Every Sunday afternoon, ‘show house ahead’ signs litter the suburban streets of South Africa. Many of these signs lead to areas of barren land with computer-generated imagery of the grand residence to be developed there soon. All that is required is that the buyer pays a refundable deposit and construction on their dream house will begin. “Don’t worry”, promises the realtor, “you are exposed to absolutely no risk”. Although a contract is signed on this day, the deposit will be repaid should the house not be delivered to the buyer, and the buyer will only have to pay the remaining purchase price on completion of the construction.

The following Monday morning the deposits are in the developer’s bank account, and the accountant now needs to decide how to account for these deposits. This decision is dependent on whether the developer has entered into a sales contract in terms of IAS 18 (AC 111), Revenue or a construction contract in terms of IAS 11 (AC 109), Construction Contracts?

Disposal of property, plant and equipment in general

Property, plant and equipment are generally sold in terms of a sales contract. In determining the date of disposal for property, plant and equipment, an entity applies the recognition criteria in terms of IAS 18 (AC 111). Revenue. The disposal criteria are in essence built around whether the risks and rewards of ownership of the property, plant and equipment sold have been transferred to the buyer. IAS 18 (AC 111) para. 15 acknowledges that this transfer generally occurs with the transfer of legal title, although this is not always the case.

Disposal of real estate

When considering the sale of property (real estate), two points of time become relevant, the date the sales contract is signed or alternatively the date that the contract is completed and the legal title passes to the buyer. It is likely at the time of signing the contract that all material information relating to the contract will be known, e.g. the selling price and related expenditure. Therefore, in the absence of any uncertainty, it would be possible to recognise the revenue from the disposal of the property at the time the contract is signed (International GAAP, 2007: pp. 1953).

Accordingly example 9 in the Appendix to IAS 18 (AC 111), Revenue, currently suggests that revenue from the sale of real estate should generally be recognised when the legal title of the real estate is transferred, provided the seller has no further significant acts to complete under the contract. The Appendix cautions that, depending on the specific circumstances, it might be more appropriate to recognise the revenue prior to the transfer of legal title provided that the recognition criteria in para. 14 of IAS 18 (AC 111), Revenue, have been met at this earlier date (International GAAP, 2007: pp. 1854).

Pre-completion contracts

Recognition of a real estate sale is however complicated when the contract to purchase the real estate is signed prior to, or during the construction of that real estate. The question is whether the contract signed still falls within the scope of IAS 18 (AC 111), Revenue, as discussed above or should it rather be accounted for in terms of IAS 11 (AC 109), Construction Contracts, as all the typical features of such a construction contract are now present, such as land development, architectural design, and construction?

IFRIC DRAFT INTERPRETATION D21 Real estate sales

To address this situation the International Financial Reporting Interpretations Committee (IFRIC) of the International Accounting Standards Board (IASB) has issued a draft interpretation note addressing real estate sales and when these sales fall within the scope of
A REAL ESTATE SALE: A CONSTRUCTION CONTRACT OR A SALES CONTRACT?

IAS 18 (AC 111), Revenue, or IAS 11 (AC 109), Construction Contracts. This was issued by SAICA for comment as ED 228.

The interpretation is applicable to the sale of real estate in general and not only to residential real estate sales. It is equally applicable to commercial or industrial property sales, which may for example involve the sale of an entire development to a single buyer.

The key to the decision on which standard is applicable to the real estate sale lies in the definition of a construction contract in IAS 11 (AC 109), Construction Contracts. This definition reads as follows:

"...a contract specifically negotiated for the construction of an asset or a combination of assets..."

Therefore a contract will fall within this definition if the seller has to provide construction services to the buyer.

The draft Interpretation provides examples of features that indicate that an agreement includes the provision of construction services. These are as follows:

1. The buyer is able to specify major structural elements of the design prior to construction, or to specify major structural changes once construction has commenced.

2. The seller transfers the risks and rewards of the ownership of the real estate in its current state as construction in progress. Indicators of this may include:
   - the construction is taking place on land owned or leased by the buyers;
   - the buyer has the right to take over the construction at any point and, for example, appoints a different contractor; or
   - if the agreement is terminated prior to completion and the buyer retains the right to the work completed at that point and the seller has the right to be paid for that work.

In these instances, the accounting treatment will fall within the scope of IAS 11 (AC 109), Construction Contracts and revenue will have to be recognised as construction progresses (the percentage of completion method).

Should the seller only be able to provide limited inputs to the design specifications, such as specifying minor variations or selecting from a range of options, the contract could, depending on the specific circumstances, be a sale contract in terms of IAS 18 (AC 111), Revenue. Further indications of this may be that the negotiations between the buyer and the seller are predominately concerned with amount and timing of payments rather than structural design etc. A further indicator could be that the buyer retains the right to acquire the completed real estate and that the seller retains the risks and rewards of ownership during construction.

Applying IAS 18 to the sales contract

Should the indicators above have suggested that the contract is in fact a sales contract, revenue will be recognised once all the conditions in para 14 of IAS 18 (AC 111), Revenue, have been met.

Two of these conditions in para 14 of IAS 18 (AC 111), Revenue, require that the significant risks and rewards of ownership and the effective control over the goods should have been transferred to the buyer. These requirements must be applied to the real estate in its current condition i.e. as work in progress, and not the completed condition at a later date. This effectively means that revenue from the sale of the real estate in terms of a sales contract cannot be recognised until completion of construction.

In certain instances, the seller may retain such a degree of continuing involvement after delivery of the real estate to the buyer. This may be the case where the buyer is unable to ensure the completion of the project, or where the seller is required to undertake warranties or guarantees relating to the completed real estate.
buyer that the significant risks and rewards of ownership and the effective control are still not transferred to that buyer. Examples of such circumstances include:

- sale and repurchase agreements that include put and call options; or
- an agreement whereby the seller guarantees occupancy of the property for a specified period or guarantees a return on the buyer's investment.

These circumstances may result in a delay in the recognition of the revenue.

**Remaining obligations**

Where the seller's involvement after delivery of the real estate to the buyer is not of such a nature that prevents the transfer of the significant risks and rewards of ownership and effective control to the buyer, any remaining obligation is recognised in one of two ways.

First, where the seller is required to perform further work on the property that has already been delivered (such as minor repairs or completion of interior design) these expenses shall be recognised in terms of para 19 of IAS 18 (AC 111), Revenue and the resultant liability shall be recognised in accordance with IAS 37 (AC 130), Provisions, contingent liabilities and contingent assets.

Second, where the delivery of further goods or services is separately identifiable from the real estate that has already been delivered, these goods or services should be treated as a separate component of the sale in terms of para 13 of IAS 18 (AC 111), Revenue. The fair value of the total consideration received must therefore be allocated between the components already delivered and those not yet delivered. Revenue can only be recognised in respect of the component that has not yet been delivered when the applicable recognition criteria in terms of IAS 18 (AC 111), Revenue, have been met for those goods and services.

**Conclusion**

As with any sale, the main issue or concern on the sale of uncompleted real estate is the timing of the transfer of the risks and rewards of ownership to the buyer, i.e. whether the risks and rewards remain with the seller/developer until completion or whether they are transferred to the buyer as construction progresses. Draft Interpretation D21, Real Estate sales (ED 226), attempts to provide guidance on this matter with the final interpretation expected during the first half of 2008.

**References**


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