Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Sent electronically through the IASB Website (www.iasb.org)

29 June 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Discussion Paper on *Preliminary Views on Revenue Recognition in Contracts with Customers*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Discussion Paper. Our responses to the questions raised in your Discussion Paper are set out in the Appendix for your consideration.

Overall, we support the boards' objective to develop a single, contract-based revenue recognition model to address the inconsistencies and lack of guidance currently in IFRSs and US GAAP. In addition, this should also enhance comparability of revenue across industries and geographical boundaries.

We are concerned that there may be undue focus on a single legalistic indicator of which party has "control" of the asset, which may result in inconsistency in revenue recognition between those long term contracts completed "off site" (such as the construction of a ship) and those completed "on site" (such as the construction of a building on land owned by the customer). More examples might help to clarify the board's intended meaning of key concepts such as "enforceable obligation" and "transfer of control" in order to ensure proper interpretation and application on a consistent basis.

We note that the IASB and the FASB are working on a number of projects that have transactions that are similar to those addressed in the discussion paper, or are based around a concept of control (including leases, derecognition and consolidation). We believe that it is important to ensure consistency in application to economically similar transactions, and application of a similar concept of control across all of these projects.

Further details of our views are set out in the Appendix to this letter in the form of responses to the consultation questions which you have raised. If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

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APPENDIX

Hong Kong Institute of CPAs

Comments on the IASB Discussion Paper on *Preliminary Views on Revenue Recognition in Contracts with Customers*

<u>Question 1</u>

Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

Yes, we agree with the boards' proposal to develop a single, contract-based revenue recognition model. We believe that a single model, if sufficiently principle-based, would enhance comparability of revenue across various industries and transactions.

<u>Question 2</u>

Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

We support the boards' consideration to exclude the types of contracts referred to in paragraph S11 of the Discussion Paper. Nonetheless, we believe revenue recognition for such contracts, even if they are outside the scope of the revenue standard, should be consistent with the basic principles as proposed in the Discussion Paper.

There are situations where the principles are still not clear to us. These are elaborated on further in our response to Question 8. Specifically we refer to long-term construction contracts such as ship building. What is not clear to us is the focus on "control" of the asset and what this means. In a shipbuilding contract, "control" over the asset does not pass to the customer until completion, however this does not recognize the economic substance of the transaction in our view. On the other hand, the customer does retain "control" over the design features and amendments to the original design although physical control over the use of the asset may not happen until sea trials and acceptance have been completed. The application of the principles would not, in our view, give rise to decision-useful information if revenue is not recorded until sea trials are complete and the ship handed over.

<u>Question 3</u>

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Yes, we agree. However, we note that the boards appear to have taken a legalistic approach with respect to the definition of a contract. As we further explain in our response to Question 8, we believe that additional guidance illustrating the types of legal terms or conditions which would constitute an enforceable obligation as intended by the board would help to limit any unintended consequences as result of applying the proposed definition.

We believe that the boards should clarify that the definition of a contract includes contracts with Governments acting on behalf of consumers as a whole for example where utilities operate under a rate-regulated scheme of control.

Question 4

Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

While we support the boards' proposed definition, we believe that there is ambiguity in identifying when a performance obligation exists when applying this definition.

For example, we are uncertain as to whether a general product liability guarantee is a performance obligation under the proposed definition. On one hand, it arises from the operation of law, which based on paragraph 3.5 of the Discussion Paper suggests that it is a performance obligation. On the other hand, even if one can accept such a guarantee as a performance obligation, it seems overly difficult to measure and account for this guarantee under the proposed standard due to its pervasive nature. We wonder if it is the boards' intent for the proposed definition to be interpreted in such a broad sense.

Consider another type of contract often found in the computer and software industries in which a bundled sale comprises of the sale of a software and a customer's right to receive free software upgrades *if and when available* over a period of time. Some may argue that the promised upgrades do not translate into a performance obligation that is enforceable against the seller as the seller is not required to develop and hence deliver any upgrades. However, under the view set out in paragraph 3.37 of the Discussion Paper, others would argue that as a customer would pay additional consideration for that right, this indicates that the promised conditional right is a performance obligation.

In addition, we would be concerned if an entity were required to recognise revenue for the delivery of software, separately from the installation and customisation of that software, if installation and customisation of that software were a significant part of the customer's product acceptance criteria and there was no observable stand-alone price for the uncustomised software.

