Accounting for Investment Property in Hong Kong
(Relevant to PBE Paper I – Financial Accounting)

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Introduction

In Hong Kong, listed entities, especially property development companies, frequently purchase properties for investment, i.e. to earn rentals and/or for capital appreciation. As the investment properties of such companies often constitute a major part of their total assets, a given company's accounting treatment for investment properties could have a substantial impact on its financial position and performance. HKAS 40 *Investment Property* sets out the principles and guidelines to account for such properties.

Investment property is one of the most frequently examined issues on *PBE Paper I: Financial Accounting*. For this reason, in this article we address the definition, recognition, and measurement of the value of investment property.

What is Investment Property?

HKAS 40 defines investment property as a property (land or a building — or part of a building — or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

- use in the production or supply of goods or services or for administrative purposes; or
- sale in the ordinary course of business.

According to the above definition, investment property is held for the purpose of earning rentals or for the potential increase in value, or both. Investment property is therefore distinguished from owner-occupied property, which is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services, or for administrative purposes.

HKAS 40 provides some examples of investment property as follows:

- land held for long-term capital appreciation
- land held for undecided future use
- a building leased out under an operating lease
- a vacant building held to be leased out under an operating lease
- property being constructed or developed for future use as investment property.

HKAS 40 clarifies that the following properties are not investment properties:

- property intended for sale in the ordinary course of business or being constructed or developed for such sale (see HKAS 2 *Inventories*)

- property being constructed or developed on behalf of third parties (see HKFRS 15 *Revenue from Contracts with Customers*)
- owner-occupied property (see HKAS 16 *Property, Plant and Equipment*), which includes:
  - (a) property held for future owner-occupation;
  - (b) property held for future development before owner-occupation;
  - (c) property occupied by employees (regardless of whether or not they pay market rent); and
  - (d) owner-occupied property awaiting disposal.
- property that is leased to another entity under a finance lease.

Partly Owner-occupied Property

Property development companies in Hong Kong may hold properties for dual purposes, i.e. a portion of the property is used as investment property and another portion is reserved for the owner's own use. Such properties are referred to as 'partly owner-occupied properties'.

The accounting treatment for partly-owner-occupied properties depends on whether or not the portions of the property could be sold or leased separately. If they could not be sold or leased separately, then the whole property is treated as investment property only if an insignificant portion is held for owner-occupied use. HKAS 40, however, does not provide guidance on what constitutes an 'insignificant' portion for this purpose.

Ancillary Services

An entity may sometimes provide ancillary services (e.g. security or maintenance) to the occupants of a property it holds. The classification of property as investment property depends on the significance of the services provided:

(a) If the ancillary services are 'insignificant' to the arrangement as a whole, the property is treated as investment property. This happens when, for example, the owner of a shopping centre merely provides cleaning services to the tenants.

(b) If the ancillary services are 'significant', the property should be classified as owner-occupied property, and therefore not as investment property. For example, if an entity owns and manages a hotel, the provision of services to the guests as services is considered to be significant to the arrangement as a whole. Indeed, the hotel is for use by the entity in the normal course of its business. Whether or not the entity may also hold the hotel for long-term appreciation, this does not constitute the principal reason for holding the hotel. Hence, an owner-managed hotel is classified as an owner-occupied property.

In practice, the determination as to whether ancillary services are 'insignificant' or 'significant' requires the exercise of good judgement.

Property Leased to another Group Member

An entity may lease a property to its parent or group companies. Such property is not recognized as investment property in the *consolidated* financial statements because the property is owner-occupied from the perspective of the group. However, from the *individual entity's* perspective, that entity should treat it as investment property if it meets the requirements of HKAS 40 to be classified as an investment property.

Example 1 demonstrates the identification of investment property in various situations.

Example 1
Elegance Investment Ltd ("Elegance"), a listed company in Hong Kong, owns the following three properties at 31 December 20X6:

<u>Harbour Tower</u>
Harbour Tower is an office building in Tsim Sha Tsui that has 20 units. Elegance uses one of these units as the company's office and rents the remainder of the units out to commercial tenants. Elegance provides these tenants with security and maintenance services in the building.

<u>Pacific Square</u>
The construction of Pacific Square in Causeway Bay begins in April 20X6 and the building is expected to be completed in May 20X9. Elegance will then rent this property out to its subsidiary, Polyventure Ltd, upon its completion.

<u>Concord Hotel</u>
Concord Hotel is a five-star hotel located in Central that was acquired and managed by Elegance beginning on 1 April 20X6. The hotel has 250 rooms. Ten of these rooms are rented out to Elegance's top management at the prevailing market price and the remainder of the rooms are rented out to hotel guests.

