Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室
電話：2521 1160, 2521 1169 圖文傳真：2868 5035
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

19 October 2010

By email: ong@hkicpa.org.hk & by post

Mr. Steve Ong
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East
Wanchai
Hong Kong

Exposure Draft –Revenue from Contracts with Customers

Dear Steve:

We refer to your letter dated 29 June 2010 and would like to set out our comments on the International Accounting Standards Board's Exposure Draft – Revenue from Contracts with Customers.

Our comments on the specific questions raised in the exposure draft are attached. We would be happy to further clarify or discuss any of the above points should you so wish.

Yours sincerely,

Rita Liu
Secretary

Enc.

Chairman Standard Chartered Bank (Hong Kong) Ltd
Vice Chairmen Bank of China (Hong Kong) Ltd
The Hongkong and Shanghai Banking Corporation Ltd
Secretary Rita Liu

主席 渣打銀行（香港）有限公司
副主席 中國銀行（香港）有限公司
香港上海匯豐銀行有限公司
秘書 廖碧瑩

Incorporated by Ordinance, Cap. 364
根據條例第364章成立

Response to Specific Questions in the International Accounting Standards Board's Exposure Draft ED/2010/6 *Revenue from Contracts with Customers*

Recognition of Revenue

Question 1

Paragraphs 12 – 19 propose a principle (price interdependence) to help an entity determine whether:

(a) to combine two or more contracts and account for them as a single contract;
(b) to segment a single contract and account for it as two or more contracts; and
(c) to account for a contract modification as a separate contract or as part of the original contract.

Do you agree with the principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

We generally agree that price interdependence should be the criteria by which contracts are combined and that price independence should be the criteria by which contracts are segregated. However, we believe that additional clarification is necessary in determining when price interdependence exists. In addition, we have concerns that the requirements of the ED will require significant judgment to implement and may result in significant variation among reporting entities without additional clarification.

Paragraph 13 provides indicators that two or more contracts have interdependent pricing. We believe that the factors presented are less indicative that interdependent pricing exists than that interdependent pricing might exist and further analysis is necessary. The paragraph should be clarified accordingly.

We believe that interdependent pricing results from two or more contracts entered into in contemplation of each other (which the criteria in paragraph 13 would indicate) and that one or more contract(s) has been priced at a discount that is compensated for by the pricing on the other contract(s). This would be consistent (although inversely) with the concept of independent pricing as described in paragraph 15, which requires that a discount has not been provided when selling goods or services together. We believe that the combination of contracts for revenue recognition purposes should occur only when there is objective evidence that one or more contracts within a group is priced below fair value and the economic rationale for that discount can only be explained by reference to the pricing on another contract(s) in the group.

Question 2

The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised goods or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

While we do not have a conceptual disagreement with the guidance regarding identifying specific performance obligations, we have significant concerns regarding the practical application of this guidance to the financial services industry.

Currently, financial institutions offer retail and commercial customers a variety of service options in connection with depository relationships (such as checking, ATM access, electronic banking, bill payment, and related services). In most cases, the fees charged are dependent on the level and scope of services offered as well as the amount of cash maintained on deposit. In some cases incremental services (e.g., cashier checks, foreign ATM fees, etc.) are not separately charged for or are charged at an amount different from other service packages or a stand alone service fee. Industry practice is to recognize any associated fee when the fee becomes due and payable. Therefore, monthly checking/current account fees are recognized when due from the customer and incremental fees, such as ATM fees, are recognized when the transaction occurs.

Credit card services exhibit many of the same characteristics as depository relationships. In many instances, credit card services are essentially transaction processing services because the financial institution is not advancing funds to the customer when the customer pays its monthly charges in full. In addition to transaction processing, credit card relationships often involve the provision of a number of other services at the option of the customer (e.g., travel related, advisory, concierge services, etc.) These services may be priced separately at amounts below a stand alone price or provided at no additional charge when an annual fee is assessed or in contemplation of earning interest on those customers who ultimately do borrow funds from the financial institution.

