Inland Revenue Department

The Government of the Hong Kong Special Administrative Region
of the People's Republic of China

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

NO. 1 (REVISED)

PROFITS TAX

PART A: COMPUTING ASSESSABLE PROFITS

PART B: REVENUE RECOGNITION

PART C: MEASUREMENT OF INVENTORIES OR STOCK

These notes are issued for the information of taxpayers and their tax representatives. They contain the Department's interpretation and practices in relation to the law as it stood at the date of publication. Taxpayers are reminded that their right of objection against the assessment and their right of appeal to the Commissioner, the Board of Review or the Court are not affected by the application of these notes.

These notes replace those issued in July 2006.

TAM Tai-pang
Commissioner of Inland Revenue

September 2020

DEPARTMENTAL INTERPRETATION AND PRACTICE NOTES

No. 1 (REVISED)

CONTENT

PART A: COMPUTING ASSESSABLE PROFITS

BASIS FOR COMPUTING ASSESSABLE PROFITS

Profits arisen or derived

Profits tax is charged under section 14 of the Inland Revenue Ordinance (the Ordinance) on a person carrying on a trade, profession or business in Hong Kong in respect of the person's assessable profits arising in or derived from Hong Kong from such trade, profession or business. Section 2 defines "assessable profits" to mean the profits in respect of which a person is chargeable to tax for the basis period for any year of assessment.

Full amount of profits

2. Section 18B(1) provides that the assessable profits for any year of assessment from any trade, profession or business carried on in Hong Kong shall be computed on the full amount of the profits arising in or derived from Hong Kong during the year of assessment. The full amount of the profits arisen or derived during the year of assessment is determined in accordance with generally accepted accounting principles subject to the requirement of conformity with the tax laws (i.e. the Ordinance and the relevant judicial interpretations). In *CIR v Secan Ltd & Another* (2000) 3 HKCFAR 411, Lord Millett NPJ said at page 419 that losses, of course, are merely the mirror image of profits, and must be ascertained for tax purposes in the like manner. Further, section 19D provides that the amount of loss incurred by a person shall be computed in like manner and for such basis period as assessable profits would have been computed.

Accounting period as basis period

3. Section 18B(2) allows a person to choose an accounting period that ends on a day within a year of assessment as the basis period for that year. If the financial statements are drawn up to 31 March annually, the basis period for the year of assessment 2019/20 will be the accounting year ended 31 March 2020. If the financial statements are drawn up to 30 June annually, the basis period for the year of assessment 2019/20 will be the accounting year ended 30 June 2019. If the financial statements are drawn up to 31 December annually, the basis

period for the year of assessment 2019/20 will be the accounting year ended 31 December 2019.

Deductible expenses

4. Profits of a person cannot be ascertained without considering deduction of outgoings and expenses. If an expense is a proper deduction in accordance with generally accepted accounting principles, the expense should be allowed unless the expense is prohibited for deduction under the Ordinance. The concept of "profits" needs the making of such deductions as generally accepted accounting principles would require: see *Usher's Wiltshire Brewery Ltd v Bruce* [1914] 6 TC 399, *Atherton v British Insulated and Helsby Cables Ltd* [1925] 10 TC 155, and *Morley v Lawford* [1928] 14 TC 229.

5. Section 16 governs the deduction of outgoings and expenses while section 17 disallows certain deductions. In *CIR v Secan Ltd & Another* (2000) 3 HKCFAR 411, Lord Millett NPJ said that sections 16 and 17 are enacted for the protection of the revenue, not the taxpayer, and section 16 is to be read in a negative sense. Section 16 permits outgoings and expenses to be deducted only to the extent to which they are incurred in a year of assessment. If accounting profits, determined in accordance with generally accepted accounting principles, have taken into account expenses that are not deductible under the Ordinance, those expenses are to be excluded for tax purposes in order to conform with the Ordinance.

RELEVANCE OF ACCOUNTING PRINCIPLES

Accrual accounting

6. For profits tax purposes, the application of generally accepted accounting principles to the transactions of the trade or business is the starting point for computing assessable profits. In general, financial statements prepared in accordance with generally accepted accounting principles will provide the practical basis for computing assessable profits.

7. Since accrual accounting is the fundamental concept which underpins the preparation of financial statements, revenue and expenses are recognised

even if receipts and payments occur in a different period. The point at which revenue is recognised is usually the same point at which any related expenses are recognised.

8. In buying and selling of goods, the cost of the purchases is usually carried as inventories in the statement of financial position until such time as the inventories are sold and the related revenue is recognised. Inventories are then recognised as cost of sales and thus an expense.

9. Revenue is derived or earned when goods are sold or services are provided (i.e. promised goods or services are transferred) and is measured at the amount of consideration a person expects to be entitled in exchange for transferring promised goods or services. Accordingly, when sales are made in an accounting period, the sale price should normally be brought into account for profits tax purposes in that period even if the proceeds are not received until after the end of the period subject to a possible provision for bad debts.

10. The Commissioner normally does not accept cash basis since profits from trading or business are recognised on an accrual basis. Thus, profits recognised on an accrual basis in accordance with generally accepted accounting principles are normally taken as profits "arisen" or "derived" for the purposes of section 14 provided that the accrual is not "anticipatory" but made to reflect the existence of a contract of sale.

Interaction between accountancy and tax laws

11. While profits computed in accordance with generally accepted accounting principles form the starting point for the computation of assessable profits, adjustments to those profits may need to be made to conform with tax laws (i.e. the Ordinance and the relevant judicial interpretations). Adjustments may also be needed to give effect to more general tax principles (e.g. profits of a capital nature) to tax the full amount of the profits of the trade, profession or business.

12. The courts in the United Kingdom have been increasingly reluctant to override generally accepted accounting principles: see the judgments in *Threlfall v Jones* [1993] 66 TC 77, *Johnston v Britannia Airways Ltd* [1994] 67 TC 99 and, specifically on the timing of receipts, *Symons v Lord Llewelyn-Davies'*

Personal Representative and Others [1982] 56 TC 630. In particular, they have been especially unready to override accounting treatment, which in commercial terms is the only acceptable treatment: see the observations of the Master of the Rolls in *Threlfall v Jone*s at page 123.

13. The Court of Final Appeal's judgment in *CIR v Secan Ltd & Another* (2000) 3 HKCFAR 411 is the highest authority in Hong Kong on the relevance of commercial accounting principles in ascertaining profits for the purposes of section 14. Lord Millett NPJ held that profits and losses must be ascertained in accordance with the ordinary principles of commercial accounting as modified to conform with the Ordinance. Where the financial statements of a person are correctly drawn in accordance with such principles and in conformity with the Ordinance, no further modifications are required or permitted.

14. In the United Kingdom, this principle was reaffirmed by the House of Lords in *Revenue and Customs Commissioners v William Grant & Sons Distillers Ltd* [2007] 1 WLR 1448 at page 1458 per Lord Hope of Craighead who also adopted Sir Thomas Bingham MR's observation in *Gallagher v Jones* [1994] Ch 107 that the principles of commercial accountancy are not static but so long as they remain current and generally accepted, they provide the surest guide to the question that the legislation requires to be answered.

Application of accounting principles

15. Whilst accounting principles are relevant to the ascertainment of assessable profits, their application is subject to several considerations:

(a) the court will have recourse to the evidence of accountants in determining what the correct principles of commercial accounting are and has to make a final decision as to whether such practice corresponds to the correct principles of commercial accountancy, as there may be a divergence of views between accountants or there may be alternative principles[1];

(b) the court will always have the last word though great weight

[1] See *Odeon Associated Theatres Ltd v Jones* 48 TC 257 at 273.

would be attached to the view of the accounting profession[2] and the court would not regard itself as being bound by the evidence of accountants as it would be wrong to do so[3];

(c) the principles of commercial accountancy must yield not only to statutory provisions, but also to any overriding principle of tax law[4].

Two cardinal principles

16. In *Nice Cheer Investment Ltd v CIR* (2013) 16 HKCFAR 813, Lord Millett NPJ at the Court of Final Appeal clarified the expression "in conformity with the Ordinance" and elaborated what constitutes taxable profits within the meaning of the Ordinance. Lord Millett NPJ said there are two cardinal principles of tax law: "profits" connotes actual or realised and not potential or anticipated profits; and neither profits nor losses may be anticipated[5].

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Hong Kong Financial Reporting Standards

17. For the purposes of computing the full amount of profits arisen or derived in the basis period for a year of assessment, the relevant generally accepted accounting principles can be found in Hong Kong Financial Reporting Standards (HKFRS), including both Standards (i.e. HKFRS and Hong Kong Accounting Standards (HKAS)) and Interpretations (i.e. Hong Kong (IFRIC) Interpretations, Hong Kong Interpretations and Hong Kong (SIC) Interpretations), published by the Hong Kong Institute of Certified Public Accountants (HKICPA).

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[2] *Ostime v Duple Motor Bodies Ltd* [1961] 39 TC 537, per Lord Reid at 570.

[3] *Heather v P-E Consulting Group Ltd* [1973] Ch 189, per Lord Denning at 217.

[4] *Willingale v International Commercial Bank Ltd* [1977] Ch 78 at 97.

[5] In the *Nice Cheer* case, the unrealised gains related to fair value changes of securities which were held for trading. Such gains are currently accounted for in accordance with HKFRS 9 *Financial Instruments* and do not relate to any contract or transaction with a customer as defined under HKFRS 15 *Revenue from Contracts with Customers* (see Part B of this Practice Note). As a rule of practice, revenue recognised under HKFRS 15 upon transfer of goods or services is generally treated as having been realised and would be assessed as profits having been derived.

18. For small and medium-sized entities and private entities, the relevant generally accepted accounting principles can be found in *Small and Medium-Sized Entity Financial Reporting Framework and Financial Reporting Standard* (SME-FRF & SME-FRS) and *Hong Kong Financial Reporting Standard for Private Entities* (HKFRS for Private Entities).

19. HKFRS determine generally accepted accounting principles in Hong Kong and set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events that are important in general purpose financial statements. HKFRS are based on the *Conceptual Framework for Financial Reporting*, which addresses the concepts underlying the information presented in general purpose financial statements.

New or revised standards

20. From time to time, new or revised standards will be developed to address new and changing transactions and events, or improve the standards by removing options, developing better treatments and addressing issues more specifically. A new or revised standard will determine generally accepted accounting principles in Hong Kong from the date the new or revised standard becomes effective.

HKFRS applicable to Hong Kong incorporated companies

21. Companies incorporated in Hong Kong are required under Part 9 of the Companies Ordinance (Cap. 622) to prepare annual financial statements which are in compliance with generally accepted accounting principles. Section 380(4)(b) of the Companies Ordinance requires that the financial statements of a financial year must comply with the accounting standards applicable to the financial statements. A company which prepares financial statements in compliance with HKFRS is required to make an explicit and unreserved statement of such compliance in the notes to the financial statements. Where a company, in an extremely rare circumstance, concludes that compliance with a requirement in an HKFRS would be so misleading that it would conflict with the objective of financial statements set out in the *Conceptual Framework for Financial Reporting*, the company may depart from that requirement by making necessary disclosures.

Standards applicable to non-Hong Kong incorporated companies

22. For companies incorporated outside Hong Kong, including branches, which carry on business in Hong Kong, their financial statements may be prepared in accordance with financial reporting standards which vary from those in Hong Kong (e.g. HKFRS). The Commissioner would generally accept an accounting treatment which is in accordance with the relevant financial reporting standard of the "home" jurisdiction or International Financial Reporting Standards issued by the International Accounting Standards Board, and is consistent with the true facts or otherwise apt to determine the true profits or losses of the business. Though the financial reporting standards of the "home" jurisdiction may be accepted for determining the accounting profits or losses, such profits or losses would be subject to the requirement of conformity with the tax laws.

