CPA
Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Alert

Updates on financial reporting and auditing

Issue 9 (May 2010)

Dear members,

Educational points identified from reviews of published financial statements – HKAS 16 and HKAS 40

1. This alert summarizes common issues noted on accounting for properties under HKAS 40 *Investment Property* and HKAS 16 *Property, Plant and Equipment*.

2. Companies in Hong Kong commonly own properties. However, there are important differences in classification in financial statements when they are held for different purposes.

HKAS 40 *Investment Property*

3. HKAS 40 prescribes recognition, measurement and disclosure requirements for investment property. As defined in paragraph 5 of HKAS 40, investment property is land or a building (including part of a building or both), held to earn rentals or for capital appreciation or both. It is not owner-occupied, and is not used in production or supply of goods and services, or for administration. It is also not a property that is for sale in the ordinary course of business.

4. Investment property is owned or may be held by a lessee under a finance lease. A lessee may also classify a property interest held under an operating lease as investment property if the property would otherwise meet the definition of an investment property and the lessee uses the fair value model. Examples of investment property and examples of items that are not investment property can be found in paragraphs 8 and 9 of HKAS 40 respectively.

5. An investment property is initially measured at cost. After that, an entity chooses either the "fair value model" or the "cost model" to account for all investment properties held. If the cost model is used, fair value must be disclosed. Therefore the fair value at the end of reporting period must be determined for measurement (if fair value model is used) or for disclosure (if cost model is used).

6. Particular issues arise when transfers of properties are made, e.g. from investment property to inventory, or from owner-occupied property to investment property. In this alert, we highlight important matters that members should consider in accounting for the transfers.

7. Paragraph 57 of HKAS 40 addresses the requirements on transfers to, or from, investment property which should be supported by evidence of "change in use." We noted during our reviews of published financial statements that in some cases the transfers took place primarily based on the entity's changes of “intentions.” We would like to remind members that transfers can be made when and only when a

change in "use" has taken place. For example, a transfer from investment property to owner-occupied property must be evidenced by commencement of owner-occupation.

8. Since there is no change in the carrying amount of transferred property if the investment property is measured under the cost model, the issue we have focused on is measurement when the fair value model is used for investment property. The relevant requirements are set out in paragraphs 60 to 65 of HKAS 40.

9. Following the example in paragraph 7 above, the fair value of investment property carried at fair value at the date of transfer is the deemed cost for subsequent accounting of owner-occupied property in accordance with HKAS 16. The same requirement is applied for transfer from investment property carried at fair value to inventory, whereby the fair value at the date of transfer is the deemed cost for subsequent accounting of inventory under HKAS 2.

10. Conversely, when an owner-occupied property is transferred to investment property that will be carried at fair value, the property is accounted for under HKAS 16 up to the date of transfer. The difference between the fair value and carrying amount of the property at the transfer date is recognized as revaluation surplus or deficit in accordance with HKAS 16.

HKAS 16 *Property, Plant and Equipment*

11. Property, plant and equipment are tangible assets held for more than one accounting period and used in the production or supply of goods and services, or for administration. They include assets rented to others but not investment property, which is covered in HKAS 40.

12. As for investment property, property accounted for under HKAS 16 is also initially recorded at cost. An entity may choose to use cost model or revaluation model for subsequent accounting. Members are reminded that under HKAS 16, when an item of property, plant and equipment is revalued, the entire class to which that asset belongs shall be revalued. We noted occasions that the same entity accounted for its buildings, some at cost and the others at valuation, and this is inappropriate under HKAS 16.

13. HKAS 16 also requires that under the revaluation model, regular revaluations shall be performed to ensure the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. HKAS 16 suggests that even if there are only insignificant changes in fair value, it may be necessary to revalue the item every three or five years.

14. Under the revaluation model of HKAS 16, a revaluation increase of a property is recognized in other comprehensive income and accumulated equity under the heading of revaluation surplus. Such increase shall be recognized in profit or loss to the extent it reverses a revaluation decrease of the same property previously recognized in profit or loss. Revaluation decrease is recognized in profit or loss. However the decrease shall be recognized in other comprehensive income to the extent of any credit balance existing in the revaluation surplus of that property. However, under fair value model of HKAS 40, changes in fair value of investment property are recognized in profit or loss.

Observations on insufficient disclosures of HKAS 40 and HKAS 16

15. Common missing disclosures are:

- Description of the events and circumstances that led to the recognition/reversal of impairment losses of properties which are accounted for under cost model of HKAS 40 or HKAS 16, as required by HKAS 36.

- Methods and significant assumptions applied in estimating the fair values when the properties are stated at revalued amount under HKAS 16 or at fair value under HKAS 40.

- Disclosures on direct operating expenses (including repairs and maintenance) arising from both investment properties that generated and did not generate rental income during the period. Members are reminded that gross rental income and direct operating expenses should be disclosed separately.

- Other disclosure matters required under the Tenth Schedule of the Companies Ordinance: (a) classification of leases (i.e. short, medium or long term) in respect of the carrying amounts of property, plant and equipment and investment property; and (b) information on whether the properties are situated in Hong Kong and elsewhere. Members are also reminded that if a substantial part of the entity's revenue consists of rental income, the net income from rents of land and building (i.e. after deduction of outgoings) should be disclosed as required by the Tenth Schedule of the Companies Ordinance.

Improvements to HKFRSs

16. HKAS 40 was amended as a result of *Improvements to HKFRSs* issued by the Institute in October 2008. The amendment, which has become effective in 2009, requires an entity to account for properties being constructed or under development for future use as investment property under HKAS 40, and not HKAS 16. Members may refer to a technical article in *A Plus* at: http://app1.hkicpa.org.hk/APLUS/0907/QA.pdf.

17. The Institute has issued a Question & Answer to discuss the potential impact the classification of leasehold interests in Hong Kong relating to amendments of HKAS 17 *Leases*. Members can read the Q&A at: (http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/ref-material/2009/hkas17-q-n-a.pdf)

Sincere regards,

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