Our specific concerns are as follows:

1. Revenue Recognition on Fee Based Depository/Credit Card Relationships:

   While many depository services are provided only in connection with depository relationships (e.g., check processing, electronic banking, etc.), there are other services offered within a depository relationship that are also provided separately to customers at a stand alone price. This also applies to credit card relationships. Accordingly, we believe that separately offered services could be viewed as distinct services under paragraph 23 of the ED and require being accounted for as separate performance obligations. For financial institutions providing depository and credit card services, a requirement to allocate a transaction price among the

various services would be impractical and would not provide useful information to users of financial statements.

We also note that there exists an inconsistency between paragraph 20 of the ED which requires an entity to identify performance obligations based, in part, on an entity's customary business practices. However, paragraph 23(a) indicates that a performance obligation is distinct (and thus requires separate accounting) if the entity, or another entity, sells an identical or similar good or service separately. Whether another entity sells an items separately is not related to the reporting entity's customary business practice and would require an impractical level of due diligence to determine whether any other entity sells an item separately.

Many of the services provided in depository and credit card relationships require the financial institution to stand ready to provide such service (e.g., ATM services). The services would be utilized at the option of the customer. Paragraph B87(b) of the ED would require a reporting entity to estimate the likelihood that the option will be exercised in estimating the amount of the transaction price to allocate to that performance obligation. Given the number of services offered by financial institutions, it would not be practical to develop reasonable expectations of utilization of every service offered within a depository relationship.

Nearly all depository relationships represent contractual obligations that renew on a continuous basis and require that a fee be paid monthly to the extent that a fee is charged. One view on the application of the ED could be that the monthly service fee is compensation for the customer's option on a menu of services and that option expires monthly. Therefore, revenue would be recognized monthly based on the fee charged.

However, paragraph B88 of the ED discusses options to acquire additional goods or services that provide the customer with a material right and that, typically, those types of options are for contract renewals. The option to continue the depository relationship (whether contractually present or based on past practice or economic compulsion) could be viewed as a material right to the customer if the customer is expected to utilize more services in the future as the customer becomes more familiar with the offered services, or the customer's needs change or service offerings improve (e.g., increase in the number of ATM machines available). Paragraph B25 of the ED states that if the option provides a material right, the customer in effect pays the entity in advance for future goods or services and the entity recognizes revenue when those future goods or services are transferred or when the option expires. (This would be consistent with Example 27 in the ED which addresses maintenance contracts with a renewal option.)

In regards to options, we note that the definition of performance obligations in the ED includes both options and standing ready to provide goods or services,

which would typically be done in connection with issuing an option. We believe this creates confusion as to whether the revenue associated with issuing an option should be recognized ratably over the period in which the entity stands ready or when the goods or services are delivered as contemplated by paragraph B25.

Credit card relationships would typically involve an annual fee that would compensate for the provisions of services across multiple reporting periods. Thus, the allocation of credit card fee revenue to performance obligations in future reporting periods would need to be considered regardless of any consideration related to renewal options.

Paragraph 50 of the ED requires that an entity allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations at contract inception (i.e., on a relative stand-alone selling price basis.) Paragraph 34 of the ED requires that when an entity satisfies a performance obligation, it shall recognize as revenue the amount of the transaction price allocated to that performance obligation. Allocating monthly fees across all performance obligations would require significant system enhancements to identify all cross service relationships and track the associated revenue. Given the costs of such enhancements, it is possible that at least some financial institutions would reduce the menu of service options available rather than deal with the related accounting burden.

2. Onerous Performance Obligations

Many services provided to customers under a depository relationship are provided at no additional charge or at a reduced price because of the benefits to the financial institution of obtaining low cost funding from the customer deposits. For relationships in which the customer is not charged, a question arises as to whether the accounting for the contract is within the scope of the ED or IAS 37, *Provisions, Contingent Liabilities and Contingent Assets.* Paragraph 10 of the ED identifies criteria for identifying whether a contract exists for the purpose of applying the revenue requirements of the ED. Those criteria include whether the entity can identify the terms and manner of payments for those goods or services. It is not clear whether those criteria apply to the requirements in paragraph 54 of the ED to recognize a liability for an onerous performance obligation or that such an arrangement is not a contract within the scope of the ED.

