

## **Impact of Adoption of HKAS 40 on Investment Property Companies**

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The Hong Kong Institute of Certified Public Accountants has issued Hong Kong Accounting Standard (“HKAS”) 40 “Investment Property” which is effective for the accounting periods beginning on or after 1 January, 2005. All companies engaged in the business of investment property are affected by this new accounting standard in preparing their coming financial statements.

HKAS 40 applies to all property companies if they hold property for generating rental income or capital appreciation. The new accounting standard allows a company to adopt either a cost model or a fair value model in measuring the value of its investment property.

Under the cost model, an investment property is stated at cost less depreciation and impairment losses. This accounting treatment is different from the old accounting standard SSAP 13 which requires an investment property to state at cost less impairment losses if its estimated market value is less than HK\$50 million or less than 15 per cent of the carrying amount of total assets of the company and no depreciation is provided for unless the unexpired lease term of the relevant investment property is less than 20 years.

Under the old SSAP 13, if the estimated market value of the investment property is more than HK\$50 million or more than 15 per cent of the carrying amount of total assets of the company, the accounting treatment would be more or less similar to the fair value model as explained below.

For the fair value model, the valuation of investment property is measured in the financial statements on fair value at the balance sheet date. The criteria for the exemption of stating the investment property at its fair market value under the old SSAP 13 are no longer available in the new HKAS 40.

To determine the fair value of the investment property, certain major factors such as the present value of the rental income stream and current property market conditions should be considered. Accordingly, the carrying amount of the investment property has to be revalued to reflect property market conditions at the end of each financial year. The new accounting standard allows the directors of the company to undertake the property revaluation but engagement of an independent professional property valuer in performing property valuation is still encouraged.

To comply with the HKAS 40, all surplus or deficit arising from property revaluation is directly taken to the income statement, rather than in the property revaluation reserve, as it was required under the previous accounting standard SSAP 13. Obviously, any fluctuation in property market has significant impact on the stability of profit or loss of the property investment company. A company may record remarkable profit benefited from the revaluation gain during the time of the booming property market but report huge losses suffering from the revaluation deficit in the case of a downturn of the property market.

In addition to the increase in the volatility of a company's profit, the adoption of the HKAS 40 may also affect the dividend distribution policy of a company if the company makes its decision on dividend payment with reference to the company's profit. It should be understood that the unrealized gain or loss from the property revaluation does not involve any cash inflow or outflow to the company. As such, the company may not have sufficient fund to pay dividend if the enormous profit of the company is mainly contributed by the unrealized gain from the property revaluation. Perhaps, net profit before unrealized gain or loss from property revaluation is a better indicator for certain companies to make their decision on dividend payment.

In summary, the real value of a property company will be truly reflected in its financial statements by measuring the investment property at fair value at the balance sheet date.