We consider that in order to operationalise the principles in the discussion paper it would be necessary to include far clearer discussion of what factors are determinative in identifying the various "performance obligations" contained in contracts with customers.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

We agree with the concept of splitting a contract with a customer into its components for the purposes of recognising revenue from those components when the activity to meet performance obligations fall into more than one reporting period.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

In paragraph 3.26 it is stated that "the boards do not have a preliminary view on whether those promises are performance obligations". The views in Hong Kong are very divided on this matter also.

Some have stated that they do not believe a performance obligation exists in the example of goods sold with a right of return. Some commentators suggest that a sale has occurred and full revenue should be accounted for with a provision (based on historical statistics) set up in respect of expected returns. These commentators argue that this result will arrive at decision – useful information when the assumptions are adequately disclosed in the notes. Going beyond these unnecessarily complicates the accounting.

Others have expressed the view that while they accept that there could be an argument that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation, they consider that the accounting when goods are subsequently returned is counter-intuitive and presents a misleading picture of performance. To illustrate, consider the following example (consistent with paragraph 3.34 of the Discussion Paper):

RetailCo offers its customers a full cash refund if items are returned within 90 days in a saleable condition.

On 1 January X0 RetailCo sells an item for gross sale proceeds of $1,000. $XXX of this is allocated to the sale of goods and therefore $1000-$XXX=$YYY is allocated to the return service[1]. RetailCo records the following:

Dr	Cash	1,000	
Cr	Revenue (related to sale of good)		XXX
Cr	Liability (related to future provision of return service)		YYY
	To record the partially completed sale		
Dr	Costs of sale	600	
Cr	Inventory		600
	To record the cost associated with the sale of good		

Assume that the customer returns the good the next day. Under the proposed revenue recognition principle as discussed in the Discussion Paper, it is presumed that revenue would be recognised as RetailCo has provided the return service as promised under the sale agreement.

Dr	Liability (related to future provision of return service)	YYY	
Cr	Revenue (related to actual provision of return service)		YYY
	To record revenue due to provision of return service		

It is also presumed that under this approach RetailCo would need to record the acceptance of the returned good at full retail value (i.e. equal to the value of the refund) as if they were newly acquiring the item i.e.:

[1] In addition to having concerns about the double entry for this approach, we cannot comprehend how an entity should estimate the "stand-alone" value of the "performance obligation" of the returns service, since we do not believe that either the customer or the retailer would view this as a revenue generating service that the customer is paying for.

Dr	Inventory	1,000	
Cr	Cash		1,000

In addition to being unable to estimate an appropriate amount to defer as the "stand-alone value" of the refund service, these commentators consider that in principle this approach is flawed. That is, to recognise revenue when goods are returned is counter-intuitive and to inflate inventory in such a manner is misleading.

These commentators find that the arguments set out in paragraph 3.39 in the Discussion Paper to be persuasive. They consider that the return is confirmation of a failed sale, and that such returns should be statistically estimated at the time of original sale as discussed in paragraph 3.41 of the Discussion Paper. However, they do not accept that a consequence of the failed sale approach is that inventory would continue to be recognised (as asserted in paragraph 3.42 of the Discussion Paper). Instead, they consider that this issue would be dealt with by measuring the returns provision on the balance sheet net of the inventory value relating to the items expected to be returned. This treatment in effect restricts the returns provision to be the gross margin of the failed sales plus any expected loss in value in the inventory held by customers. They consider this to be a fair measure of the provision since the customer is required to surrender these goods in saleable condition before they are entitled to the cash back of the full sales value.

For example: During period 1 RetailCo receives $1,000 gross proceeds from multiple sales. From past experience, RetailCo expects a returns rate of 20%. Following the expected failed sales approach, during period 1 RetailCo would record the following:

Dr	Cash	1,000	
Cr	Revenue (re items expected to be retained by customers)		800
Cr	Returns provision (re sales value of items expected to be returned)		200
	To record the sales (adjusted for those expected to fail)		
Cr	Inventory (cost of items transferred to customers)		600
Dr	Cost of sales (re items expected to be retained by customers)	480	
Dr	Returns provision (re inventory value of items expected to be returned)	120	
	To record the transfer of goods to customers, including those expected to be returned in saleable condition		

As a result of the above entries, a net returns provision of $80 is carried at the end of period 1, being excess of the cash value that the entity expects to refund to the customers over the inventory value of the goods that the entity expects to receive in return.

