Accounting for investment properties under construction - a practical guide

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Real Estate Industry Practice

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Introduction

The Hong Kong Institute of Certified Public Accountants has made an amendment to HKAS 40 Investment Property in 2008 that affects the accounting treatment for properties under construction or development for future use as investment properties (hereinafter referred to as "investment properties under construction"). This amendment was based on the amendment made, in May 2008, to IAS 40 Investment Property as part of the 2008 Improvements to International Financial Reporting Standards. The amendment is made to include within the scope of HKAS 40 investment properties under construction.

The amendment has resulted in a significant change in the accounting for investment properties under construction. Before the amendment, investment properties under construction were within the scope of HKAS 16 Property, Plant and Equipment and were measured at cost less impairment (if any). After the amendment, investment properties under construction are required to be accounted for as investment properties.

The amendment to HKAS 40 applies prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted provided that the fair values of investment properties under construction were previously determined at the application date.

In this guide, for simplicity, all references are made to HKAS 40 and other applicable Hong Kong Financial Reporting Standards (HKFRSs) only.

This guide (through the questions and responses below) provides preparers with guidance as to how to apply the new requirements on the following aspects:

- Scope
- Measurement
- Recognition of fair value gains or losses and transitional provisions
- Transfers
- Disclosures

Particularly, this guide includes the following frequently asked questions:

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Scope

Question 1: Is the amendment to HKAS 40 applicable to investment properties under construction that exist at the date of the application of the amendment?

Under the amendment, investment properties under construction are within the scope of HKAS 40 [Paragraph 8(e) of amended HKAS 40].

Consider the following scenario:

Entity A has existing investment properties under construction as at 1 January 2009. The construction of these properties started before 1 January 2009. Assume that the financial year end of Entity A is the calendar year end.

Is Entity A required to apply the amendment to HKAS 40 to investment properties under construction for which construction began before 1 January 2009?

Response:

Yes. The amendment to HKAS 40 requires prospective application. Entity A should apply the amendment to HKAS 40, from 1 January 2009 onwards, to investment properties under construction including investment properties for which construction started before 1 January 2009. This will ensure that investment properties under construction, regardless of when construction began, are accounted for in the same way. Please refer to Question 6 in relation to how the difference between the fair value of investment properties under construction as at 1 January 2009 and the previously recognised carrying amount as at 1 January 2009 should be recognised.

Question 2: After the amendment, can entities account for leasehold land in accordance with HKAS 17?

Specifically, when an entity acquires a piece of leasehold land (classified as an operating lease in accordance with HKAS 17 Leases) and constructs a building on that piece of land for future use as an investment property, can the entity make use of paragraph 6 of HKAS 40 so that the leasehold land is carried at cost less amortisation in accordance with HKAS 17?

Response:

Paragraph 6 of HKAS 40 states that a property interest held under an operating lease may be classified and accounted for as investment property if, and only if, the property meets the definition of an investment property and the lessee uses the fair value model to account for the property interest. Such a classification alternative can be made on a property-by-property basis.

An entity can apply paragraph 6 of HKAS 40 such that the leasehold land is accounted for in accordance with HKAS 17. However, we believe that the classification alternative, once determined on initial recognition, cannot be changed. In other words, the lessee should continue to account for the leasehold land in accordance with HKAS 17 until the property is disposed of - the lessee cannot reclassify the leasehold land to investment property when the construction is complete and, hence cannot recognise any fair value gain or loss. The building element during construction, however, is within the scope of HKAS 40 and, hence should be accounted for as investment property under construction in accordance with the new requirements in HKAS 40.

Measurement

Question 3: Are entities required to measure all investment properties under construction at fair value?

Response:

It depends on:

- whether entities have used the fair value model or the cost model to account for their investment properties; and
- whether the fair values of the investment properties under construction can be determined reliably (when the fair value model is used).

