HKFRS 15
Revenue from Contracts with Customers

Newsletter – Issue No. 06/2014

MAIN FEATURES

- Hong Kong Financial Reporting Standard ("HKFRS") 15 establishes a comprehensive framework for determining when to recognise revenue and how much revenue to recognise.
- It supersedes Hong Kong Accounting Standard ("HKAS") 11 *Construction Contracts* and HKAS 18 *Revenue* and related Interpretations.
- CORE PRINCIPLE: An entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
- An entity should apply a model consisting five steps for recognising revenue.
- More extensive disclosure, both quantitatively and qualitatively, is required.
- The amendments are to be applied retrospectively.
- Effective for annual periods beginning on or after 1 January 2017, with earlier application permitted.

Background

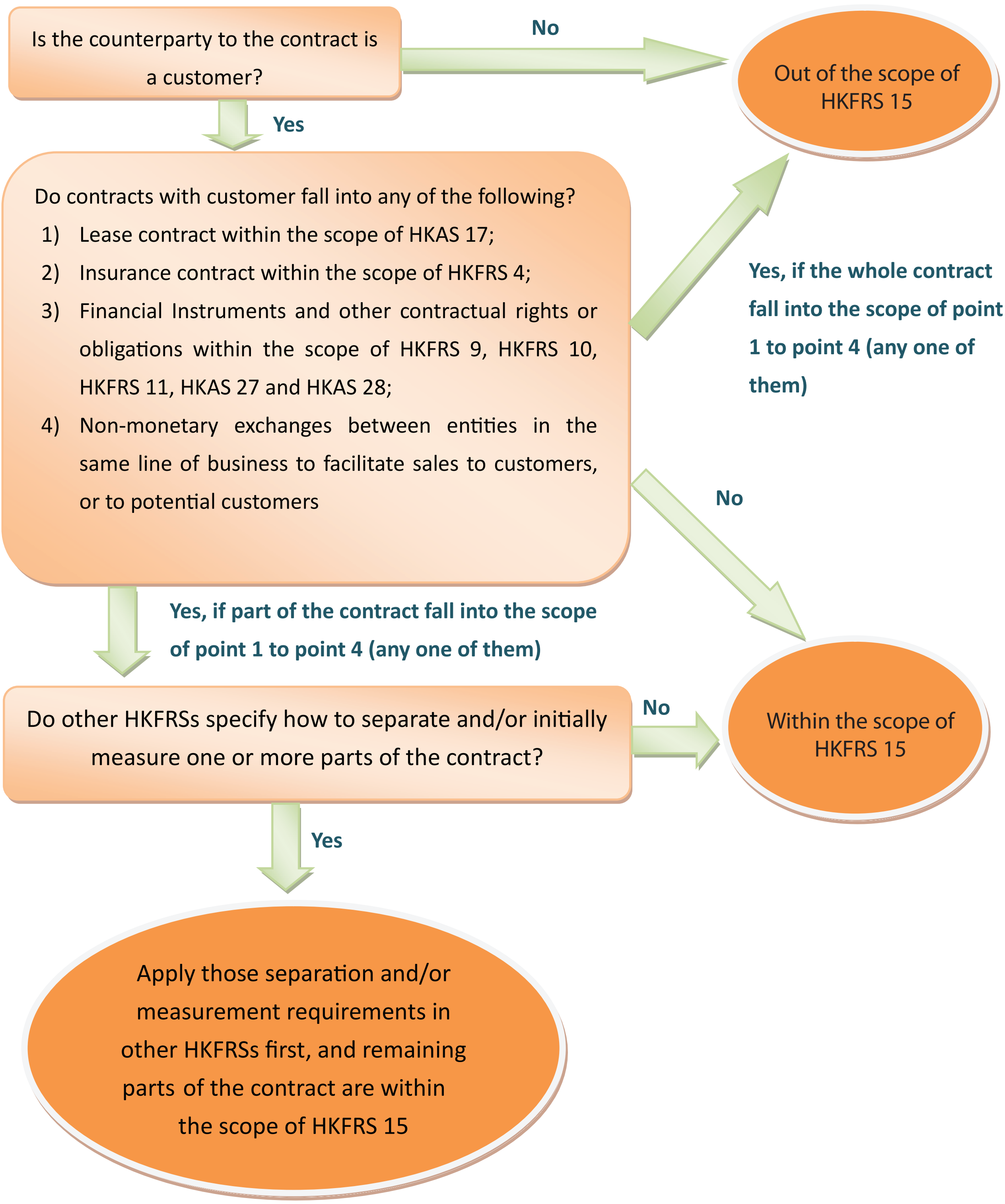
The International Accounting Standards Board and Financial Accounting Standards Board have jointly carried out a project to rewrite the standards to clarify the principles for recognising revenue and to develop a common revenue standard for International Financial Reporting Standards ("IFRS") and Generally Accepted Accounting Principles in the United States ("US GAAP") with the aim of tackling the following issues:

