

21 October 2010

IFRS Foundation/ International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom

Comments on Exposure Draft "Revenue from Contracts with Customers"

Dear Sir/ Madam,

Construction Association of Korea (hereinafter "CAK") welcomes the opportunity to comment on the Exposure Draft "Revenue from Contracts with Customers". We are pleased to submit our comments as we believe that it has potentially the great impact on construction industry globally.

CAK is a statutory organization incorporated based on the Framework Act on the Construction Industry of the Republic of Korea representing about 13,000 Korean general contractors. The main objectives of CAK are to improve systems, policies and technologies relevant to construction industry. As such, our comments around this ED relate mainly to construction industry.

CAK has assessed the whole ED considering the environment of housing construction industry in the Republic of Korea of which the main characteristics are described following the response to Question 14. Reflecting upon the factors of Korean housing construction market, CAK believes that revenue recognized according to the progress better presents economical substance than that of the contract completion. However, judgment is not clear under the ED by the currently proposed indicators and examples.

The ED tends to provide decisive indicators and too many conclusive examples which restrict fair judgment based on principles. For the same reason, the IAS 11 is also too restricted within the IFRIC 15, hence, it should also be reconsidered even before the ED becomes effective. CAK believes that the ED should maintain the principle-based statements, which we believe is the sublime value of the IFRS.

For this purpose, CAK believes that;

• the customer perspective in paragraph 25 should be reassessed whether it is generally



applicable,

- the two concepts defining the control in paragraph 26 should be reconsidered whether they are generally compatible for transferring not only goods but in case of services as well,
- additional factors should be included in paragraph 32 to better explain the situation where control is transferred "continuously", and
- the Example 17 in B68 should be deleted otherwise we propose additional examples that could follow principle-based approaches to draw conclusions.

For more details, please see the responses in Appendix 1 to **Question 3 and 14** which we only answer as they seem to be the most important to construction industry.

I would be happy to further discuss all or any of these issues with you.

Yours sincerely,

Hong-sa, Kwon

President

Construction Association of Korea(CAK)

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APPENDIX 1

Question 3:

Do you think that the proposed guidance in paragraph 25-31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

CAK believes that paragraph 25-31 in the ED does not clearly demonstrate when control is transferred in practices including construction contracts for the following reasons.

Imbalance between customer's perspective and seller's perspective

Firstly, paragraph 25 clearly shows the ED follows customer's perspective with stating that "A good or service is transferred when the customer obtains control of that good or service". CAK understands the Board has the intention to emphasize customer's perspective as mentioned in BC63. However, exclusive application of customer's perspective is confusing and ambiguous in practice.

- i. CAK believes that the definition of control should include both customer's and seller's perspectives. Paragraph 26 states that control does not only refer to the ability to direct the use of, and receive the benefit from the good or service, but also to the ability to prevent other entities from doing so. As such, in case where a customer cannot direct the use of, or receive benefit from a good or service (i.e. control is not obtained by a customer), but can prevent others from doing so (i.e. control is transferred away from a seller), seller can believe that the definition of control is met in his perspective, which might be ambiguous in customer's.
- ii. CAK believes that the presumption for the Board's selection of customer's perspective is not supportive. BC63 states that the Board believes, in many cases, both perspectives are likely to lead to the same results, and they finally pick customer's in order to minimize the risk of an entity recognizing revenue without the transfer of goods or services. However, CAK cannot agree with the presumption because many cases would lead to different results depending on the perspectives, especially in construction industry. CAK believes that for certain situations as described in the following paragraph seller's perspective could provide more useful information
- iii. CAK believes that seller's perspective is more consistent with the definition of performance obligation which refers to an enforceable promise for an entity to fulfill a contract. As it is not always practically possible for an entity to assess the fulfillment of contract in customer's perspective, it is clearer in seller's perspective whether performance obligation is satisfied or not. If judgment should be made in customer's



perspective, an entity might have a problem in determining whether control is transferred even though an entity is considered to have satisfied performance obligation (i.e. an entity performs promised activities).

Based on the reasons above, <u>CAK believes that satisfaction of a performance obligation should be</u> assessed in a balanced perspective between both customer and seller. <u>CAK suggests paragraph 25</u> be amended for this purpose.