Financial statements required to give a true and fair view

23. The requirement for the assessable profits of a trade or business to be computed in accordance with generally accepted accounting principles does not, in itself, impose any audit requirement. Companies formed and registered under the Companies Ordinance, however, must have their financial statements audited unless they are dormant. A company must keep such accounting records as will enable its directors to comply with the requirements of the Companies Ordinance.

24. The auditor's report, where required, must state whether in the auditor's opinion the financial statements have been properly prepared in compliance with the Companies Ordinance and give a true and fair view of the financial performance and financial position of the company if the company does not fall within the reporting exemption for the financial year. If the financial statements do not represent a true and fair view, the auditor must qualify the report accordingly. In practice, the application of the principal qualitative characteristics under the *Conceptual Framework for Financial Reporting* and of appropriate accounting standards (i.e. HKFRS and HKFRS for Private Entities), with additional disclosure when necessary, normally results in financial statements that give what is generally understood as a true and fair view of, or as presenting fairly such information.

25. Private companies or companies limited by guarantee which qualify for reporting exemption under section 359 of the Companies Ordinance and take advantage of the reporting exemption are exempt from the requirement for their financial statements to give a true and fair view. Instead of preparing financial statements under the fair presentation framework, companies taking advantage of the reporting exemption are required to prepare their financial statements in accordance with SME-FRF & SME-FRS as these are the applicable accounting standards for such companies for the purposes of complying with section 380(4)(b) of the Companies Ordinance.

Profits tax return

26. When submitting a profits tax return, a company must attach certified copies of its audited financial statements if required by the Board of Inland Revenue. Without the audited financial statements, the profits tax return will not be accepted as being complete and the company will not be accepted as having complied with the filing obligation under the Ordinance. The company may be subject to penal action if the audited financial statements cannot be submitted before the filing deadline. An estimated assessment may be raised on the company if the company is considered to be chargeable to profits tax.

PART B: REVENUE RECOGNITION

REVENUE FROM CONTRACTS WITH CUSTOMERS

Objective of HKFRS 15

27. HKFRS 15 *Revenue from Contracts with Customers*[6] was issued to replace a number of Standards and Interpretations[7]. The objective of this standard is to establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer. It provides comprehensive guidance to be applied in order to recognise revenue from contracts with customers. It considers goods and services provided in a contract to be performance obligations that must be satisfied before revenue can be recognised. It was issued with an effective date of 1 January 2017 which was later revised to 1 January 2018.

28. While appropriate adjustments are still required to be made for profits tax purposes, the introduction of HKFRS 15 has brought in certainty and clarity regarding the recognition of profits for both accounting and profits tax purposes. Under HKFRS 15, revenue is recognised when performance obligations of the contract are satisfied (i.e. when control of the goods or services has been transferred to the customer). In contrast, profits tax is charged when the profit is derived and the expense is incurred. In practice, the difference, if any, should not be significant since the five-step approach under HKFRS 15 means that the accounting treatment follows a substance-based approach which is based on the transfer of control of the goods or services. Appendix 1 gives an overview of HKFRS 15.

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[6] HKFRS 15 does not apply to revenue arising from the following:
- (a) lease contracts within the scope of HKFRS 16 *Leases*;
- (b) insurance contracts within the scope of HKFRS 4 *Insurance Contracts*;
- (c) financial instruments and other contractual rights or obligations within the scope of HKFRS 9 *Financial Instruments*, HKFRS 10 *Consolidated Financial Statements*, HKFRS 11 *Joint Arrangements*, HKAS 27 *Separate Financial Statements* and HKAS 28 *Investment in Associates and Joint Ventures*; and
- (d) non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

[7] HKAS 11 *Construction Contracts*, HKAS 18 *Revenue*, HK(IFRIC)-Int 13 *Customer Loyalty Programmes*, HK(IFRIC)-Int 15 *Agreements for the Construction of Real Estate*, HK(IFRIC)-Int 18 *Transfer of Assets from Customers* and HK(SIC)-Int 31 *Revenue—Barter Transactions Involving Advertising Services*.

Five-step revenue recognition model under HKFRS 15

29. The core principle of HKFRS 15 is that an entity recognises 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 recognises revenue in accordance with that core principle by applying the following steps:

(a) Step 1: Identify the contract(s) with a customer;

(b) Step 2: Identify the performance obligations in the contract;

(c) Step 3: Determine the transaction price;

(d) Step 4: Allocate the transaction price to the performance obligations in the contract; and

(e) Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. A performance obligation is a promise in a contract with a customer to transfer to the customer either a good or service or a bundle of goods or services that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. When an entity transfers promised goods or services to a customer, the transaction price is the amount of consideration in a contract to which the entity expects to be entitled in exchange for the transfer.

30. Regarding construction contracts, and pre-completion sale and purchase agreements for units in multi-storey residential buildings, the application of the revenue recognition principles under HKFRS 15 is explained in Appendices 2 and 3. Small and medium-sized entities and private entities, which fulfill the criteria for reporting under SME-FRF & SME-FRS and HKFRS for Private Entities, should recognise revenue from such contracts or agreements in accordance with:

(a) section 8 (Construction Contracts) or section 11 (Revenue) of SME-FRF & SME-FRS; or

(b) section 23 (Revenue) of HKFRS for Private Entities.

Performance obligation satisfied over time or at a point in time

31. Under HKFRS 15, revenue should be recognised when performance obligation is satisfied (i.e. control of the promised good or service of a contract is obtained by the customer). The customer has control of the promised good or service when the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service by the use, consumption, sale or exchange, pledging and holding of the good or service. In practice, if a person has recognised a revenue under Step 5, the Commissioner would regard the revenue as having been realised (i.e. the revenue is not anticipated) and such revenue should be included as the assessable profits of the person.

32. At contract inception, it has to be determined whether the performance obligation is satisfied over time or at a point in time in accordance with paragraphs 35 to 38 of HKFRS 15. If the performance obligation is not satisfied over time, it is satisfied at a point in time. For the purposes of determining the point in time at which a customer obtains control of the good or service, the indicators of the transfer of control taken into account should include, but not limited to, the following:

(a) the person has a present right to payment for the good or service;

(b) the customer has legal title to the good or service;

(c) the person has transferred physical possession of the good or service;

(d) the customer has the significant risks and rewards of ownership of the good or service; and

(e) the customer has accepted the good or service.

The indicators are usually present if the customer has the control of the good or service. However, the indicators are not individually determinative and they are not a list of conditions that have to be met. The nature of the good or service in question and the terms of the contract would generally determine which indicators of the transfer of the control would be of relevance.

HKFRS 15 for computing assessable profits

33. When applying HKFRS 15, the terms of the contract entered into with the customer and all relevant facts and circumstances have to be considered. Given HKFRS 15 provides the generally accepted accounting principles for recognition of revenue, the Commissioner would accept that accounting profits determined in accordance with HKFRS 15 would form the starting point for computing assessable profits. The examples in this Practice Note are not intended to comprehensively address all possible tax issues that may arise. It should not be assumed that the examples will provide a definite answer in every case. Each example addresses the tax issues in relation to the specific facts given.

<u>Example 1</u>

Company-HK developed a new computer equipment which would not function or be sold without an operating software. On 1 January 2019, Company-HK entered into a contract with a customer for selling the computer equipment for $4,000,000. The contract with two-year maintenance services, which covered parts, labour and software repairs, would commence upon delivery of the computer equipment. On 1 February 2019, the computer equipment was delivered to the customer. Company-HK determined that the stand-alone selling prices at contract inception were: $3,500,000 for the computer equipment and the operating software (as a bundle); and $500,000 for the maintenance services. Company-HK closed its accounts on 31 December annually.

The five-step revenue recognition model under HKFRS 15 would need to be applied as follows:

Step 1: Identify the contract with a customer

(a) Company-HK would be required to account for the contract since the five criteria in paragraph 9 of HKFRS 15 are met (i.e.

contract approved and performance obligations committed; rights regarding the equipment and services identified; payment terms for the equipment and services identified; commercial substance found; and consideration entitled collectable).

Step 2: Identify the performance obligations in the contract

(b) In the sale contract, there were two performance obligations: transfer of the computer equipment and operating software; and provision of two-year maintenance services. Since benefits could not be obtained from the computer equipment without the operating software, the computer equipment and operating software were not distinct goods and the promises regarding their transfer could not be treated as separate performance obligations.

Step 3: Determine the transaction price

(c) Transaction price of $4,000,000 fixed in the sale contract was the consideration that Company-HK would expect to be entitled to in exchange for transferring the computer equipment and operating software, and the maintenance services to the customer.

Step 4: Allocate the transaction price to the performance obligations in the contract

(d) $4,000,000 should be allocated to each of the performance obligations in the contract based on the relative stand-alone selling price. $3,500,000 and $500,000 should be allocated to the computer equipment and operating software, and the maintenance services respectively.

Step 5: Recognise revenue when or as the performance obligations are satisfied

(e) Revenue from the sale of the computer equipment and operating software should be recognised at a point in time since none of the criteria in paragraph 35 of HKFRS 15 was met. Revenue of $3,500,000 should be recognised in Company-HK's accounts for the year ended 31 December 2019 upon delivery. Revenue from the provision of maintenance services should be recognised over time since the customer would consume and receive benefit from the maintenance services over a two-year period (i.e. 1 February 2019 to 31 January 2021). Revenue of $500,000 would be recognised in Company-HK's accounts for the years ended 31 December 2019, 2020 and 2021 using an appropriate basis for measuring progress towards completion of the maintenance services.

For profits tax purposes, the revenue as recognised in the accounting periods for the years ended 31 December 2019, 2020 and 2021 would be regarded as having arisen or been derived under section 18B in the years of assessment 2019/20, 2020/21 and 2021/22 respectively. Expenses, which satisfied the deduction rules under sections 16 and 17 and were incurred in the production of the revenue for the years ended 31 December 2019, 2020 and 2021, would be matched against the revenue to arrive at the assessable profits of Company-HK for the years of assessment 2019/20, 2020/21 and 2021/22.

Variable consideration

34. Where a contract includes variable consideration (e.g. price discounts, rebates, incentives and performance bonuses), a person has to recognise variable consideration as revenue 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 related to the variable consideration is subsequently resolved. For profits tax purposes, the Commissioner takes the view that the variable consideration recognised as revenue in such a situation would be regarded as having been realised and the resulting profits after deduction of expenses would be assessed accordingly.

Example 2

Bank-HK entered into a contract to help a customer with an equity placement. Bank-HK determined at contract inception that the performance obligation would be satisfied at a point in time upon completion of the equity placement. In addition to a fixed fee of $10 million, Bank-HK would receive a bonus of $1 million if the placement was successful. Bank-HK determined that the most likely amount provided the best estimation of the amount of consideration to which it would be entitled though there would be a 75% chance that the placement would be successful and a 25% chance that it would be unsuccessful.

If the most likely amount was adopted, the variable consideration that Bank-HK expected to be entitled to would be $1 million. Since the payment of the bonus was highly susceptible to market volatility, which was outside the control of Bank-HK and the customer, it would be concluded that the variable consideration should be constrained to zero until the equity placement was completed. For profits tax purposes, the variable consideration of $1 million would be regarded as having been realised when the equity placement was completed (i.e. tax treatment and accounting treatment of the variable consideration are the same).