Under HKAS 40, entities are given a choice as to how to measure their investment properties; entities can measure their investment properties using the fair value model or the cost model. Once the decision is taken, entities should apply the chosen policy consistently to all of their investment properties including investment properties under construction [Paragraph 30 of HKAS 40]. Therefore, if an entity has chosen to account for its completed investment properties using the fair value model, it should also account for its investment properties under construction using the fair value model. Alternatively, if an entity has decided to account for its completed investment properties using the cost model, it should also account for its investment properties under construction using the cost model. HKAS 40 requires entities to disclose the fair values of investment properties even when the cost model is used (see ***Question 10*** for details).

Under the fair value model, there is a rebuttable presumption that an entity can reliably determine the fair value of investment property on a continuing basis. However, in exceptional cases, when an entity first acquires an investment property or when an existing property first becomes investment property after a change in use, there may be clear evidence that the fair value of the investment property is not reliably determinable on a continuing basis. This arises when, and only when, comparable market transactions are infrequent and alternative estimates of fair value (e.g. based on discounted cash flow projections) are not available [Paragraph 53 of HKAS 40].

Specifically, regarding investment properties under construction, if an entity determines that the fair value of an investment property under construction is at present not reliably determinable but expects the fair value of the property to be reliably determinable when construction is complete, the entity should measure that investment property under construction at cost until either its fair value becomes reliably determinable or construction is complete (whichever is earlier) [Paragraph 53 of amended HKAS 40]. Please refer to the guidance set out in ***Question 4*** in relation to how to determine the fair value of an investment property under construction. When an entity is compelled, for the reason above, to measure an investment property under construction at cost, it continues to measure all of its other investment properties (including investment properties under construction) at fair value.

Where investment properties under construction are measured at cost, they are subject to impairment provisions set out in HKAS 36 *Impairment of Assets*. HKAS 36 requires an entity to perform an impairment assessment for an asset whenever there is indication that the asset may be impaired. The recoverable amount of an asset under HKAS 36 is determined as the higher of (a) value in use (that is determined based on discounted cash flow method), or (b) fair value less costs to sell. Impairment losses, if any, should be recognised in profit or loss immediately.

Once an entity becomes able to measure reliably the fair value of an investment property under construction that has previously been measured at cost, it should measure that property at its fair value. In addition, once construction of that property is complete, it is presumed that fair value can be measured reliably (unless, as mentioned earlier, the fair value of the completed property cannot be determined reliably because comparable market transactions are infrequent and alternative reliable estimates of fair value are not available). If this is not the case, following the completion, the property should be measured using the cost model in accordance with HKAS 16 [Paragraph 53A of amended HKAS 40].

Question 4: How should entities determine the fair value of investment properties under construction?

Response:

Under HKAS 40, the fair value of investment properties (including investment properties under construction) is the price at which the properties could be exchanged between knowledgeable, willing parties in an arm's length transaction [Paragraph 36 of HKAS 40].

Although HKAS 40 does not provide specific guidance on how to determine the fair value of investment properties under construction, it does contain some guidance on how to determine the fair value of investment properties in general. Such guidance may help us determine the fair value of investment properties under construction. The guidance in HKAS 40 is set out as follows:

- The fair value of investment property should reflect market conditions at the end of the reporting period [Paragraph 38 of HKAS 40].
- The best evidence of fair value is given by current prices in an active market for similar property in the same location and condition and subject to similar lease and other contracts [Paragraph 45 of HKAS 40].
- In the absence of current prices in an active market, there is a fair value hierarchy in HKAS 40 that helps determine the fair value of an investment property from a variety of sources, including [Paragraph 46 of HKAS 40]:
  - current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;
  - recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and
  - discounted cash flow projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and (when possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

In January 2009, the International Valuation Standards Council (IVSC) has published an Interim Position Statement that provides some guidance on the valuation of investment property under construction. The Interim Position Statement contains the IVSC's preliminary views of valuation principles.

Following the publication of the Interim Position Statement, the IVSC established a working group to consider the issues in more detail and developed an exposure draft for public comment. In August 2009, the IVSC published an Exposure Draft on *Proposed Guidance Note - The Valuation of Investment Property under Construction.* Comment deadline is 31 October 2009.

Major proposals in the IVSC's Exposure Draft are set out in the ***appendix*** to this guide.