During period 2 customers returned $200 of these goods (retail value) and RetailCo records the following:

Cr	Cash		200
Dr	Returns provision	80	
Dr	Inventory (carried at lower of original cost and current NRV)	120	
	To record the failed sales and returned inventory		

In the view of these commentators, the above accounting entries properly reflect the substance of a sale with a right of return which is expected to be exercised and the presentation can cope relatively easily and appropriately with changes in the actual and estimated levels of returns. They also consider that this approach provides more decision-

useful information than an approach which regards rights of returns as performance obligations and returned inventory as a purchase of inventory at full retail value.

If instead the right of return period expires without the goods being returned, then the appropriate entries would be to record the original sale in profit or loss.

Cr	Revenue		200
Dr	Returns provision	80	
Dr	Cost of goods	120	

Yet other commentators have commented as follows:

The discussion paper explores two methods for accounting for a customer's right to return a product: as a performance obligation or as a failed sale. Individually each of these models creates challenges in application.

Recording the return right based solely on the performance obligation model creates an inconsistency between the amount of revenue recognised and the cash received. It also creates an inconsistency between the balance of inventory derecognised and the amount recorded for cost of sales. These inconsistencies result from recording the returned goods as if the entity had entered into a separate transaction for purchase of inventory and does not reflect that, economically, the return is the unwinding of a previous transaction. For these reasons these commentators do not believe that accounting for returns solely as a performance obligation reflects the economics.

Application of the failed sale model results in an entity continuing to recognise goods on its balance sheet despite control of those goods having transferred to the customer. This creates an exception to the control transfer principle and fails to recognise the seller's obligation to stand-ready to accept the returned goods. It is considered that creating an exception to the revenue recognition principle in the discussion paper is not appropriate.

These commentators suggest a combination of the two models. An entity should first consider whether a sale has occurred.

If the evidence supports that the goods will be returned, a sale has not occurred. No performance obligation is recorded as the expected contract consideration is zero since consideration received from the customer is expected to be refunded. A failed sale results in the entity receiving cash but having a corresponding liability to return that cash. However, the entity has also relinquished control of the inventory therefore the inventory must be derecognised. The liability created by the failed sale represents the liability to return the cash advanced from the customer when the sale fails. A corresponding asset, an inventory repurchase right, should be recorded for the value of the goods to be returned. Recording both the liability and the related asset reflects the executory nature of the return of the product. It also accurately depicts the economics of unwinding the sales transaction by reinstating inventory at the lower of its original cost or impaired value.

A successful sale with a right of return results in two performance obligations: one for delivery of the initial good and a second for the stand ready obligation to accept any returns. A portion of the contract consideration should be allocated to the stand-ready obligation at the time of sale. An entity should recognise revenue for the transaction price allocated to the goods and derecognise the full cost of those goods when control of the goods transfers to the customer.

The proposed "two-step" model provides an accounting result compatible with the principle of recognising revenue on transfer of control of the good or performance of the service. It is believed that this model more accurately depicts the economics underlying a sale of goods with a return right than either of the models proposed on a stand-alone basis.

Question 7

Do you think that sales incentives (eg discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Yes, we agree that sales incentives which take the form of a promise to provide goods or services of a determinable value give rise to performance obligations (consistent with the conclusions reached in IFRIC 13).

However, we do not consider that sales incentives which take the form of discount cards giving discounts on unlimited sales volumes fall within this scope. For example, we do not consider that issuing cards which promise the customer 10% off any purchases made within the next year can be regarded as an unfulfilled performance obligation, even if the customer only became entitled to the card after purchasing a specified minimum quantity of the entity's goods. Instead we consider that such schemes are simply a form of preferential pricing offered to a sub-set of customers and should be dealt with simply by recording revenue on those subsequent sales at the amount that the customer was required to pay (i.e. after discount).

Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

We agree in principle that performance under the contract is key to determining when to recognize revenue. However, we consider that the Board should field test the principles against a range of contracts typically found in practice and give clear indication in the proposed standard (or any accompanying implementation guidance) as to which factors in those contracts in the Board's view were determinative in identifying that control had, or had not, passed.

In general we would not request such additional guidance in a standard, but in this particular case, we consider that without such guidance entities may frequently be unable to understand the intended meaning of the principle, and without such understanding, entities may be unable to apply the principle to their own facts and circumstances with any degree of certainty that they are complying with the standard.

