Thomas Oversberg

From: Jon Di-Stefano
Sent: Dienstag, 25. September 2007 11:10
To: Thomas Oversberg
Subject: RE: D21 - Real Estate Sales
Attachments: D21 Comment letter 25 September 2007.pdf

Thomas,

I was pleased to see your comment letter on the website and to note that we share some common concerns. I have attached our own letter which may be of interest although you will appreciate that we are coming from a different perspective on the issue.

Kind regards,

Jon

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25 September 2007

D21 Comment Letters
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sirs,

Draft Interpretation D21 – Real Estate Sales

Thank-you for the opportunity to comment on the draft interpretation. We have set out our comments below making reference to relevant paragraphs within D21 as appropriate.

Telford Homes Plc

Telford Homes Plc is an AIM listed housebuilder operating in and around East and North London. The company was formed in 2000 and from incorporation has accounted for revenue from the point of exchange of legally binding contracts on a percentage complete basis. This means that revenue is recognized as construction proceeds. In doing this we have applied the principles of SSAP 9 'Stocks and long term contracts' under UK accounting rules.

Under IFRS from 1 April 2007 we intend to apply IAS 11 'Construction Contracts' and therefore account for revenue in a very similar manner.

We believe that this method of accounting for revenue is entirely appropriate for our business and therefore disagree with the principles set out in D21.

In this letter we have set out five key areas of concern:

- Transfer of risks and rewards
- Economic substance of a transaction
- The purchasers involvement in the specification
- Existing differences in accounting practice between countries
- The indicators of a contract to provide construction services

In addition we have some comments on the effective date and transition.

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Transfer of risks and rewards

Telford Homes Plc sells properties at an early stage in the construction process. These sales are supported by legally binding contracts for the purchase of the properties with the payment of a non-refundable 10% deposit. These sales remove the most significant aspect of risk and reward from the development process this being movements in the market price of the property.

We primarily construct homes in areas of regeneration which is a very different market place to that of traditional 'greenfield' development. Regeneration of run-down areas is typically enabled by selling early in the construction process with purchasers speculating on the long term value of property as the area becomes regenerated. Telford Homes meanwhile can inject the necessary capital into each project only because we have removed the risk in market prices at an early stage in the development.

Paragraph 9(b) of D21 makes reference to the transfer of significant risks and rewards of ownership of the work in progress in its current state. We see no reason to distinguish between a half completed property and a fully completed property in terms of the transfer of risk and reward if the entity constructing the property is reasonably certain of completing the construction.

We do not see that retaining the right to use the work in progress (paragraph BC14) gives any significant right when there is a legally binding contract to deliver the property to an agreed specification.

A purchaser not only takes on the risks and rewards of ownership in relation to the market price but also is able to sell on the property and this can happen several times during the course of construction. This would support the buyer having effective control over the completed asset, and not just the right to acquire it (paragraph BC15), while Telford Homes is in a contract to supply that asset.

In practice, and certainly this is the experience of Telford Homes, the construction risks are minimal compared with the market price risks acquired by the buyer. In addition it should be noted that there are many other examples of construction services that are procured at a fixed price (roads, ships, stadiums) which would still be covered by IAS 11. In these fixed price agreements the future construction risk is no different to real estate sales made at a fixed price and in some cases is likely to be greater. Under these circumstances an assessment is made of the likelihood of profit being realized.

A decision over whether to recognize any revenue from a sale should therefore come down to an assessment of whether Telford Homes can complete the property as contracted and this incorporates the construction risks referred to in paragraph BC14. If Telford Homes and our auditors are satisfied that this is the case then due to the long term nature of the sales being made we believe it is appropriate to apply IAS 11.

Economic substance of a transaction

We specifically sell early to secure a fixed price for the properties and therefore largely eliminate our risk in the development. This secured sale is often made up to three years in advance of legal completion of the property concerned. In paragraph BC4 (b) we note that IFRIC considered the argument that recognizing revenue under IAS 18 would distort the reality of economic transactions and the underlying profitability of a business. This argument has been dismissed in paragraph BC5 and we do not think the reasons for this have been properly considered. This is a key point and should not be overshadowed by other factors.

Telford Homes would have reported very different figures year on year accounting for revenue on legal completion. The reality has seen steady growth by accounting for revenue under SSAP 9. Had results been reported as required under IAS 18 then these would have followed peaks and troughs depending on development completions and would not have been a true representation of the rate of sales of the business.