We noted that the IVSC's Exposure Draft proposes that it will not comment on whether the fair value of investment properties under construction can be reliably determined on the grounds that it is not the role of the valuation standards to direct how entities or their advisors interpret the accounting standard on investment property. The Interim Position Statement issued in January 2009, however, stated that investment properties under construction should be capable of reliable determination in all cases where there is sufficient comparable market data available to undertake a valuation.

Under the IVSC's Exposure Draft, in order to determine the fair value of an investment property under construction, entities are required to estimate first the value of the completed property. The IVSC's Exposure Draft proposes two approaches in estimating the value of the completed property, as follows:

- Current value approach - the value of the completed property is determined on the date of valuation as if the property was completed and leased at the date of the valuation; and
- Prospective value approach - the value of the completed property is determined based on the reasonable expectation of market participants of the value on the date that the property is anticipated to be completed and leased.

The IVSC's Exposure Draft states that the more appropriate approach will be the one prevailing in the market for the class of property on the valuation date.

Whether the fair value of an investment property can be determined reliably is a matter of judgment and depends on specific facts and circumstances. We believe that, in determining whether the fair value of an investment property under construction can be determined reliably, the following factors should be considered:

- The status of approval from the relevant government authorities regarding how the property can be used.
- Whether the value of the completed property can be reliably determined. This indeed depends on whether there are frequent comparable market transaction data available.
- Whether future development costs can be estimated reliably.
- The risks and returns associated with the property (e.g. risks associated with variations in construction costs, finance costs and the construction programme, and risks as to whether the anticipated income or capital appreciation determined on the date of valuation can be achieved when the construction is complete).
- The duration for the project to complete.
- Other facts and circumstances that specifically relate to the individual development.

Question 5: If the fair value of an investment property under construction has previously been measured at fair value, is it possible for an entity to use the cost model to account for the property at a subsequent reporting date (e.g. when property market becomes inactive)?

Response:

No. The presumption that the fair value of investment property under construction can be measured reliably can be rebutted only on initial recognition [Paragraph 53B of amended HKAS 40]. Therefore, entities should continue to measure the property at fair value in future periods until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of business), even if comparable market transactions become less frequent or market prices become less readily available [Paragraph 55 of HKAS 40]. Entities may have to use one or more valuation methods (e.g. discounted cash flow method) to estimate the fair value of the investment property under construction.

Recognition of fair value gains or losses and transitional provisions

Question 6: Where should entities recognise the previously unrecognised gains at the date of the application of the amendment?

As mentioned in ***Question 1*** earlier, the new requirements apply to investment properties under construction that exist at the date of the application of the amendment to HKAS 40. At the date of the initial application of the amendment, how should any difference between the fair value of investment properties under construction and the previously recognised carrying amount be recognised?

Response:

The amendment should be applied by entities prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted [Paragraph 85B of amended HKAS 40]. However, the amendment does not provide clear guidance as to how the previously unrecognised fair value gains or losses should be recognised. To reflect "prospective" application, we believe that recognising such gains or losses in profit or loss would be the most appropriate.

Question 7: When investment properties under construction are measured at fair value, how should additional construction costs be accounted for?

Response:

Costs incurred during the construction period should be capitalised as part of the cost of the investment properties. At each reporting date, investment properties under construction are remeasured to their fair values. Therefore, in effect, fair value gains or losses recognised during the reporting period reflect the construction that took place during the period.

Transfers

Question 8: Can a property under development (previously intended to be developed for self-use) be transferred to investment property under construction when the intention to use changes?

Response:

Paragraph 57 of HKAS 40 specifies situations as to when transfers to or from investment properties should take place. Paragraph 57 of HKAS 40 states that a change in use must be supported with evidence. Therefore, we believe that, if the change in use is supported by evidence (e.g. the concerned entity has entered into a lease agreement such that it would use the property to earn rentals after the completion of the development), the property under development can be transferred to investment property under construction, and hence be carried at fair value (if the entity has chosen to apply the fair value model to all of its investment properties).

