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*The HKICPA's Standard Setting Department welcomes your comments and feedback on this paper, which should be sent to [commentletters@hkicpa.org.hk](mailto:commentletters@hkicpa.org.hk).*

## **Illustrative examples on sponsor fee income**

In February 2019, the Financial Reporting Standards Committee (FRSC) of the Hong Kong Institute of Certified Public Accountants (HKICPA) published questions and answers (Q&As)

(<https://www.hkicpa.org.hk/en/Tools/FAQ/Standards/HKFRS/HKFRS-15-Revenue-from-Contracts-with-Customers---IPO-sponsors>) to provide guidance on the recognition of IPO sponsor fee income under HKFRS 15 *Revenue from Contracts with Customers* by a sponsor in Hong Kong. The Q&As highlight the major issues likely to be encountered in applying HKFRS 15's five step revenue recognition model to a typical IPO sponsor arrangement in Hong Kong, and identify the principles and references in HKFRS 15 that provide the key considerations in addressing these issues.

In this publication, we provide examples to illustrate the application of the principles in HKFRS 15 to some of the issues discussed in the Q&As, namely:

- determination of the transaction price when there is variable consideration; and
- how a clause in the contract which entitles the sponsor to receive payment for its performance completed to date if the contract is terminated (a "right to payment clause") might impact the timing of revenue recognition.

This article should be read in conjunction with the Q&As.



### Background information

Sponsor A in Hong Kong enters into typical IPO sponsor arrangements as described in the fact pattern in the Q&As. Sponsor A enters into three separate contracts with three listing applicants having the following payment terms.

	Contract 1	Contract 2	Contract 3
Total consideration	\$1,000,000	\$1,000,000	\$1,000,000
Total costs	\$350,000	\$350,000	\$350,000
Initial deposit on signing of contract (% of total consideration)	60%	20%	20%
Milestone payments (due when sponsor reaches the following milestones):			
Submission of listing application	30%	50%	50%
Date of listing approval meeting (i.e. date of the hearing)	5%	20%	20%
Successful listing of shares	5%	10%	10%

*Note: The numbers used in the table above are for illustration purpose only and not bright line rules leading to a particular accounting outcome. The listing application document is customised for each applicant.*

Contract 2 contains a clause that provides Sponsor A with an enforceable right to payment for performance completed to date at all times throughout the duration of the contract, even if milestones have not been reached. Contracts 1 and 3 do not.

Sponsor A receives an initial non-refundable deposit from the listing applicants upon signing the contracts. Sponsor A is entitled to further payments if and when the stated milestones in the contracts are reached. The payment at each milestone becomes unconditional upon the milestone being reached and is non-refundable. The majority of the sponsor's costs under the contract are incurred before submission of the listing application.

### Determination of the transaction price when there is variable consideration

(Refer to Question 2 of the Q&As which describes the HKFRS 15 requirements in more detail)

The amount of sponsor fee income ultimately received by the sponsor under the contract will be less than the total contractual amount if one or more of the milestones in the contract are not met. When determining the transaction price, the sponsor will need to assess the probability of meeting the different milestones in the contract and also the likelihood of granting a price concession. Furthermore, this



estimate of variable consideration is only included in the transaction price to the extent that it is highly probable that a significant reversal in the amount of cumulated revenue recognised will not occur, applying the constraint in HKFRS 15.56.

The example below illustrates the requirements for determining the transaction price, including constraining estimates of the variable consideration, under HKFRS 15.

**Example 1: Determination of transaction price and constraining estimates of variable consideration**

*Additional facts:*

Sponsor A makes the following assessments at contract inception:

- There is a 70% chance that the listing application in Contract 1 would be approved if the listing applicant files the application and the shares would list successfully.
- There is only a 30% chance that the listing application in Contract 2 would be approved. However, the listing applicant wants to go ahead with the application even though it is unlikely a listing approval meeting will be granted. If the listing is unsuccessful (e.g. the application is not accepted and so does not proceed for hearing and approval), Sponsor A expects to give this listing applicant a price concession of 5% of the milestone payments payable.
- There is a 90% chance that the listing application in Contract 3 would be approved if the listing applicant files the application and the shares would list successfully.

Sponsor A uses the most likely amount method to estimate the variable consideration in its contracts applying HKFRS 15.53 because it is the method that Sponsor A expects to better predict the amount of consideration to which it will be entitled.

*Analysis:*

The transaction price is the amount of consideration that Sponsor A expects to be entitled in exchange for completion of its promised services. Completion of services will either occur on successful listing or abortion/rejection of IPO.

Contract 1



In Contract 1, Sponsor A considers the milestone payments as variable consideration because the amount it expects to receive can vary depending on the achievement of the future milestones.