In addition we spend several million pounds on marketing and selling costs. These costs are incurred when contracts are exchanged. Under IAS 2 these costs are written off as incurred and under IAS 18 this could be up to three years in advance of any revenue being recognized. This is a clear and substantial mismatch of revenues and costs.

We see no reason why individual businesses, supported by auditors, cannot apply either IAS 11 or IAS 18 depending on the precise nature of the real estate developments they are constructing and the timing of sales versus construction completion. This choice should reflect the economic substance of the transactions being made.

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Involvement in specification

Paragraph 9(a) suggests that an agreement where the buyer can specify major structural elements of the design of real estate before construction begins would be accounted for under IAS 11. Whilst this is different to normal real estate sales we cannot see a difference between the two once construction has commenced.

For example, one property is sold under a contract that enables the purchaser to make a structural change before the start of construction and another is sold under a contract without this right. Once the purchaser of the first property has decided on any changes and construction commences, then both contracts are now the same in substance. Under both the developer is constructing a property to an agreed specification no matter how that specification was arrived at.

As construction proceeds the two contracts would be treated differently under the current drafting of D21. We do not think that there is an accounting, legal or economic reason for this.

Differing practice between countries

It was clear during the IFRIC deliberations that different countries are likely to be able to apply IAS 11 or IAS 18 depending on their legal framework within the provisions of D21. We do not think that D21 should mean different treatments are applied between countries just because the legal framework is different. This should be addressed by the provisions of the interpretation.

In addition it is noted that current US accounting is similar to IAS 11. While we agree that divergence from US policy is not a reason to change international accounting (paragraph BC5 (c)) we also believe that there is little point creating another divergence without discussing it within the joint project on revenue recognition.

Indicators of a contract to provide construction services

Allowing for the views expressed above we would also point out that the indicators in paragraph 9 are not robust enough in our opinion.

Legal contracts can be redrafted to satisfy both the specification issue in 9(a) and the right to take over work in progress in 9(b(ii)). If contracts were drafted to allow for full reimbursement of any costs associated with these situations plus appropriate penalties then a legal framework can be created that is practically no different to a normal contract for sale of real estate.

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Regardless of our views on D21 as a whole these conditions encourage less clarity in the legal framework behind the transactions that are actually taking place.

As drafted, a sale could meet one of the indicators of a construction contract and one of the indicators of a sale of goods. An agreement could satisfy either 9(a) or 9(b) and also the opposite section of paragraph 10. They are not mutually exclusive and this would still lead to divergent practice.

Effective date and transition

Again not withstanding our views on D21, should it be introduced, we would ask that the effective date be later than three months after the interpretation is finalized.

Our systems are geared towards the date of exchange of contracts and measurement of percentage completion on sites. We do not need to make reference to legal completion dates and historically have not done so.

The implementation of D21 would be a fundamental change in our accounting practice and therefore would require an overhaul of our management information systems and our accounting systems. In addition there would be significant work involved in restatement of prior periods.

Due to the long term nature of some of our sales we may need to unwind revenues for the three to four years prior to implementation and therefore need as much time as possible to prepare for any change.

Summary

In summary our key concerns are:

- The market price risk / reward is transferred to a purchaser upon exchanging contracts for a property and this represents the key issue in the sale of real estate. Construction risks can be separately assessed, as they are in all fixed price construction contracts.
- The significance of the right to own work in progress is just a function of implied construction risk and in other contracts is only relevant where construction fails. The likelihood of this can be considered when recognising revenue, as is currently the case for all contracts under IAS 11.
- The true economic substance of a transaction is not being captured when accounting for partially constructed real estate under IAS 18. There is a clear mismatch of expensing marketing and selling costs against the recognition of revenue, with up to three years between them.

- Once construction is underway there is no practical difference between a contract where the specification can be altered before construction and one where it cannot, D21 suggests that there is.
- D21 will not remove divergent practice due to the different legal frameworks in place between countries.
- In fact D21 encourages divergence from US accounting and we strongly believe that this should be addressed under the joint project on revenue recognition before being introduced.
- The indicators of a contract to provide construction services are not robust enough and can be easily satisfied by redrafting contracts.
- Many contracts will satisfy one of the conditions that indicate they are for construction services and one of the conditions that indicate they are for the sale of goods. This will not make required accounting practice clear.

I hope that these comments are helpful and I would be happy to discuss them with you in more detail should this be required. I can be contacted on 01992 809800 or by email at jon@telfordhomes.plc.uk.

Yours faithfully,

Jon Di-Stefano
Financial Director
For and on behalf of Telford Homes Plc