Significant financing component

35. Where the timing of payment agreed in the contract provides a person or the person's customer with a significant benefit of financing the transfer of the good or service, an adjustment of the compromised consideration for the effects of the time value of money is required and the effects of financing (i.e. interest revenue or interest expense) are presented separately from revenue from contracts with customers.

36. Though notional interest revenue or interest expense are recognised in the financial statements in accordance with HKFRS 15, there is no actual interest receipt or interest payment. A person receiving advance payments from a customer has no obligation or accrued liability to pay interest to the customer whereas a person receiving deferred payments from a customer does not have

any right, legal or contractual, to receive interest from the customer. The Commissioner therefore takes the view that such interest revenue and interest expense are notional constructs made solely for complying with the accounting requirements of HKFRS 15 and should not be brought to tax.

37. For profits tax purposes:

(a) any sum recognised as notional interest revenue as required under HKFRS 15 for deferred payments made by a customer should be recognised as part of the revenue derived from sale of the good or service in the year of assessment in which the good or service is transferred to the customer;

(b) any sum recognised as notional interest expense as required under HKFRS 15 for advance payments made by a customer should be ignored and the cash payment received upfront (i.e. without any notional interest expense) should be recognised as revenue derived from sale of the good or service in the year of assessment in which the good or service is transferred to the customer.

In the tax computations, tax adjustments relating to significant financing components have to be made and clearly disclosed.

Example 3

On 1 January 2018, Company-HK sold Product A to a customer with delivery on that same day. It was agreed in the contract that the price of $500,000 would be deferred for payment until 31 December 2019. The incremental borrowing rate of Company-HK was 5%. Company-HK closed its accounts on 31 December each year. Given that the contract contained a significant financing component, Company-HK accounted for the revenue and significant financing component in accordance with HKFRS 15 as follows:

Account	*Debit*	*Credit*
	$	*$*
<u>Year ended 31 December 2018</u>		
To recognise revenue upon delivery of Product A:		
Receivable	*453,514*	
Revenue ($500,000 ÷ 1.05^2)		*453,514*
To recognise interest revenue:		
Receivable	*22,676*	
Interest revenue ($453,514 × 5%)		*22,676*
<u>Year ended 31 December 2019</u>		
To recognise interest revenue:		
Receivable	*23,810*	
Interest revenue ($476,190 × 5%)		*23,810*
To recognise receipt of payment:		
Bank	*500,000*	
Receivable		*500,000*

Though $46,486 (i.e. $22,676 + $23,810), which formed part of the sale price, was recognised as notional interest revenue in accordance with the requirement under HKFRS 15, Company-HK had no right to receive any interest from the customer. $500,000 (i.e. $453,514 + $22,676 + $23,810) should be recognised as revenue in the year of assessment 2018/19 since control of Product A was obtained by the customer upon delivery on 1 January 2018. $22,676 and $23,810 should not be assessed as interest revenue for the years of assessment 2018/19 and 2019/20.

In the tax computation for the year of assessment 2018/19, Company-HK should declare revenue of $500,000 as having been derived from sale of Product A and disregard the notional interest revenue of $22,676. In the tax computation for the year of assessment 2019/20, Company-HK should disregard the interest revenue of $23,810.

Example 4

On 1 January 2018, Company-HK sold Product B to a customer at $500,000 and an upfront payment was made by the customer. It was agreed in the contract that Product B would be delivered to the customer on 31 December 2019. The incremental borrowing rate of Company-HK was 5%. Company-HK closed its accounts on 31 December each year. Given that the contract contained a significant financing component, Company-HK accounted for the revenue and significant financing component in accordance with HKFRS 15 as follows:

Account	*Debit*	*Credit*
	$	*$*
Year ended 31 December 2018		
To recognise receipt of payment:		
Cash	*500,000*	
Contract liability		*500,000*
To recognise interest expense:		
Interest expense ($500,000 × 5%)	*25,000*	
Contract liability		*25,000*
Year ended 31 December 2019		
To recognise interest expense:		
Interest expense ($525,000 × 5%)	*26,250*	
Contract liability		*26,250*
To recognise revenue upon delivery of Product B:		
Contract liability	*551,250*	
Revenue		*551,250*

Though $51,250 (i.e. $25,000 + $26,250) was recognised as notional interest expense in accordance with the requirement under HKFRS 15, Company-HK had no legal obligation to pay any interest to the customer and such notional interest expense should be ignored for profits tax purposes. Since Product B was transferred to the customer upon delivery on 31 December 2019, $500,000 (i.e.

$551,250 − $25,000 − $26,250) should be recognised as revenue in the year of assessment 2019/20.

In the tax computation for the year of assessment 2018/19, Company-HK should add back the notional interest expense of $25,000. In the tax computation for the year of assessment 2019/20, Company-HK should add back the notional interest expense of $26,250 and declare revenue of $500,000 as having been derived from sale of Product B.

Transitional adjustments

38. HKFRS 15 prescribes the transitional accounting adjustments when a person first applies the standard. HKFRS 15 is allowed to be adopted by using one of the following two methods:

(a) retrospectively to each prior reporting period presented in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (i.e. full retrospective method); or

(b) retrospectively with the cumulative effect of initially applying HKFRS 15 recognised at the date of initial application (i.e. modified retrospective method).

Regardless of the method adopted, the Commissioner takes the view that any upward transitional adjustment that is revenue in nature should be subject to tax and any downward transitional adjustment that is revenue in nature would be deducted from the profits or allowed as a deduction, as the case may be, in the year of assessment relating to the basis period in which HKFRS 15 was adopted for the first time.

<u>Example 5</u>

Company-HK, a software company, entered into a contract with a customer to provide a software term licence and telephone support for two years at a fixed price of $4,000. The software was delivered and operational on 1 July 2016. Company-HK recognised revenue in its accounts for the years ended 31 December 2016 and 2017 on a *straight-line basis:*

Year ended 31 December	*2016*	*2017*	*Total*
	$	*$*	*$*
Revenue	*1,000*	*2,000*	*3,000*

Revenue assessed was: $1,000 for the year of assessment 2016/17; and $2,000 for the year of assessment 2017/18.

Company-HK adopted HKFRS 15 on 1 January 2018. It allocated $3,000 and $1,000 to the two performance obligations, the software licence and telephone support respectively, based on the relative stand-alone selling prices. Company-HK determined that the software licence was a point-in-time performance obligation whereas the telephone support was a performance obligation satisfied over time. Under HKFRS 15, revenue from software licence should be recognised on the delivery date of 1 July 2016 and revenue from telephone support should be recognised by reference to the progress which was measured by time lapse (2016: $250; 2017: $500; 2018: $250).

Scenario 1: Company-HK applied the transition provisions of HKFRS 15 using the full retrospective method. The financial statements for the years ended 31 December 2016 and 2017 were restated as below:

Year ended 31 December	*2016*	*2017*	*2018*	*Total*
	$	*$*	*$*	*$*
Revenue	*3,250*	*500*	*250*	*4,000*

Under the full retrospective method, revenue restated was: $3,250 for the year ended 31 December 2016; and $500 for the year ended 31 December 2017. The adjustment of $750 (i.e. $3,250 + $500 – $3,000) formed part of the contract revenue and would be assessed in the year of assessment 2018/19 relating to the basis period in which HKFRS 15 was first adopted by Company-HK. Revenue of $250 would also be assessed in the year of assessment 2018/19. In the tax computation for the year of assessment 2018/19, Company-HK should declare the adjustment of $750 for assessment.

Scenario 2: Company-HK applied the transition provisions of HKFRS 15 using the modified retrospective method. Adjustment was made to increase its opening balance of retained earnings as below:

Year ended 31 December	*2018*	*Total*
	$	*$*
Revenue	*250*	*250*
Adjustment to opening balance of retained earnings	*750*	*750*

Under the modified retrospective method, an adjustment of $750 would be made to the opening balance of retained earnings at the date of initial application of HKFRS 15 (i.e. 1 January 2018). The adjustment of $750 formed part of the contract revenue and would be assessed in the year of assessment 2018/19 relating to the basis period in which HKFRS 15 was first adopted by Company-HK. Revenue of $250 would also be assessed in the year of assessment 2018/19. In the tax computation for the year of assessment 2018/19, Company-HK should declare the adjustment of $750 for assessment.

PART C: MEASUREMENT OF INVENTORIES OR STOCK

INVENTORIES OR STOCK

Meaning of inventories or stock

39. Inventories can be anything acquired with a view to reselling at a profit. The term “trading stock” is used as an alternative to the term “inventories” in financial statements prepared in accordance with generally accepted accounting principles. For the purposes of this Practice Note, the two terms are equivalent and interchangeable.

40. The primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised.

Objective of HKAS 2

41. HKAS 2 *Inventories* prescribes the accounting treatment for inventories and provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories. Appendix 5 gives an overview of HKAS 2.

COST OF STOCK

Opening and closing stock

42. A person has to account for the value of inventories at the end of each year (i.e. closing stock). The value of closing stock at the end of a year automatically becomes the value of opening stock at the beginning of the next year. Since opening stock and closing stock are components of the calculation of the cost of goods sold, it is necessary to have a correct and accurate valuation of both opening and closing stock for a given period to ensure that the profits of the person would not be overstated or understated.

43. Stock valuation can never be absolutely precise since there are a number of practical considerations which may affect the accuracy of the estimate. Generally accepted accounting principles provide the starting point for stock valuation for tax purposes. In the Ordinance, there are two specific provisions relating to stock valuation:

(a) section 15C provides for how trading stock should be valued when a person ceases to carry on a trade or business in Hong Kong; and

(b) section 15BA provides for how trading stock should be valued when the stock is appropriated for non-trade purposes or disposed of otherwise than in the course of trade.

Stock expenses

44. The case of *Whimster & Co v CIR* [1925] 12 TC 813 established that the correct way of computing trading profits for tax purposes was to bring in opening stock and closing stock into the computation at the lower of cost or market value. Nowadays, the basic rule is that stock is to be valued at the lower of cost and net realisable value.

45. In *Threlfall v Jones* [1993] 66 TC 77, Lord Nolan discussed the long-standing practice of bringing into account unsold stock-in-trade at the beginning and at the end of the period at the lower of cost or market value and the reasoning behind and the effect of that practice. He considered Lord Reid's judgment in *Ostime v Duple Motor Bodies Ltd* [1961] 39 TC 537 and concluded that, as a matter of legal analysis, it involved the deduction of the whole of the expenses incurred during the period but the crediting against them of a closing figure for unsold stock and for work in progress as a notional receipt.

Valuation bases

46. The acceptable basis for stock is the lower of cost and net realisable value: see *Whimster & Co v CIR* [1925] 12 TC 813. HKAS 2 also requires that stock is to be measured at the lower of cost and net realisable value. An item by item basis should be adopted for the valuation of stock at the lower of cost and net realisable value: see *CIR v Cock Russell & Co Ltd* [1949] 29 TC 387.

47. The need for the basis of valuation to reflect the actual facts was emphasised in *Minister of National Revenue v Anaconda American Brass Ltd* [1956] 2 WLR 31. A valuation that pays insufficient attention to the facts will not be acceptable even if it is made on a recognised basis. In some circumstances there may be more than one acceptable method of computing the value of stock but the valuation policy should be consistent unless the reasons for change outweigh the need for consistency.

