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Dear Steve,

### **IASB Discussion Paper on Preliminary Views on Revenue Recognition in Contracts with Customers ("Discussion Paper")**

I refer to your letter dated 2 February 2009 on the above Discussion Paper to our Mr. Paul Chow which has been passed to me for my attention.

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

#### General

The Discussion Paper sets out the preliminary views of the IASB and FASB (the "Boards") on proposals to develop 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 Discussion Paper 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.

Although we agree with the intended objective, we have concerns that the Discussion Paper is in substance a discussion paper concerning a revision of the meaning of "revenue". The Discussion Paper seeks views on the revised meaning of "revenue" which is a high level conceptual issue which should have been included on the work programme of the Conceptual Framework working group. A discussion of "revenue" in isolation would be incomplete and requires a full discussion of the other related fundamental concepts of what is or should be regarded as an "asset" or a "liability". This is particularly important as the Discussion Paper proposes that revenue recognition should be based on changes in "assets" and "liabilities".

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Based on the Discussion Paper issues appear to arise due to the multitude of industry-specific and inconsistent guidance provided in standards under US GAAP. We believe the fundamental issue is the need for a robust definition of revenue and a clear and concise explanation of what is the purpose of revenue recognition and what it purports to portray. We believe that the principal difficulty is how to distinguish the provision of a service from the sale of goods and especially in contracts that have elements of both.

From the sellers' perspective, we believe that revenue should represent claims that have been made by the seller to the customer and there is an expectation by the seller and acknowledgement or understanding by the customer that such claims will be settled. That is, revenue recognition should require that there has been a "transaction" or an exchange of goods and services between the seller and the customer. We believe that it is not necessary for the customer to obtain control of the asset as suggested in the Discussion Paper as whether physical control is transferred is at the discretion of the customer (e.g. bill-and-hold arrangements). Further research and discussion on what would constitute a "transaction" should be carried out. This should also provide an opportunity to reconsider the conceptual basis for re-measurements of assets (and liabilities) based on a hypothetical transaction or the occurring of specific "events" which is the current practice for certain assets (e.g. re-measurement of trading assets, foreign currencies and investment properties to their market values at the year end date).

The preliminary views in the Discussion Paper would result in a significant change to current practice. The timing of revenue recognition for companies involved in construction contracts (e.g. property companies) and service contracts that extend beyond twelve months would be significantly affected and this will also lead to tax and dividend distribution issues. In developing a standard, we believe the proposals should be sufficiently trial tested to determine the practical issues involved and the costs of implementation.

### Continuous measure approach

The concept of the continuous measure of activity is important to construction industries and certain service industries as it provides an indication of the extent of activity of an entity. However, we understand the proposal in the Discussion Paper would allow recognition of revenue over time regardless of whether the buyer is satisfied with the work and whether economic inflows are expected to flow to the entity. This may not provide more decision-useful information to users of financial statements and may sometimes be misleading as revenue recognition will inevitably lead to issues on profit recognition. We believe that reasonable expectations of economic inflows should be a condition for revenue recognition.

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We envisage that if the proposals proceed, certain industries will restructure their contracts so that they appear to have separate individual smaller contracts to justify revenue recognition. This will add to costs and is counter productive. We therefore suggest the Boards further discuss in detail whether the proposed revenue recognition model in the Discussion Paper would result in more decision-useful information than the existing standards. An alternative would be to expand the guidance of the existing standards which have generally served us well.

### Identification of performance obligations

We agree that several performance obligations may exist in one contract. Identification of separate performance obligations in a contract on a consistent basis would be a practical issue, in particular for contracts with multiple and inter-related deliverables. We believe that the future standard should allow preparers to make professional judgements on the extent to which separate performance obligations need to be sought and identified. This judgement should take into account the expectations of the buyer of what unit of measurement would be regarded as a completed obligation.

### Control vs. risks and rewards

The Discussion Paper proposes that an asset (good or service) is transferred to the customer when the “control” of that asset is passed to the customer, which is usually indicated by physical possession of the asset by the customer.

We consider that “control” alone is insufficient and under current business practice, it is common that a customer may not be in “physical possession” of his asset. Also, it appears that the Discussion Paper assumes that the loss of control by the entity and the gain of control of the customer occurs simultaneously. This is not always the case. For instance, in international trade where a local seller delivers goods to its overseas customer by ship, during shipping neither the seller nor the customer has “control” over the goods. Whether risks and rewards of the goods rests with the seller or the customer depends on the contract terms. We therefore believe further discussion is needed on this issue and whether “control” alone is an appropriate basis for recognising revenue.