The measurement of a potentially onerous contract liability could differ depending on whether the provisions of the ED or IAS 37 is applied. Under the ED, a performance obligation is onerous if the present value of the probability-weighted costs that relate directly to satisfying that performance obligation exceeds the amount of the transaction price allocated to that performance obligation. Transaction price is defined in the ED as the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for

transferring goods or services, excluding amounts collected on behalf of third parties (for example, taxes). Currently, IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. While IAS 37 would take into consideration the economic benefits of the deposits to the financial institution, the ED would appear to result in such a depository relationship being an onerous contract based on the pricing associated with the contract (which would often be nil) as opposed to the overall economics of the relationship. Also, the definition of probability weighted costs under the ED is different than the definition of unavoidable costs under IAS 37.

We support the objective of creating a single revenue recognition model for all contracts with customers and believe that financial services (other than in regards to financial instruments) should be incorporated into that model. However, based on our observations discussed above, we believe that certain changes and clarifications, as follows, to the proposed revenue recognition model are necessary to make the proposed standard operational for financial services entities:

a. The definition of distinct in paragraph 23 should allow that a menu of similar but distinct products or services provided in exchange for a bundled price represents a single performance obligation when (i) customers have the option to take/use or not take/use any of the goods or services; and (ii) it is not practical to determine either the probability of usage or the amount of usage that would be allocable to each period within the contract term including any renewal options. Revenue should be allocated ratably over the contract period where the cost to meet the single performance obligation (i.e., menu of goods or services) are primarily based on a standing ready to do so basis.

   We believe that this would be consistent with the concept of control in that the customer initially obtains control upon receipt of the option over the menu of services. For example, when a customer receives a debit card, they then control the use of ATM services and that control is transferred to the customer continuously over the term of the depository relationship as the financial institution stands ready to service the customer. The actual performance of many of the obligations related to a depository or credit card relationship would generally incur little incremental cost; rather, costs are typically incurred in connection with standing ready to provide such services, which is done ratably over the contract period consistent with the transfer of control. Therefore, where the fee is a fixed monthly amount, revenue recognized in a period would be equal to the number of months in a period multiplied by the fixed monthly fee.

   The concept of similar products and services would not include reward programs offered with other financial services, as we believe that reward

programs are fundamentally different in nature than the provision of financial services such as ATM, check cashing, etc.

b. The definition of onerous contract should be revised to require a comparison of the expected costs against the economic benefits of the contract rather than the price of the contract. Otherwise, contracts that have positive economic benefits to an entity will be treated as onerous thus creating a mismatch between revenues and expenses. In addition, the scope of the ED and IAS 37 in regards to onerous performance obligations should be clarified.

c. The ED should provide examples applicable to depository and credit card relationships that demonstrate the principles in the ED and that reflect our concerns and comments.

Question 3

Do you think that the proposed guidance in paragraphs 25 – 31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

The ED proposes a revenue recognition model whereby the trigger for recognition of revenue is based on whether the customer has obtained control of the goods or services. Paragraph 26 of the ED states that a customer has obtained 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. Under IFRS 18, revenue on service contracts is recognized based on, in part, whether the stage of completion, the costs incurred and costs to complete a transaction can be measured reliably.

In regards to service revenue, the ED moves the trigger for revenue recognition away from the provider of the services to the consumer of the services. Given that revenue is intended to reflect benefits that flow to the reporting entity, we believe that the current trigger is more appropriate than that proposed in the ED. In addition, control over services is a tenuous concept that will be difficult to apply in practice. Requiring that the customer have both the ability to direct the use of services and receive the benefits is particularly problematic. Whether a customer benefits from services should be ascertainable. However, in many cases a customer may have little ability to direct the use of services particularly when those services are provided by experienced professionals with particular expertise. Consistent with our view in Question 2 that the customer initially obtains control upon receipt of the option over the menu of services, we believe the criteria for revenue recognition of services should be based on whether the provider of services can reliably measure the extent to which it has fulfilled its obligations.

