The Choice and Reason Analysis of Measurement Model of Investment Real Estate in China

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Keywords: Investment Real Estate, Cost Measurement, Fair Value Measurement.

Abstract. Pursuant to the provisions in Accounting Standard for Business Enterprises No. 3 - Investment Property (CAS3) issued on February 27, 2006 by the Ministry of Finance, China’s investment real estate follow-up measurement method can choose the cost model or the fair value model. But after investigation we found that, currently, only less than 5% of the enterprises with investment real estate projects in Shanghai and Shenzhen used a fair value model in the follow-up measurement. Therefore, in view of this phenomenon, this paper analyzes the factors influencing the fair value measurement model of investment real estate.

1. Introduction

In February 27, 2006, the Ministry of Finance has clearly defined the measurement model of investment real estate in the release of CAS3: the enterprise shall use the cost model to carry on the follow-up measurement to the investment real estate on the balance sheet date. But there is conclusive evidence that the fair value of investment real estate can be sustained and reliable obtained, and can use fair value model of investment real estate for follow-up measurement. When choosing the enterprises who adopt the fair value measurement, two conditions should be satisfied: first, there is an active real estate market in the investment real estate location; second, enterprises can obtain the market price of similar or similar real estate and other relevant information from the real estate market, so as to make a reasonable estimate of investment real estate.

In 2014, the Ministry of Finance officially modified the accounting standards in the original, added new accounting standards for business enterprises and explained it. At the same time, the relevant content of fair value in the “Enterprise Accounting Standards - Basic Standards” has been modified. From July 1, the new standard has been fully implemented in the implementation of corporate accounting standards within the enterprise. The publication of this standard means that the market economy of our country is becoming more and more international, which makes our country’s economic move towards a globalized development path.

2. Comparison of Cost Model and Fair Value Model

As shown in the specific accounting, the accounting entries of investment real estate in the initial measurement are the same, and both are initially recorded at cost. The difference is in the follow-up measurement. In cost model, enterprises need to accrue depreciation or amortization of the measured investment in real estate. At the end of the period, if it is found that there are signs of impairment, the provision for impairment should be made. If the appreciation or hedge occurs, it does not need to treat. If the enterprise has already made provision for the impairment of the asset, even if the appreciation or hedge occurs, the enterprise cannot charge against the impairment provision provisioned for the previous year [1]. When the enterprise uses the fair value model to measure the assets it owns, the enterprise only needs to record the fair value changes occurred at the end of each year in the fair value change.

Thus, when the enterprise uses cost model to measure its own investment real estate, as a result of the need for depreciation and amortization, the value of the enterprise assets will decline. On the
current status of China’s real estate, real estate often does not have depreciation but appreciation. Therefore, the use of cost models cannot truly reflect the true value of the investment real estate. While if the enterprise uses the letter model to measure, it can achieve a convergence with the international, which makes the enterprise’s own assets accounting more accurate. It is obvious that the adoption of fair value model for investment real estate follow-up measurement is more reasonable.

3. The Current Appliance of Cost Model and Fair Value Model

Seeing from the CSMAR financial statements database, among the six years from 2007 to 2012, the number of quoted companies who held investment real estate and used the fair value measurement model was less than 5%. The specific numbers are shown in Table 1.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of listed companies holding real estate</th>
<th>Number of listed companies using fair value measurement model</th>
<th>Number of listed companies using cost measurement model</th>
<th>The proportion of fair value measurement model</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>626</td>
<td>14</td>
<td>612</td>
<td>2.24%</td>
</tr>
<tr>
<td>2008</td>
<td>690</td>
<td>20</td>
<td>668</td>
<td>2.90%</td>
</tr>
<tr>
<td>2009</td>
<td>727</td>
<td>26</td>
<td>701</td>
<td>3.58%</td>
</tr>
<tr>
<td>2010</td>
<td>833</td>
<td>27</td>
<td>806</td>
<td>3.24%</td>
</tr>
<tr>
<td>2011</td>
<td>899</td>
<td>29</td>
<td>870</td>
<td>3.22%</td>
</tr>
<tr>
<td>2012</td>
<td>1042</td>
<td>43</td>
<td>999</td>
<td>4.13%</td>
</tr>
</tbody>
</table>

As can be seen from Table 1, since the new accounting standards implemented in 2007, the number of enterprises who used the fair value model of investment in real estate follow-up measurement in the real estate industry did not have significant growth, the proportion of listed companies who held investment real estate was also maintained at between 2% - 4%. It can be seen that although the “Enterprise Accounting Standards No. 3 - investment real estate” provided that the enterprise can use the fair value model to carry on the follow-up measurement to the investment real estate, but in practice, the use of fair value model measurement was not deep.