At contract inception, Sponsor A estimates that there is a 70% chance that the listing application would be successful if filed. The consideration is estimated to be \$1,000,000, which is considered the most likely outcome of the contract (i.e. the milestone that Sponsor A expects to achieve is successful listing of the shares). However, given that the milestone payments are significant and the successful submission of the listing application and approval of listing are largely not within the control of Sponsor A, both are subject to significant uncertainties, Sponsor A determines that the criterion in HKFRS 15.56 is not met for the milestone payments. In this case the milestone payments are excluded from the transaction price prior to achieving the respective milestone and at contract inception the transaction price is estimated to be \$600,000 (i.e. the initial non-refundable deposit received).

#### Contract 2

Similarly, the milestone payments in Contract 2 are considered as variable consideration.

At contract inception, Sponsor A estimates that there is only a 30% chance that the listing would be successful and the case is not likely to proceed to listing approval meeting. Sponsor A considers which milestones are expected to be achieved and whether any price concession (which would be considered variable consideration) is likely to be provided to the customer if the IPO is aborted or the listing is unsuccessful.

Sponsor A expects to achieve the milestone for the submission of the listing application but also expects to provide a 5% price concession for this milestone payment if the listing application fails. Therefore, at contract inception, Sponsor A estimates the consideration to be equal to \$675,000, consisting of the initial deposit of \$200,000 [ $\$1,000,000 \times 20\%$ ] plus \$475,000 comprising 95% of the milestone on submission of the application [ $\$1,000,000 \times (50\% \times 0.95)$ ]. However, given that the milestone payments are significant and the successful submission of the listing application is largely not within the control of Sponsor A and subject to significant uncertainty, Sponsor A determines that the highly probable criterion in HKFRS 15.56 is not met for the milestone payment.

Nevertheless, Contract 2 contains a right to payment clause which entitles Sponsor A to an enforceable right to payment for its performance completed to



date at all times throughout the duration of the contract even if the respective milestones are not achieved. Therefore Sponsor A considers whether the transaction price should include part of the \$475,000, in addition to the deposit of \$200,000, to cover expected progress towards meeting the milestone for the submission of listing application, subject to the constraint in HKFRS 15.56.

Sponsor A applies its judgement and estimates the transaction price (i.e. in the range of \$200,000 to \$675,000) at concept inception.

### Contract 3

Similarly, the milestone payments in Contract 3 are treated as variable consideration.

At contract inception, Sponsor A estimates there is a 90% chance that the listing application would be successful if filed. Similar to Contract 1, given that the milestone payments are significant and the successful submission of the listing application and approval of listing are largely not within the control of Sponsor A, Sponsor A determines that the highly probable criterion in HKFRS 15.56 is not met for the subsequent milestone payments. This is because even though Sponsor A's estimated chance of approval is 90%, there are still significant uncertainties including whether the listing applicant ultimately decides to proceed for the filing or otherwise changes its listing plans before the submission. In this case the milestone payments are excluded from the transaction price prior to achieving the respective milestone and the transaction price is estimated to be \$200,000 at contract inception (i.e. the initial non-refundable deposit received).

### Reassessment of variable consideration

At each reporting date, Sponsor A considers any change in expected outcome and updates its estimation of the transaction price (including updating its estimate of variable consideration and whether that estimate is constrained) by applying HKFRS 15.59.

For example, assume at Sponsor A's next reporting date the listing application has been submitted for Contract 2, but the listing approval meeting has not been scheduled. The revised estimated transaction price at this date is now the deposit plus 95% of the expected milestone payment, i.e. \$675,000 [\$200,000 + \$475,000], being the amount of the consideration based on the latest assessment that the milestone for the submission of listing application has been reached but it is still uncertain that a listing approval meeting will take place.



### Notes

The illustration above only considers how to estimate the transaction price. It does not cover the timing of revenue recognition. If a contract meets one of the criteria under HKFRS 15.35 to recognise revenue over time, the estimated transaction price will need to be determined at each reporting date during the contract period. This is because the transaction price, together with the entity's measure of progress, will be used to measure revenue at each reporting date. Conversely, if a contract does not meet any of the criteria under HKFRS 15.35 to recognise revenue over time, the estimated transaction price is only measured at the date the revenue is recognised (i.e. completion of sponsor services).