- Different accounting for transactions that are economically similar under the extant IFRS and the US GAAP requirements;
- Revenue recognition requirements under IFRS lacks sufficient detail while accounting requirement of the US GAAP are considered to be overly prescriptive and conflicting in certain areas.

In June 2014, IFRS 15 *Revenue for Contracts with Customers* was issued. Subsequently in July 2014, the Hong Kong Institute of Certified Public Accountants also issued the same standard, HKFRS 15 *Revenue from Contracts with Customers*, so as to maintain the convergence with IFRS.

Content of HKFRS 15

(A) Scope



(B) Core Principle

The core principle of HKFRS 15 is that an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services.

In order to recognise revenue in accordance with the core principle, an entity should apply all of the following steps:

(a) Identify the contract(s) with the customer;

(b) Identify the performance obligations ("PO(s)") in the contract;

(c) Determine the transaction price;

(d) Allocate the transaction price to the POs in the contract; and

(e) Recognise revenue when (or as) the entity satisfies a PO.

The following table summarised the areas that required particulars attention when going through these five steps:

(a) Identify the contract(s) with the customer
• Contracts are an agreement between two or more parties that create enforceable rights and obligations. Contracts can be written, oral or implied by an entity's customary practices. A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party or parties.
• HKFRS 15 is applied to a contract with a customer only when all of the following criteria are met: (a) the parties to the contract have approved the contract and are committed to perform their respective obligation; (b) the entity can identify each party's rights regarding the goods or services to be transferred; (c) the entity can identify the payment terms for the goods or services to be transferred; (d) the contract has commercial substance[1]; and (e) it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.
• An entity should combine two or more contracts entered into at or near the same time with the same customers (or related parties of the customer) and account for the contracts as single contract if one or more of the following criteria are met: (a) The contracts are negotiated as a package with a single commercial objective; (b) The amount of consideration to be paid in one contract depends on the price or performance of the other contract; or (c) The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single PO.

[1] A contract has commercial substance if the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract.

(B) Core Principle - *continued*

(a) Identify the contract(s) with the customer - Continued

- Contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. For details, please refer to section (C) of this newsletter.

(b) Identify the POs in the contract

- A PO is a promise in a contract with a customer to transfer to the customer either:

  (a) a good or service (or a bundle of goods or services) that is distinct; or

  (b) a series of distinct goods or services that are substantially the same and that have same pattern of transfer to the customer.

- At contract inception, an entity should evaluate the goods or services that are "distinct" promised in a contract with a customer and shall identify as a PO each promise to the customer. Goods or services are "distinct" if they met both of the following criteria:

  (a) The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer; and

  (b) The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

- PO includes promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer. PO may not be limited to the goods or services that are explicitly stated in that contract.

- PO excludes activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer.

(c) Determine the transaction price

- When (or as) a PO is satisfied by transferring a promised good or service (i.e. an asset) to a customer (i.e. when (or as) the customer obtains control of that asset), an entity should recognise as revenue the amount of the transaction price (which excludes of variable consideration that are constrained in accordance with paragraph 56 of HKFRS 15.

