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Dear Steve,

IASB Exposure Draft on Revenue from Contracts with Customers ("Exposure Draft")

I refer to your letter dated 23 July 2010 on the above Exposure Draft to our Mr. Mark Dickens which has been passed to me for my attention.

We have completed our review of the Exposure Draft and our views are set out in the paragraphs below.

General

The Exposure Draft proposes a single revenue recognition model that can be applied consistently regardless of industry so as to improve the comparability of revenue for users of financial statements. The Exposure Draft also aims at providing clearer guidance which the current IAS 11 *Construction Contracts* and IAS 18 *Revenue* lack and to eliminate the extensive industry-specific standards under US GAAP. The proposed standard would replace IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IFRIC 13 *Customer Loyalty Programmes*, IFRIC 15 *Agreements for the Construction of Real Estate*, IFRIC 18 *Transfers of Assets from Customers* and SIC 31 *Revenue – Barter Transactions Involving Advertising Services*.

Although we agree with the intended objective of the Exposure Draft, we have concerns that there appears to have been insufficient debate on the meaning of "revenue" and what it should represent. We believe that meaning of "revenue" is a high level conceptual issue which should have been included on the work programme of the Conceptual Framework working group. A discussion and determination of "revenue" in isolation from other conceptual issues would be incomplete. We believe the subject matter of

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revenue recognition requires a full discussion of the other related fundamental concepts of what is, and when should an “asset” or a “liability” be recognised as revenue often represents the other side of the same coin. We note that on page 38 of the Exposure Draft “revenue” is defined as *“income arising in the course of an entity’s ordinary activities”*. “Income” is further defined as *“Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants”*.

We observe that the meaning of “income” is different from the meaning used in the existing Conceptual Framework. In particular, we note that under the current Conceptual Framework “income” encompasses both “revenues” and “gains”. However, under the proposals this distinction is lost. The new meaning of “income” (which we also believe should be dealt with at the Conceptual Framework level) would encompass all increases in economic benefits and not only those that relate to “activities” or “recurring transactions” which we believe is what revenue should portray.

The Exposure Draft proposes a complex revenue recognition model. We believe the proposed model would not assist layman users of the financial statements in better understanding what “revenue” represents and whether the amount disclosed provides more decision-useful information.

Before finalising the Exposure Draft, we would suggest that the IASB should first clearly describe what “revenue” should represent and only then proceed to consider how to measure it. We believe that revenue should portray the “activity” of an entity which should normally represent the billings for the goods or services delivered by a seller, the payment for which have been agreed by its customers.

“Control” of goods and services and a suggested alternative approach

Under the proposals the concept of “control” is key in determining revenue recognition. Paragraph 25 of the Exposure Draft proposes that an entity should recognise revenue when it satisfies a performance obligation by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains “control” of the good or service. Paragraph 26 continues to explain that a customer obtains “control” of a good or service when the customer has the ability to direct the use of and receive the benefit from the good or service. Control also includes the ability to prevent other entities from directing the use of, and receiving the benefit from, the good or service.

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We do not support the proposed model for revenue recognition which is premised on an assessment of control. First, we believe that digressing and considering “control” over-complicates the approach to revenue recognition and the assessment of control will be difficult to apply in practice. We believe that the meaning of “control” should be developed under the Conceptual Framework instead of at a standard level to ensure consistency in the use of the term across all accounting standards. We note that the meaning of “control” in the Exposure Draft differs from that used elsewhere such as that used under IAS 27 – *Consolidated and separate financial statements*. Paragraph 30 the Exposure Draft provides some “indicators” on determining whether a customer has obtained “control”. However, the “indicators” are all from the customers’ perspective. We believe that determining whether and when control is transferred will be more problematic in respect of businesses that provide services and where there is a continuous transfer of goods and services.

Second, we believe that the issue of revenue recognition is in substance a fundamental issue concerning when and how a “completed and agreed transaction” (as distinct from “commitments or future obligations” which we believe should be dealt with by disclosure) should be recognised.

