Abstract
Almost all estate agencies that are involved in residential property sales recognise the commission income from a sale when the commission concerned is actually received. This practice is at variance with generally accepted accounting practice, which requires recognition of income to occur on the signing of the agreement or when the sales contract becomes firm (i.e. unconditional).

The South African Revenue Services (SARS) has required the few estate agencies that apply generally accepted accounting practice in their financial statements to align their income tax accounting with their financial accounting. This alignment results in tax being paid on the commission that is due from the sale of properties that have not yet been transferred.

This paper debates the issue of the recognition of income. It provides suggestions for the improvement of disclosure in estate agencies’ financial statements. Furthermore, it suggests changes to estate agencies’ standard sales contracts to the effect that income is deemed to have been earned upon the registration of the transfer of a property.

Key words
Income recognition Firm contract
Accrual Estate agency
Estate Agency Affairs Act Prudence
Registration of transfer Gross taxable income
Consistency Commission
Value Statement Income tax
1 Introduction

This paper briefly outlines the estate agency business in the residential market in South Africa and examines the accounting policies of estate agencies with regard to the recognition of income. Empirical research reveals that few estate agencies follow generally accepted accounting practice. There is nevertheless consistency in their accounting, because most of them recognise income upon the registration of transfer. The paper proposes a format in terms of which estate agencies can disclose information on the values of mandates and contracts in respect of which registration of transfer has not yet taken place, but which are currently undisclosed.

2 Estate agency in South Africa

It is generally accepted that someone who brings together a willing and able buyer and a seller (or lessor and lessee) of immovable property for commission is an estate agent. (Gluckman v Landau and Co 1944 TDP 261). An estate agency is a business entity that undertakes estate agency work. An estate agency usually comprises principal agents who own the agency, employee agents and independent contractors who work for the principals. An estate agency can operate as a limited company, close corporation, partnership or sole trader. Directors, members and partners are the principals. Unlike accountancy and law, in which unregistered members of staff can undertake the work performed and only the partners have to be registered with the appropriate authority, the estate agency business requires all members of staff that practice the work of an estate agent to be registered with the Estate Agency Affairs Board.

The Estate Agency Affairs Board is authorised by the Estate Agency Affairs Act No. 112 of 1976 to regulate the activities of estate agencies and estate agents. It does this through a system of registration (Delport 2000:829), a statutory code of conduct (Delport 2000:269) and a requirement for the trust accounts of estate agencies to be audited annually by registered auditors (Delport 2000:346). The Act also prescribes the stage at which an estate agency is entitled to receive the commission earned on a transaction (Estate Agents Board 1993:16).

Prior to 1976, the estate agency business was unregulated, although there were professional or trade associations that regulated voluntary membership. The most prominent of these associations was the Institute of Estate Agents of Southern Africa, which was founded in 1937 (Miller 1995:3). The advantages of membership of the Institute were that it afforded members a degree of status to present to the community, provided them with a medium for communication between members, a code of conduct, a commission tariff and a collective voice for addressing the relevant authorities and the Government. The Institute still exists and has approximately 4 500 members. However, it is the Estate Agency Affairs Board that regulates and controls all the affairs of estate agents in the Republic of South Africa, including membership of the Institute. According to
the Board, there were 29 927 registered estate agents and 8 667 registered firms (estate agencies) in South Africa on 27 August 2001.

3 The stages of a property transaction from the perspective of an estate agency

A typical property transaction usually begins when the seller of a property gives an estate agency an instruction (mandate) to market the property. The instruction may be a verbal, except that in the case of an exclusive or a sole mandate the instruction must be in writing (Estate Agents Board 1993:4). The mandate is fulfilled when the agent introduces a willing and able buyer to the seller and the latter two parties enter into a contract of sale (Estate Agents Board 1993:14). The sale agreement (or accepted offer to purchase) is usually a pre-printed document that is supplied by the estate agent and states that the agent is deemed to have earned commission upon it being signed.