Court decisions

48. The Courts have ruled on certain methods:

(a) In the case of *Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd* [1929] 8 ATC 575, it was held that where opening and closing stocks have been undervalued, the true profits can only be established by raising both valuations.

(b) *CIR v Cock Russell & Co Ltd* [1949] 29 TC 387, established the right to apply cost or lower market value to individual items of stock.

(c) In *Minister of National Revenue v Anaconda American Brass Ltd* [1956] 2 WLR 31, the last-in, first-out (LIFO) method of determining cost was rejected by the Privy Council.

(d) In *Patrick v Broadstone Mills Ltd* [1935] 35 TC 44, the base stock method was rejected, even though it was accepted as sound commercial practice in the cotton spinning trade.

(e) In *Ostime v Duple Motor Bodies Ltd* [1961] 39 TC 537, consistency in the basis of valuation of stock and work-in-progress was stressed. The Courts, however, in refusing to decide between the rival claims of direct cost and on cost methods of valuation as a broad principle, found that the direct cost method, which had been consistently applied in the past, was one of the methods recognised as sound accountancy practice and saw no reason, in the circumstances of that case, to compel a change to the on cost basis.

(f) In *BSC Footwear Ltd v Ridgeway* [1971] 47 TC 495, it was held that for tax purposes replacement value is not acceptable.

(g) In *Pearce v Woodall-Duckham Ltd* [1978] 51 TC 271, it was held that the estimated accrued profits resulting from the change in valuation method of work in progress in that case should be treated as a taxable receipt for the year in which the amount was first revealed and brought into account.

Alternative valuation basis

49. Depending on the facts and circumstances, there may be two or more acceptable bases to valuing stock. For profits tax purposes, the Commissioner generally does not have the right to substitute one valid basis for another valid basis, or to adopt a different basis in computing profits. In *Pearce v Woodall-Duckham Ltd* [1978] 51 TC 271, Templeman J said:

> "the company was entitled to produce accounts based on its on-cost method prior to 1969. The company was entitled, but not bound, to produce accounts for 1969 and subsequent years by the accrued profit method. The change was made for sound commercial reasons."

Equally, where a valid basis for tax purposes has been adopted in a person's financial statements, the person does not have the right to adopt a different basis in computing the profits figure to be entered on the person's tax return.

Change in basis of valuation

50. A basis of stock valuation is valid if it is in accordance with the Ordinance or the generally accepted accounting principles applicable for a given period. However, if a basis of stock valuation does not follow the generally accepted accounting principles or the facts suggest that it does not reflect cost or net realisable value, the basis may be invalid.

51. In *Bombay Commissioner of Income Tax v Ahmedabad New Cotton Mills Co Ltd* [1929] 8 ATC 575, the company's account for the year

ended 31 December 1925 described stock in trade as being below cost. It was subsequently agreed that the figure of closing stock in those accounts was about 37% of the proper valuation of lower of cost and market value. The company argued that if the value of closing stock was increased then it had to also increase the value of its opening stock for that year in order to properly compute the profits for that year. The Privy Council agreed that in order to determine the annual profit it was not correct to raise the valuation of the closing stock without taking into consideration the similar undervaluation of the opening stock. This was a case in which the basis of valuation of stock was not an accepted method and was invalid so the company was made to change for tax purposes to a valid method.

52. In *Pearce v Woodall-Duckham Ltd* [1978] 51 TC 271, the company changed its method of valuing work in progress from an on-cost basis to an accrued profit basis in the 1969 accounts. It valued both the opening and the closing work in progress on the new basis and brought in the difference between the 1968 closing value and the 1969 opening value as surplus arising on change in valuation of contract work in progress at 31 December 1968. The figure was not taken to the trading profit and loss account but shown in the company's profit and loss appropriation account under profit after taxation. It was common ground that both the old basis and the new basis were valid valuation methods for work in progress and that the change had been made for sound commercial reasons. It was held that the amount of the adjustment was taxable in 1969 as profits of that year.

53. For computing the full amount of profits, if there is a change from one valid basis on which the profits of a trade or business are calculated to another valid basis (e.g. on a change of accounting policy), an adjustment must be calculated to ensure that trading or business receipts will be taxed only once and deductions will be given once and once only.

54. Where the change is from an invalid basis to a valid basis, the profits for the period of account have to be computed on the new valid basis. Any adjustments which need to be made to previous periods' computations in order to compute those profits on a valid basis must be done by changing the computations for those periods. Where the change is from one valid basis to another valid basis for tax purposes, the taxable profits for the accounting period include any tax adjustment needed for the prior period adjustment. The

adjustment could either be in respect of profits recognised in the accounting period or of a loss recognised in the accounting period.

Estimation of cost of stock

55. The process of ascertaining cost of stock is primarily a matter of identification. For physically identifiable and distinguishable items which are sold in the same condition as they are bought, the cost of stock should be specifically identified and the process of ascertaining the cost of such stock should not be difficult. Where physical identification is not possible (e.g. interchangeable items), the cost of stock may not be ascertained precisely. It is thus necessary to base the valuation on assumptions to arrive at the closest approximation to historical cost that is practically attainable.

Shares and securities that are stock

56. Shares and securities are financial instruments. Thus, they are outside the scope of HKAS 2. The accounting treatment of shares and securities is covered by HKFRS 9 *Financial Instruments*. For more details concerning the valuation and tax treatment of financial instruments, please refer to Part A of Departmental Interpretation and Practice Notes (DIPN) No. 42 *Profits Tax – Taxation of Financial Instruments and Taxation of Foreign Exchange Differences*.

Keeping stock records

57. Section 51C requires a person carrying on a trade, profession or business in Hong Kong to keep sufficient records, in English or Chinese, of the person's income and expenditure to enable the person's assessable profits to be readily ascertained. The required records include statements (including quantities and values) of trading stock held by the person at the end of each accounting period. All records of stocktakings from which any statement of trading stock has been prepared should be retained. Such records should include:

(a) a list describing each article of stock on hand (including raw materials and work in progress), together with the value of each;

(b) the person who did the stocktaking;

(c) the way how the stocktaking was done;

(d) the date of the stocktaking; and

(e) the basis of the valuation.

It is an offence not to keep sufficient business records, with conviction carrying a maximum penalty of $100,000.

ADJUSTMENT TO COST OF STOCK

Basis of valuation used

58. Since more than one interpretation can be placed on the term "net realisable value" or "cost", the Assessor should be made aware as to exactly what basis of valuation has been used by a person. Where the basis adopted for the valuation of stock is one that is clearly not acceptable for profits tax purposes, the adjustment that is considered necessary by the person should be made in the profits returned for assessment. The basis on which the adjustment is made should be brought to the notice of the Assessor.

59. Once a satisfactory basis of valuation has been agreed, information is required to be given in a person's annual profits tax return only if there is subsequent change to the agreed basis. It must be emphasised that the agreed basis of stock valuation should be consistently adopted. Any change in the basis of valuation should be justified with documentary evidence.

Undervaluation of stock

60. From time to time, a clear undervaluation of stock for tax purposes is revealed in the financial statements submitted or discovered in the course of a field audit or investigation. An undervaluation of stock that gives rise to an understatement of profits for a year of assessment may be a result of:

(a) a change from one valid basis of valuation to another;

(b) the use of an invalid basis of valuation for both opening and closing stock;

(c) a change from an invalid basis of valuation to a valid basis;

(d) a change from a valid basis of valuation to an invalid basis; or

(e) an omission of stock or an incorrect estimation of quantity or value.

If an incorrect valuation of stock (e.g. an omission of stock or incorrect estimation of quantity or value) by a person gives rise to an understatement of profits of the person, depending on the facts of the case, penal action may be considered.

Quantification of profit understatements

Change from one valid valuation basis to another

61. The opening stock figure in the year of change should remain the same as the closing stock figure for the preceding year. The Commissioner will not allow a tax free uplift where the change would result in a higher opening figure, or seek to tax the trade or business where the change would result in a lower opening figure, in response to any contention that the opening and closing figures are normally valued on the same basis.

Use of invalid valuation basis for both opening and closing stock

62. Both the opening stock and closing stock must be valued on a valid basis which is appropriate for the stock in question. Depending on the facts of the case, the Commissioner will review liabilities for earlier years.

Change from invalid valuation basis to valid basis

63. The opening stock must be revalued on the same basis as the closing stock. The liabilities for earlier years will be reviewed if it is considered appropriate. In a case where there is no question of fraudulent or negligent conduct, the total tax sought to be recovered for past years would not exceed the "tax saving" resulting from the uplift of the opening valuation for the year of change.

Change from valid valuation basis to invalid basis

64. The closing stock is to be revalued on the same valid basis as the opening stock. The valid basis must be followed for future years.

Omission of stock or incorrect estimation of quantity or value

65. For cases where a valid basis is used, but there has been omission of stock or incorrect estimation of quantity or value, the Assessor will ascertain the amount of understatement by a method which is appropriate in the circumstances. Various matters may be taken into account, e.g. the production process and the average stock-holding period.

CESSATION OF BUSINESS

Valuation of stock on cessation of business

66. Section 15C provides for the valuation of trading stock on cessation of business. In *Southtime Limited v CIR* [2002] 2 HKLRD 275, the court ruled that if a taxpayer was carrying on two different businesses, or alternatively one trade and one different business, and one of them subsequently ceased, section 15C will apply in respect of the one that ceased. Where section 15C applies, the trading stock is to be valued at the date of cessation for the purposes of computing the profits of the person who has ceased the trade or business.

Amount to be brought into account

67. Where trading stock is sold or transferred for valuable consideration to a person who carries on or intends to carry on a trade or business in Hong Kong so that the cost will be deductible when the profits of the purchaser's trade or business are computed, section 15C(a) provides that the actual consideration (i.e. the sale price or the transfer price) should be brought into the final account of the vendor. Where trading stock falls outside the scope of section 15C(a) (e.g. stock is not sold or is transferred not for valuable consideration), the amount which it would have realised if sold in the open market at the date of cessation should be brought into the final account.

APPROPRIATION OF STOCK

Rule in Sharkey v Wernher

68. It is a well-accepted principle that tax computation needs to be adjusted to reflect the market value of an asset with respect to which a change of intention occurs (i.e. the market value principle): see *Sharkey v Wernher* [1956] AC 58 and *Simmons v IRC* [1980] 1 WLR 1196. The market value principle also applies where a trading stock is appropriated for non-trade purpose or acquired/disposed of other than in the course of trade, and has all along been applied in Hong Kong in determining profits or loss from appropriation or disposal of trading stock for profits tax purposes. The principle has been applied by the Board of Review and the courts in a number of cases: see *Church Body of the Hong Kong Sheng Kung Hui & Anor v CIR* (2016) 19 HKCFAR 54.

69. Section 15BA, which was enacted under the Inland Revenue (Amendment) (No. 6) Ordinance 2018 to codify the market value principle, requires adjustments to taxable profits or allowable loss to reflect the following at market value:

(a) any appropriation from or into trading stock; or

(b) any acquisition or disposal of trading stock other than in the course of trade or business.

The provisions of section 15BA apply in relation to a year of assessment commencing on or after 1 April 2018. For details relating to the market value principle and the relationship between sections 15BA, 15C and 50AAF, reference can be made to Appendix 4 (Trading Stock) of DIPN No. 59 *Transfer Pricing between Associated Persons*.

