Our Ref : A/C-210-2002/HLP

Deputy Director, Accounting
Hong Kong Society of Accountants
4th Floor, Tower Two, Lippo Centre,
89 Queensway,
Hong Kong.

20th August 2002

Dear Sir,

Re: **Accounting for investment properties**

We are writing to express our concern on the proposed changes on accounting for investment properties. Following the recent revisions to International Accounting Standard 40 "Investment Property" ("IAS 40") proposed by International Accounting Standards Board ("IASB"), we understand that the Society intends to revise the equivalent Hong Kong accounting standard in the near future, namely, the Statement of Standard Accounting Practice 2.113 "Accounting for Investment Properties" ("SSAP 13") by following the accounting policies required under IAS 40. Being one of the property developers in Hong Kong holding a large portfolio of investment properties, we consider that the adoption of accounting policies under IAS 40 would have a significant *but undesirable* impact on the financial statements of Hong Kong property companies including our group. Accordingly, we would like to highlight our concern to the Society for consideration.

In summary, IAS 40 requires investment properties to be carried at valuation with gains or losses on changes in fair value to be included in the income statement (the "fair value model"), or alternatively, to be re-stated at depreciated cost (the "cost model"). The recent amendments to IAS 40 (and IAS 17 "Leases") proposed by IASB is intended to remove the technical limitation that leasehold interests in land cannot be carried at valuation, and thereby allowing the valuation of leasehold interests in land and building as a whole under the fair value model. While we appreciate that IASB's proposed amendments have taken into account the special circumstances about leasehold land in Hong Kong, there are still major issues yet to be addressed before considering the adoption of IAS 40, as discussed below.

Our major concern is the requirement to deal with the gains and losses on changes in fair value of investment properties in income statement. If this happens, the profit and loss of a property company would no longer depend on the actual results from rental operations. Instead the results would depend on the opinion of "professional" valuers, which is a human factor and could be rather subjective. This can be illustrated by the following example:

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恒隆地產有限公司 香港中環德輔道中四號渣打銀行大廈二十八樓 電話：28790111 傳真：28686031

	Value of property $M	Return on Property	Rental Income $M	
Year 1	25,000	7%	1,750	
Year 2	27,500	7%	1,925	
Increase in property value	2,500			
Profit for Year 2 excluding property valuation increase			1,925	10% up from year 1
Profit for Year 2 including property valuation increase			4,425	152% up from year 1

Based on the Year 1 rental income, the return on property is 7%. If rental income grows by 10% in Year 2, the value of the property would be also be increased by 10% *assuming* capitalization of the same return on property. Capitalization of rental income is one of the common approaches for property valuations and different approach can be adopted by different "professional" valuers, a human and subjective consideration. The total profit from property, nevertheless, will be increased by 152% if property revaluation gain is included in the profit and loss of the company. This also means for every increase in rental income by $1 million, the total "profit" would be increased by $14 million.

In addition to the above, the recognition of unrealized gains and losses in income statement would significantly increase the volatility of operating results and therefore distort the reporting entity's operating performance. More importantly, the inclusion of the unrealized revaluation gains in the income statement may give an incorrect impression to investors that those unrealized gains are available for dividend distribution. Alternatively, dividend payout ratio would be significantly distorted if unrealized gains or losses from investment properties valuation are included in net profit available for distribution but excluded for the purpose of dividend distribution. Other financial ratios, such as earnings per share, would also be seriously distorted.

These negative impacts can be illustrated as follows:

Year	Net profit* $M	Annual revaluation surplus/ (deficit)* $M	Adjusted net profit** $M	*% change on net profit*	Dividend payout* before reval. gain/loss	*Dividend payout after reval. gain/loss*
1992	916	4,385	5,301	*83%*	68%	*12%*
1993	1,213	3,470	4,683	*74%*	67%	*17%*
1994	1,504	5,645	7,149	*79%*	62%	*13%*
1995	1,548	(1,612)	(64)	*> -100%*	64%	*>-100%*
1996	1,580	292	1,872	*16%*	69%	*58%*
1997	2,490	3,887	6,377	*61%*	51%	*20%*
1998	2,653	(9,139)	(6,486)	*>-100%*	52%	*-21%*
1999	1,896	(4,204)	(2,128)	*>-100%*	51%	*-45%*
2000	1,218	1,095	2,313	*47%*	86%	*45%*
2001	1,384	(545)	839	*-65%*	84%	*>100%*

** Figures sourced from annual reports of Hang Lung Properties Limited*
*** Adjusted to include annual revaluation surplus or deficit*

The above table demonstrates that the net profit attributable to shareholders and dividend payout ratio would be seriously distorted if unrealized gains or losses on investment properties valuation are included in the income statement of our group over the past ten years. It can be argued that these problems may be resolved by displaying the changes in fair value in question on the face of income statement as a separate item, with additional notes to remind such gains or losses are unrealized etc, *but back to the basic question*, why do we have to do so and not simply keep the changes in fair value of investment properties as equity movements?

We would also like to point out that, although our above concerns have already been mentioned in the discussion papers of IAS 40, it seems that IASB has ignored the issue of *materiality*. While IASB has mentioned different arguments supporting and opposing the adoption of fair value model, the significant and undue fluctuations on income statement is clearly a dominant and critical factor for not supporting fair value model because of the materiality involved. All other arguments raised by IASB to support the fair value model, such as difficulty in calculating gain or loss on disposal of investment properties, impairment loss accounting, etc, would become much less important when taking into account their impact on operating results. When applying IAS 40 for Hong Kong, it is necessary to re-assess the pros and cons of fair value model based on the materiality to financial statements.

There are other arguments opposing the fair value model, such as inconsistent accounting treatment for property, plant and equipment carried at valuation (whereby the corresponding fair value changes are dealt with in revaluation reserves in the first place) and the likes. We consider these arguments are rather conceptual in nature.

In respect of the cost model as an alternative accounting method for investment properties permitted under IAS 40, we consider such alternative is again not a practical approach that can be adopted by Hong Kong real estate developers. The use of cost model will require retrospective adjustment to write down the investment properties from their carrying value to depreciated cost. This would reduce the shareholders' equity to a great extent. It is undesirable to make significant write-off in our books simply due to a change in accounting policy that does not reflect reality.

Finally, we suggest that the Society should take a practical approach in carefully determining how to apply the principles of IAS 40 while avoiding the undesirable results from the simple adoption of IAS 40 for Hong Kong companies. One possible solution is to make use of supplementary disclosures. The financial impact in adopting the fair value model, if necessary, could be displayed by way of supplementary notes to the accounts, so that for those readers who are interested to know the "financial performance" of investment properties, being one of the key arguments raised by IASB, will be able to get those information from the notes to the accounts. The revaluation changes, on the other hand, shall continue to be dealt with as reserve movements on the balance sheet.

We sincerely hope that the Society can seriously consider our above concerns before issuing the exposure draft on revision of accounting for investment properties.

Thank you for your kind attention.

Yours faithfully,
For and on behalf of
HANG LUNG PROPERTIES LIMITED

Robin Ching
Assistant Director – Finance