香港地產建設商會
THE REAL ESTATE DEVELOPERS ASSOCIATION OF HONG KONG
香港中環德輔道中十九號環球大廈1403室
Room 1403, World-Wide House, 19 Des Voeux Road Central, Hong Kong.
Tel: 2826 0111 Fax: 2845 2521

30 August 2002

Mr. Alvin Wong,
President,
Hong Kong Society of Accountants,
4th Floor, Tower Two, Lippo Centre,
89 Queensway,
Hong Kong.

Dear Mr. Wong,

Proposed Revision of SSAP 13

Introduction

1. We understand that the Hong Kong Society of Accountants (HKSA) is planning to issue in the near future an exposure draft proposing a wholesale revision to Hong Kong Statement of Standard Accounting Practice 13 (SSAP 13) covering accounting for investment properties, which will incorporate the provisions of International Accounting Standard 40 (IAS 40).

2. The HKSA is taking this step in pursuit of its stated strategy of achieving convergence for Hong Kong SSAPs with the International Accounting Standards (IAS) promulgated by the International Accounting Standards Board (IASB). This sensible objective is designed to allow international consistency of presentation (and therefore comparability) of accounts – the European Council of Ministers having recently approved a Regulation to make IAS compulsory for financial years beginning on or after 1st January 2005 for all listed companies in Europe.

3. We understand that the proposed revision to SSAP 13 will incorporate certain changes to IAS 17 and IAS 40 on which the IASB is currently seeking views. This will eliminate one very serious flaw which could have arisen on the earlier adoption of IAS 40 in Hong Kong – namely, that it would not have been possible to account for land held on long leaseholds as investment property. This is a very welcome development.

4. However, there remains a major problem with IAS 40, and the adoption of a revised SSAP 13 in Hong Kong would have very serious implications for the local financial market. We consider the prospect alarming.

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Impact on Hong Kong Property Companies

5. In summary, the problem is that IAS 40 requires investment properties to be carried at valuation with gains or losses on changes in fair value to be included in the income statement (the "fair value model"), or alternatively, to be re-stated at depreciated cost (the "cost model").

6. Our major concern is the requirement to deal with gains and losses on changes in the fair value of investment properties in the income statement. If this were adopted, the profit and loss account of a property company would no longer reflect actual results from rental operations. Results would also include the opinion of professional valuers. This can be illustrated by the following example:

	Value of Property $M	Return on Property	Rental Income $M	
Year 1	25,000	7%	1,750	
Year 2	27,500	7%	1,925	
Increase in property value	2,500			
Profit for Year 2 excluding property valuation increase			1,925	10% increase over Year 1
Profit for Year 2 including property valuation increase			4,425	152% increase over Year 1

7. Based on Year 1 rental income, the return on investment property is 7%. If rental income grows by 10% in Year 2, the value of the property would also increase by 10% assuming capitalization of the same return. The total declared profit, however, will increase by 152% if the property revaluation gain is included in the profit and loss of the company. For every increase in rental income of $1 million, the total "profit" would increase by $14 million. This is, of course, a nonsense. There must be a clear distinction between normal operating profits and valuation adjustments.

8. The recognition of unrealized gains and losses in the income statement would significantly increase the volatility of operating results and therefore distort the reporting entity's operating performance. The inclusion of unrealized revaluation gains in the income statement could also give an incorrect impression to investors that those unrealized gains are available for dividend distribution. Dividend payout ratios would be significantly distorted if unrealized gains or losses from the valuation of investment properties are included in net profit but excluded for the purpose of dividend distribution. Other financial ratios, such as earnings per share, would also be seriously distorted. The following example, from the published accounts of one of our member companies, illustrates the point:

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Year	Net profit* $M	Annual revaluation surplus/ (deficit)* $M	Adjusted net profit** $M	% change in net profit	Dividend payout before reval. gain/loss*	Dividend payout after reval. gain/loss
1992	916	4,385	5,301	83%	68%	12%
1993	1,213	3,470	4,683	74%	67%	17%
1994	1,504	5,645	7,149	79%	62%	13%
1995	1,548	(1,612)	(64)	>-100%	64%	>-100%
1996	1,580	292	1,872	16%	69%	58%
1997	2,490	3,887	6,377	61%	51%	20%
1998	2,653	(9,139)	(6,486)	>-100%	52%	-21%
1999	1,896	(4,204)	(2,128)	>-100%	51%	-45%
2000	1,218	1,095	2,313	47%	86%	45%
2001	1,384	(545)	839	-65%	84%	>100%

* Figures sourced from annual reports of Hang Lung Properties Limited
** Adjusted to include annual revaluation surplus or deficit

9. The above table demonstrates over a ten-year period that the net profit attributable to shareholders and the dividend payout ratio would be seriously distorted if unrealized gains and losses on the valuation of investment properties are included in the income statement. A track record of "adjusted net profit" presents an extremely confusing and unwarranted picture to the reader of these accounts.