Required:
How should Elegance account for each of the above properties in its financial statements for the year ended 31 December 20X6?

Solution:
<u>Harbour Tower</u>
Harbour Tower is a partly owner-occupied property. Elegance should first determine whether the units in Harbour Tower could be sold or leased separately. Here, it is apparent that the units have already been leased separately to commercial tenants. Therefore, the unit occupied by Elegance should be accounted for as owner-occupied property under HKAS 16, and the remaining 19 units would be classified as investment property. The security and maintenance services provided by Elegance to its tenants are 'insignificant' and hence would not affect the classification of the remaining 19 units as investment property.

<u>Pacific Square</u>
Pacific Square is being constructed for rental purposes in future, and hence the property should be classified as investment property in Elegance's individual financial statements. Since Elegance will lease Pacific Square to its subsidiary, the property is

accounted for as owner-occupied property in Elegance's consolidated financial statements.

Concord Hotel

HKAS 40 specifically states that, if a property is rented to employees of an entity, the property is treated as owner-occupied property even if the employees pay rent at market rates. This means that although the 10 rooms under consideration are held to earn rentals, the property is not investment property because it is rented to top management (i.e. employee) of Elegance. The 10 rooms should therefore be accounted for as owner-occupied property under HKAS 16. Concord Hotel is an owner-managed hotel that provides 'significant' services to hotel guests, and thus the 240 rooms (being rented out to third parties) are also accounted for as owner-occupied property.

Recognition

HKAS 40 provides that an entity should recognize an investment property as an asset when the following two conditions are fulfilled:

(a) It is probable that the future economic benefits that are associated with the investment property will flow to the entity; and

(b) The cost of the investment property can be measured reliably.

Initial Measurement

An Investment property should be measured initially at its cost, including transaction costs. Transaction costs are directly attributable expenditures, such as professional fees for legal services and property transfer taxes.

Subsequent Measurement

Subsequent to the initial recognition, HKAS 40 requires an entity to choose as its accounting policy either the fair value model or the cost model and to apply that policy to all of its investment property.

Fair Value Model

Investment property should be measured at its fair value. Fair value is the price that would be received to sell an asset or that would pay to transfer a liability in an orderly transaction between market participants at the measurement date (See HKFRS 13 *Fair Value Measurement*). In determining the fair value of an investment property, the best evidence is the current market price in the property market (i.e. in the principal market under HKFRS 13).

For each reporting period, the carrying amount of investment property should be re-measured at its current fair value. Any gain or loss arising from a change in the fair value of investment property should be recognized in profit or loss for the period in which it arises.

Cost Model

Investment property should be measured in accordance with the requirements of HKAS 16, i.e. cost less any accumulated depreciation and accumulated impairment losses.

Transfers to or from Investment Property

HKAS 40 requires that transfers to, or from, investment property should be made only when there is a change in use. The major requirements on accounting for transfers are summarized in the table below:

Evidence of change in use	Measurement rules
Commencement of owner-occupation (transfer from investment property carried at fair value to owner-occupied property or inventories)	The property's deemed cost for subsequent accounting in accordance with HKAS 16 or HKAS 2 is its fair value at the date of change in use.
End of owner-occupation (transfer from owner-occupied property to investment property carried at fair value)	HKAS 16 should be applied to the owner-occupied property up to the date of the change in use. Any difference at that date between the carrying amount of the property and its fair value should be treated in the same way as a revaluation in accordance with HKAS 16.
Commencement of an operating lease to another party (transfer from inventories to investment property carried at fair value)	Any difference between the fair value of the property at the date of transfer and its previous carrying amount should be recognized in profit or loss.

Example 2 is a comprehensive example that requires knowledge of the definition of, measurement of and treatment of the transfer of investment property.

Example 2
Profit Properties Ltd ("Profit") acquired Double Square in Hong Kong at a cost of $50 million on 1 January 20X4 and split Double Square into 20 separate units. All of the units in Double Square were used by Profit as the company's offices and showrooms.

From 31 December 20X5, Profit continues to use 5 units of Double Square and rents the remainder of the units out to various tenants. Under the lease agreement, Profit provides its tenants with a manned reception, security and maintenance services.

The fair values of Double Square were as follows:

Fair value at:	$'000
31 December 20X4	54,000
31 December 20X5	56,000
31 December 20X6	63,000

Profit measures the investment property using the fair value model. Profit measures the owner-occupied property using the cost model and depreciates it over a 20-year period on a straight-line basis.

A full year of depreciation is provided for in the year of purchase, disposal or transfer of the property.

