1. Objective of HKAS 18

Income is defined in the *Framework for the Preparation and Presentation of Financial Statements* as:

- increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. Income encompasses both revenue and gains.

Revenue is income that arises in the course of ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends and royalties.

The objective of HKAS 18 is to prescribe the accounting treatment of revenue arising from certain types of transactions and events.

The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when

- it is probable that future economic benefits will flow to the entity and
- these benefits can be measured reliably.

HKAS 18 identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria.

2. Scope of HKAS 18

HKAS 18 shall be applied in accounting for revenue arising from the following transactions and events:

(a) the sale of goods;

(b) the rendering of services; and

(c) the use by others of entity assets yielding interest, royalties and dividends. *(HKAS 18 para. 1)*[2]

Goods includes goods produced by the entity for the purpose of sale and goods purchased for resale, such as merchandise purchased by a retailer or land and other property held for resale.

The rendering of services typically involves the performance by the entity of a contractually agreed task over an agreed period of time. The services may be rendered within a single period or over more than one period.

Some contracts for the rendering of services are directly related to construction contracts, for example, those for the services of project managers and architects. Revenue arising from these contracts is not dealt with in HKAS 18 but is dealt with in accordance with the requirements for construction contracts as specified in HKAS 11 *Construction Contracts*.

The use by others of entity assets gives rise to revenue in the form of:

(a) interest – charges for the use of cash or cash equivalents or amounts due to the entity;

(b) royalties – charges for the use of long-term assets of the entity, for example, patents, trademarks, copyrights and computer software; and

(c) dividends – distributions of profits to holders of equity investments in proportion to their holdings of a particular class of capital.

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[1] *This note is sourced from HKAS 18 Revenue. While the note is aimed at covering all critical points of HKAS 12, a complete and comprehensive coverage of it should still be the original standard, HKAS 12.*

[2] *All the paragraphs in HKAS have equal authority while main principles are highlighted in bold.*

HKAS 18 does not deal with revenue arising from:

(a) lease agreements (see HKAS 17 *Leases*);

(b) dividends arising from investments which are accounted for under the equity method (see HKAS 28 *Investments in Associates*);

(c) insurance contracts within the scope of HKFRS 4 *Insurance Contracts*;

(d) changes in the fair value of financial assets and financial liabilities or their disposal (see HKAS 39 *Financial Instruments: Recognition and Measurement*);

(e) changes in the value of other current assets;

(f) initial recognition and from changes in the fair value of biological assets related to agricultural activity (see HKAS 41 *Agriculture*);

(g) initial recognition of agricultural produce (see HKAS 41); and

(h) the extraction of mineral ores.

3. Definitions (What is Revenue?)

***Revenue** is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.* *(HKAS 18 para. 7)*

3.1 Revenue From Own Account Only

Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue.

Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

4. Measurement of Revenue

4.1 Revenue Measured at Fair Value

Revenue shall be measured at the fair value of the consideration received or receivable. *(HKAS 18 para. 9)*

***Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction* *(HKAS 18 para. 7)*

The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. It is measured at

- the fair value of the consideration received or receivable
- taking into account the amount of any trade discounts and volume rebates allowed by the entity.

In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable.

4.1.1 Discounting Needed When Inflow of Cash or Cash Equivalents Deferred

However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable.

For example, an entity may provide interest free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods.

When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest.

The imputed rate of interest is the more clearly determinable of either:

(a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or

(b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with section 8 below (paragraphs 29 and 30 of HKAS 18) and in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*.

4.1.2 Exchange of goods or services

1. Similar goods or services

When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. This is often the case with commodities like oil or milk where suppliers exchange or swap inventories in various locations to fulfil demand on a timely basis in a particular location.

2. Dissimilar goods and services

When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue.

The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred.

When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

5. Identification of the Transaction

The recognition criteria in HKAS 18 are usually applied separately to each transaction.

5.1 Recognition Criteria Applied to Separately Identifiable Components of a Single Transaction

However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.

For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed.