(B) Core Principle - *continued*

(c) *Determine the transaction price - Continued*
• The nature, timing and amount of consideration promised by a customer affect the estimate of the transaction price. When determining the transaction price, an entity should consider the effects of all of the following: (a) Variable consideration; (b) Constraining estimates of variable consideration; (c) The existence of a significant financing component in the contract; (d) Non-cash consideration; and (e) Consideration payable to a customer.
Variable consideration • If the consideration promised in a contract includes a variable amount, an entity should estimate the total amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.
• An entity should estimate an amount of variable consideration by using either the expected value method or the most likely amount method, and apply the method consistently throughout the contract.
Constraining estimates of variable consideration • An entity should include in the transaction price some or all of an amount of variable consideration estimated only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.
• An entity should consider both the likelihood and the magnitude of the revenue reversal when assessing the terms "highly probable" as mention above.
• At the end of each reporting period, an entity should update the estimated transaction price (including updating its assessment of whether an estimate of variable consideration is constrained) to represent faithfully the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period.

(B) Core Principle - *continued*

(c) Determine the transaction price - Continued
The existence of a significant financing component in the contract • In determining the transaction price, an entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer.
• An entity should present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (i.e. profit or loss).
• An entity should use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. The rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity. After contract inception, an entity should not update the discount rate for changes in interest rates or other circumstances.
• As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.
Non-cash consideration • An entity should measure the non-cash consideration at fair value.
• If an entity cannot reasonably estimate the fair value of the non-cash consideration, an entity should measure the consideration indirectly by reference to the stand-alone selling price of the goods or services promised to the customer in exchange for the consideration. Stand-alone selling price is a price at which an entity would sell a promised good or service separately to a customer.

(B) Core Principle - *continued*

(c) Determine the transaction price - Continued
• If a customer contributes goods or services (e.g. materials, equipment or labour) to facilitate an entity's fulfillment of the contract, an entity should assess whether it obtains control of those contributed goods or services. If so, the entity should account for the contributed goods or services as non-cash consideration received from the customer.
<u>Consideration payable to a customer</u> • An entity should account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct goods or services that the customers transfers to the entity (in which case the consideration should be accounted for as purchase of good or service).
• If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity should account for such an excess as a reduction of the transaction price.
• If the entity cannot reasonably estimate the fair value of the good or service received from the customer, it should account for all of the consideration payable to a customer as a reduction of transaction price.
• If consideration payable to a customer is accounted for as a reduction of the transaction price, an entity should recognise the reduction of revenue when (or as) the later of either of the following occurs: (a) The entity recognises revenue for the transfer of the related goods or services to the customer; and (b) The entity pays or promises to pay the consideration (even if the payment is conditional on a future event).

(B) Core Principle - *continued*

(d) Allocate the transaction price to the POs in the contract
• An entity should allocate the transaction price to each PO (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.
• An entity should allocate transaction price to each PO identified in a contract on a relative stand-alone selling price basis.
• No allocation of transaction price or discount is required if a contract has only one PO (i.e. paragraphs 76 to 86 of HKFRS 15 are not applicable in this case).
Allocation based on stand-alone selling price • To allocate an appropriate amount of consideration to each separate PO, an entity should determine the stand-alone selling price at contract inception of the distinct good or service underlying each PO in the contract and allocate the transaction price in proportion to those stand-alone selling prices.
• Best evidence of a stand-alone selling price: (a) Observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers; (b) Contractually stated price or a list price for a good or service (this price may be but should not be presumed to be the stand-alone selling price).
• If a stand-alone selling price is not directly observable, an entity should estimate it by: (a) considering all information that is reasonably available to the entity; (b) maximising the use of observable inputs; and (c) applying the estimation method consistently in similar circumstances.