Required:

(a) Explain how Double Square should be classified in the financial statements of Profit as at 31 December 20X4, 20X5 and 20X6.

(b) Prepare the journal entries to record all transactions in respect of Double Square from the years 20X4 to 20X6.

(c) Prepare extracts from Profit's statement of profit or loss and other comprehensive income and statement of financial position for the years ended 31 December 20X4, 20X5 and 20X6, in respect of Double Square.

(d) If all units of Double Square were let to a subsidiary of Profit, explain how Double Square should be classified in the individual financial statements of Profit and in the consolidated financial statements of Profit's Group.

Solution:

(a) HKAS 40 defines owner-occupied property as property held for use in the production or supply of goods or services, or for administrative purposes. As all units in Double Square were used by Profit as the company's own offices and showrooms from 1 January 20X4, those properties meet the definition of owner-occupied property.

HKAS 40 also defines an investment property as property held by the owner, or by the lessee under a finance lease, to earn rentals or for capital appreciation, or both.

For a partly owner-occupied property, HKAS 40 requires that the portions of owner-occupied property and investment property be accounted for separately if the respective portions could be sold or leased separately. Therefore, from 31 December 20X5, the 5 units used by Profit would be classified as owner-occupied property and the remaining 15 units leased out by Profit would be classified as investment property. Consequently, Profit should account for Double Square with 5/20 as owner-occupied property and 15/20 as investment property.

HKAS 40 also states that when there is a change in the use of a property, the property should be measured at fair value at the date of the change. In this case, 15 units should be transferred from owner-occupied property to investment property at fair value at the date of the change in use (i.e. 31 December 20X5).

(b) The journal entries to record the transactions in respect of Double Square are as follows:

	$'000	$'000
1 January 20X4	$'000	$'000
Dr. Property, plant and equipment – Double Square	50,000	
Cr. Bank		50,000
To recognize acquisition of Double Square.		
31 December 20X4	$'000	$'000
Dr. Depreciation – Double Square	2,500	
Cr. Accumulated depreciation – Double Square		2,500
To recognize depreciation for Double Square. ($50m / 20 years)		
31 December 20X5	$'000	$'000
Dr. Depreciation – Double Square	2,500	
Cr. Accumulated depreciation – Double Square		2,500
To recognize depreciation for Double Square. ($50m / 20 years)		
31 December 20X5	$'000	$'000
Dr. Investment property – Double Square ($56m × 15/20)	42,000	
Dr. Accumulated depreciation – Double Square ($5m × 15/20)	3,750	
Cr. Property, plant and equipment – Double Square ($50m × 15/20)		37,500
Cr. Other comprehensive income – Revaluation gain on transfer of property		8,250
To recognize gain on the transfer of usage for 15 units of Double Square.		
31 December 20X6	$'000	$'000
Dr. Depreciation – Double Square $50m × 5/20 / 20 years	625	
Cr. Accumulated depreciation – Double Square		625
To recognize depreciation for 5 units of Double Square.		
31 December 20X6	$'000	$'000
Dr. Investment property – Double Square	5,250	
Cr. Profit or loss – Fair value gain of investment property		5,250
To recognize fair value gain of 15 units of Double Square. ($63m − $56m) × 15/20		

(c) Extracts of Profit's statement of profit or loss and other comprehensive income for the years ended 31 December

	20X4	20X5	20X6
Profit or loss section	$'000	$'000	$'000
Depreciation	(2,500)	(2,500)	(625)
Fair value gain on investment property	-	-	5,250
Other comprehensive income section			
Revaluation gain on transfer of property	-	8,250	-

Extracts of Profit's Statement of financial position as at 31 December

	20X4	20X5	20X6
	$'000	$'000	$'000
Non-current assets			
Investment property	-	42,000	47,250
Property, plant and equipment	47,500	11,250	10,625
Equity			
Revaluation surplus	-	8,250	8,250

(d) If an entity owns a property that is leased to, and occupied by, its parent or another subsidiary, the property does not qualify as investment property in the consolidated financial statements, because the property is owner-occupied from the perspective of the group. However, from the perspective of the entity that owns it, the property is an investment property if it meets the definition of an investment property given above. Therefore, the entity treats the property as investment property in its individual financial statements.

If all units in Double Square were let to a subsidiary, it would therefore not be an investment property in the consolidated financial statements of Profit's Group. It would, however, be an investment property in the individual financial statements of Profit since it was held by Profit to earn rentals.

Conclusion

Students sitting for PBE Paper I: Financial Accounting must possess in-depth knowledge of the accounting treatment of investment properties. In this article, we have distinguished investment property and owner-occupied property, and fully explained how to properly account for investment property.