5.2 Recognition Criteria Applied to Two or More Transactions Together

Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole.

For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

6. Sale of Goods

6.1 Main Principle

Revenue from the sale of goods shall be recognised <u>when all</u> the following conditions have been satisfied:

- ***(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;***
- ***(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;***
- ***(c) the amount of revenue can be measured reliably;***
- ***(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and***
- ***(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.*** *(HKAS 18 para. 14)*

The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction.

In most cases, the transfer of risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales.

In other cases, the transfer of the risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.

<u>Example (Appendix Example 9)</u>

Real estate sales

Revenue is normally recognised when legal title passes to the buyer. However, in some jurisdictions the equitable interest in a property may vest in the buyer before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue. In either case, if the seller is obliged to perform any significant acts after the transfer of the equitable and/or legal title, revenue is recognised as the acts are performed. An example is a building or other facility on which construction has not been completed.

In some cases, real estate may be sold with a degree of continuing involvement by the seller such that the risks and rewards of ownership have not been transferred. Examples are sale and repurchase agreements which include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such cases, the nature and extent of the seller's continuing involvement determines how the transaction is accounted for. It may be accounted for as a sale, or as a financing, leasing or some other profit sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.

A seller also considers the means of payment and evidence of the buyer's commitment to complete payment. For example, when the aggregate of the payments received, including the buyer's initial down payment, or continuing payments by the buyer, provide insufficient evidence of the buyer's commitment to complete payment, revenue is recognised only to the extent cash is received.

6.2 Entity Retains Significant Risks of Ownership

If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain a significant risk of ownership in a number of ways.

Examples of situations in which the entity may retain the significant risks and rewards of ownership are:

(a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;

(b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;

(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and

(d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

Example (Appendix Example 5)

Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase, or the buyer has a put option to require the repurchase, by the seller, of the goods

For a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised.

When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue. For a sale and repurchase agreement on a financial asset, HKAS 39 *Financial Instruments: Recognition and Measurement* applies.

Example (Appendix Example 2)

Goods shipped subject to conditions

(a) *Installation and inspection*

Revenue is normally recognised when the buyer accepts delivery, and installation and inspection are complete. However, revenue is recognised immediately upon the buyer's acceptance of delivery when:

(i) the installation process is simple in nature, for example the installation of a factory tested television receiver which only requires unpacking and connection of power and antennae; or

(ii) the inspection is performed only for purposes of final determination of contract prices, for example, shipments of iron ore, sugar or soya beans.

(b) On approval when the buyer has negotiated a limited right of return

If there is uncertainty about the possibility of return, revenue is recognised when the shipment has been formally accepted by the buyer or the goods have been delivered and the time period for rejection has elapsed.

(c) Consignment sales under which the recipient (buyer) undertakes to sell the goods on behalf of the shipper (seller)

Revenue is recognised by the shipper when the goods are sold by the recipient to a third party.

(d) Cash on delivery sales

Revenue is recognised when delivery is made and cash is received by the seller or its agent.

Examination question

Question *Modified from CPA QP FPE 2002 December Paper II Case Q3 Q2(d)*

Cyber Technology Company Limited (CTC) is a system integrator specialising in providing Point-of-Sales (POS) solutions. CTC includes the following standard contract terms in the agreement with the distributors when CTC sells the software to the distributors in various cities in the Mainland of China:

Contract sum:	HK$5 million CIF (Cost, insurance and freight) The seller (CTC) bears all risks of loss of or damage to the goods until such time as they have passed the ship's rail at the port of shipment.
Contract term:	1 year
Method of payment:	Paid on contract day HK$2 million. After delivery of products, the remaining balance should be remitted to the designated bank account in Hong Kong.

Others:	HK$2 million is non-refundable irrespective of how much software the distributors have sold. At the end of the year, if the total sales made by the distributors are less than HK$2 million, CTC would only be required to refund 3 million to the customer. Any unsold software should be returned, intact, to CTC for intellectual property protection purposes. The cost of producing such software is insignificant.

