Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH

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Dear David

IASB Exposure Draft – ED/2010/6  
Revenue from Contracts with Customers

We welcome the opportunity to comment on the IASB’s Exposure Draft on Revenue from Contracts with Customers (the ‘ED’) and thank the Board for enabling us to participate in this debate.

HSBC is one of the largest banking and financial services organisations in the world, with assets of US$2,418 billion at 30 June 2010. Headquartered in London, HSBC serves customers worldwide from more than 8,000 offices in 87 countries and territories in six geographical regions. HSBC’s businesses encompass a very broad range of financial services and products, including personal financial services, commercial lending, global banking and markets, private banking, asset management and insurance.

We understand the importance of creating a single, converged revenue recognition standard and appreciate the efforts of the IASB and FASB in issuing a joint exposure draft on Revenue from Contracts with Customers. The ED has clarified a number of questions and uncertainties that existed with the proposals outlined in the IASB Discussion Paper – Revenue Recognition in Contracts with Customers. We specifically welcome the boards’ decision to exclude from the scope of the ED lease contracts within the scope of IAS 17 Leases, insurance contracts within the scope of IFRS 4 Insurance Contracts and contractual rights or obligations within the scope of IFRS 9 Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement. We support the proposed principles for combining and segmenting contracts, and for identifying separate performance obligations. In general, an effort has been made to establish clear principles rather than rules, which is to be welcomed.

However, we have a number of conceptual and practical concerns with the proposals in the ED. In general, we are concerned about the difficulty of implementing the proposals, and, we do not believe that the costs of implementation would be justified by the benefits of the proposals. We summarise our main concerns below.
It is proposed that revenue is recognised when the customer obtains control of a good or service, which will be the case when the customer has the ability to direct the use of, and receive the benefit from, the good or service. We do not believe that it is appropriate to apply this concept to service contracts because, for example, in the case of a cancellation of the contract, the customer may not receive the benefit but may still be obliged to pay for the services rendered to date. In our view, the percentage of completion method in IAS 18 is a well understood concept which has proven to be operationally viable in accounting for service contracts.

We are also concerned about the proposal to recognise variable consideration based on probability-weighted expected values. In our view, the expected value methodology will not always result in the most meaningful or decision-useful information. The expected value approach has some merit when applied to a large and homogeneous group of performance obligations, and could result in a realistic estimate of revenue. However, we believe that it is inappropriate for the measurement of single performance obligations, because the probability-weighted value is almost certainly not the amount that will be received. We believe this approach may result in increased volatility in the income statement, and the resulting reported numbers may be difficult to explain to users of the financial statements. We believe that the current measurement criteria in IAS 18 paragraph 20 are widely understood, easier to apply and provide more meaningful and decision-useful information to the users of the financial statements.

We do not agree with the proposal to consider a customer’s credit risk in the measurement of revenue. In our opinion, the effect of credit losses should be presented in a separate line in the income statement. We also do not support the proposal to assess onerous obligations at the level of individual performance obligations, as this could result in the recognition of liabilities for performance obligations within contracts which are in overall terms profitable.

As a result of these concerns, we would support further work to simplify the proposals, and to make them more operational in practice and easier to implement. This is particularly important given the extensive IFRS change programme already underway. We recommend that the proposals should be reconsidered to ensure that the desired improvement in the quality of information for the users of the financial statements is better balanced against the cost for the preparers to implement the proposals. If the Board decides to proceed with the proposals, we would recommend an extensive transition period to enable preparers of financial statements to gather the required information.

As always, we would be pleased to discuss our comments with you in further detail if that would be helpful.

Yours sincerely

[Signature]
Appendix 1 – Questions for respondents

Recognition of revenue (paragraphs 8-33)

Question 1

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

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

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

We agree with the principles for combining and segmenting contracts as outlined in the exposure draft, and believe that the guidance in paragraph 13 and 14 is sufficiently clear. We have a specific question on the example in B3 on contract modifications, which appears to contradict this guidance. In particular, in Scenario 2 of the example, two contracts are treated as interdependent due the amount of discount received. However, paragraph 14 of the ED states that the price of a contract is not interdependent with the price of another contract solely because the customer receives a discount on goods or services in the contract as a result of an existing customer relationship arising from previous contracts.

Question 2

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

We agree with the proposed principle for identifying separate performance obligations and welcome the practical expedient in paragraph 24, whereby performance obligations can be accounted for together if applying the same revenue recognition method to those services would faithfully depict the transfer of services to the customer. However, it will be difficult and costly for financial institutions to determine whether the criteria of paragraph 24 are met, because of the requirement to establish that the accounting for the performance obligations together would result in the same amount and timing of revenue recognition as if they were accounted for separately. An example would be where a bank charges a fee for a bundled product. Therefore, we would encourage the Board to enhance the guidance in paragraph 24 by allowing performance obligations to be accounted for together, if on initial analysis, the
revenue recognised in the income statement would not be significantly different from that recognised if the performance obligations were accounted for separately.