Here is an example:

Example 1: Transfer from property under development to investment property under construction

Facts

- In 20X1, Entity A acquired a piece of land and started constructing the building element. The original plan was that the property would be used by Entity A as a commercial building upon completion.
- The leasehold land element was presented as a prepaid lease payment in accordance with HKAS 17 and the building element was accounted for in accordance with HKAS 16.
- During the construction period, Entity A changed its mind as to how it would use the property upon completion. Rather than self-occupying it, Entity A now intends to use the property to earn rentals and for capital appreciation purpose. Also, to support the change of intention, Entity A has entered into a lease agreement with Entity B that gives Entity B the right to use the property for 10 years after completion of development of the property. In return, Entity A will earn rental income during the lease term.

Response:

We believe that it is appropriate for Entity A to transfer the property under development to investment property under construction when Entity A changes its intention as to how to use the property evidenced by Entity A entering into the lease agreement with Entity B. Any difference between the fair value of the property at the date of transfer and the previously recognised carrying amount should be recognised in the same way as a revaluation in accordance with HKAS 16 and hence the difference will never be reclassified to profit or loss.

Disclosures

Question 9: Upon the initial application of the amendment to HKAS 40, what disclosures should an entity make in its financial statements in addition to the disclosures required by HKAS 40?

Response:

The requirement to account for investment properties under construction in accordance with the amendment to HKAS 40 is a change in accounting policy. When an entity initially applies a standard or an interpretation that has an effect on the current period or any prior period, the entity should make certain disclosures, as set out in paragraph 28 of HKAS 8. The disclosures required by paragraph 28 of HKAS 8 that are relevant to this subject matter are as follows:

a) the title of the Standard or Interpretation;

b) the fact that the change in accounting policy is made in accordance with its transitional provisions;

c) the nature of the change in accounting policy;

d) a description of the transitional provisions; and

e) for the current period presented, to the extent practicable, the amount of the adjustment:

   i) for each financial statement line item affected; and

   ii) if HKAS 33 Earnings per Share applies to the entity, for basic and diluted earnings per share.

Here is an example.

Example 2: Description of the nature of the change in the accounting policy for investment properties under construction and the financial effect

HKAS 40 Investment Property has been amended to include within its scope properties under construction or development for future use as investment properties and to require such properties to be measured at fair value (where the fair value model is used and the fair values of the properties are reliably determinable). In the past, the leasehold land and building elements of properties under construction were accounted for separately. The leasehold land element was accounted for as an operating lease and the building element was carried at cost less accumulated impairment losses. The Group has used the fair value model to account for its investment properties including investment properties under construction. The Group has applied the amendment to HKAS 40 prospectively from 1 January 2009 in accordance with the relevant transitional provision. As a result of the application of the amendment, the Group's properties under construction for future use as investment properties that include the leasehold land and buildings elements have been classified as investment properties and measured at fair value as at 31 December 2009, with the fair value [gain/loss] being recognised in profit or loss for the year ended 31 December 2009. Included in the fair value [gain/loss] recognised in profit or loss for the year ended 31 December 2009 is the fair value [gain/loss] of HK$[X] that represents the difference between the fair value of the properties as at 1 January 2009 and the aggregate of the previous carrying amounts as at 1 January 2009.

Note: The above example has not yet taken into account the income tax effect and has not included the disclosure set out in sub-paragraph (e)(ii) above.

In addition, when investment properties under construction are measured at fair value and the estimation of the fair value of investment properties under construction involves significant judgment and assumptions, an entity is required to disclose information about the key assumptions, sources of estimation uncertainty and sensitivity analysis, as set out in paragraphs 125 and 129(b) of HKAS 1.

Question 10: Where investment properties under construction are accounted for using the cost model, are entities required to disclose the fair value of such properties under construction?

Response:

Yes. Paragraph 79(e) of HKAS 40 requires an entity to disclose the fair value of its investment properties even when the entity uses the cost model to account for its investment properties (except where the fair value of investment properties cannot be determined reliably).

Question 11: What additional disclosures are required when an investment property under construction is measured at cost because the fair value of the property under construction cannot be determined reliably?

Response:

In such a situation, paragraph 78 of HKAS 40 requires an entity to disclose the following:

a) A description of the investment property;

b) An explanation of why fair value cannot be measured reliably;

c) If possible, the range of estimates within which fair value is highly likely to lie; and

d) On disposal of investment property not carried at fair value, the fact that the entity has disposed of investment property not carried at fair value, the carrying amount of that investment property at the time of sale, and the amount of gain or loss recognised.