You are required to advise the appropriate accounting treatment of the above contract for sale of the POS software. What additional information would you require from CTC to make a better judgment on the accounting treatment? Your answer does not need to consider the HK$2 million as service income. (7 marks)

Answers

Whether the contract should be recognized as income, the following analysis is helpful:

Under paragraph 14 of the HKAS 18, revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

(i) the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;
(ii) the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
(iii) the amount of revenue can be measured reliably;
(iv) it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
(v) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

The question that really needs to be asked is whether the risks have been passed to the distributors.

Obviously, for aggressive revenue recognition, CTC would like to explore the likelihood of whether all sales of HK$5 million could be recognized at the date of the delivery to the shipping port. If CTC retains the significant risks of ownership, the transaction is not a sale and revenue is not recognised. An enterprise may retain a significant risk of ownership in a number of ways including when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods. [Paragraph16(b) of HKAS 18, or point b of section 6.2 above]

If there were no sales at all, CTC would have HK$2 million sales even though they can get all of the inventory back. Therefore, at most HK$3 million is the subject of argument. Since the transaction can be separated into two parts, HK$2 million goods sales has been completed and HK$3 million goods could be viewed as an assignment of goods but CTC would require a deposit for risk protection purposes.

Since it is not refundable, it should be counted as revenue when the software was delivered at the shipping port, as the amount of revenue can be measured reliably and it is probable that the economic benefits associated with the transaction will flow to the enterprise as HK$2 million have been received at the date of contract. The cost of the software is not a determining factor as it is insignificant.

Since the earnings process has not been completed at the day of delivery of the software for the HK$3 million goods, the deferral of revenue is more appropriate. Accordingly, one can argue that such additional revenue could be recognized by CTC upon sales of software by the distributor over the HK$2 million sales value to CTC.

There is another school of thought that the HK$2 million may be recognised over the term of the contract if certain services were required by CTC. Accordingly, it is required to know that whether CTC would need to perform any other services during the term of the contract.

6.3 Entity Retains Only Insignificant Risks of Ownership

If an entity retains only an insignificant risk of ownership, the transaction is a sale and revenue is recognised.

For example, a seller may retain the legal title to the goods solely to protect the collectibility of the amount due. In such a case, if the entity has transferred the significant risks and rewards of ownership, the transaction is a sale and revenue is recognised.

Another example of an entity retaining only an insignificant risk of ownership may be a retail sale when a refund is offered if the customer is not satisfied. Revenue in such cases is recognised at the time of sale provided the seller can reliably estimate future returns and recognises a liability for returns based on previous experience and other relevant factors.

Example (Appendix Example 1)

"Bill and hold" sales, in which delivery is delayed at the buyer's request but the buyer takes title and accepts billing.

Revenue is recognised when the buyer takes title, provided:

(a) it is probable that delivery will be made;

(b) the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;

(c) the buyer specifically acknowledges the deferred delivery instructions; and

(d) the usual payment terms apply.

Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.

6.4 Inflow of Future Economic Benefits Not Probable

6.4.1 Revenue not recognised if inflow is not probable

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. In some cases, this may not be probable until the consideration is received or until an uncertainty is removed.

For example, it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country. When the permission is granted, the uncertainty is removed and revenue is recognised.

Example (Appendix Example 3)

Lay away sales under which the goods are delivered only when the buyer makes the final payment in a series of installments

Revenue from such sales is recognised when the goods are delivered. However, when experience indicates that most such sales are consummated, revenue may be recognised when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the buyer.

6.4.2 Inflow is not probable after revenue is recognised

However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

6.5 Matching of Revenues and Expenses

Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; this process is commonly referred to as the matching of revenues and expenses.

Expenses, including warranties and other costs to be incurred after the shipment of the goods can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied.

However, revenue cannot be recognised when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of the goods is recognised as a liability.