Question 3

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

Our main concerns with the proposed guidance are as follows:

While we appreciate the Board’s efforts to provide extensive guidance to illustrate when control of a promised good or service is transferred to a customer, we do not believe that the four indicators of control as set out in paragraph 30 (a) – (d) are sufficient to clarify the application of the principle in all circumstances. For example, where services are not customer specific and fees are charged upfront only indicator (a) is applicable. However, even though indicator (a) is fulfilled paragraph B28 would prohibit the recognition of revenue upfront in many cases because the customer does not receive a service at the time when the fee is paid.

In respect of service obligations a customer obtains control of the service when the customer has the ability to direct the use of, and receive the benefit from the service. We do not believe that it is appropriate to apply this concept to service contracts because, for example, in the case of a cancellation the customer may not receive the benefit but may still be obliged to pay for the services rendered to date. In our view, the percentage of completion method in IAS 18 is a well understood concept, and is more operational than the proposed control approach for service obligations.

Measurement of revenue (paragraphs 34-53)

Question 4

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

Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?
We appreciate the Board’s effort to include guidance surrounding the recognition of variable consideration. However, we believe that the current approach in IAS 18 provides more useful information to users of financial statements. Our main concerns with the proposed guidance are as follows:

Paragraph 38 states that an entity shall recognise revenue from satisfying a performance obligation if the transaction price can be reasonably estimated. This will be the case when a) the entity has experience with similar types of contracts; and b) the experience is relevant. In our view, the guidance in paragraphs 39 and 40 does not sufficiently explain the application of paragraph 38 and is open to wide interpretation. This is likely to result in inconsistent application of the principle. The example in B76 is based on a relatively simple set of assumptions about the fact pattern. Further examples would be needed to show how the principles could be applied in more complex circumstances.

We are also concerned about the proposal to recognise variable consideration based on probability-weighted expected values. In our view, the expected value methodology will not always result in the most meaningful or decision-useful information. The expected value approach has some merit when applied to a large homogeneous group of performance obligations, and could result in a realistic estimate of revenue. However, we believe that it is inappropriate for the measurement of single performance obligations, because the probability-weighted value is almost certainly not the amount that will be received. Additionally, this may result in increased volatility in the income statement and the resulting reported numbers may be difficult to explain to users of the financial statements. We believe that current measurement criteria in IAS 18 paragraph 20 are widely understood, easier to apply and provide more meaningful and decision useful information to the users of the financial statements.

Question 5

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

We do not share the Board’s view that credit risk should affect how much revenue an entity recognises. In our view the inclusion of credit risk in the measurement of revenue does not provide meaningful information to users of the financial statements and we are also concerned that the proposals would require significant operational effort to implement.

In HSBC’s view the effect of credit risk should be presented in a separate line from revenue and any adjustment to credit risk should be recognised in the same line as the initial credit loss or impairment. We believe that our view is more consistent with the tentative decision taken during the re-deliberations on phase II of the replacement project for IAS 39 Financial
Instruments: Recognition and Measurement, where the Board tentatively decided to permit the use of a 'decoupled' effective interest rate, so that the expected loss estimate and effective interest rate are calculated and accounted for separately over the life of a portfolio of financial assets.

Question 6

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

We agree with the Board that the time value of money should be considered where there is a significant time difference between the good or service being provided and the payment by the customer, so that the amount ultimately paid reflects a material financing component. However, we believe that this should only be applied to significant financing arrangements, because the application of this approach to a large number of small performance obligations, which may capture timing differences resulting from administrative processes, would be unduly difficult to implement and costly relative to the value of the information provided.

Question 7

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

We agree with the Board’s proposal to allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations.

Contract costs (paragraphs 57-63)

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 Intangible Assets or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?
HSBC shares the Board’s view that the proposals for the costs of fulfilling contracts are operational and sufficient. HSBC believes that there can be valid conceptual grounds for recognising costs of obtaining contracts as assets in certain circumstances. We note that there is a conceptual difference in approach to that taken in IAS 39. Under IAS 39, transaction costs that are directly attributable to the acquisition or issue of a financial asset/liability measured at amortised cost are recognised as part of the asset/liability, and amortised through the effective interest rate calculation.

Question 9

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

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

Yes, we agree with the costs specified in paragraph 58.

Disclosure (paragraphs 69-83)

Question 10

The objective of the boards’ proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

We agree that, in general, the proposed disclosure requirements will meet the objective to help users of the financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. However, we are supportive of principle-based disclosures and are concerned about the list of mandatory disclosure requirements which in our view would not provide useful information in all cases.

While a reconciliation of contract balances, as required by paragraph 75, may often provide useful information, we do not believe that this information is always useful. For example, IFRS 7 does not require a reconciliation for interest accruals, therefore we do not see how a similar reconciliation would be useful for fee accruals in an asset management contract.

As per our additional comments in Appendix 2 we believe that onerous obligations should be assessed at contract level and that the accounting rules and disclosure requirements would be better placed within IAS 37. Please refer to question 12 to see our concerns in relation to the disclosure of disaggregation of revenue.
Question 11

The boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.

Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

We agree with the proposed disclosure requirement.

Question 12

Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

While we agree with the proposal it is our view that it should be considered as part of the Financial Statement Presentation project to ensure that the presentation in the income statement and in the disclosures provides a clear and understandable picture of revenue to the user of the financial statements.

Effective date and transition (paragraphs 84 and 85)

Question 13

Do you agree that an entity should apply the proposed requirements retrospectively (ie as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why?

Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

While we agree with the Board that retrospective application of new standards is generally desirable, we believe that retrospective application of this standard will be potentially very costly and represent a considerable operational burden. Even with prospective-only application there may be some complex systems changes involved in implementing the proposals as currently drafted. If retrospective application is required, we believe that a very significant lead time will need to be allowed to implement the required system changes. It is not currently possible for us to estimate the required lead time, however given that extensive changes in accounting standards are proposed over the next few years very careful consideration should be given to the transition arrangements and cost/benefit considerations.
Application guidance (paragraphs B1-B96)

Question 14

The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

We believe that some examples provided in the appendix to the ED are too simplified and do not provide sufficient guidance in all cases. For example:

- The example in B76 assumes that the company does not have relevant experience because the variable consideration amount is highly susceptible to external factors and the uncertainty is not expected to be resolved until the end of the year. The example could be read to mean that external factors like market risk always result in no recognition of revenue until the revenue becomes known with certainty. However, paragraph 39 and 40 of the ED could be read to mean that an entity must make an assessment of the likelihood that the performance fee will be payable as the contract progresses towards the date the fee becomes known with certainty. We are not sure, therefore, that the example faithfully illustrates the intended operation of the principles.

- As stated in question 2 above, the example provided in B3 appears to contradict the guidance in paragraph 14.

- The example in B79 assumes that when an entity enters into a contract with a customer there is a 10% chance that the customer will not pay the consideration. In our view, such a scenario is unlikely to occur in practice because it is doubtful that a company would enter into a contract with such a high loss rate on a regular basis. The example serves to highlight the issues raised in question 5 in respect of credit risk being part of the measurement of revenue rather than part of the recognition criteria. It also highlights the issue raised in question 4 in respect of probability-weighted transaction prices as the revenue ultimately recognised by the entity neither reflects the money ultimately received nor the agreed sales price. In addition, the effect of credit risk is included in two different lines in the income statement so that the loss due to credit risk is not evident for the users of the financial statements.
Question 15

The boards propose that an entity should distinguish between the following types of product warranties:

(a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.

(b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

No comment.

Question 16

The boards propose the following if a licence is not considered to be a sale of intellectual property:

(a) if an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the licence; and

(b) if an entity grants a customer a non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and it satisfies that obligation when the customer is able to use and benefit from the licence.

Do you agree that the pattern of revenue recognition should depend on whether the licence is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?

No comment.
Consequential amendments

Question 17

The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

Subject to our concerns in questions 1-16, and our additional comments in Appendix 2, we agree that an entity should apply the recognition and measurement principles of the ED in accounting for the gain or loss on the sale of some non-financial assets.
Appendix 2 – Additional comments

Onerous performance obligations

In HSBC’s view onerous obligations should be accounted for in line with IAS 37, and continue to be assessed at a contract level.

We do not agree with the Board’s proposal to assess onerous obligations at the level of performance obligations as this may lead to recognition of liabilities even if a contract is overall profitable. This is specifically an issue where a performance obligation does not relate to the benefits received by the service provider and the benefit might not be within the scope of the standard. This issue can be demonstrated using the example of a current account for which there is no fee. The benefit for the bank is a lower cost of funding compared to other sources but this benefit is not included as part of revenue under the ED and does not relate to the performance obligation of administering the account. As costs will be incurred for the administration of the account, the assessment for onerous obligations at the level of performance obligations may lead to the recognition of a liability for onerous obligations even though the bank may obtain an overall benefit from the account. Furthermore, it is our view that the assessment of onerous obligations at the level of performance obligations would be operationally complex and costly to implement.

Inconsistency with IASB Exposure Draft 2010/9 Leases (‘Leases ED’)

We note that there is an inconsistency in the criteria defining a sale between the Leases ED and this ED.

The criteria defining a sale in paragraph B9 of the Leases ED include the transfer of control of the entire underlying asset and all but a trivial amount of the risks and benefits associated with the entire underlying asset. However, the ED states in paragraph 25 that ‘A good or service is transferred when the customer obtains control of that good or service’. Given that contracts meeting the criteria defining a sale in paragraph B9 of the Leases ED will fall into the scope of this ED rather than being accounted for as leases, we believe that it is important that the Board can justify the use of different definitions.

Loan commitment fees

The ED does not carry forward existing guidance in IAS 18 on the accounting for fees on loan commitments outside the scope of IAS 39. Therefore, it is unclear what criteria should be applied in deciding whether the accounting for such fees would fall within the scope of the proposed standard or IAS 39.