The sale agreement usually contains a number of conditions that are to be fulfilled before the agreement can proceed and the contract becomes firm. When the contract becomes unconditional, the seller has a clear liability to pay the estate agent the commission upon the registration of transfer. Prior to 1993, the estate agent was entitled to appropriate the commission from any deposit paid by the purchaser when all the suspensive conditions had been fulfilled. The Estate Agency Affairs Act was amended to prohibit this practice and to defer payment until the registration of transfer (although an estate agent can be paid earlier, provided that good cause can be shown and certain criteria complied with). In most cases, payment upon the registration of transfer is the norm (Estate Agents Board 1993:16).

When this change came into effect, it placed considerable strain on the cash flow of many estate agencies. It also led to the establishment of organisations that would lend money to estate agents against firm sales contracts that are ceded to the lender.

The final stage of the property transaction is the registration of transfer, whereupon the estate agent receives the commission via the conveyancer and/or an appropriation from the deposit in the estate agency’s trust account.

4 Recognition of income in the form of estate agency commission

The juncture at which an estate agency should recognise income has become a contentious issue. In recent years, some of the larger estate agencies have been persuaded by their accountants to recognise income at the juncture at which the sales contract becomes firm, which practice accords with generally accepted accounting practice. Paragraph 22 of the Statement of Generally Accepted Accounting Practice (AC 111 April 2001) states _inter alia_ that:
When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised .......... and in paragraph 24:
Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the enterprise.

In the context of a property transaction, the sales contract becomes firm after all suspensive conditions, such as obtaining a mortgage bond or selling another property, have been fulfilled. In the case of real estate sales, revenue is normally recognised when legal title passes to the buyer. The Estate Agency Affairs Act, as amended, also requires that the payment of commission be deferred until the registration of transfer. The taxation authorities have also observed this requirement. One of the respondents in the empirical study, which is described in a following section, stated that the SARS required the particular agency to recognise income when the contract became firm and to pay tax accordingly. There is a time lag of some two to three months from the date that a contract becomes firm until the registration of transfer is completed.

While the time lag may not appear to be significant, it could have a severe effect on an estate agency’s cash flow and give rise to the earlier payment of corporate income tax.

While it would appear that generally accepted accounting practice is observed by recognising commission income when the contract becomes firm, it is also worthwhile to examine some of the other criteria that have a bearing on the issue. The recognition or realisation principle is the accounting rule that states that: (1) the inflow of assets associated with a revenue does not have to be in the form of cash (2) a revenue should be recorded as a revenue at the time, but not before, it is earned and (3) the amount of a revenue should be measured in terms of the cash plus cash equivalent amount of other assets received (Larsen 1990: 36). When this rule is applied to a property transaction, it is clear that the commission has been earned and therefore it can be recognised as income on the one hand and as accounts receivable on the other. Commission can also be viewed from the critical-event approach (Davies Paterson and Wilson 1997:134). This approach is based on the notion that revenue is earned at that juncture in the operating sequence when the most critical act is performed. Proponents of the accrual of commission consider the firming of the contract to be the most critical event (or even the signing of the contract, when it becomes binding and the suspensive conditions are of little consequence). Proponents of the cash basis consider the registration of transfer to be the most critical event, because this event triggers the payment of commission. Proponents of the former position can demonstrate the high probability that firm contracts will ultimately come to fruition, whereas proponents of the latter position can claim that an estate agency has no control over the collection of the payment of commission until the registration of transfer occurs.

It is obvious that a contract is a document of critical importance. Estate agencies could amend their pre-printed agreements to read that commission is
earned upon the transfer of the property. An estate agent could argue that this amendment would remove a valuable right to claim commission in the event of breach. Perhaps the estate agent should weigh against this loss the remote likelihood that a breach would occur and also note that it would still be possible to sue for damages on the basis that a breach would prevent the estate agent from earning commission upon registration. The practicalities of a situation in which a breach occurs, is that more often than not the estate agency will not do anything, because experience has shown that the breaching party is usually a purchaser who does not have personal funds of any consequence. It makes more sense for the estate agent not to take legal action and rather to sell three or four properties in the time that would be expended on pursuing the legal route. Therefore, while the estate agent earns commission upon the signing of a contract, which crystallises when suspensive conditions in terms of the contract are fulfilled, for all practical purposes, commission is earned upon the transfer of the property. Instead of having a clause in the agreement that is unlikely to be enforced if the opportunity should present itself, it is better to have the agreement state that commission is earned upon the transfer of the property. It could be claimed that the prudence concept is applied by the use of the cash-accounting policy.