As can be seen from the industry distribution, 29 listed companies who invested real estate used fair value measurement model in 2011, the industry distribution was mainly concentrated in the real estate development and management industry, banking, retail, beverage manufacturing. While the real estate development and management industry and the banking industry accounted for the largest share, for 18.52% in average. However, many well-known real estate enterprises in China (such as Vanke Group) still use the cost model for investment real estate follow-up measurement.

There is a big difference between the present situation and our fair value measurement model analysis. Compared with the cost model, fair measurement is highly regarded because it can improve the quality of accounting information, and it has been analyzed previously, in that case the overall trend in real estate prices rose, the fair value measurement would significantly increase its book value and increase current profit. The fair value measurement should be put in an important position both in practitioners and the theorists. Based on this, we cannot help but think, what are the main factors to be taken into consideration when the management of the company chooses the investment real estate measurement model? What affects the widespread application of the fair value measurement model?
4. Analysis on the Factors Influencing the Choice of Measurement Model of Investment Real Estate

4.1 The cost of information disclosure of listed companies

In the “Accounting standards for business enterprises - basic standards” promulgated by China’s Ministry of Finance on February 2006, the definition of fair value measurement attribute has been added in the measurement attribute: in the fair value measurement, assets and liabilities are traded on an arm’s length basis. The amount of money exchanged between the two parties who are familiar with the situation, voluntarily engaged in the exchange of assets or liabilities.

On January 26, 2014, in order to meet the needs of the development of socialist market economy, and to promote China’s accounting standards and further convergence of international accounting standards, standardize the measurement and disclosure of fair value, improve the quality of accounting information, according to “Accounting Standards for Business Enterprises - Basic Standards”, the Ministry of Finance formulated the “Accounting Standards for Enterprises No.39 - Fair Value Measurement” (CAS39), which has been implemented within the scope of all enterprises that implement the accounting standards for business enterprises since July 1, 2014, and encouraged enterprises listed in the overseas to performance this ahead of schedule.

Whether it is the definition of fair value in the “Accounting Standard for Business Enterprises - Basic Standard” in 2006, or the definition of fair value in CAS39, enterprises usually use three ways in the actual operation: the first is to hire a specialized assessment agencies to assess; the second is to determine the price by referring similar real estate transaction price; the third is to determine according to the real estate survey report punished by government agencies. While 50% of the enterprises who used the fair value measurement model in 2011 have hired a special assessment agencies to assess. Thus, the determination of the fair value needs the listed companies to pay a not small evaluation fee or information collection fee. While by using cost measurement model, it almost has no additional disclosure costs.

4.2 The attitude of the management of the company

The fair value measurement model is affected by the real estate market cycle, which may bring greater fluctuations in corporate profits. Specifically, when the real estate market condition is good, the use of fair value model measurement will make the assets and profits increase at the same time; in contract, when the real estate market condition is weak, the use of fair value model measurement will affect the fair value gains and losses, the asset’s book value and profit will decrease at the same time, the aesthetics of the financial statements will be affected, which causes investors to sell stocks.

Although the overall price of China’s real estate market is in a steady upward trend, but from the year 2005 to 2013, “regulation”, “curb housing prices” and other words were mentioned in the prime minister’s government work report each year [3]. But it does not mean that the government no longer control, but no longer blindly using administrative means to curb excessive growth in housing prices. More flexible market means are incorporated into it, like curbing investment speculative demand in hotspot cities, etc.

Based on this, once it is affected by the government’s macro-control policies, the house prices will fell sharply and the corporate profits will inevitably have a lot of volatility, thus affecting the company’s performance, executive compensation awards and stock market performance. Therefore, for their own interests, the managements often do not want to have a greater volatility in profits. The greater volatility will give investors a feeling that the company management is unstable, so that they may question the management ability of management [4]. Therefore, the managements hold a reservation of fair value measurement model, cautiously measure investment real estate by using cost model.

4.3 Special purpose requirements

Mainly including financing needs and earnings management needs:

As housing prices continued to rise in recent years, after using the fair value model to measure,
the capital structure of listed companies will improve in the short term, so that the financing capacity of listed companies improves. For example, in 2010, BBMG converted the cost model to fair value model of the follow-up measurement of investment real estates, the proportion of short-term borrowing to total assets increased from 3.54% to 11.54% at that year. Thus it can be seen, when companies have external financing needs, it will lead to follow-up measurement of investment real estate model changes.

The typical model of modern corporate governance is that ownership separates from management. Managers can directly control the operation and management of enterprises; and because the owner does not participate in the operation of enterprises, the corporate information obtained by them is not as directly and comprehensive as the manager.

5. Summary

Through the analysis of the application status of two subsequent measurement models of investment real estate in China and the factors influencing the choice of the two models, the following conclusions can be drawn:

(1) The number of enterprises who held investment real estate and used the fair value model in the follow-up measurement was less than 5%, but the number is on the rise.

(2) The choice of measurement model of investment real estate enterprises is mainly affected by factors such as disclosure cost, management attitude, corporate financing demand and earnings management demand.

References