### **Impact of contractual right to payment clause on revenue recognition**

(Refer to Question 3 of the Q&As which describes the HKFRS 15 requirements in more detail)

An entity satisfies a performance obligation over time if one of the criteria in HKFRS 15.35 is met. The typical sponsor agreement discussed in the Q&As published in February 2019 does not meet criterion HKFRS 15.35(a) or (b) (See Question 3 of the Q&As for guidance). Therefore, a sponsor needs to consider whether the agreement satisfies HKFRS 15.35(c), i.e. whether the sponsor's performance creates an asset with no alternative use to the sponsor and specifically, whether the sponsor has an enforceable right to payment for its performance completed to date in accordance with HKFRS 15.35(c), 37 and B9-B13.

A sponsor should consider all the payment and termination clauses in the contract and determine whether they are legally enforceable considering the relevant laws and regulations in Hong Kong when assessing whether it has an enforceable right to payment for performance completed to date in the event of termination of the contract by the applicant applying HKFRS 15.35(c).

The example below illustrates how the existence of a contractual right to payment clause might impact the timing of revenue recognition. For simplicity, it does not address whether the sponsor is compensated for a reasonable margin throughout the contract period (HKFRS 15.B9), nor consider the legal interpretation of the enforceability of the terms in the contracts.

**Example 2: How the contractual right to payment clause affects the timing of recognition of sponsor fee income**

*Additional facts:*

Sponsor A makes the following assessments at contract inception:

- Sponsor A identifies that it has a single performance obligation in each of its contracts applying HKFRS 15.22-30 (Refer to Question 1 of the Q&As for guidance).
- Sponsor A expects to incur 80% of the total contract costs (\$280,000) during the period before the submission of the listing application for all contracts.
- Sponsor A assesses that compensation for a reasonable margin for all contracts before the submission of the listing application and for the whole contract ranges from 45%-55% and 60%-70%, respectively.

*Analysis:*

Contract 1

Contract 1 does not contain a right to payment clause. The initial deposit represents 60% of the total contract price (\$600,000) which is non-refundable. Based on the assessment performed by Sponsor A, the initial deposit is sufficient to cover its estimated costs (\$280,000) plus a reasonable margin (53%) before submission of the listing application. Furthermore, the initial deposit plus the first milestone payment (\$900,000 = \$600,000 + \$300,000) are sufficient to cover total estimated costs (\$350,000) under the contract plus a reasonable margin (61%) for the remaining contract period after the submission of the listing application. Assuming the payment terms in the contract are legally enforceable, Sponsor A has an enforceable right to payment for performance completed to date. This is because:

- the expected costs incurred plus a reasonable profit margin before the submission of the listing application are less than the initial non-refundable deposit; and
- the expected total costs incurred plus a reasonable profit margin are less than the initial non-refundable deposit plus the first milestone payment after the submission of the listing application.

Consequently, HKFRS 15.35(c) is met and sponsor fee income is recognised over time.

Contract 2

Contract 2 has a right to payment clause, meaning Sponsor A has a contractual right to be compensated for the performance completed to date in case of



termination of the contract. Assuming that the right to payment clause is legally enforceable, HKFRS 15.35(c) is met and sponsor fee income is recognised over time.

### Contract 3

Contract 3 does not have a right to payment clause. The initial deposit only represents 20% of the total contract price (\$200,000) and so it is not sufficient to cover Sponsor A's estimated costs (\$280,000) incurred during the period before submission of the listing application. Consequently, Sponsor A does not have an enforceable right to payment for its performance completed to date under Contract 3. HKFRS 15.35(c) is not met and sponsor fee income is recognised at the point in time when the sponsor completes its services (either when the shares are successfully listed or the IPO is aborted or rejected).

Based on the above analysis, Sponsor A satisfies its performance obligation in Contracts 1 and 2 over time and its performance obligation in Contract 3 at a point in time. Please refer to Question 4 of the Q&As which describes the appropriate methods for measurement of progress if revenue is recognised over time.

### Notes

Revenue for Contract 3 is recognised at a point in time based on the above analysis. Consequently, the transaction price is only required to be measured at the date revenue is recognised (when the sponsor completes its services). Hence, an assessment of the variable consideration over the contract period will not be necessary for measurement purposes for Contract 3, because there is no uncertainty over which milestones are achieved at the time revenue is recognised.

In contrast, for Contracts 1 and 2, an assessment of the variable consideration throughout the duration of the contract is required for revenue recognition over the contract period. The amount of revenue recognised is based on the transaction price determined after considering any constraints under HKFRS 15.56 (see Example 1) multiplied by the percentage of the progress as measured using an appropriate input or output method (See Question 4 of the Q&As for guidance).

Therefore, under all contracts, the initial non-refundable deposit is not recognised when received. Under Contract 3, the deposit is recognised only at completion of services. Under Contracts 1 and 2, the deposit must be recognised over the





contract period as services are performed (not on receipt of the deposit) and hence the deposit would only be fully recognised upon completion of sponsor services.