Amount to be brought into account as receipt

Stock appropriated for non-trade purpose

70. Where trading stock of a trade or business is appropriated for non-trade purpose, section 15BA(2) provides that the amount that should be brought into account as a receipt for computing profits is the amount that would have

realised if the stock were sold in the open market (i.e. the market value) at the time of the appropriation. The actual amount received from the appropriation of trading stock, if any, is to be left out of account. Trading stock is appropriated for non-trade purpose when it is appropriated for a purpose other than the relevant trade or business (e.g. the stock is taken by a person carrying on a trade or business for private use or put into use in another trade or business of the person). Section 15BA(2) also applies when the trading stock is appropriated as capital asset meaning that a change of intention towards the asset occurs. The market value that should be brought into account is treated as arising on the date of the appropriation.

Stock disposed of otherwise than in the course of trade or business

71. Where trading stock of a trade or business is disposed of otherwise than in the course of trade or business and section 15BA(2) does not apply, the amount that would have realised if the stock were sold in the open market at the time of the disposal should be brought into account as a receipt for computing profits as per section 15BA(4). The actual consideration obtained for the disposal, if any, is to be left out of account. Where trading stock is disposed of by way of gift or through a sale of a trade or business, the trading stock should be treated as being "disposed of otherwise than in the course of trade or business". The market value that should be brought into account is treated as arising on the date of the disposal.

Amount to be brought into account as cost

72. While section 15BA(2) and (4) concerns the value of trading stock to be brought into the account as a receipt, section 15BA(3) and (5) concerns the value of trading stock that should be included in the account as cost. Section 15BA(3) applies when something that belongs to a person carrying on a trade or business, but that is not trading stock of the trade or business, becomes trading stock of the trade or business. This covers the situation where the person changed intention of holding an asset as a capital asset to holding it as trading stock of the trade or business. Section 15BA(5) applies when the trading stock of a trade or business has been acquired otherwise than in the course of trade or business and section 15BA(3) does not apply.

73. When section 15BA(3) or (5) applies, the cost of stock to be included in the account for computing profits should be the market value. The value given for an asset becoming trading stock or acquiring it as trading stock is to be left out of account. The cost of stock is treated as being incurred on the date the asset became or was acquired as trading stock of the trade or business.

Appendix 1

<u>Overview of HKFRS 15</u>

Revenue recognition model

1. The core principle of HKFRS 15 *Revenue from Contracts with Customers* is that an entity recognises 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 recognises revenue in accordance with that core principle by applying the following steps:

(a) Step 1: Identify the contract(s) with a customer;

(b) Step 2: Identify the performance obligations in the contract;

(c) Step 3: Determine the transaction price;

(d) Step 4: Allocate the transaction price to the performance obligations in the contract; and

(e) Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. A performance obligation is a promise in a contract with a customer to transfer to the customer either a good or service or a bundle of goods or services that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. When an entity transfers promised goods or services to a customer, the transaction price is the amount of consideration in a contract to which the entity expects to be entitled in exchange for the transfer.

Recognition of revenue

Recognise revenue when performance obligations are satisfied

2. An entity shall recognise revenue when (or as) the entity satisfies a performance obligation 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. Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly (e.g. using the asset to produce goods or services; using the asset to enhance the value of other assets, using the asset to settle liabilities or reduce expenses, selling or exchanging the asset, pledging the asset to secure a loan and holding the asset).

3. For each performance obligation identified, an entity shall determine at contract inception whether it satisfies the performance obligation over time or satisfies the performance obligation at a point in time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

Performance obligations satisfied over time

4. An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

(b) the entity's performance creates or enhances an asset (e.g. work in progress) that the customer controls as the asset is created or enhanced; or

(c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

5. An entity shall recognise revenue for a performance obligation satisfied over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. A single method of measuring progress should be applied for each performance obligation satisfied over time. Appropriate methods of measuring progress include output methods (e.g. units produced, work certified or contract milestones achieved) and input methods (e.g. costs incurred, labour hours expended or time lapsed). In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.

Performance obligations satisfied at a point in time

6. If a performance obligation is not satisfied over time, the performance obligation is satisfied at a point in time. To determine the point in time at which a customer obtains control of a promised asset such that the performance obligation is satisfied, the entity shall consider the requirements for control and indicators of the transfer of control, which include, but are not limited to the following:

(a) the entity has a present right to payment for the asset;

(b) the customer has legal title to the asset;

(c) the entity has transferred physical possession of the asset;

(d) the customer has the significant risks and rewards of ownership of the asset;

(e) the customer has accepted the asset.

Transaction price allocated to performance obligation

Determining the transaction price

7. When (or as) a performance obligation is satisfied, an entity shall recognise as revenue the amount of the transaction price (which excludes estimates of variable consideration that are constrained) that is allocated to that performance obligation. To determine the transaction price, an entity shall consider the terms of the contract and its customary business practices. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

Variable consideration

8. An amount of consideration promised in a contract can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items, or if an entity's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. The variability relating to the consideration promised by a customer may be stated in a contract or otherwise (e.g. the customer has a valid expectation arising from an entity's customary business practices that the entity will accept an amount of consideration that is less than the price stated in the contract). An amount of variable consideration may be estimated using either the expected value method (i.e. the sum of probability-weighted amounts in a range of possible consideration amounts) or the most likely amount method (i.e. the single most likely amount in a range of possible consideration amounts), depending on which method an entity expects to better predict the amount of consideration that the entity will be entitled to. The estimated amount of variable consideration will be included in the transaction price 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.

Significant financing component

9. An entity shall 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 of the contract provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer (i.e. the contract contains a significant financing component). A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties of the contract.

10. The objective for adjusting the promised amount of consideration for a significant financing component is to recognise revenue at an amount that reflects the price that a customer would have paid for the promised goods or services if the customer has paid cash for those goods or services when they are transferred to the customer (i.e. the cash selling price). To assess whether a contract contains a significant financing component, an entity shall consider all relevant facts and circumstances, including: the difference between the amount of promised consideration and the cash selling price of the promised goods and services, and the expected length of time between the transfer of goods and services and payment, and the prevailing interest rates in the relevant market.

11. An entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and the entity's customer at contract inception. An entity is required to present the effects of financing (i.e. interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income. Interest revenue or interest expense is recognised only to the extent that a contract asset or receivable or a contract liability is recognised for a contract with a customer.

Allocating the transaction price

12. An entity has to allocate the transaction price to each performance obligation 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 shall allocate the transaction price to each performance obligation in proportion to the relative stand-alone selling price of the promised good or service. The stand-alone selling price is the price at

which an entity would sell the good or service separately to a customer. Where the stand-alone selling price of the good or service is not directly observable, the entity has to estimate the stand-alone selling price using suitable methods which may include but are not limited to adjusted market assessment approach, expected cost plus a margin approach and residual approach.

Contract costs

Costs of obtaining a contract

13. HKFRS 15 deals with the costs of obtaining a contract and the costs of fulfilling a contract. An entity shall recognise as an asset the incremental costs of obtaining a contract with a customer (i.e. costs that would not have incurred if the contract had not been obtained) if the entity expects to recover those costs. The incremental costs are amortised on a basis that reflects the transfer of goods or services to the customer. The incremental costs of obtaining a contract can be recognised as an expenses when incurred if the amortisation period is one year or less.

14. Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognised as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

Costs of fulfilling a contract

15. Any costs incurred to fulfill a contract that do not fall within the scope of another standard (e.g. HKAS 2 *Inventories*, HKAS 16 *Property, Plant and Equipment* or HKAS 38 *Intangible Assets*) are to be accounted for in accordance with HKFRS 15. Under HKFRS 15, the following costs are to be recognised when incurred:

(a) general and administrative costs;

(b) costs of wasted materials, labour or other resources to fulfil the contract that were not reflected in the price of the contract;

(c) costs relating to performance obligations that have been satisfied (i.e. costs relating to past performance); and

(d) costs that an entity cannot distinguish as relating to satisfied or unsatisfied performance obligations.

16. Costs incurred for fulfilling a contract that are not identified above shall be recognised as asset if those costs meet all of the following:

(a) the costs relate directly to a contract or an anticipated contract that is specifically identifiable;

(b) the costs generate or enhance resources of the entity that will be used to satisfy performance obligations in the future; and

(c) the costs are expected to be recovered.

Costs that relate directly to a contract or an anticipated contract include direct labour, direct materials, allocation of costs that relate directly to the contract or contract activities (e.g. insurance and depreciation of tools and equipment used in fulfilling the contract), costs that are explicitly chargeable to the customer under the contract and other costs that are incurred only because an entity entered into the contract (e.g. payments to subcontractors).

<u>Construction Contracts</u>

Meaning of construction contracts

1. Construction contracts include engineering and construction contracts which appoint contractors for engineering and construction work (e.g. construction of roads). Construction contracts are long-term contracts which normally take more than one year to complete. In this Appendix, long-term construction contracts refer to contracts under which engineering and construction work extends beyond one year of assessment. A construction contract which runs for less than twelve months, but straddles two or more years of assessment is therefore regarded as a long-term construction contract.

2. Profits from long-term construction contracts include:

(a) profits from construction of buildings, bridges, dams, pipelines, tunnels and other civil engineering projects;

(b) profits from related activities (e.g. demolition, dredging, heavy earth moving projects);

(c) profits from the construction of major plant items including ships and transport vessels;

(d) profits from similar contracts in associated fields, depending on the facts and circumstances (i.e. the contract and substance of the agreement), like air conditioning contracts, major electrical wiring or rewiring contracts, major refurbishment of hotels, stores; and

(e) profits from major construction management contracts.

3. A long-term construction contract does not include a contract for the sale and supply of what may ordinarily be regarded as the sale of trading stock

(e.g. it does not include a contract for the supply and installation of office furniture in a new building even though the furniture may need to be assembled upon delivery). In general, profits from sale of trading stock are derived for profits tax purposes when the trading stock is sold and a debt is created notwithstanding that the debt is not payable until a future year: see *J Rowe & Son Pty Limited v Commissioner of Taxation* (1971) 124 CLR 421.

4. Before HKFRS 15 *Revenue from Contracts with Customers* had become effective, the accounting treatment of revenue and costs associated with construction contracts was prescribed by HKAS 11 *Construction Contracts*. Under HKAS 11,

(a) when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period; and

(b) any expected excess of total contract costs over total contract revenue for contract should be recognised as an expense immediately.

HKAS 11 did not allow the adoption of the realisation or completion of contract method which recognise profits only when a contract was completed.

Recognition of revenue from construction contracts

5. Under HKFRS 15, revenue is recognised when (or as) performance obligations are satisfied through the transfer of control of a good or service under a construction contract to a customer. For examples, revenue is recognised over time if the customer receives and consumes the benefits from the engineering and construction services as they are provided, and revenue is recognised at a point in time if the plant constructed has to be delivered to the customer before a right to enforce payment arises. If a performance obligation is not satisfied over time, it is satisfied at a point in time.

6. Though HKFRS 15 retains over time revenue recognition which is similar to the stage of completion method under HKAS 11, specified criteria

must be met before revenue can be recognised over time. Under HKFRS 15, a performance obligation is satisfied over time when at least one of the following three criteria is met:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

(b) the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

(c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Criterion (a) may not be relevant: the customer does not simultaneously receive and consume the benefits provided by the contractor's performance as the contractor performs. Criterion (b) may be relevant: construction work is done on the customer's premises. Criterion (c) may also be relevant: construction contracts commonly create an asset in accordance with customers' specific requirements. Such asset is less likely to have an alternative use because it may be highly customised for a particular customer or significant costs have to be incurred to reconfigure the asset for sale to another customer. The asset created does not have an alternative use to the entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. When evaluating whether the entity has an enforceable right to payment for performance completed to date, the entity shall consider the terms of the contract and any laws that apply to the contract. The entity has a right to payment for performance completed to date if the entity would be entitled to an amount that at least compensates the entity for performance completed to date (e.g. recovery of costs incurred plus a reasonable profit margin) in the event that the customer or another party terminates the contract for reasons other than the entity's failure to perform as promised.