We believe an alternative simpler approach to revenue recognition is to look at whether there has been a “completed and agreed transaction”. Under this approach there is no need to look at “control” but only to examine the facts to see whether there has been an agreed and completed exchange. We believe that an exchange and therefore revenue should be recognised once there has been a “completed and agreed transaction”, that is, when a good or service ordered by the buyer has been delivered by the supplier to the satisfaction of the buyer. In a completed transaction, the buyer has agreed to accept the good or service and acknowledges that the consideration for the good or service is immediately due and payable. From the point of view of the supplier, it has completed his obligations when it has delivered a product or service in the required condition and specified place in accordance with the contract agreement. From the point of view of the buyer, the transaction is completed if it acknowledges that a “present obligation” to pay has been created, that is, it accepts that it has incurred a “liability”.

We believe that “agreement” of completion of a transaction by both the buyer and seller is an essential precondition for the creation of an asset (i.e. cash or a receivable) and therefore the related revenue from the seller’s perspective, and the creation of a liability to pay for the good or service from the buyer’s perspective.

Although the Exposure Draft discusses performance obligations, it focuses on those performed by the seller. We believe that performance obligations to be performed by both parties should be considered. To illustrate, the goods ordered need to be produced by the seller who needs to manufacture or acquire them and then safely deliver the goods to the buyer. From the buyer’s perspective, he also has obligations such as checking that

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the goods delivered are those specified in his order, and if not, they are rejected with reasons and returned to the seller. No assets or liabilities are created and there should be no related revenue recognition until there has been an “agreed” exchange.

In summary, we believe that a simpler approach to revenue recognition is to examine the facts to identify whether the two contracting parties have agreed (explicitly or implicitly) that the good or service has been delivered and an obligation to pay has crystallised. The agreement that an exchange has been completed can be determined from the terms of the contract and the actions taken by both the seller and buyer. This approach would expand the existing guidance in IAS 18 Revenue which, in respect of exchange of goods, looks at whether there has been an exchange and the transfer of the risks and rewards of ownership (and not necessarily legal ownership). We believe that the transfer of the “risks and rewards of ownership” are clearer in recognising the completion of an exchange.

We believe that this simple and more easily understandable approach would also faithfully record the activities of entities with long term contracts that extend beyond one financial year which is the subject of IAS 11 – *Construction contracts*. Under the “agreed exchange model”, revenue would be recognised as the work “progresses” on a long term contract which involves progress payments. In substance the long term contract represents a contract comprising a series of “transactions” that are agreed to be completed during the life of the contract. We believe the progress billings “agreed” by the customer for the percentage of total work to be completed under the contract should be recognised as revenue. Any accumulated cost of work-in-progress that relate to the amount billed would be expensed. This would recognise the economic substance of the “activities” of entity through the series of transactions that have been carried out in relation to the contract.

We note that this model would not be significantly different from that adopted in the Exposure Draft which focuses on “contracts” and “performance obligations” but will be simpler to implement in practice as it does not require assessment of “control” over the good or service. We believe that whether a performance obligation is satisfied should be considered from both the seller’s and customer’s perspectives. A “completed exchange” requires both the delivery of the product or service and the acceptance of a crystallised obligation to pay by the buyer, but not necessarily a transfer of control of the good or service to the buyer.

A discussion of “customer acceptance” of goods and services is included in paragraphs B69 to B73 of the Exposure Draft and we believe that this is a consideration which should be included as a key principle in the main text of the standard.

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Continuous transfer of goods and services

The Exposure Draft proposes that when goods or services are transferred to a customer continuously, an entity should apply a revenue recognition method that best depicts the transfer of goods or services. The following three methods are allowed by the Exposure Draft:-

- (a) output methods that recognise revenue on the basis of units produced, units delivered, contract milestones, or surveys of work performed;
- (b) input methods that recognise revenue on the basis of costs incurred, labour hours expended, or machine hours used; and
- (c) methods based on the passage of time.

