

## **Invest, occupy or sell? A modern challenge in Hong Kong (Relevant to AAT Examination Paper 7 – Financial Accounting)**

Annie Mok Yuet-ngo, City University of Hong Kong  
Michael So Yuen-hon, Hong Kong Baptist University

In a modern city like Hong Kong, many companies have acquired different properties. Several Hong Kong Accounting Standards (HKASs) deal with the initial acquisition and recognition of property. This article focuses on how to distinguish property recognized under HKAS 40 “Investment Property” from that recognized under two other standards: HKAS 16 “Property, Plant and Equipment” and HKAS 2 “Inventories”. It also discusses the definitions and classifications of property under each of the standards.

### **HKAS 40 “Investment property”**

In accordance with HKAS 40, investment property is held to earn rentals, for capital appreciation, or for both reasons. An investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property. Owner-occupied property should be initially recognized as property, plant and equipment under HKAS 16.

HKAS 40 provides the following examples of investment property:

- a. Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
- b. Land held for a currently undetermined future use. (If an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation.)
- c. A building owned by the entity (or held by the entity under a finance lease) and leased out under one or more operating leases.
- d. A building that is vacant but is held to be leased out under one or more operating leases.
- e. Property that is being constructed or developed for future use as investment property.

HKAS 40 also provides examples of items that are not investment property:

- a. Property intended for sale in the ordinary course of business or in the process of construction or development for such sale. For example, property acquired exclusively with a view to subsequent disposal in the near future or for development and resale.
- b. Property being constructed or developed on behalf of third parties.
- c. Owner-occupied property, including (among other things) property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees (whether or not the employees pay rent at market rates) and owner-occupied property awaiting disposal.
- d. Property that is leased to another entity under a finance lease.

Property recorded under Investment property must be depreciated if cost model is adopted. However, if fair value model is adopted, the entity should not depreciate the property.

### **HKAS 16 “Property, Plant and Equipment”**

In accordance with HKAS 16, property, plant and equipment are tangible items that:

- a. are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- b. are expected to be used during more than one period.

Property recorded under property, plant and equipment must be depreciated no matter which cost model or revaluation model is adopted. However, no depreciation is allowed for land.

### **HKAS 2 “Inventories”**

In accordance with HKAS 2, inventories are assets:

- a. held for sale in the ordinary course of business;
- b. in the process of production for such sale; or
- c. in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Property recorded under inventories must not be depreciated.

### **Examples**

The following real-life examples should be noted:

#### Example 1:

An entity is a manufacturing company and it has developed some land and built a factory on the land. In this case, the property is not an investment property under HKAS 40. The property is regarded as an owner-occupied property because the entity is to be occupied as factory, a production unit. Hence, the factory should be initially recorded as property, plant and equipment under HKAS 16. Accordingly, the entity should depreciate the building no matter which cost model or revaluation model is adopted. However, no depreciation should be charged for the cost of the land.

#### Example 2:

A property developer intends to develop some land as a residential estate for future sale. As in example 1, the property is not an investment property under HKAS 40. It should be treated as inventory under HKAS 2 because the property is an asset held for sale in the ordinary course of business. Hence, the property should be measured at the lower of cost and net realizable value. No depreciation should be charged on the property.

Example 3:

An entity intends to develop a property for future use as investment property. However, at the end of the financial year, the development has not been completed. In this case, the property is treated as investment property under HKAS 40 because HKAS 40 applies also to property that is being constructed or developed for future use as an investment property. If the cost model is adopted, the entity should charge depreciation. However, no depreciation is allowed if the entity adopts the fair value model.

Example 4:

An entity currently holds some land but has not determined whether it will use the land as an owner-occupier or for capital appreciation purpose.

Investment property is held to earn rentals or for capital appreciation or both. Therefore, an investment property generates cash flows largely independently of the other assets held by and entity. If the entity has not determined how it will use the land, the land is regarded as being held for capital appreciation purposes. Hence it should be initially recorded as investment property under HKAS 40. If the cost model is adopted, the entity should charge depreciation. However, no depreciation is allowed if the entity adopts the fair value model.

**Conclusion**

Judgement is required to determine whether a property qualifies as investment property, property, plant and equipment, or inventory. The accountants should exercise their judgement consistently in accordance with the definitions and classifications of property under the respective Hong Kong accounting standards.