7. If a performance obligation is satisfied over time, revenue should be recognised over time by measuring the progress towards completion using a method that best depicts the transfer of the goods or services to the customer (e.g.

output methods or input methods). Depending on the method adopted, significant estimates and judgments may be required having regard to past experience.

Example 1

On 1 August 2019, Construction Company-HK entered into a contract to construct a hotel for a customer and the customer paid a non-refundable deposit. The customer was required to make progress payments to Construction Company-HK during the period of construction. Construction Company-HK was not allowed to direct any parts of the hotel to another customer and the customer could not terminate the contract unless Construction Company-HK failed to perform in accordance with the contract terms.

Construction Company-HK was required to determine on 1 August 2019 whether its promise to construct and transfer the hotel to the customer was a performance obligation satisfied over time or at a point in time. Since the contract had substantial terms precluding Construction Company-HK to redirect any parts of the hotel to another customer, Construction Company-HK would not have an alternative use of the hotel. If Construction Company-HK had the right to payment for performance completed to date in accordance with the terms of the contract, Construction Company-HK should recognise the contract revenue, including the deposit, over time because it satisfied the performance obligation over time. Profits derived from the construction contract for each reporting period should be determined in accordance with HKFRS 15, taking into account the expenses incurred. If tax adjustments to the profits were not required under the Ordinance, Construction Company-HK would be assessed in respect of the reported profits from the construction contract for each year of assessment.

8. The application of revenue recognition criteria under HKFRS 15 may similarly result in the recognition of revenue over time for long-term construction contracts (i.e. similar to the stage of completion method in HKAS 11) subject to the meeting of specific criteria. To decide whether revenue should be recognised over time, it will be necessary to evaluate contracts against

HKFRS 15's criteria. Profits arising from a construction contract recognised in the financial statements in accordance with HKFRS 15 would generally be adopted for profits tax purposes.

9. If the financial statements are prepared in accordance with HKFRS 15 and revenue is recognised over time, the Commissioner would not accept any profits be excluded from assessment by way of a computational adjustment on the ground that the profits are not taxable until the entire contract is completed. If a person is required to prepare financial statements in accordance with HKFRS 15 and to recognise profits over time but the person has failed to do so, the Commissioner will make an adjustment to the returned profits to assess profits which should have been recognised over time: see *Smith v Revenue and Customs Commissioners* [2011] STC 1724.

Variable consideration

10. It is common for a construction contract to contain an element of consideration that is variable or contingent upon certain thresholds or event being achieved or occurred (e.g. awards or incentive payments, penalties and claims). Revenue related to variable consideration has to be included in the transaction price and recognised if 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.

<u>Example 2</u>

Ship Building Company-HK entered into a construction contract with a customer to build a ship which was required to be delivered on 31 December 2021. The building work commenced on 1 May 2019. The agreed contract price was $48 million. Ship Building Company-HK would be paid an award fee of $2 million if the ship was completed on time. During the year ended 31 December 2019, Ship Building Company-HK incurred costs of $9 million, including cost of material of $1 million which could not be used for failing to meet the required standard. Total cost of the building work, excluding the wasted material of $1 million, was $20 million. The value of the work certified as at 31 December 2019 was $18 million.

Ship Building Company-HK determined at contract inception that the performance obligation was satisfied over time. Since the building work was progressing ahead of the agreed schedule, Ship Building Company-HK assessed that there was a 80% chance that the building work of the ship would be completed on time.

Scenario 1: Ship Building Company-HK adopted an input method to recognise revenue.

Scenario 2: Ship Building Company-HK adopted an output method to recognise revenue.

The award fee of $2 million was a variable consideration. If Ship Building Company-HK adopted the most likely amount method to estimate the transaction price (i.e. two possible outcomes $48 or $50 million), the transaction price would be $50 million since the building work would most likely be completed on time. The transaction price of $50 million included the variable consideration of $2 million.

<u>Scenario 1</u>

If the input method based on costs incurred to date was used, the building work would be 40% complete (i.e. costs incurred to date ($9 million − $1 million) ÷ total expected costs $20 million). Revenue recognised for the year ended 31 December 2019 would be $20 million (i.e. $50 million × 40%). Such revenue, including the allocated variable consideration, which was determined by Ship Building Company-HK with reasonable certainty, should be assessed in the year of assessment 2019/20. Though the wasted materials of $1 million were not accounted for under the input method for measuring the work progress, the costs should be charged in the accounts as a wastage expense.

<u>Scenario 2</u>

If the output method based on work certified was adopted, the building work would be 36% complete (i.e. work certified $18 million ÷ transaction price $50 million). Revenue recognised for the year ended 31 December 2019 would be $18 million (i.e. $50 million × 36%). Such revenue, including the allocated variable consideration, should be assessed in the year of assessment 2019/20.

Significant financing component

11. The existence of a significant financing component is of particular relevance for long-term construction contracts in which payments by a customer and performance by a person may occur at significantly different times. It is therefore necessary to assess the timing of customer payments in relation to the transfer of goods and services by the person. If the timing of payments agreed to by the parties to a construction contract, explicitly or implicitly, provides a significant benefit of financing the transfer of goods or services to the customer or the person, it may indicate that the contract contains a significant financing component such that the promised amount of consideration should be adjusted for the time value of money.

12. The effect of financing (i.e. interest revenue or interest expense) is to be separately presented from the revenue from a construction contract. The required tax adjustments in paragraphs 36 and 37 of this DIPN, resulting from notional interest revenue and interest expense, are equally applicable to a construction contract which contains a significant financing component.

<u>Example 3</u>

On 1 January 2018, Ship Building Company-HK entered into a contract with a customer for building a ship. The ship was scheduled for completion within two years and control of the ship would be passed to the customer upon completion (i.e. performance obligation would be satisfied at a point in time). The customer agreed to pay $20 million at the contract inception. The incremental borrowing rate of Ship Building Company-HK was 5%.

Ship Building Company-HK closed its accounts on 31 December each year. Given that the contract contained a significant financing component, Ship Building Company-HK accounted for the revenue and significant financing component in accordance with HKFRS 15 as follows:

Account	*Debit*	*Credit*
	$	*$*
Year ended 31 December 2018		
To recognise receipt of funds:		
Bank	*20,000,000*	
Contract liability		*20,000,000*
To recognise interest expense:		
Interest expense ($20m × 5%)	*1,000,000*	
Contract liability		*1,000,000*
Year ended 31 December 2019		
To recognise interest expense:		
Interest expense ($21m × 5%)	*1,050,000*	
Contract liability		*1,050,000*
To recognise revenue upon transfer of the ship:		
Contract liability	*22,050,000*	
Revenue		*22,050,000*

Though interest expense was recognised in the accounts for the year ended 31 December 2018 and 2019 as required under HKFRS 15, Ship Building Company-HK did not incur any interest (i.e. it had no legal obligation to pay interest to the customer). The notional interest expense of $1,000,000 and $1,050,000 should be ignored for profits tax purposes. Revenue of $20,000,000 (i.e. $22,050,000 − $1,000,000 − $1,050,000) should be recognised upon transfer of the ship to the customer in the year of assessment 2019/20. Details regarding the tax adjustments should be clearly disclosed in the tax computation prepared by Ship Building Company-HK for the years of assessment 2018/19 and 2019/20 respectively.

Example 4

Construction Company-HK entered into a three-year contract for the construction of a hospital which included progress payments based on various contractual milestones. The performance obligation to construct the hospital was satisfied over time and the payment *milestones were estimated to coincide with Construction Company-HK's expected performance. The contract specified that the customer would retain 5% of each milestone payment throughout the contract and only pay the amounts retained to Construction Company-HK upon completion.*

Construction Company-HK had to consider all relevant facts and circumstances, including the substantive business purposes of the progress payments, to determine whether the contract had a significant financing component. If the withholding of a specified percentage of each milestone payment was a typical payment term of the construction industry intending to protect the customer from Construction Company-HK's failure to adequately complete its obligations under the contract, the amounts to be retained by the customer would be for a primary purpose other than the provision of finance to Construction Company-HK. Construction Company-HK thus concluded that the construction contract did not include a significant financing component and would not be required to adjust the transaction price for the effects of the time value of money in accordance with HKFRS 15. Since no notional interest expense was charged in the accounts, tax adjustments were not required for re-computing the correct amount of profits for tax purposes.

Loss making contracts

13. Unlike HKAS 11 which specifically required an expected loss of a construction contract (i.e. total contract costs exceeding total contract revenue) to be recognised as an expense immediately, the amount of contract costs or provisions which are determined in accordance with the ordinary principles of accounting would be deductible, subject to the conditions for deduction set out in the Ordinance being satisfied.

Contract costs

14. Various costs incurred prior to commencement of a construction contract may arise (e.g. mobilisation costs, site set up costs and costs of feasibility studies) and they are costs incurred to fulfill a contract. Where such costs of fulfilling a contract are expected to be recovered, they should be

capitalised and amortised over the course of the contract consistent with the transfer of goods or services to a customer. Thus, deduction of such costs would follow the amortisation treatment in HKFRS 15.

Building site or construction or installation project constituting a permanent establishment

15. Construction or installation projects or activities performed at a site in Hong Kong by a non-Hong Kong resident person may give rise to a permanent establishment if it is a fixed place of business through which the person's business is wholly or partly carried on and the activities carried on by the person are not preparatory or auxiliary. If a non-Hong Kong resident person is a DTA territory[1] resident person, the question whether the non-Hong Kong resident person has a permanent establishment in Hong Kong is to be determined in accordance with the permanent establishment article of the relevant DTA. If the non-Hong Kong resident person is a non-DTA territory resident person, the question is to be determined in accordance with Part 3 of Schedule 17G of the Ordinance.

16. For a building site or construction or installation project, it will be regarded as a permanent establishment of an enterprise which is a non-DTA territory resident person under section 4(3) of Part 3 of Schedule 17G if:

(a) the enterprise has carried on activities at the site or project for a period of more than 12 months; or

(b) all of the following apply:

(i) the enterprise has carried on activities at the site or project for a period that exceeds, or two or more periods that in the aggregate exceed, 30 days;

(ii) connected activities have been carried on at the site or project by one or more closely related enterprises of the enterprise for one or more different periods that each exceeds 30 days;

[1] A DTA territory means a territory with which Hong Kong has made a double taxation agreement or arrangement (DTA).

(iii) all the periods referred to in subparagraphs (i) and (ii) in the aggregate exceed 12 months.

The term “building site or construction or installation project” should cover the work listed in paragraph 2 of this Appendix and installation work related to a construction project. The 12-month threshold should apply to each individual site or project.

17. A building site exists from the date on which the building or construction work begins, including any preparatory work, in the jurisdiction where the building or construction work is to be established. The site would continue to exist until the work is completed and the building or facilities are delivered to the customer, or the work is permanently abandoned. However, any period of temporary interruption or discontinuation of work (e.g. due to bad weather) should not be excluded from counting the period of time under section 4(3) of Part 3 of Schedule 17G.