(B) Core Principle - *continued*

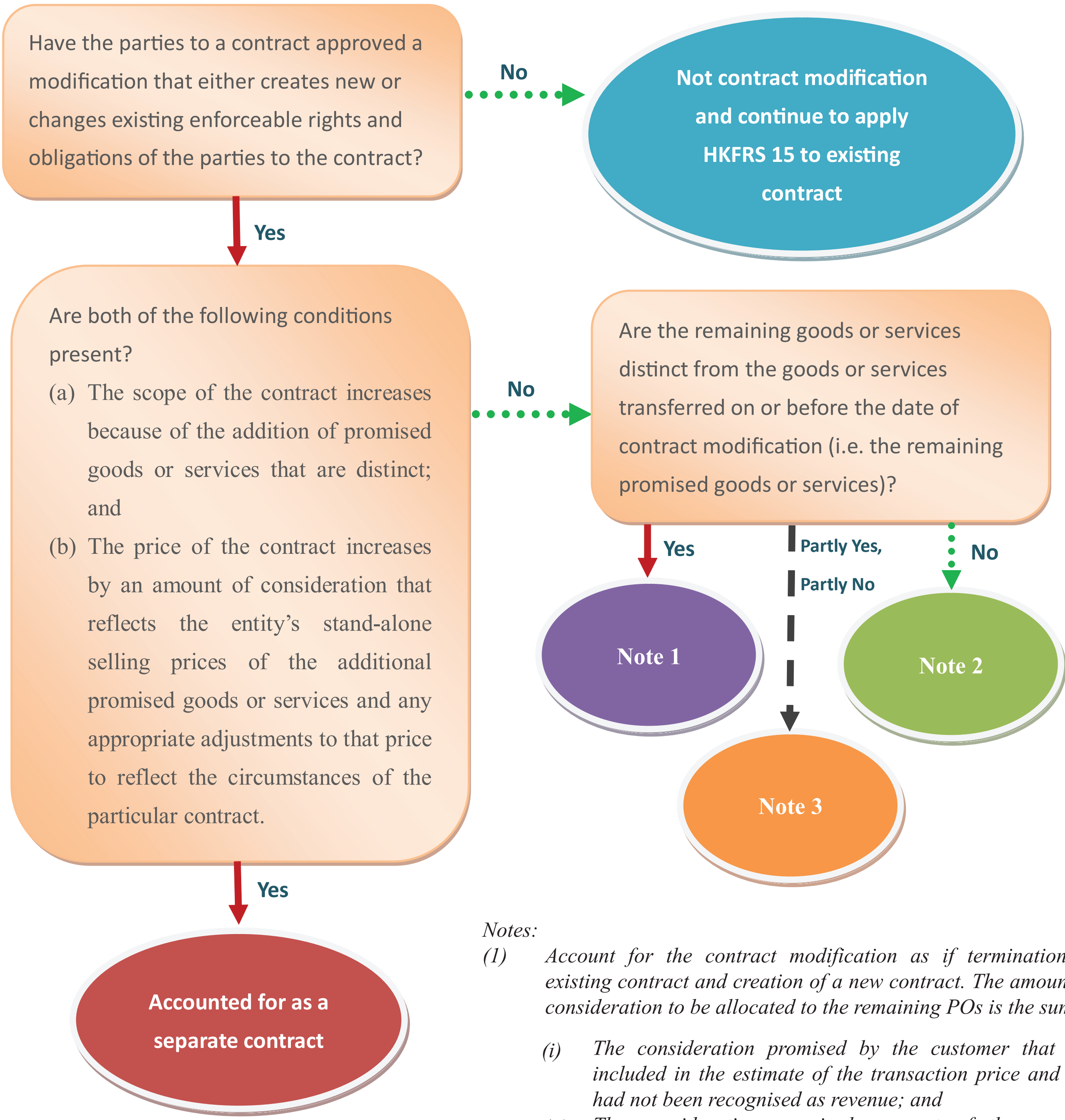
(d) Allocate the transaction price to the POs in the contract - Continued
• Suitable estimation method includes: (a) Adjusted market assessment approach; (b) Expected cost plus a margin approach; and (c) Residual approach. Details of these methods are discussed in paragraph 79 of HKFRS 15.
• HKFRS 15 also discussed about allocation of a discount, change in transaction price, and variable consideration. Details of these information are discussed in paragraphs 81 to 90 of HKFRS 15.
(e) Recognise revenue when (or as) the entity satisfies a PO
• An entity should recognise revenue when (or as) the entity satisfies a PO by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.
• PO could be satisfied: (a) Over time; or (b) At a point in time.
<u>POs satisfied over time</u> • An entity transfers control of a good or service over time, and, hence, therefore, satisfies a PO and recognise revenue over time, if one of the following criteria has been met: (a) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs; (b) he entity's performance creates or enhances an asset that the customer control as the asset is created or enhanced; or (c) The entity's performance does not create an asset with alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