Disharmony of concepts included in the definition of control

Secondly, paragraph 26 shows that the definition of control consists of two concepts as it states that "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". CAK believes that the two concepts, "direct the use of" and "receive the benefit from" are incompatible in some cases.

According to paragraph 27, the ability to "direct the use" refers to "the present right to use the asset for its remaining economic life or to consume the asset in the customer's activities". (BC62 (b) refers to the customer's right to deploy an asset in its activities). The ability to "receive the benefit" is referred to "the present right to obtain substantially all of the potential cash flows from the asset". (BC62 (c) refers to a potential cash flow).

These two concepts are treated together under Paragraph 26 as if they always coincide. However, CAK believes that these concepts could be incompatible sometimes because the first concept, "the ability to direct the use" is not clearly defined to the situation where a service is rendered. This concept would also cast an ambiguity over construction-in-progress where a customer cannot deploy it in its purposed activities, but can obtain substantially all of the potential cash flow by ways including disposal, sale, exchange, pledge. CAK questions whether there is any case that work-in-progress can be used or deployed in its activities during construction. If not, this definition seems to limit revenue on all construction-type contracts from being recognized according to the stage of completion.

Based on the reasons above, <u>CAK</u> believes that the <u>ED</u> should clarify how the concept, "the ability to direct the use" could be interpreted and applied when a service is rendered, or either one of the two concepts should be considered appropriate to meet the definition of control. <u>CAK</u> suggest paragraph 26 be amended for this purpose.



Insufficient guidance on continuous transfer

Finally, paragraph 32 does not seem to provide sufficient guidance on continuous transfer. It only states that "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."

This paragraph does not elaborate on situations that indicate "continuous" transfer of control, and CAK believes that, the four indicators in paragraph 30 do not properly consider the "continuous transfer" situations but only the "transfer" of control.

Based on the reasons above, <u>CAK believes that additional factors should be considered in paragraph 32 to help determine whether control is transferred continuously. CAK suggests the following factors considered for this purpose.</u>

- The customer obtains benefit exclusively as the entity performs activities.
- Non-refundable progress payment is made by the customer
- The seller is acting under the direction of the customer and is compensated accordingly.
- There is no need to re-perform previous work, even if vendors change.

Question 14:

The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

CAK acknowledges the Board's efforts to adopt a single and consistent principle-based standard relating to revenue recognition as paragraph 31 states that "Not one of the preceding indicators determines by itself whether the customer has obtained control of the good or service. Moreover, some indicators may not be relevant to a particular contract (e.g., physical possession and legal title would not be relevant to services)".

Hence, CAK believes that indicators in paragraph 30 should be considered only as references for principle-based approach, not as decisive guidance. However, the conclusion in examples is drawn by strictly following four indicators in paragraph 30, thus, has a high risk of misleading to readers to believe that those indicators are certified drivers to judgment. Moreover, in Example 17 in B68, the final indicator, "customer-specific" is only effectively used for the conclusion as others are not directly relevant to construction-type contracts. This approach seems to be against the Board's intention mentioned in paragraph 31, "Not one of the preceding indicators determines by itself



whether the customer has obtained control of the good or service".

CAK believes that the indicators in paragraph 30 should not be practically used for construction-type contracts as they generally have more complicated economical substance than simplified characteristics mentioned in Example 17. <u>CAK is concerned that readers believe the indicators are complete and the only references for the conclusion.</u> To prevent this misunderstanding, CAK suggest Example 17 be removed. However, if not possible, CAK suggest;

- Conclusion on Example 17 be drawn based on principles, not on indicators, or;
- The ED shows additional example where a different conclusion is drawn using definition of control of transfer as follows:

Additional Example

An entity is developing residential real estate and begins to market individual apartments before and during their construction under the legal framework. An entity enters into a contract with a customer for the sale of a specific apartment and the selling price differs depending on the storey and aspect of the unit. While the entity determines the designs and models of the apartments in compliance with government regulation, the customer can request to make changes to the original design within authorized regulations by paying extra fees.

When the customer enters into the contract, he pays a non-refundable deposit. Once the first progress payment is made, the contract cannot be revoked solely by the customer, also the entity cannot replace the contracted unit to other unit. Progress payment is made according to the predetermined schedule based on the expected progress of the construction at the planning stage.