Question 12: Are entities required to disclose "completed investment properties" and "investment properties under construction" as two separate line items on the face of the statement of financial position?

Response:

Paragraph 54 of HKAS 1 requires an entity, as a minimum, to disclose investment properties as a single line item on the face of the statement of financial position. HKAS 1 does not specifically requires "completed investment properties" and "investment properties under construction" to be disclosed as two separate line items on the face of the statement of financial position. However, paragraph 55 of HKAS 1 states that additional line items should be disclosed when such presentation is relevant to the understanding of the entity's financial position.

We believe that it is useful to disclose information about "completed investment properties" and "investment properties under construction" separately. Such disclosures can be made in the notes to the financial statements.

Appendix

Summary of the Exposure Draft on Proposed Guidance Note - The Valuation of Investment Property under Construction in relation to how to determine the fair value of investment properties under construction issued by the IVSC

In August 2009, the IVSC published an exposure draft relating to how to determine the fair value of investment properties under construction. Major proposals are set out below:

Valuation approach

The Exposure Draft states that, since directly comparable sales evidence is unlikely to be found for investment property under construction, the value has to be estimated using one or more alternative market-based approaches. The Exposure Draft does not stipulate a particular approach. Instead, it suggests that some approaches may be appropriate including:

- Sales evidence of similar properties in different locations or in different conditions with adjustments made to account for such differences;
- Sales evidence of comparable properties transacted in different economic conditions with adjustments made to account for such differences;
- Discounted cash flow projections supported by comparable market data on construction costs, lease terms, operating costs, growth, assumptions, discount rates and other key inputs.

The Exposure Draft states that it is inappropriate to estimate the market value of a partially completed investment property solely by reference to the project plan or feasibility study produced at the commencement of the project. In addition, the market value of a partially completed investment property will reflect the expectations of market participants of the value of the property when complete, less deductions for the costs required to complete the project and an appropriate adjustment for risk. Moreover, where the time value of money is likely to be significant, it would be appropriate to use a valuation method that reflects the probable timing of those cash flows.

Valuation inputs

The Exposure Draft states that the inputs below will normally be required in order to reliably estimate the fair value of an investment property under construction.

- Completed building: This may be either the value on the assumption that the project had been already completed on the date of valuation or the prospective value on the date completion is anticipated. The more appropriate of these alternatives will be the one prevailing in the market for the class of property on the valuation date.

- Leasing: If lessees for the property after completion have still to be identified, allowance will need to be taken of the time and costs (inclusive of incentives and fees) that it would be realistic to allow for the maximum potential income or capital to be generated from the project in current market conditions. If there are leasing agreements in place that are conditional on the project, or a relevant part, being completed, these should normally be reflected.
- Construction costs: The benefit of any work carried out prior to the valuation date will be reflected in the current value, but will not determine that value. Consequently, previous payments under the actual building contract prior to the valuation date are not relevant to current value.
- Finance costs and risk: Valuation should consider the need to reflect finance costs and the return that a buyer of the property under construction would require. In addition, all significant risk should be identified and evaluated. Typical risks associated with any partially completed construction project will include variations in construction costs, finance costs and the construction programme. Additional risks associated with investment property under construction include fluctuations in the value of the completed project between inception and completion, and the time that will be required to secure lessees and a stablilised income.
- Investor's return: Allowance should be made for the return that would be required by a buyer of the partially completed investment project in the market place. This should reflect the risks associated with the completion of the construction programme and in achieving the anticipated income or capital appreciation on the date of valuation.

Reporting

The Exposure Draft proposes that the valuation report should:

- state clearly in a heading that the project is under construction;
- include a description of the project, the stage of development reached;
- the valuation methods used;
- the key inputs to the valuation; and
- the assumptions made in determining those inputs.

In particular, the Exposure Draft proposes that the valuation report should identify and if possible, quantify the remaining risks and costs associated with the project and how these have been reflected in the valuation. In quantifying such risks, distinction should be made between risks in respect of generating rental income and construction risks.

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