(B) Core Principle - *continued*

(e) Recognise revenue when (or as) the entity satisfies a PO - Continued
• An entity should recognise revenue over time by measuring the progress towards complete satisfaction of that PO.
• At the end of each reporting period, an entity should remeasure its progress towards complete satisfaction of a PO satisfied over time.
• Appropriate methods of measuring progress include output methods and input methods. The method of measuring progress should be applied consistently to similar POs and in similar circumstances.
• An entity should recognise revenue for a PO satisfied over time only if the entity can reasonably measure its progress towards complete satisfaction of the PO.
<u>POs satisfied at a point in time</u> • If a PO is not satisfied over time, an entity satisfies the PO at a point in time (i.e. the point in time that when a customer obtains control of a promised asset and an entity satisfies a PO). Indicators for transfer of control include, but not limited to, the following: ▶ The entity has a present obligation to payment for the asset; ▶ The customer has legal title to the asset; ▶ The entity has transferred physical possession of the asset; ▶ The customer has the significant risks and rewards of ownership of the asset; ▶ The customer has accepted the asset.

(C) Contract Modifications

The following chart summarises the accounting treatment for situations that contract modifications may exists:



Notes:

(1) Account for the contract modification as if termination of existing contract and creation of a new contract. The amount of consideration to be allocated to the remaining POs is the sum of:

(i) The consideration promised by the customer that was included in the estimate of the transaction price and that had not been recognised as revenue; and

(ii) The consideration promised as part of the contract modification.

(2) Account for the contract modification as if it were a part of existing contract. The effect is recognised as an adjustment to revenue at the date of contract modification (i.e. adjustments to revenue is made on a cumulative catch-up basis).

(3) If remaining goods or services are partly distinct and are partly not distinct from goods or services transferred, then entity should accounts for the effects of the modification on the unsatisfied POs in the modified contract in a manner that is consistent with the objectives that HKFRS 15 requires.