The existing IAS 18 states that revenue from the sale of goods shall be recognised only when all the specified relevant conditions are satisfied and one of the conditions is the entity has transferred to the customer the significant risks and rewards of ownership of the goods. We believe the guidance is useful and should be retained.

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### Construction contracts

Revenue recognition for construction contracts could be significantly changed if the proposed model discussed in the Discussion Paper is adopted. Currently, recognition of revenue from construction contracts is based on the stage of completion under IAS 11.

According to the Discussion Paper's proposals, we understand that revenue would not be recognised until the completion of construction and the transfer of the completed asset to the customer. This would result in no revenue being recognised during the accounting periods in which most of the construction activity is performed. Moreover, all revenue would be recognised in the accounting period in which minimal construction activity is performed. We do not think this approach provides more meaningful information to users of financial statements as the pattern of revenue recognition does not best reflect the activity of the entity and completion of "transactions". Therefore, we believe further discussion is needed on the revenue recognition for construction contracts or contracts that take more than twelve months to complete. This discussion should lead to clarifying thoughts on a sound Conceptual Framework. This should be carried out before discussion papers are issued on proposals to revising detailed accounting standards.

### Warranties and other post-sale services

The proposed model in the Discussion Paper would significantly change the accounting for post-sales services, such as warranties. At present, warranties and other post-sales services are usually accounted for as cost of repairs and rectifications when they occur. Under the proposed model, these services would be treated as performance obligations and revenue associated with these services would be separated from the original total selling price and recognised as deferred income. We believe that accounting should be kept as simple as possible and practical. To defer revenue arising from expected warranty services takes the view that they represent service charges included in the original selling price. Given that warranty service is contingent in nature an alternative view is that they are possible future obligations of free repairs that will be provided in the event that they are required and should be expensed when they are incurred.

We also note that the Discussion Paper does not elaborate on how or when such warranty services should be regarded as "having been transferred" to the customer and therefore the deferred income can be released. For example, a customer purchases a product which has a three-year warranty. According to the Discussion Paper's proposed model, two performance obligations, the delivery of the product and the three-year warranty, are identified and "*revenue would be recognised at the time when the product transfers to the customer and over time as the warranty services are transferred to the customer*" (see paragraph 6.28 of the Discussion Paper). The question then arises as to when the warranty service is transferred to the customer, at the end of the warranty period, when the customer returns the product for repairs or evenly over the three-year period. If the

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service is regarded as “having been transferred” to the customer at the end of the warranty period, should the costs of the repairs over the three years also be deferred so as to match the revenue? It appears that it would be unreasonable to recognise warranty revenue regardless of when the repair activity is carried out which can be more than just once, and the costs of the repairs. If revenue is recognised when a customer returns the product for repairs, what amount of revenue should be recognised?

We believe recognition of revenue on the identification of a defective product is counter intuitive. How the costs of the repairs should be recognised to match the revenue amount would increase complexity and does not justify the costs. The cost of maintaining records for accounting for uncertainties and similar services does not appear to be justified. We therefore believe further consideration is required on whether revenue associated with “future” warranty services should be separated and deferred.

We believe the same issues arise in accounting for “sales incentives”, such as customer loyalty programmes or “customer vouchers” for products and services. We believe these generally are not existing performance obligations but only contingent obligations which may arise in the future. An alternative view is they represent prior notification of a possible discount on the selling price for a possible future sale. We acknowledge that this leads to a discussion on how to account for contingencies, commitments as well as options and a conceptual framework study of the issues would be useful.

### Banks and insurance companies

The Discussion Paper does not adequately address revenue recognition implications for banks and insurance companies. If the principles are followed, the proposals in the Discussion Paper may significantly change their revenue recognition practices. For example, banks make mortgage loans to their customers and currently banks recognise interest income arising from the mortgage loans on a continuous basis. According to the Discussion Paper’s proposals, revenue from such lending service should be recognised when the service is “transferred” to the customer. The question then arises as to when the service is regarded as “having been transferred” to the customer. Should interest income be recognised at the end of the loan period only? For insurance companies that provide life insurance, should insurance income only be recognised when the insurance contract ends, i.e., when the client passes away?

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We hope that the above comments are useful in developing thoughts for discussion on the Conceptual Framework and subsequently a future more detailed standard on revenue recognition.

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



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