18. If a building site or construction or installation project of a non-Hong Kong resident person constitutes a permanent establishment in Hong Kong, the non-Hong Kong resident person is regarded as carrying on a trade, profession or business in Hong Kong for the purpose of charging profits tax in accordance with the provisions of section 50AAK(1). The profits attributable to the construction permanent establishment will be charged to profits tax. For more details on the meaning of permanent establishment and the two-step approach for profits attribution to a permanent establishment, please refer to DIPN No. 60 *Attribution of Profits to Permanent Establishments in Hong Kong*

19. Chargeability to profits tax under section 14 does not depend on having a permanent establishment in Hong Kong. Profits arising in or derived from Hong Kong in respect of a business carried on in Hong Kong by a non-DTA territory resident person, without a permanent establishment, are chargeable to profits tax. The Commissioner generally takes the view that a non-DTA territory resident person which undertakes construction or installation projects or performs activities at a site in Hong Kong would be regarded as carrying on a business in Hong Kong and profits arising in or derived from Hong Kong from such business would be chargeable to profits tax.

Real Estate Development

Property developed for resale and investment property

1. In this Appendix, the term "real estate development" refers to development of property for resale and does not cover development of property for letting (i.e. earning rentals) or capital appreciation (e.g. long-term business use). Property that is held to earn rentals or for capital appreciation or both is defined as "investment property" under HKAS 40 *Investment Property*. Accordingly, the definition of "investment property" under HKAS 40 does not cover "real estate development" referred to in this Appendix. Appendix 4 gives an overview of investment property under HKAS 40.

Pre-completion sale of units in multi-storey residential building

2. In Hong Kong, developers construct or cause to be constructed multi-storey residential buildings with multiple units and enter into pre-completion sales in respect of such units with customers in the retail market. Before the application of HKFRS 15 *Revenue from Contracts with Customers,* real estate pre-completion sales in Hong Kong were generally recognised at a single point in time as a sale of goods in accordance with HKAS 11 *Construction Contracts*, HKAS 18 *Revenue* and in conjunction with the guidance under HK(IFRIC)-Int 15 *Agreements for the Construction of Real Estate*, particularly paragraphs 16 to 19.

3. The sale and purchase agreements used by developers are standardised to a large extent (e.g. the standard sale and purchase agreement available on the website of the Law Society of Hong Kong) while the legal and regulatory environment and other specific facts and circumstances in Hong Kong are quite different from those in other jurisdictions. In Hong Kong, the construction activity relating to multi-storey residential buildings has to be at an advanced stage before the developer is allowed to enter into any pre-completion sales agreements with retail customers.

4. When a customer decides to buy a particular unit from a developer before the construction is complete, the customer will usually first enter into a

preliminary agreement for sale and purchase (PASP) with the developer. The PASP constitutes a legally enforceable contract which specifies:

(a) the property to be delivered;

(b) the consideration;

(c) the date of completion of the sale and purchase; and

(d) a payment schedule if payment is to be effected by instalments.

5. According to the Residential Properties (First-hand Sales) Ordinance (Cap. 621), at the time of signing the PASP, the customer is required to pay a preliminary deposit of 5% of the purchase price. For the purchase to proceed further, the customer is required to enter into a formal agreement for sale and purchase (ASP) with the developer that supersedes the PASP within five working days after signing the PASP. The ASP will contain more detailed terms governing the sale and purchase than the PASP. If the customer fails to enter into the ASP, the PASP is terminated, the developer forfeits the preliminary deposit and the developer does not have any further claim against the customer for the failure to enter into the ASP.

6. The five-step revenue recognition model under HKFRS 15 is analysed below in the context of a sale of such a pre-completed unit in a multi-storey residential building:

Step 1: Identify the contract with a customer

(a) The PASP is a legally binding contract while the ASP supersedes the PASP. In the context of HKFRS 15, the contract inception date is the date when the PASP is entered into.

Step 2: Identify the performance obligations in the contract

(b) The single performance obligation of the developer for selling a unit in a multi-storey residential building in Hong Kong is: the obligation to complete the construction and assign the right to occupy a specified unit together with the associated undivided interests in the land on which the building is constructed. Though there may be other performance obligations identified from a full assessment of all the terms and conditions of the contract, it is assumed such other performance obligations are not material.

Step 3: Determine the transaction price

(c) The transaction price is the consideration for the unit, which is fixed and stated in both the PASP and ASP.

Step 4: Allocate the transaction price to the performance obligations in the contract

(d) The transaction price identified is required to be allocated to each performance obligation identified. On the assumption that other performance obligations are immaterial, the transaction price is to be allocated to the single performance obligation identified in the contract.

Step 5: Determine when the transaction price allocated to each separate performance obligation should be recognised as revenue, being at a particular point in time or over time

(e) Per paragraph 35 of HKFRS 15, revenue for any contract is recognised over time when any one or more of the criteria below is met:

    (i) the customer simultaneously receives and consumes the benefits provided by the developer's performance as the developer performs;

    (ii) the developer's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or

    (iii) the developer's performance does not create an asset with an alternative use to the developer and the developer has an enforceable right to payment for performance completed to date.

If none of these criteria are met, then the revenue must be recognised at a point in time. Criterion (i) is not relevant to pre-completion sales: the customer does not simultaneously receive and consume the benefits provided by the developer's performance as the developer performs. Criterion (ii) is not relevant: the customer does not obtain physical possession of or access to the purchased unit in the multi-storey residential building until completion. Criterion (iii) is also not relevant: though the developer in a pre-completion sale under a standard ASP is contractually restricted from re-selling the purchased unit to another customer, the developer in Hong Kong does not have an enforceable right to payment for performance completed to date given the customary practice regarding payment and the uncertainty of the equitable relief of specific performance.

In summary, the Commissioner accepts that consideration from pre-completion sales to customers in the retail market of units in a multi-storey residential building, under standard ASPs in Hong Kong with typical contractual terms, should not be recognised as revenue until the point in time at which the developer fully satisfies the performance obligation (i.e. when the customer obtains control over the purchased unit).

Variable consideration

7. For real estate development, variable consideration may come in the form of claims, awards, rebates or other similar items. The promised consideration can also vary if a developer's entitlement to the consideration is contingent on the occurrence or non-occurrence of a future event. A developer is required to estimate variable consideration using either the expected value method (i.e. the sum of probability-weighted amounts) or the most likely amount method (i.e. the single most likely outcome), whichever better predicts the amount of consideration to which the developer will be entitled. The developer has to include variable consideration in the transaction price if the developer

concludes that it is highly probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved. The Commissioner's view on the tax treatment of variable consideration in paragraph 34 of this DIPN should be followed.

Significant financing component

8. In Hong Kong, it is common for developers to offer different payment schemes to customers. When the timing of payments by a customer is different from the timing of revenue recognition (i.e. deferred payments or advanced payments), a developer has to consider all relevant facts and circumstances and apply judgement in determining whether the PASP contains a significant financing component. The financing component is estimated at the time the PASP is entered into and the payment plan is confirmed by the customer. When the financing effect of the PASP is significant, the developer has to account for interest revenue or interest expenses separately from revenue from the PASP. The required tax adjustments in paragraphs 36 and 37 of this DIPN, resulting from notional interest revenue and interest expense, are equally applicable to a PASP which contains a significant financing component.

Appendix 4

Investment Property

Overview of HKAS 40

1. HKAS 40 *Investment Property* prescribes the accounting treatment for investment property. Under HKAS 40, “investment property” is defined to mean property (land or building or a part of a building or both) held (by the owner or by the lessee as a right-of-use asset) to earn rentals or for capital appreciation, or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes (i.e. owner-occupied property); or

(b) sale in the ordinary course of business.

Therefore, an investment property generates cash flows largely independently of the other assets held by an entity. This distinguishes investment property from owner-occupied property where the production or supply of goods or services or the use of property for administrative purposes generates cash flows that are attributable not only to property, but also to other assets used in the production or supply process.

2. “Owner-occupied property” is defined under HKAS 40 to mean property held (by the owner or by the lessee as a right-of-use asset) for use in the production or supply of goods or services or for administrative purposes.

3. The definition of investment property in effect refers to both owned investment property and leased investment property while the definition of owner-occupied property in effect refers to both owned owner-occupied property and leased owner-occupied property.

4. In this Appendix, the term “investment property” refers to one that is held by an owner (i.e. owned investment property).

5. HKAS 40 provides some examples of investment property, including:

(a) land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business;

(b) land held for a currently undetermined future use if it has not been determined that the land will be used as owner-occupied property or for short-term sale in the ordinary course of business;

(c) a building owned by the entity (or a right-of-use asset relating to a building held by the entity) and leased out under one or more operating leases;

(d) a building that is vacant but is held to be leased out under one or more operating leases;

(e) property that is being constructed or developed for future use as investment property.

Therefore, property that is intended for sale in the ordinary course of business or in the process of construction or development for such sale (i.e. real estate development referred to in Appendix 3) is not investment property as defined in HKAS 40. For profits tax purposes, a property acquired with the intention for resale at a profit is a trading asset (i.e. the property is acquired with a trading motive).

6. Under HKAS 40, an owned investment property shall be measured initially at cost, together with transaction costs. After initial recognition, an entity shall choose the cost model or the fair value model[1] to measure all investment property of the entity. If the cost model is used, fair value must be disclosed. The fair value at the end of reporting period must be determined for measurement (if the fair value model is used) or for disclosure (if the cost model is used). A gain or loss arising from a change in the fair value of investment property shall be recognised in profit or loss for the period in which it arises.

[1] Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Other applicable HKFRS

Purpose of holding

7. HKAS 2 *Inventories* and HKAS 16 *Property, Plant and Equipment* may also be relevant to a property that is held by an owner apart from HKAS 40. The applicability of the standard (i.e. HKAS 2, HKAS 16 or HKAS 40) to a property would depend on the purposes for which the property is held.

HKAS 2

8. Property that is held for sale in the ordinary course of business (e.g. property acquired exclusively with a view to subsequent disposal in the near future or for development and resale) should be accounted for under HKAS 2 and measured at the lower of cost and net realisable value. The carrying amount of the property should be recognised as an expense in the period when the property is sold.

HKAS 16

9. Property that is held for use in the production or supply of goods or services or for administrative purposes (i.e. owner-occupied property) and expected to be used during more than one period should be accounted as property, plant and equipment (PPE) under HKAS 16 and measured initially at cost. After initial recognition, an entity shall choose the cost model or the revaluation model to measure the entire class of PPE to which that property belongs. Under the revaluation model, the carrying amount[2] of a property shall be adjusted to the revalued amount[3]. Any revaluation increase of a property should be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus, and such increase should be recognised in profit or loss to the extent it reverses a revaluation decrease of the same property previously recognised in profit or loss. Any revaluation decrease should be recognised in profit or loss. However, the decrease should be recognised in other comprehensive income to the extent to any credit balance existing in the revaluation surplus of that property.

[2] Carrying amount is the amount at which a property is recognised after deducting any accumulated depreciation and accumulated impairment losses.

[3] Revalued amount is the fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent impairment losses.

Relevance of accounting classification for profits tax purposes

10. Though a property should be recognised and measured in the financial statements in accordance with the generally accepted accounting principles (i.e. under HKAS 2, HKAS 16 or HKAS 40 as the case may be), the accounting classification of a property is not decisive in determining whether the property is a trading stock or capital asset for profits tax purposes. It is a question of law, and all the relevant facts and circumstances, including the accounting classification, have to be taken into consideration.