The Conceptual Problem

10. The root cause of the problem appears to lie with the IASB's active project to introduce a more comprehensive system of performance reporting, and as a result the HKSA's strategy of convergence with IAS has led it to the point where it is apparently proposing to introduce an accounting practice for investment properties to which it was, in late 1999, implacably opposed. When IAS 40 was issued as a draft (E64) the HKSA responded to the IASC in a letter dated 19th October 1999 to the specific question: "Do you agree that changes in the fair value of investment property should be recognised in net profit or loss for the period?" as follows:

> "No we do not agree...............Recognising changes in the fair value of investment properties in net profit or loss may lead to large fluctuations in profit or loss in situations where the property market is volatile......... This treatment will confuse the reader, may not be meaningful and is unlikely to present a true and fair view. It is also inconsistent with IAS 16 and IAS 39..................We note that the G4+1 is working on a project on performance reporting which involves the preparation of a comprehensive statement reflecting the performance of an enterprise. We believe that it would be premature to require the reporting of the change in fair value of an investment property in income until there are resolutions of various substantial issues about performance reporting."

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11. Given the HKSA's view in 1999, it seems almost inconceivable that the HKSA should now be proposing to revise SSAP 13 in accordance with IAS 40. A review of other responses to E64 (and specifically of the answers to the question quoted in the above paragraph) from national accounting bodies, standards setting bodies, financial analyst groups, accounting firms, industry groups and individual companies shows consistent support for the HKSA's views.

12. A common theme of E64 respondents in 1999 was that fair value accounting for investment properties could not be treated in isolation from a more comprehensive solution to total performance reporting. In essence, whilst it was accepted conceptually that rental income and capital appreciation are measurable elements of management performance, mixing these two elements in a profit and loss account/income statement would be misleading. The G4+1 report referenced in the HKSA letter formed the basis of discussion for this issue, and since 1999 performance reporting remains an active project of the IASB that has not yet been resolved. Respondents to E64 raising these specific points included (in addition to the HKSA):

The Institute of Chartered Accountants in England and Wales (UK)
- The Chartered Institute of Management Accountants (UK)
- Japanese Institute of Certified Public Accountants (Japan)
- Association for Investment Management and Research (USA)
- International Organization of Securities Commissions
- Deloitte Touche Tohmatsu
- Ernst & Young
- KPMG
- Pricewaterhouse Coopers
- National Association of Real Estate Investment Trusts (USA)
- British Property Federation (UK)

13. In short, there was a considerable body of opinion in 1999, including all the Big Four accounting firms and IOSCO, that either did not consider it appropriate to recognise changes in fair value in net profit or loss or forecast confusion/difficulty as a result of doing so.

Other Problems with IAS 40

14. There are further issues in IAS 40 with which we disagree. We do not accept, for example, that owner-operated hotels and service apartments may not be treated as investment properties. We see no conceptual reason for treating owner-operated hotels differently from those operated by third parties. We also consider there is a conceptual inconsistency between IAS 40 and IAS 39 on financial instruments, whereby the change in fair value of non-trading financial assets is to be recognised as a component of equity and is available to be passed through the profit and loss account when actually sold.

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Recommendation

15. Our over-riding concern is the undoubted confusion and uncertainty that would be created by the prospect of IAS 40 principles being adopted in Hong Kong at this time. The topic of financial performance reporting is in a transitional phase, and an expanded statement of comprehensive income could combine gains and losses of varying types which could be classified appropriately and widely understood. However, we are not yet at that point, and issuing an exposure draft to revise SSAP 13 whilst we are in transition will be confusing and unnecessary.

16. In our view, the HKSA should defer the release of the exposure draft for SSAP 13 until such time as there has been a resolution within the international accounting community of the issue of performance reporting.

17. We would welcome the opportunity to discuss this issue should you think it helpful.

Yours sincerely,

Louis Loong
Secretary General