Legal title of the apartment is transferred to the customer once the construction is completed. However, due to the regulation to protect the customer's right, the entity is prohibited from engaging in actions such as setting a pledge or leasehold, selling or donating the contracted portion of work-in-progress. To the contrary, customer could place the work-in-progress in a pledge to apply for mortgages or re-sale the contract to a new buyer, who then becomes a contract party while construction is still in progress.

In this example, the terms of the contract and all related facts and circumstances indicate that the customer obtains control of the apartment continuously.

Although the customer cannot "physically use" the apartment as the construction is still in progress, the customer obtains the ability to prevent other entities from directing the use of, and



receiving the benefit from the specific contracted asset because customer's rights are protected by the regulation. In addition, the customer has the ability to receive the benefit from the work-in-progress by selling the contracted unit or hold it in a pledge, where on the other hand, the entity is not entitled to do so. The customer has an unconditional obligation to pay in line with the completion stage. Consequently, the entity satisfies the performance obligation while constructing because the customer obtains the control continuously.

However, it is difficult to build a robust judgment on transfer of control through the indicators provided within the ED. Though the entity does not transfer the legal title to the buyer until the construction is completed, the buyer can exercise substantial rights (selling the contracted unit or holding it in pledge). Considering the characteristics of the constructions that physical possession before the completion is impossible, determining physical possession as a transfer of control is not reasonable. For above case, it is difficult to determine whether the case falls under a customer-specific because it is directly regulated both when the basic designs are proposed by the entity and when the customer request for a additional change to the design

For better understanding of practical situations which are so complicated that judgment based on such a simplified example might be misleading, here below the main characteristics of housing construction industry in the Republic of Korea is described:

- i. As apartments are so preferred as residential places due to population density that standard contract for apartment trade and detailed regulations have been developed by the government in order to specify and secure buyer's rights and to allow them realize capital gains through re-sale of the contract or pledge of a land under construction for borrowing purpose. Sales contract for an apartment is preferred to be made even before or in early stage of construction period and the pre-sale of apartment in Korea differs from a forward contract mentioned in IFRIC 15 IE7. Re-sale of the contract is when a new buyer purchases an uncompleted property while construction is still in progress at the date of the purchase, thus, it differs from a forward contract that promises a future transfer of legal title once the construction is completed. Accordingly, upon the re-sale, only the constructor and the new buyer become contract parties.
- ii. Constructor's right to sold portion of work-in-progress is strictly limited. Under the apartment pre-sale system, constructor is prohibited from engaging in actions such as setting a pledge or leasehold, selling or donating work-in-progress. This is supported by the official ownership registration maintained by the government which states the above restrictions that the apartment under construction cannot be seized or disposed without consents of the contracted customers. To the contrary, customer could place the land in a



pledge to apply for mortgages.

- iii. Customer cannot freely rescind the agreed contract during construction if any portion of progress payment was made at least once. Without the sellers' consents, it becomes almost infeasible for customers to terminate their housing contract due to a penalty.
- iv. Details of housing construction are directly and actively controlled through the regulations and guidance by the authorities for various reasons such as safety, environment, and traffic. Hence, customers are not entitled to freely decide or amend major elements of structural design even after construction is completed and legal title is transferred. As long as in compliance with the regulations and guidance, design can be amended by customers during construction as regulation states that any changes of the business plan including design is permitted only with the consents from contracted customers. On the other hand, constructor cannot amend business plan at their will as it should obtain approval from the authorities after initial approval for the commencement of construction. Even before construction is commenced, constructor's design is subject to the regulations and guidance by the authorities.
- v. In case when the construction is ceased, the constructor can be paid to the extent that the construction is accomplished. As the construction is required to be insured by the public insurance company, if constructor cannot fulfill housing contract obligations due to reasons such as bankruptcy, customer can request the completion of the remaining portion to the insurance company. Under such circumstances, insurance company is obligated to help buyers find other constructors to fulfill remaining obligation and goes through settlement of accounts with the initial constructor.
- vi. According to the standard contract, progress payments in line with the stage of completion are mandatory, which is determined based on the expected progress of construction at the planning stage.