<u>Example 1</u>

Company-HK held some properties and land for development at 31 December 2019, including: a factory which was built on its land in District X for producing goods; some land in District Y which it intended to develop as a residential estate for future sale; and certain properties under construction in District Z which would be for rental purposes after completion.

Since the factory in District X was used as a production unit of Company-HK, the factory should not be an investment property under HKAS 40 but an owner-occupied property under HKAS 16 (i.e. initially measured at cost and subsequently measured using the cost model or the revaluation model). Given that the land in District Y would be developed for sale in the ordinary course of business of Company-HK, the land should not be an investment property under HKAS 40 but should be classified as inventory under HKAS 2 (i.e. measured at the lower of cost and net realisable value). Since the properties in District Z were under construction for future use as investment properties, they should be recognised under HKAS 40 (i.e. initially measured at cost and subsequently measured using the cost model or the fair value model).

Though Company-HK would be expected to apply the appropriate accounting standards to classify the properties and land in its accounts, such accounting classification would not be decisive in determining whether the properties are trading stocks or capital assets for profits tax purposes.

Transactions that are “equivocal” may also be dual motive transactions. A dual motive transaction is a transaction entered into with two objects (e.g. an acquisition of land both to provide accommodation for an existing trade and for eventual development and resale at profit). It would be a question of fact in such circumstances whether one of those motives is a trading motive and, if so, to what extent it colours the whole transaction as being, in essence, a trading transaction. Nourse LJ’s comments in *Kirkham v Williams* [1991] 64 TC 253 are relevant.

Change in fair value recognised in profit or loss under HKAS 40

11. If an owned property is classified as an investment property under HKAS 40 and the fair value model is applied to measure the investment property, a change in the fair value (i.e. gain or loss) is to be recognised in profit or loss in the period in which the gain or loss arises. If the property is a capital asset, any gain or loss arising from the change in the fair value is of capital nature and should be excluded from the computation of assessable profits. Such gain is also unrealised and not taxable in accordance with the judgement in *Nice Cheer Investment Ltd v CIR* (2013) 16 HKCFAR 813. If, however, the property is a trading asset (i.e. acquired or held as trading stock), the cumulative gain or loss will be assessed or allowed in the year in which the property is disposed of. Commercial or industrial building allowance will not be allowed in respect of the property.

Transfer to or from investment property

Accounting for transfer

12. HKAS 40 requires that transfers to, or from, investment property should only be made when there is an evidenced change in use of the property. To conclude that there is a change in use, there should be an assessment of whether the property meets or ceases to meet the definition of investment property. In accordance with HKAS 40, a change in management’s intention, in isolation, does not provide evidence of a change in use. A non-exhaustive list of examples of evidence of a change in use was provided in the standard as below:

(a) an investment property is transferred to an owner-occupied property when owner-occupation commences or the investment property is developed with a view to owner-occupation;

(b) an investment property is transferred to inventory at the time of commencement of development with a view to sale;

(c) an owner-occupied property is transferred to an investment property when owner-occupation ends; and

(d) a property held as inventory is transferred to an investment property when an operating lease to another party commences.

13. Where the cost model is used for measuring an investment property and there are transfers between investment property and owner-occupied property/inventories, HKAS 40 specifies that the transfers do not change the carrying amount of the property transferred and do not change the cost of that property for measurement purpose.

14. Where the fair value model is used for measuring an investment property and there are transfers between investment property and owner-occupied property/inventories, HKAS 40 specifies the measurement of the property at the date of change in use (i.e. date of transfer):

(a) If an investment property carried at fair value is transferred to an owner-occupied property or inventory, the property's deemed cost for subsequent accounting in accordance with HKAS 16 or HKAS 2 should be the fair value at the date of change in use.

(b) If an owner-occupied property is transferred to an investment property carried at fair value, the property should be accounted for under HKAS 16 up to the date of transfer and the difference between the carrying amount of the property and the fair value at the date of transfer should be recognised as revaluation surplus or deficit in accordance with HKAS 16.

(c) If a property that is held as inventory is transferred to an investment property carried at fair value, the difference between the fair value of the property and its carrying amount at the date of transfer should be recognised in profit or loss.

Change of intention

15. It should be emphasised that the accounting treatment of a property (i.e. as an investment property, an owner-occupied property or inventory) arising from a transfer as required under HKAS 40 is not decisive for profits tax purposes. In determining whether the property in question is a trading stock or capital asset for profits tax purposes, the intention that existed at the time of acquisition of the property is important but the intention may be changed (i.e. an investment may be put into trading stock and vice versa). Whether there has been a change of intention is a question of fact which would depend on the facts and circumstances of each case. If a change of intention is to be relied upon as the basis for a finding of an intention to trade, precision in the fact finding process is required: see *Simmons v IRC* [1980] 1 WLR 1196. In other words, there must be evidence which establishes the change of intention.

<u>Example 2</u>

Company-HK owned Property A which was used as its office for the past five years. Property A was all along classified as PPE in the accounts of Company-HK. During the year ended 31 December 2019, Company-HK moved to another property and leased Property A to a third party for three years. Company-HK reclassified Property A to investment property when it moved out of Property A and owner-occupation ceased.

For accounting purposes, Property A should be properly recognised and measured in accordance with HKAS 16 or HKAS 40, as the case may be. If Property A was acquired and held by Company-HK as a capital asset for profits tax purposes, any change in fair value arising from the accounting reclassification (i.e. from PPE to investment property) would not have any tax consequences.

Example 3

Company-HK was engaged in property development for sale and property investment for rental purposes. Property B, classified as investment property and measured using the fair value model, would be sold by Company-HK. Company-HK would redevelop Property B before sale and the redevelopment works would significantly improve and enhance Property B. Company-HK transferred Property B from investment property to inventory at the date of commencement of the redevelopment works.

For accounting purposes, Company-HK should classify Property B in accordance with HKAS 2 or HKAS 40, as the case may be, and continue the classification unless there was evidence of an actual change in use in accordance with HKAS 40. For profits tax purposes, there should be clear evidence that Property B was a capital asset as claimed since Company-HK had two lines of business (i.e. property development for sale and property investment for rental purposes). If Property B was a capital asset of Company-HK (i.e. not trading stock), it would remain a capital asset unless Company-HK changed its intention to that of trading (i.e. became trading stock). If Property B became trading stock of Company-HK, the amount that Property B would have realised in the open market at the time it became trading stock would be treated as the cost of stock under section 15BA(3). Evidence for establishing the change from a capital asset to trading stock would be required.

Example 4

Company-HK, a property developer with a history of developing properties for sale immediately after completion, constructed multi-storey residential buildings in District X for sale, and classified such properties under construction as inventories in its accounts for the year ended 31 December 2019. Given property prices were at a multi-year low, Company-HK decided not to pursue the plan to sell the property units after completion. The intended change in use was evidenced by a formal board decision and a change in Company-HK's business plan.

For accounting purposes, Company-HK should continue to classify the properties as inventories unless there was evidence of an actual change in use in accordance with HKAS 40. For profits tax purposes, if the properties held as inventories were appropriated for non-trade purposes by Company-HK, the amount that the properties would have realised in the open market at the time of the appropriation would be brought into account as a trading receipt under section 15BA(2). There would be such an appropriation if the initial intention to trade was clearly and unequivocally displaced by a subsequent intention not to trade: see *Taylor v Good* [1974] 49 TC 277. If findings of this kind were to be made, precision would be required for the date of appropriation.

Appendix 5

<u>Overview of HKAS 2</u>

Scope

1. HKAS 2 *Inventories* applies to all inventories, except:

   (a) financial instruments; and

   (b) biological assets related to agricultural activity and agricultural produce at the point of harvest.

2. HKAS 2 does not apply to the measurement of inventories held by:

   (a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realisable value in accordance with well-established practices in those industries (such inventories are measured at net realisable value and changes in that value are recognised in profit or loss in the period of the change);

   (b) commodity broker-traders who measure their inventories at fair value less costs to sell (such inventories are measured at fair value less costs to sell and changes in fair value less costs to sell are recognised in profit or loss in the period of the change).

Definitions

3. Under HKAS 2, the following terms are used with the following meanings:

   "inventories" are assets:

   (a) held for sale in the ordinary course of business;

   (b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

"net realisable value" is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

"fair value" is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

4. The definition of inventories in effect refers to:

(a) finished goods, being held for sale;

(b) work-in-progress, being in the process of production;

(c) raw materials, being those supplies to be consumed in the production process.

Measurement of inventories

Lower of cost and net realisable value

5. Inventories shall be measured at the lower of cost and net realisable value.

<u>Example 1</u>

Company-HK had three major products. As at 31 December 2019, the cost of purchase, selling price and estimated cost to sell for each product were as follows:

	Cost	*Selling price*	*Costs to sell*
	$	*$*	*$*
Product A	*4,000,000*	*6,000,000*	*200,000*
Product B	*1,200,000*	*1,200,000*	*50,000*
Product C	*800,000*	*1,000,000*	*40,000*

The closing inventory of Company-HK as at 31 December 2019 had to be measured on a product line basis, and at the lower of cost and net realisable value. The net realisable value for each product would be the selling price net of any estimated costs of sale. Products A and C would be measured at cost while Product B would be measured at net realisable value of $1,150,000 (i.e. $1,200,000 - $50,000).

Cost of inventories

6. The cost of inventories shall comprise all:

(a) costs of purchase[1];

(b) costs of conversion[2]; and

(c) other costs incurred[3]

in bringing the inventories to their present location and condition.

<u>Example 2</u>

Company-HK was a manufacturer of television components A and B. The budgeted outputs for Components A and B for December 2019 were 20,000 units and 12,000 units respectively. Company-HK incurred direct cost of $3,840,000 for Component B and unidentifiable indirect production overheads of $800,000 for both components. Total units of 20,000 and 12,000 of Components A and B were produced in December 2019. Due to technical defects for Component B, 1,500 units were scrapped at zero value and only 10,500 units were taken into inventory. The respective selling prices of Components A and B were $5,500 and $4,500 respectively.

[1] Costs of purchase may include all of: purchase price; import duties and other irrecoverable taxes; transport, handling and any other cost directly attributable to the acquisition of finished goods, services and materials. Trade discounts, rebates and other similar amounts are deducted from costs of purchase.

[2] Costs of conversion includes: costs directly related to the units of production; and a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.

[3] Other costs are costs incurred in bringing the inventories to their present location and condition. Abnormal wastage, storage costs, administrative overheads and selling costs would not be included in cost of inventories but should be recognised as an expense in the period they are incurred.

Company-HK closed its accounts on 31 December each year.

The cost of Component B included direct cost of $3,840,000 and an allocated portion of indirect production overheads of $800,000. Based on the ratio of the units produced of the two components, indirect production overheads of $300,000 (i.e. $800,000 × 12,000 ÷ 32,000) would be allocated to Component B. The cost per unit of Component B was $345 (i.e. ($3,840,000 + $300,000) ÷ 12,000). Company-HK would be required to recognise $3,622,500 ($345 × 10,500) as cost of inventory and $517,500 ($345 × 1,500) as an expense for the year of assessment 2019/20.

Cost formulas

7. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs.

8. The cost of inventories, other than those dealt with in paragraph 7, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. Under the weighted average cost formula, a recalculation of cost can be made after each purchase, or alternatively only at the period end. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

Recognition as an expense

9. When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

Techniques for the measurement of cost

10. Techniques for the measurement of the cost of inventories may be used for convenience if the results approximate cost. HKAS 2 allows the following for the measurement of cost of inventories:

(a) standard costs, which take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

(b) the retail method, which is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.