentage-of-completion method. Therefore, we recommend inserting an additional example describing a case in which the percentage-of-completion method is applicable as a second scenario for Example 17 (page 69; in this case, the currently given example would be scenario 1) as follows:

## Example 17 – Sale of apartments

### Scenario 2: Pre-sale of apartments

An entity is developing residential real estate and begins to market individual apartments after gaining government approval of the construction plan. It enters into a contract with a customer for the sale of a specific apartment. The customer is able to choose the location of the particular home from many individual apartments within the complex after considering its floor, view and direction. Thus, the entity could not replace the contracted apartment with another apartment. The customer obtains the title and the physical possession of the apartment, when its construction is completed. The customer pays a deposit and then a series of progress payments according to the construction stage and the payments are not refundable. If a construction company is not able to complete the construction due to reasons such as its bankruptcy, the customer retains the work-in-progress.

In this example, the terms of the contract and all the related facts and circumstances indicate that the customer obtains control of the apartment continuously. The customer is able to influence the ultimate value of the apartment by specifying the location of the apartment, meaning the apartment is a customer-specific asset. In addition, a reasonable customer would not pay non-refundable considerations unless control is transferred.

Consequently, as the customer obtains control of the apartment continuously, it can be said that the entity continuously provides the customer with the apartment as the construction progresses. Therefore, the percentage-of-completion method should be used.

## **Part 2: Issues of Korea’s real estate industry**

### **1. Two types of construction development projects**

In Korea, there are mainly two types of apartment construction contracts: development projects initiated by Housing Co-ops, and private construction companies that dominate Korea’s housing industry.

#### Type 1 of pre-sale (initiated by Housing Co-ops)

For real estate development projects originating from Housing Co-ops, the land is purchased by the association, and the co-op is deeply involved in the development process including structural planning and changes to the major designs. The co-op is the client of the construction company, and the company accommodates the co-op’s requests. In this sense, the co-op, a member association, has control over the construction. Consequently, the construction company can readily apply the percentage-of-completion method.

### Type 2 of pre-sale (initiated by private construction companies)

For development projects initiated by private construction companies, the construction company purchases the land and comes up with development plans before the contract is sold. At this stage, potential customers are unidentifiable, so it is impossible for customers to make any specific requests of their own. In other words, the customers cannot specify the design or request structural changes. The government imposes strict restrictions on structural changes for safety reasons. After the contract is sold, structural changes are possible but at the expense of the buyer. This was the logic behind some professionals who interpreted Type 2 for the completed contract method (or the recognition of revenues at the time of delivery) on the basis of IFRIC 15 and the current Exposure Draft.

However, once the contract is sold, the two different types have the same commercial substance; i.e., the cash flow of both development projects are exactly the same. Both projects require deposits and payments according to the progress of the construction.

It does not seem appropriate to apply the percentage-of-completion method only for Type 1 (but the completed contract method for Type 2) when both projects generate equivalent cash flows. It would distort earnings for Type 2, and earnings therefore would not reflect the cash flow. Moreover, the cash payment from customers would be recorded as liabilities (i.e., unearned revenue), which do not reflect economic substance because a portion of the performance obligation has already been met.

We believe that this conclusion comes from a misconception and a lack of understanding of the essence of Type 1 and Type 2. This is why we suggest location as the third indicator. Along with design and function, location is a critical ingredient that determines the ultimate value of a property. This is the reason for the varying prices of homes within the same apartment complex built in the same land. And, it is an element designated by the customers. This implies that applying the completed contract method (or the recognition of revenues at the time of delivery) on Type 2 comes from a misinterpretation of IFRIC 15. What is more noteworthy is that it does not reflect the characteristics of the real estate industry.

Based on our review, we believe that it would be both practical and closer to economic substance for Type 2 to recognize revenue using the percentage-of-completion method.

## **2. Other Characteristics of Pre-Sale Contracts in Korea**

Along with the customer-specific design perspective described above, pre-sale contracts in Korea entail additional issues regarding the continuous transfer of control. To illustrate, when a customer enters into a pre-sale contract of an apartment, the legal rights belong to the customer; for example, it is the customer who can use it as collateral to secure financing. Also, the customer obtains ownership rights, the right to sell its work-in-progress. The value of this right rises to become closer to the fair value as the construction progresses, indicating a continuous transfer. It is evident that the customer receives benefits from the good or service as stated in paragraph 25.

In addition, according to the same paragraph, “Control includes the ability to prevent other entities from directing the use of ... a good or service.” The Housing Supply Law states that the construction company has the ownership of the real estate. This law was enacted to protect the right of the construction company when a customer defaults for unexpected (unpredictable) reasons. However, the entity does not have any legal rights such as pledging on the property. This is the evidence that the customer holds control over the property.

Since the Korean government sometimes restricts the sale of ownership rights and newly built homes in certain areas, some professionals argue that it is questionable whether the benefit and the control over the house has been transferred to the customer. However, this is a government regulation, which is not a party to the contract. This measure was instituted to regulate the housing market and restrain speculation; it comes and goes depending on the market situation. Considering the fact that the customer is already aware of such limitations (as it is an open public policy), it is not a part of the contract between the builder and buyer, and is a completely separate issue from an entity’s revenue recognition from contracts with customers because it does not affect the control or ownership of the property.

Where the construction company goes bankrupt (for any reason) and is unable to continue the construction, the Korea Housing Guarantee Corporation steps in. The public company overtakes the business to either refund the payments up to date or to continue the construction and honor the contract depending on the collective decision by the customers (a government policy implemented for customer protection). Even in the case of the discontinuation of the construction, the customer ultimately has full right over its investments, showing that control has already been transferred to the customer to the extent of the progress of the construction.

### **3. Summary**

Housing is an extremely important and sensitive issue both economically and socially in Korea. Accordingly, the Korean government has implemented various regulations to protect customers in real estate contracts. The transfer of control of the property to the customer is secured by government regulations, which easily comply with the requirements of the Exposure Draft regarding transfer of control. This is the reason the percentage-of-completion method should be applied to pre-sale contracts in Korea.