Examination question

Question (10 marks) *Modified from CPA QP FPE 2004 June Paper I Case Q2*

Under the existing OEM agreements between Perfect Industry and its customers, customers give Perfect Industry formal written acceptance to confirm that the goods delivered conform to their specifications.

However, it may take a few weeks after the delivery of goods for some customers to send the written acceptance. Some customers do not send written acceptance until they settle the amount due. Some customers never send written acceptance.

Perfect Industry's existing accounting practice is to recognise sales revenue when goods are delivered to carriers or locations designated by the customers.

One of the directors of Perfect Industry, Mr Lam, after receiving the standard OEM agreement in detail, has queried whether this practice is appropriate.

Required: Write a memo to Mr Lam explaining your views on whether the existing revenue recognition practice for OEM sales is appropriate.

Answers

TTo : Mr. Lam, Director
From : xxx,

Re : Query regarding recognition of revenue from OEM sales

In response to your query regarding the company's existing accounting policy for the recognition of OEM revenue, we would like to advise you of the following.

General principles for recognition of revenue from sales of goods

We consider that revenue from OEM sales is revenue from sales of goods subject to HKAS 18 *Revenue*. Although we produce the products according to strict specifications as required by our customer, we are not simply providing production services.

HKAS 8 sets out that revenue from the sale of goods should be recognised when all the following conditions have been satisfied:

- the enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;
- the enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
- the amount of revenue can be measured reliably;
- it is probable that the economic benefits associated with the transaction will flow to the enterprise; and
- the costs incurred or to be incurred in respect of the transaction can be measured reliably.

Transfer of risks and rewards

Your query principally relates to when the company transfers to the buyer the significant risks and rewards of ownership of the OEM goods. To be more specific, the issue is whether the company is regarded as not having transferred the significant risks and rewards until the customers have given written acceptance of the goods to the company in accordance with the agreement.

The assessment of when the company has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction.

In most cases, the transfer of the risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer.

Acknowledgement of receipt by customers or the existence of third party transportation documents is usually regarded as evidence of transfer of the legal title or passing of possession to the buyer and is therefore critical in determining when sales of goods should be recognised.

HKAS 18, however, gives some examples of situations in which the seller may retain the significant risks and rewards of ownership after the transfer of the legal title or the passing of possession to the buyer. The absence of a formal acceptance by the customer is not an example of a seller retaining the significant risks and rewards of ownership.

Relevance of written acceptance

We conclude that it is appropriate to recognise revenue on delivery of the OEM goods to customers on the following basis:

The written customer acceptance provisions are to allow the customer to cancel the transaction when we deliver a product that does not meet the specifications of the customer's order. In such cases, revenue should not be recognised because a sale has not occurred.

We agree that the written customer sign-off provides the best evidence that these acceptance criteria have been met.

However, revenue recognition is appropriate if we can reliably demonstrate that the delivered products meet all of the specified criteria, provided all other revenue recognition criteria have been met.

If we can reliably demonstrate that a delivered product meets the customer-specified objective criteria set forth in the arrangement, the risks and rewards of ownership transfers on delivery of the goods.

In such a case, we consider that we would be successful in enforcing a claim for payment due from the customer even in the absence of formal sign-off, particularly for customers who have a track record of not giving us written confirmation.

Unless we consider that the product would not perform in the manner specified by the acceptance provisions, we can reasonably recognise the revenue. We hope we have answered your query.

Best Regards

Xxxx

7. Rendering of Services

7.1 Main Principle

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the balance sheet date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- ***(a) the amount of revenue can be measured reliably;***
- ***(b) it is probable that the economic benefits associated with the transaction will flow to the entity;***
- ***(c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and***
- ***(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.*** *(HKAS 18 para. 20)*

The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method.

Under this method, revenue is recognised in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period. HKAS 11 *Construction Contracts* also requires the recognition of revenue on this basis. The requirements of HKAS 11 are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services.

Example (Appendix Example 10)

Installation fees

Installation fees are recognised as revenue by reference to the stage of completion of the installation, unless they are incidental to the sale of a product in which case they are recognised when the goods are sold.