In accordance with the prudence concept, revenue and profits are not anticipated, but are recognised only when realised in the form of cash or in the form of other assets, the ultimate cash realisation of which can be assessed with reasonable certainty (Davies et al 1997:132). Despite the fact that the accrual (or matching concept) has to submit to the prudence concept when it is inconsistent with it (Davies et al 1997:64), there is no inconsistency in this instance. To wait for the registration of the transfer before recognising commission as income could be described as being “ultra prudent”.

Another relevant concept is that of consistency, i.e. the accounting treatment being consistent from one accounting period to the next (Davies et al 1997:54). In a different context, consistency is relevant, because business entities that operate in the same business sector should use accounting policies that are comparable (Davies et al 1997:54). It is therefore of some relevance to investigate what the accounting policies of estate agencies in South Africa are and how and why they have evolved.

5 What accounting policies do estate agencies in South Africa follow?

The following methodology was used to ascertain the accounting policies of estate agencies in South Africa, with particular reference to the recognition of income.

The principals, managers or accountants of 47 (52.2%) estate agencies, out of a total of 90 estate agencies that advertised in the main section of the Saturday Star Property Guide of 24 August 2001 were interviewed telephonically. This
sample accounted for 155,5 pages of advertising out of a total of 189 pages (82,3%).

All the major estate agencies were included in the sample as these agencies tend to use the services of the larger accounting firms and were considered to be the most likely agencies to use the accrual concept. The focus on advertising was to ensure that a sufficiently large and representative sample was used and that no major estate agency was omitted. These objectives were achieved.

Precise, explanatory questioning was applied to obtain answers to the following questions:

• When is the estate agency deemed to have earned commission?
• When does the estate agency recognise income in its financial statements?
• Does the estate agency operate an accounting system that monitors the progress of transactions from the signing of a contract to the registration of the property and the payment of commission?

The questioning methodology used to obtain answers to the above questions is detailed in an appendix to this paper. A summary of the answers provided to the questions appears below.

<table>
<thead>
<tr>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total sample of agencies selected for questioning</td>
<td>47</td>
</tr>
<tr>
<td>Number of agencies that recognise income upon the fulfilment of suspensive conditions (accrual method)</td>
<td>4</td>
</tr>
<tr>
<td>Number of agencies that recognise income upon the registration of the transfer/receipt of the commission (cash method)</td>
<td>43</td>
</tr>
<tr>
<td>Number of pages of advertisements of the agencies that recognise income upon the fulfilment of suspensive conditions</td>
<td>26</td>
</tr>
<tr>
<td>Number of pages of advertising of the agencies that recognise income upon the registration of transfer/payment of commission</td>
<td>129,5</td>
</tr>
<tr>
<td>Number of estate agencies that operate accounting systems that monitor transactions from the signing of a contract to registration/payment of commission</td>
<td>47</td>
</tr>
</tbody>
</table>

**Observations**

• It is highly unlikely that any of the estate agencies that were excluded from the sample used the accrual method to recognise income, because these agencies are all very small and their advertisements comprise only a fraction
of a page. Therefore the percentage of agencies that use the cash method is probably 95.6%.

- It is probable that estate agencies use the cash policy because their principals were employee agents who were paid upon registration and who were not subject to generally accepted accounting practice. They also view the earlier payment of taxes as a threat, because it will impact unfavourably on cash flow. This view stems from the notion that income from a tax perspective is the same as income from an accounting perspective.

- Generally adopted accounting practices should not be disregarded simply because they conflict with generally accepted accounting practices. They are well understood in the estate agency fraternity and are easy to apply, both of which are good reasons for maintaining their status quo.

Because the financial statements of most estate agencies are prepared on the cash basis by professional accountants, it would appear that the greater proportion of the accountancy profession recognises this method as being appropriate, despite it being at variance with generally accepted accounting practice. The concept of consistency is strongly in evidence.

6 Recognition of income from a tax perspective

It is convenient at this juncture to consider the recognition of income in the context of taxation, because income for tax purposes is a separate issue from income for accounting purposes.