Measurement of Revenue

Question 4

The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

The ED proposes in paragraph 35 that the transaction price be derived from the probability-weighted amount of consideration that an entity expects to receive from the customer in exchange for transferring goods or services. However, in paragraph 38 the ED states that an entity shall recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. We find these statements to be in conflict with each other. The use of multiple probability-weighted scenarios would indicate that a transaction price cannot be reasonably estimated unless there is a single scenario that carries a very high probability of occurrence, in which case we see no value to using multiple probability-weighted outcomes.

The proposals would result in the introduction of a significant amount of subjectivity in revenue recognition, resulting in increased volatility in revenues and reported income and reduced comparability among entities. The amount of revenue reported would not be reflective of management's best estimate but rather an amount derived based on multiple scenarios that have been assigned a probability that in practice will often be arbitrary. For example, estimating the probability of a refund to a customer when recognizing revenue if the customer has a right to return the product transferred or assessing the probability of exercising the option for maintenance services with a renewal option would both require significant amounts of judgment.

The current revenue recognition criteria under IAS 18 requires that revenue be recognized when, among other criteria, it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of economic benefits can be reliably measured. We believe that these two criteria result in the recognition of revenue when there is a high level of confidence that some amount of consideration has been earned and that amount can be calculated without material error. This is also consistent with paragraph 4.48 of the Conceptual Framework for Financial Reporting 2010 (the "Conceptual Framework") which states: "The procedures normally adopted in practice for recognizing income ... are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty."

We believe that the measurement criteria in the ED should be revised to be consistent with current practice under IAS 18 – probable that revenue has been earned (i.e., high level of confidence which we believe is a threshold greater than more likely than not) and the amount can be reasonably estimated. This will result in reported revenue that reflects an amount based on management's best expectations that will frequently be correct rather than a hypothetical outcome that will always be incorrect.

Question 5

Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

We do not believe that credit risk is relevant to the amount of revenue that should be recognized. However, in some cases, credit risk is relevant as to whether the criteria for revenue recognition has been met. Paragraph 10 of the ED defines when a contract exists, which requires that the parties to the contract are committed to satisfying their respective obligations. If there is significant uncertainty as to an individual customer's ability or willingness to pay, revenue should not be recognized until which time that uncertainty is resolved because the provision of goods and services in the face of significant credit risk calls into question whether a contract exists. However, we do not believe that the presence of unspecified credit risk in a group of financial assets indicates that a contract does not exist.

The initial valuation of an originated financial instrument (i.e., receivable) should be independent of the revenue recognition criteria as they are in essence two different transactions – selling goods or services and lending. The principle for the treatment of credit losses should be consistent regardless of whether a receivable arises as a result of a sale transaction or a pure lending transaction. The determination of the amount of impairment of a group of receivables should be dealt with consistent with the accounting for other financial instruments and, in our view, should result in the recognition of bad debt or impairment expense rather than a reduction of revenue or interest income.

Question 6

Paragraph 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

We agree that a trade receivable should be recorded at a discount if there is a material financing component. The discount should be a reduction of revenue because implicitly the transaction price for the contract would reflect compensation for the time value of

money in addition to the performance obligation. We believe that there should be a rebuttable presumption that the financing component for a receivable with an original maturity of less than one year is not material.

Question 7

Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

We agree that the stand-alone selling price is an appropriate basis on which to allocate the transaction price. The stand-alone selling price will often approximate the fair value of each performance obligation; consequently, allocation based on stand-alone selling price is comparable to a relative fair value method which would be common in current practice. However, we suggest that the IASB should clarify whether a stand-alone selling price would be based on standard pricing or average stand-alone selling prices actually contracted with customers or any other basis.

Contract Costs

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 389 Intangible Assets or ASC Topic 985 on software), an entity should recognize an asset only if those costs meet specified criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

We believe that the criteria are operational.

Question 9

Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?