Example (Appendix Example 12)

Advertising commissions

Media commissions are recognised when the related advertisement or commercial appears before the public. Production commissions are recognised by reference to the stage of completion of the project.

7.2 Inflow is not probable after revenue is recognised

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

7.3 Reliable Estimates of Revenue

An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:

- (a) each party's enforceable rights regarding the service to be provided and received by the parties;
- (b) the consideration to be exchanged; and
- (c) the manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of revenue as the service is performed. The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably.

7.4 Stage of Completion

The stage of completion of a transaction may be determined by a variety of methods. An entity uses the method that measures reliably the services performed. Depending on the nature of the transaction, the methods may include:

(a) surveys of work performed;

(b) services performed to date as a percentage of total services to be performed; or

(c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.

Progress payments and advances received from customers often do not reflect the services performed.

7.5 Indeterminate Number of Acts and Significant Specific Act

For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion.

When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed.

Example (Appendix Example 10)

Servicing fees included in the price of the product

When the selling price of a product includes an identifiable amount for subsequent servicing (for example, after sales support and product enhancement on the sale of software), that amount is deferred and recognised as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement, together with a reasonable profit on those services.

7.6 Outcome of Services Not Estimated Reliably

When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable. *(HKAS 18 para. 26)*

During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the transaction costs incurred. Therefore, revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the transaction cannot be estimated reliably, no profit is recognised.

When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognised and the costs incurred are recognised as an expense.

When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue is recognised in accordance with section 7.1 above (paragraph 20 of HKAS 18) rather than in accordance with this section (section 7.6 or paragraph 26 of HKAS 18).

8. Interest, Royalties and Dividends

8.1 Main Principle

Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognised on the bases set out in the following paragraph when:

(a) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(b) the amount of the revenue can be measured reliably. *(HKAS 18 para. 29)*

Revenue shall be recognised on the following bases:

(a) interest shall be recognised using the effective interest method as set out in HKAS 39, paragraphs 9 and AG5-AG8;

(b) royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and

(c) dividends shall be recognised when the shareholder's right to receive payment is established. *(HKAS 18 para. 30)*

8.2 Only Post-acquisition Portion Recognised as Revenue

When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; only the post-acquisition portion is recognised as revenue.

When dividends on equity securities are declared from pre-acquisition profits, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.

8.3 Recognition of Royalties Over the Terms of Agreement

Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis.

Example

Licence fees and royalties

Fees and royalties paid for the use of an entity's assets (such as trademarks, patents, software, music copyright, record masters and motion picture films) are normally recognised in accordance with the substance of the agreement. As a practical matter, this may be on a straight-line basis over the life of the agreement, for example, when a licensee has the right to use certain technology for a specified period of time.

An assignment of rights for a fixed fee or non refundable guarantee under a non-cancellable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. An example is a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery. Another example is the granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts. In such cases, revenue is recognised at the time of sale.

In some cases, whether or not a licence fee or royalty will be received is contingent on the occurrence of a future event. In such cases, revenue is recognised only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.

8.4 Inflow is not probable after revenue is recognised

Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity.

However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

9. Disclosure

An entity shall disclose:

(a) the accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;

(b) the amount of each significant category of revenue recognised during the period including revenue arising from:

(i) the sale of goods;

(ii) the rendering of services

(iii) interest;

(iv) royalties;

(v) dividends; and

(c) the amount of revenue arising from exchanges of goods or services included in each significant category of revenue. *(HKAS 18 para. 35)*

An entity discloses any contingent liabilities and contingent assets in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise from items such as

- warranty costs,
- claims,
- penalties or
- possible losses.

10. Effective Date

HKAS 18 becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.

If an entity applies HKAS 18 for a period beginning before 1 January 2005, it shall disclose that fact and apply Hong Kong Accounting Standards Interpretation (HKAS-INT) 31 **Revenue – Barter Transactions Involving Advertising Services** ***at the same time.*** *(HKAS 18 para. 37)*