A general rule in South African income tax law is that an amount should be recognised as income as soon as the recipient has become unconditionally entitled to the payment, even though it may not yet be payable – *Lategan v CIR* (1926 CPD 203, 2 SATC 16), *CIR v People’s Stores (Walvis Bay) (Pty) Ltd* (1990(2) SA 353 (A), 52 SATC 9). The seller may have to await the expiry of an agreed period before he can expect to receive payment (Broomberg and Kruger 1999:72).

Gross income is defined as follows in section 1 of the Income Tax Act:

- Gross income, in relation to any year or period of assessment, means -
  - (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
  - (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic, during such period of assessment ...........

In *Mooi v SIR* (1972 AD), it was held that an entitlement that is contingent on a future event does not result in an accrual until the event has occurred (Huxham and Haupt 2002:12). Applying this definition to an estate agency, it can be argued that the entitlement to receive commission is contingent on the registration of transfer. This argument could be countered by stating that if the registration of transfer does not occur as a result of a breach of the contract by one of the parties to the agreement, then the estate agent becomes entitled to
receive commission and it can claim from the alleged transgressor of the contract. If, however, the alleged transgressor contests the claim in law, then entitlement would become contingent upon the eventual outcome of the case, bearing in mind the provisions contained in the contract of sale. A practical approach to the matter might be to consider the situation of the employee agent, who normally shares commission with the agency in line with the terms of the sale agreement. The employee agent becomes entitled to the receipt of the commission concerned upon the registration of transfer, at which point income tax is deducted and paid to the South African Revenue Services each month. If commission accrues to an employee agent upon registration, it should also accrue to the employer at the same time. On the other hand, if commission accrues to the estate agency when the contract becomes firm and the company is then liable for income tax, the employee estate agent concerned becomes liable for income tax at the same time, subject to the conditions of the particular employment contract. If SARS were to attempt to collect income tax from employee agents before they have received payment, the collection would most likely prove to be virtually impossible to administer.

Perhaps the strongest argument that the point at which commission accrues to the estate agency is upon the registration of the transfer of the property and the receipt of commission, is the fact that the estate agency has no control whatsoever over when the commission is received, because the timing thereof is determined by the Estate Agency Affairs Act. In most other businesses, the provider of goods or a service can negotiate the terms of payment and decide whether a credit period is allowed. Therefore the registration of transfer and the receipt of payment precipitate the accrual of commission. A factor that may support this position is the manner in which value-added tax is collected from estate agencies. The inclusion of the output element of value-added tax on the tax return is precipitated by the actual payment of commission to the taxpayer (Urquhart, Lategan and Legge 1991:8,9). Naturally, value-added tax is not income tax, but the point is that if SARS could be pragmatic about value-added tax, it could also be pragmatic about income tax. For the most part, this appears to be the case, because almost all estate agencies are already being permitted to use the receipt of payment upon the registration of transfer as the point of recognition of income.

As noted earlier, what constitutes income and when it is recognised, can vary in terms of taxation and accounting, although, when it suits them, the taxpayer and SARS appear not to see the difference. Estate agencies would readily switch to the accrual of commission when contracts become firm in order to comply with generally accepted accounting practice, if the status quo vis-à-vis taxation were to be retained.

What it boils down to is that, with good reason, estate agencies do not trust SARS. They perceive the threat of the accrual basis as being unfairly forced on them for taxation purposes if they should use it for accounting and financial reporting purposes. If the calculation of tax should be based on the recognition
of income at the point determined by tax law, then that is the juncture at which income accrues for tax purposes, regardless of the estate agency’s accounting policy. SARS should not change the rules if the estate agency changes its accounting policy. For income tax purposes, the timing of income is recognised as being the earlier of either receipt or accrual. The case of Mooi v SIR (1972 AD) may be influential, because, as noted above, it could be interpreted that the registration of transfer is the event that entitles the estate agency to the receipt of commission.

7 The balance sheet of an estate agency

The use of the cash policy instead of the accrual policy has the effect of excluding commission receivable, which constitutes most agencies’ largest asset, from the balance sheet. It also excludes commission payable to employee agents, probably the largest current liability. In considering the balance sheet, the stakeholders’ information needs should be considered.