For example, areas where the application of the principles is at best unclear to us include the following:

- goods constructed to a customer's order where the construction takes place on the supplier's premises but there are significant financial penalties if the order is cancelled. This may also apply to major repairs, such as dry-docking a ship;

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- extended service engagements, for example research projects or sustainability audits, where it is unclear under the proposals whether the performance obligation is to provide services or to deliver an asset of a report of the findings (or a combination of both components) (and consequently it is unclear *when* the researcher or auditor should recognise revenue);
- revenue relating to providing fund management services, where the amount of the revenue is dependent on the fund's performance exceeding a specified hurdle on a single date (e.g. at the end of 3 years);
- goods shipped overseas where the physical good is neither under the control of the producer nor the customer for the duration of the voyage;
- bill and hold sales, where physical access to the goods may or may not be conditional on settlement of the purchase price;
- sales subject to retention of title clauses, where the goods are physically transferred to the customer but the customer does not obtain legal title until it settles the amount due to the supplier; and
- consignment stock, where stock may be shipped to a customer's premises irrespective of whether the customer has indicated that it intends to use such items in production or sell the items to others.

Without such analysis of common fact patterns, we are concerned that entities will be unable to operationalise this principle consistently other than in respect of straightforward sales contracts, for example those where the goods are on hand and are delivered immediately or shortly thereafter or services are provided on-site at the customer's premises.

Question 9

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

See our responses to Question 2 with respect to construction or production-type contracts and Question 4 related to product liability guarantees and free software upgrades if and when available. Also, it may be that the application of the principle to some or all of the arrangements mentioned in our response to question 8 could lead to revenue being recognised at a time which does not match the period in which the entity carried out the activities under a contract with a customer. If so, we would also consider this not to be decision-useful information. However, as we are unclear as to how the principles are intended to be applied in such cases, we are unable to comment on whether the application to these types of transactions would provide decision-useful information.

Question 10

In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

(b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

(c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

(a) Yes. We consider that this is an appropriate reflection of the substance of the contract and is also a pragmatic approach to revenue recognition, since the transaction price is generally straightforward to identify (other than in an exchange of non-monetary assets). We consider that to move to a model which permits day one recognition of profit from the selling activity would require a more fundamental review at a Conceptual Framework level of the meaning of "revenue" and when it should be recognised.

(b) Yes as this is because we do not consider it appropriate, or providing decision-useful information, to recognise a larger loss, simply in order to be able to report a profit margin at a future date. However, we do not believe that remeasurement of performance obligations when deemed onerous should be addressed in a revenue recognition standard. Guidance on the existence, recognition and measurement of onerous contracts should be included in a liability standard (such as IAS 37 at present) not a revenue standard.

(c&d) As noted in paragraph 5.85 of the Discussion Paper, some constituents are concerned that the proposed approach might not provide decision-useful information for contracts with highly variable outcomes, including some insurance contracts.

However, we agree with the boards' comments that any distinction between contracts that do or do not have highly variable outcomes would be arbitrary and inconsistent with a principle-based approach (paragraph 5.97 of the Discussion Paper). With this in mind, we believe that the allowance of two subsequent measurement approaches would simply recreate arbitrage opportunities the boards set out to eliminate in existing IFRSs (e.g. whether IAS 11 or IAS 18 applies).

Question 11

The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

(b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

(a) Yes, we agree that an entity should allocate the transaction price to the performance obligations at contract inception. This principle should be applied consistently irrespective of whether an entity explicitly charges a customer to recover the costs of obtaining a contract. We also agree that costs should be recorded as expenses unless such costs qualify for recognition as an asset in accordance with other standards (see our response to (b), below).

(b) We believe that, when the cost is only payable in the event of a successful sale, the contract origination costs should be matched with the revenue that they generate. For example, a property developer might agree to pay a sales commission to a real estate agent in respect of pre-sales of properties. In such cases, in our view it would not provide decision-useful information to charge the expense of the commission at the time of the pre-sales contract, if the revenue from the property sale will not be recognised until the property is completed and handed over to the buyer. We consider that either the expense should be deferred until the pre-sale is recognised, or a proportion of the revenue from the property sale should be recognised earlier, at the time that the expense is incurred in order to provide decision-useful information. However, we believe that there is sufficient guidance in the relevant asset standards to enable an entity to determine when the costs associated with the acquisition of such cash flow streams results in the recognition of an asset.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Yes, we generally agree as this allows for appropriate profit margins to be recognised on the different components of the contract. This issue therefore increases in complexity, the more that separate performance obligations are required to be identified, particularly if such components are not sold by the entity separately.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Yes, we generally agree. However, see also our response to Question 12.