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LKAS 40 : Investment Property

Practice Questions

Chartered Accountancy
Corporate Level

Financial Reporting and Governance (FRG)

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LKAS 40

Practice Questions

Example - ACCA question

Blackcutt wishes to create a credible investment property portfolio with a view to determining if any property may be considered surplus to the functional objectives and requirements of the local government organisation. The following portfolio of property is owned by Blackcutt.

Blackcutt owns several plots of land. Some of the land is owned by Blackcutt for capital appreciation and this may be sold at any time in the future. Other plots of land have no current purpose as Blackcutt has not determined whether it will use the land to provide services such as those provided by national parks or for short-term sale in the ordinary course of operations.

The local government organisation supplements its income by buying and selling property. The housing department regularly sells part of its housing inventory in the ordinary course of its operations as a result of changing demographics. Part of the inventory, which is not held for sale, is to provide housing to low-income employees at below market rental. The rent paid by employees covers the cost of maintenance of the property.

Thus, the land that is owned by Blackcutt for capital appreciation which may be sold at any time in the future and the land that has no current purpose are both considered to be investment property under IAS 40. If the land has no current purpose, it is considered to be held for capital appreciation.

Blackcutt supplements its income by buying and selling property, and the housing department regularly sells part of its housing inventory. As these sales are in the ordinary course of its operations and are routinely occurring, then the housing stock held for sale will be classified as inventory.

The part of the inventory held to provide housing to low-income employees at below market rental will not be treated as investment property as the property is not held for capital appreciation and the income just covers the cost of maintaining the properties and thus is not for profit. The property is held to provide housing services rather than rentals. The rental revenue is incidental to the purposes for which the property is held. This property will be accounted for under IAS 16 Property, Plant and Equipment. The property is treated as owner occupied as set out above.

ACCA December 2016

Evolve operates in a jurisdiction with a specific tax regime for listed real estate companies. Upon adoption of this tax regime, the entity has to pay a single tax payment based on the unrealised gains of its investment properties. Evolve purchased Monk whose only asset was an investment property for $10 million. The purchase price of Monk was below the market value of the investment property, which was $14 million, and Evolve chose to account for the investment property under the cost model. However, Evolve considered that the transaction constituted a 'bargain purchase' under IFRS 3 Business Combinations. As a result, Evolve accounted for the potential gain of $4 million in profit or loss and increased the 'cost' of the investment property to $14 million. At the same time, Evolve opted for the specific tax regime for the newly acquired investment property and agreed to pay the corresponding tax of $1 million. Evolve considered that the tax payment qualifies as an expenditure necessary to bring the property to the condition necessary for its operations, and therefore was directly attributable to the acquisition of the property. Hence, the tax payment was capitalised and the value of the investment property was stated at $15 million.

Required:

Advise Evolve on how the above transaction should be correctly dealt with in its financial statements with reference to relevant International Financial Reporting Standards. (6 marks)

ACCA June 2017

On 1 March 2014, Canto acquired a property for $15 million, which was used as an office building. Canto measured the property on the cost basis in property, plant and equipment. The useful life of the building was estimated at 30 years from 1 March 2014 with no residual value. Depreciation is charged on the straight-line basis over its useful life. At acquisition, the value of the land content of the property was thought to be immaterial.

During the financial year to 28 February 2017, the planning authorities approved the land to build industrial units and retail outlets on the site. During 2017, Canto ceased using the property as an office and converted the property to an industrial unit. Canto also built retail units on the land during the year to 28 February 2017.

At 28 February 2017, Canto wishes to transfer the property at fair value to investment property at $20 million. This valuation was based upon other similar properties owned by Canto. However, if the whole site were sold including the retail outlets, it is estimated that the value of the industrial units would be $25 million because of synergies and complementary cash flows.

The directors of Canto wish to know whether the fair valuation of the investment property is in line with International Financial Reporting Standards and how to account for the change in use of the property in the financial statements at 28 February 2017. (8 marks)

June 2017 CFR Q2 (a)

Multi Land Finance PLC (MLF) is a leasing company registered under the Central Bank of Sri Lanka. On 01 April 2016 one of the debtors of MLF transferred a block of land to the company, in order to offset its debt. The land is situated in Rajagiriya, an area in Colombo where apartment complexes are booming. On 01 June 2016 MLF decides to venture into the real estate industry by developing a luxury apartment complex within a three year time. The project is expected to be funded by bank borrowing. The proposed project structure is as follows: • First 2 floors: Corporate office of MLF • Balance 10 floors: Apartments • Rooftop The management is considering selling 50% of the apartments to third parties, and retaining the balance for rental purposes.

Required:

Advise the finance manager of MLF on the following:

(i) How the land will be accounted for at initial recognition as at 01 April 2016. (2 marks)

(ii) How the first 2 floors of the apartment complex will be classified and initially measured, upon completion. (3 marks)

(iii) How the floors that are identified to be rented will be classified and initially measured, upon completion. (3 marks)

(iv) How the borrowing cost on the project loan will be accounted for during the loan tenure. (4 marks)

December 2015 Q7

Delicious Foods (Pvt) Limited (DFPL) operates a chain of restaurants in main cities of the country. In addition, the company owns two medium-sized hotels in Kandy and Dambulla. DFPL serves food of different cuisines in its restaurants. The two hotels are built on land leased by the government to the entity for a period of 99 years with no transfer of titles to the company at the end of the leases. Some restaurants are built on DFPL's own land and certain other restaurants are operated on leased premises. The financial statements of DFPL for the year ended 31 March 2015 are yet to be finalized and the management seeks your assistance on the following areas:

(i) The management of DFPL leased out its hotel situated in Dambulla under an operating lease to a hotel management group with effect from 1 January 2015 as the company had not been able to effectively manage the business operations of this hotel. The hotel building's useful life is expected to be approximately 30 years. There are no provisions in the lease to return the land with the building intact at the end of the 99 year lease with the government. On 15 January 2015 DFPL purchased a new plot of land in Negombo. However, the management has not yet decided the future intended use of this land and it remains vacant as of 27 March 2015. The board of directors is of the view that the land and building of the Dambulla hotel and the land in Negombo should be classified as investment properties in DFPL's financial statements.

(a) Analyse the view of the board of directors on the classification of investment properties stated in (i) above. (6 marks)