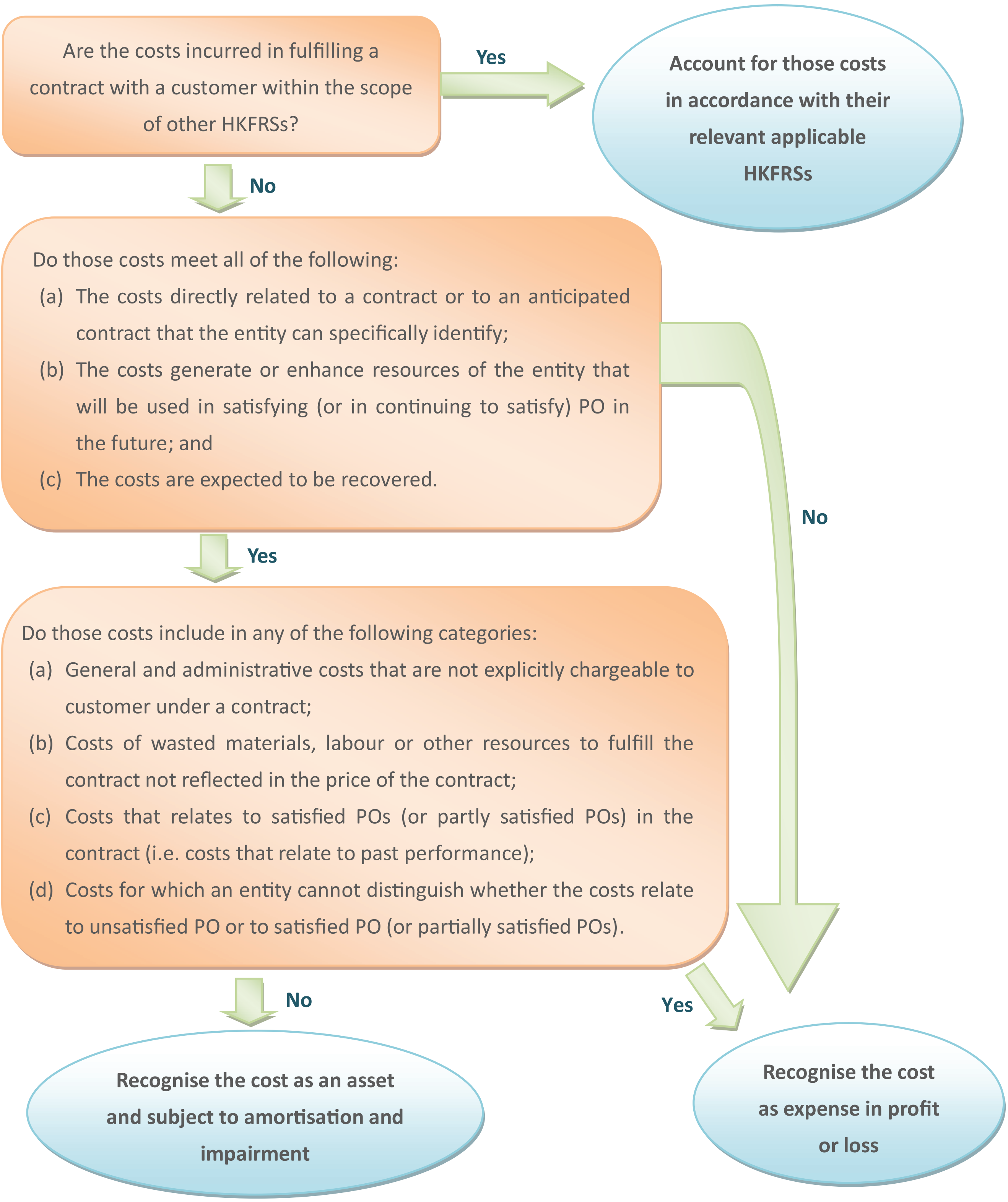
(D) Contract Costs

Contract costs could be divided into:

(i) Costs to fulfill a contract

(ii) Incremental costs of obtaining a contract

<u>Accounting treatment for costs to fulfill a contract</u>



(D) Contract Costs - *Continued*

Accounting treatment for incremental costs of obtaining a contract

Will the costs for obtaining a contract with a customer be incurred if the contract had not been obtained?

No → **Recognise the cost as expense**

Yes ↓

Does the entity expect to recover those costs?

No → **Recognise the cost as expense**

Yes ↓

Recognise the cost as an asset and subject to amortisation and impairment (note)

Note: As a practical expedient, an entity may recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity otherwise would have recognised is one year or less.

(D) Contract Costs - *Continued*

Amortisation and impairment

The points to note for amortisation and impairment are summarised as follow:

<table>
<tr><th>Amortisation</th><th>Impairment</th></tr>
<tr><td>• An asset recognised arising from above costs should be amortised on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates.</td><td>• An entity should recognise an impairment loss in profit or loss to the extent that the carrying amount of cost capitalised exceeds:
(a) the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
(b) the cost that relate directly to providing those goods or services and that have not been recognised as expenses.</td></tr>
<tr><td>• The amortisation should be updated to reflect a significant change in entity's expected timing of transfer to the customer of goods or services to which the asset relates. Such a change should be accounted for as a change in accounting estimate in accordance with HKAS 8.</td><td>• Before recognising an impairment loss for the asset (i.e. cost capitalised as per above), an entity should recognise any impairment loss for assets related to the contract that are recognised in accordance with other HKFRSs.</td></tr>
<tr><td></td><td>• After recognising the impairment loss by applying the method mentioned above, an entity should include the resulting carrying amount of cost capitalised in the carrying amount of the cash-generating unit ("CGU") to which it belongs to for the purpose of applying HKAS 36 Impairment of Assets to that CGU.</td></tr>
<tr><td></td><td>• A reversal of some or all of an impairment loss previously recognised should be recognised in profit or loss when impairment condition no longer exist or have improved. The increased carrying amount of the asset should not exceed the amount that would have been determined (net of amortisation) if no impairment loss had been recognised previously.</td></tr>
</table>