Which stakeholders are involved? Three important stakeholders are the owners of the business, potential purchasers of the business and potential lenders to the business. The owners of the business have direct access to the off-balance-sheet information. This information should be disclosed to a potential purchaser, if the business should be for sale, and to financial institutions (or major creditors) that may put themselves at risk by transacting with the estate agency. The question to be answered, is how to disclose this information and other information. One way to do so would be to produce a value statement to supplement the financial statements. A value statement could be drawn up in the format presented below:

**Mandates**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated commission to be received from converted mandates</td>
<td>xxx xxx</td>
</tr>
<tr>
<td>Less: Estimated commission payable to employee agents (if applicable)</td>
<td>(x xxx)</td>
</tr>
<tr>
<td>Net unrealised commission receivable</td>
<td>xx xxx</td>
</tr>
</tbody>
</table>

**Contracts in progress**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracts still subject to suspensive conditions</td>
<td>xx xxx</td>
</tr>
<tr>
<td>Less: Provision for contracts becoming null and void</td>
<td>(x xxx)</td>
</tr>
<tr>
<td>Less: Estimated commission payable to employee agents (if applicable)</td>
<td>(x xxx)</td>
</tr>
<tr>
<td>Net unrealised commission receivable</td>
<td>xx xxx</td>
</tr>
</tbody>
</table>
Firm contracts

Contracts in respect of which all suspensive conditions have been met xxx xxx

Less: Estimated commission payable to employee agents (if applicable) (xx xxx)

Net unrealised commission receivable xx xxx

**Total net unrealised commission receivable** xx xxx

This disclosure is more extensive than that provided by the accrual method, because it provides information on mandates and contracts that have still to become firm. Estate agencies that follow the accrual method could provide a more comprehensive disclosure by producing a similar value statement that omits firm contracts.

8 Conclusion and recommendations

This paper discusses the recognition of income by South African estate agencies. The issue is contentious and almost all estate agencies are at variance with generally accepted accounting practice.

The following is recommended:

• Estate agencies should be encouraged to follow generally accepted accounting practice, provided that SARS agrees that a change in accounting policy will not necessarily bring about a change in the status quo of taxation. It would be in SARS’s interest to develop a relationship of trust rather than of apprehension between itself and the taxpayer. SARS should not, however, have any influence on good accounting practice.

• If the above-mentioned recommendation is not implemented by SARS, estate agencies should consider changing their pre-printed contracts to reflect the earning of commission upon the registration of transfer. Estate agencies and accountants that advise estate agencies should consider the introduction of supplementary value statements in order to provide more comprehensive and meaningful financial information to stakeholders.

• Those responsible for accounting standards in South Africa should consider giving special attention to the business of estate agencies in South Africa, particularly with regard to when commission is earned and when commission is paid as well as the inability of an estate agency to control the latter.

Some guidance is required, because almost all estate agencies are at variance with generally accepted accounting practice, which requires the presentation of a true and fair balance sheet, showing commission receivable and commission payable.
Appendix

Questionnaire used for the empirical study

The researcher communicated directly with the respondents and asked them the following questions:
1. When is your estate agency deemed to have earned commission?
2. When does your estate agency recognise income in its financial statements?
3. Does your estate agency operate an accounting system that tracks transactions from the signing of a contract to the registration of transfer and payment of commission?

The researcher introduced himself and explained the nature of the research project. Being well known in the real estate business, it was a simply matter for him to establish a rapport with the respondents. In several instances, the respondents did not understand the questions asked in the above format and it was necessary to ask additional questions to obtain answers. For example, an approach to question one was to ask the respondent to read the commission clause in the agency’s standard contract document. In respect of question two, it was frequently necessary to explain that the financial statements were the annual income and balance sheet that are certified by the auditor or prepared by the accounting officer, then to ask whether commission receivable was included in accounts receivable and whether commission payable to employee agents was included in accounts payable. The third question was well understood by respondents, many of whom went to some lengths to explain how their system was computerised and how it functions.

In the light of the supplementary questioning and the clarification provided by the researcher, it is unlikely that any of the three key questions were answered incorrectly.

Bibliography

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*Lategan v CIR.* 1926. CPD 203, 2 SATC 16.
*Mooi v SIR.* 1972. AD.