Paragraphs B63 to B68 tries to explain how to determine whether a good or service is transferred to a customer continuously. We believe that the application guidance is unclear as to the principle to be applied and appears to be rule-based. It also focuses on the viewpoint from the seller's perspective. We believe the alternative "completed and agreed transaction" model mentioned above which requires considering the facts and the perspectives of both the seller and buyer would be a simpler principle and solution.

Reflecting customer's credit risk in the transaction price

The Exposure Draft proposes that in determining the transaction price, an entity should reduce the amount of promised consideration to reflect the customer's credit risk (paragraph 43 of the Exposure Draft). We do not support this proposal as it raises the issue of what "revenue" is supposed to measure. We are also concerned that this would make "revenue" subjective and volatile, and users of financial statements will find it more difficult to predict the entity's level of "activity".

We believe that revenue should be a measure of an entity's "activity" and should be recognised independently of credit risk which should be recognised separately. We consider that recognising credit risk on "receivables" subsequent to recognising the transaction is more appropriate. Nevertheless, we agree that no revenue should be recognised on a failed sale and where a contract as a whole is expected to result in a loss, a provision for impairment should be made immediately.

Warranties

The Exposure Draft identifies two types of warranty, a warranty that provides coverage of latent defects and a warranty that covers faults that arise after the product is transferred.

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It is proposed that a warranty that provides coverage of latent defects is not a separate performance obligation but the entity might estimate the amount of unsatisfied performance obligations based on the likelihood and extent of latent defects. Revenue should be deferred for latent defects that are expected to be repaired.

It is also proposed that a warranty that covers faults that arise after the product is transferred gives rise to a separate performance obligation, and a portion of the transaction price should be allocated to it and revenue attributable to that portion is to be deferred. The percentage used to defer revenue is also to be applied to defer cost of sales.

We do not agree with the proposals as we believe that they are unduly complex and the costs will exceed the benefits. The distinction made between latent defects and defects arising after the product is transferred assumes that a seller can identify the cause of defects as being latent or otherwise at the point of sale. Moreover, revenue related to both defects are proposed to be deferred so the distinction made does not alter the treatment.

We envisage practical difficulties on how it will be applied in practice. For example, in a simple scenario there are three sales of an identical product of HK\$1,000 each to Party A, B and C. It is assumed that there will be no bad debts and the company would therefore receive the full HK\$3,000 related to the sales. If it is estimated that one third of the sales have latent or after sale defects that will be claimed for repair within 3 years of the sale and revenue of HK\$1,000 is deferred, to which customer would this be attributable to and when should the revenue be released? Should it be released equally over three years or only released when a claim, if any, is made? The Exposure Draft does not adequately explain how or when such warranty services should be regarded as “having been transferred” to the customer and therefore when and how deferred income can be released and recognised as revenue during the period of the warranty.

We also consider that recognising deferred “warranty income” and “deferred cost of sales” based on the percentage of deferred revenue is counter-intuitive. The deferred cost of sales may not represent the full cost of future repairs.

The IASB may wish to consider the following two possible alternative views concerning warranties:-

- (a) Rather than looking at warranties from the point of view of revenue recognition and the need to defer a portion of the agreed transaction price, warranty service could be viewed as expenditures that should have been incurred in producing the product and therefore warranty costs represent an understatement of the cost of goods or services sold. Warranty defects in substance represent defects in production and quality control in producing the product. Under this view, accruals or provisions for repair costs should be made in the year of sale. From the point of view of cash inflows, as illustrated in the example above, the

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revenue from the billings of HK\$3,000 will have been received by the company but expenditures or cash outflows will need to be incurred in repairing the defective product.

- (b) Another possible alternative view on warranties is that they are in substance costs to support the brand name or the reputation of the company. Under this view the costs of maintaining the brand should normally be expensed when incurred. This would not preclude an entity from making provisions for “commitments and future obligations” to make repairs in the event a valid claim is made in the future. At the time of the sale, the seller believed that the product was in the appropriate working condition and was expected to provide useful service for a number of years. Similarly, the buyer was of the same view and was willing to pay the relevant consideration for the good or service.

We hope that the above comments are useful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited



Colin Chau
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CC/CRC/el

c.c. Mr. Mark Dickens – Head of Listing