(E) Disclosure

In accordance with paragraph 110 of HKFRS 15, the objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, HKFRS 15 requires an entity to disclose qualitative and quantitative information about all of the following:

(i) Revenue recognised from contracts with customers, including the disaggregation of revenue into appropriate catergories;

(ii) Contract balances, including the opening and closing balances of receivables, contract assets and contract liabilities;

(iii) POs, including when the company typically satisfies its POs and the amount of the transaction price that is allocated to the remaining POs in a contract;

(iv) Significant judgments, and changes in judgments, made in applying the requirements; and

V) Assets recognised from the costs to obtain or fulfill a contract with a customer.

Accounting standards superseded by HKFRS 15

Once HKFRS 15 becomes effective, the following accounting standards and interpretations ("Int") would be superseded:

- HKAS 11 *Construction Contracts*;
- HKAS 18 *Revenue*;
- Hong Kong (International Financial Reporting Interpretations Committee) ("HK(IFRIC)") – Int 13 *Customer Loyalty Programmes*;
- HK(IFRIC) – Int 15 *Agreements for the Construction of Real Estate*;
- HK(IFRIC) – Int 18 *Transfers of Assets from Customers*; and
- Hong Kong (Standard Interpretation Committee) – Int 31 *Revenue – Barter Transactions Involving Advertising Services*.

The Transition and Effective Date

HKFRS 15 becomes effective for annual periods beginning on or after 1 January 2017. Earlier application is permitted. If an entity applies HKFRS 15 for an earlier period, it shall disclose that fact.

An entity shall apply HKFRS 15 using one of the following methods:

(a) retrospectively to each prior reporting period presented in accordance with HKAS 8; or

(b) retrospectively with the cumulative effect of initially applying HKFRS 15 recognised at the date of initial application.

Contact us

HONG KONG
43/F., The Lee Gardens,
33 Hysan Avenue,
Causeway Bay, Hong Kong
Tel: (852) 3583 3800
Fax: (852) 3583 8001
Email: info@shinewing.hk
Website: www.shinewing.hk

BEIJING
9/F,Block A, Fu Hua Mansion
No.8 Chaoyang Men Beidajie,
Dongcheng District, Beijing,
PRC (Postal Code: 100027)
Tel: (86) 10 6554 2288
Fax: (86) 10 6554 7190

SHENZHEN
10/F, Block A, United Plaza,Binhe Road,
Futian District, Shenzhen,
PRC (Postal Code: 518000)
Tel: (86) 755 8290 0800
Fax: (86) 755 8290 0815

CHENGDU
12/F, Block A, No.1, Hang Kong Road,
Air China Century Center, Chengdu,
PRC (Postal Code: 610041)
Tel: (86) 28 8672 2255
Fax: (86) 28 8529 3622

SHANGHAI
32/F, China Development Bank Tower,
No.500, Pudong South Road, Pudong New Area,
Shanghai, PRC (Postal Code: 200120)
Tel: (86) 21 6164 3939
Fax: (86) 21 6164 3900

XI'AN
16/F, Block C, Fortune Center, No.180,
Western section of the second ring road,
Xi'an, PRC (Postal Code: 710075)
Tel: (86) 29 8836 4536
Fax: (86) 29 8836 4578

TIANJIN
21/F, Xinda Plaza, No.188, Jiefang Road,
Heping District, Tianjin, PRC
(Postal Code: 300042)
Tel: (86) 22 5829 6288
Fax: (86) 22 5829 6299

QINGDAO
27/F, HuaYin Mansion, No.5,
Donghai Road(west), Shinan District, Qingdao,
PRC (Postal Code: 266071)
Tel: (86) 532 8089 5858
Fax: (86) 532 8089 5959

CHANGSHA
7/F, Yun Da Guo Ji Plaza, No.478, Section 1,
Middle Furong Road, Changsha, Hunan,
PRC (Postal Code: 410005)
Tel: (86) 731 8828 5566
Fax: (86) 731 8828 5567

CHANGCHUN
7/F, Building 7, Wanhao International Business
Plaza, No.9399, People Street, Changchun,
Jilin, PRC (Postal Code: 130022)
Tel: (86) 431 8193 9933
Fax: (86) 431 8190 2003

YINCHUAN
11/F, Investment Plaza, No.65,
Hubin Street(west), Xingqing District,
Yinchuan, Nixia, PRC (Postal Code: 750001)
Tel: (86) 951 672 1993
Fax: (86) 951 672 1553

JINAN
6/F Huate Plaza, No.17703 Jingshi Road, Lixia
District, Jinan, PRC (Postal Code: 250012)
Tel: (86) 531 8925 9000
Fax: (86) 531 8925 9099

DALIAN
15/F, Block B, Karen International Mansion,
No.1-1 Section A Wucai Town,
Dalian Development Area, Liaoning,
PRC (Postal Code: 116600)
Tel: (86) 0411 8762 6818
Fax: (86) 0411 8762 6307

KUNMING
9/F, Ruyi Plaza, No.36,
Middle People Road, Kunming,
Yunnan, PRC (Postal Code: 650021)
Tel: (86) 871 364 8720
Fax: (86) 871 364 5939

GUANGZHOU
No. 2503 East Tower, Tianyu Business Plaza,
No. 753 Dongfeng, East Road, Yuexiu District,
Guangzhou, PRC (Postal Code: 510080)
Tel: (86) 020 2281 6856
Fax: (86) 020 2281 6866

FUZHOU
13/F, Block A, Hongli Mansion,No.168,
Hudong Road, Fuzhou,350003,
PRC (Postal Code: 350003)
Tel: (86) 0591 2830 9955
Fax: (86) 0591 2830 9000

NANJING
7/F, Hetai International Mansions, No. 128,
Shanxi Road, Nanjing, Jiangsu, PRC
(Postal Code: 210009)
Tel: (86) 025 8372 1886
Fax: (86) 025 8371 6000

URUMQI
13/F, Hongshan New Century Building, No. 8, Xin
Hua North Road, Urumuqi, Xinjiang, PRC
(Postal Code: 830002)
Tel: (86) 0991 8891 969
Fax: (86) 0991 8890 116

WUHAN
Room 2701-2709, 27/F, Block 4, Xingguang
Wuxian Building (Guanggu Yinzuo), No.727
Luoyu Road, Donghu New Technology
Development Zone, Wuhan, Hubei, PRC
(Postal Code: 430071)
Tel: (86) 027 5975 9900
Fax: (86) 027 5975 9922

HANGZHOU
Room 702, Wangjiang Internatioal Center,
Shangcheng District, Hangzhou, Zhejiang, PRC
(Postal Code: 310008)
Tel: (86) 0571 2689 7676
Fax: (86) 0571 2689 7636

TAIYUAN
Room 1103/1105, Fortune Building, No.98
Southern Inner Ring Street, Taiyuan, Shanxi, PRC
(Postal Code: 030012)
Tel: (86) 0351 7899 187
Fax: (86) 0351 7899 023

SINGAPORE
151 Chin Swee Road, No. 02-05/06 Manhattan
House, Singapore (Postal Code: 169876)
Tel: (65) 6732 4150
Fax: (65) 6732 4152

MELBOURNE
CITIC House, Level 1, 99 King Street,
Melbourne, Vic, 3000, Australia
Tel: (613) 8613 0000
Fax: (613) 8613 0099

JAPAN
2-2-15-402 Hamamatsu Chou, Minato-ku,
Tokyo, 105-0013 Japan
Tel: (81-3) 3436 1188
Fax: (81-50) 3020 3622