

For the meeting on 24 March 2015

For information

**Subcommittee on Four Subsidiary Legislation Related to Competition
Ordinance Gazetted on 18 February 2015**

**Responses to Follow-up Questions
Arising From the Meeting on 16 March 2015**

Purpose

This paper responds to the questions raised by Members at the meeting on 16 March 2015 in respect of section 2 of the Competition (Turnover) Regulation (“C(T)R”).

Elaboration of the term “ordinary activities”

2. The Government explained in the letter dated 13 March 2015 (LC Paper No. CB(4)640/14-15(02)) that the use of the term “ordinary activities” in section 2 of C(T)R is a concept familiar to the accounting profession and generally applied in the auditing of accounts. Revenue from “ordinary activities” for the purpose of C(T)R includes revenue arising from the use by others of entity assets yielding interest, royalties and dividends, apart from the sale of goods and/or rendering of services, with reference to the Hong Kong Accounting Standard 18 (“HKAS 18”).

3. Whether transactions of properties and foreign currencies, and distribution of bonus or dividends are regarded as “ordinary activities” would depend on the nature of business of the undertaking concerned. For example, if the business of an undertaking involves purchasing of properties for resale, the transactions of such properties would be considered as sale of goods and constitute the revenue arising from its “ordinary activities”. Likewise, if the business of an undertaking involves investment in equity for dividends, then generally speaking such dividends would be considered as revenue arising from its “ordinary activities”.

4. Also with reference to the HKAS 18, examples of revenue not considered as arising from “ordinary activities” include contributions from equity participants, and amounts collected on behalf of the principal by an agent.

Status of the Hong Kong Accounting Standards

5. The Hong Kong Accounting Standards (“HKAS”) are issued by the Hong Kong Institute of Certified Public Accountants (“HKICPA”) under section 18A of the Professional Accountants Ordinance (Cap. 50) (“PAO”). According to section 18A of the PAO, the accounting standards issued by the HKICPA are required to be observed, maintained or otherwise applied by any certified public accountant. Furthermore, under section 380 of the Companies Ordinance (Cap. 622), a company’s financial statements for a financial year must comply with the accounting standards applicable to the financial statements.

6. In order to draw a clearer reference to the accounting standards under the C(T)R, we will consider adding a new sub-section under section 2 of the C(T)R to the effect that under that section, the turnover of an undertaking, which is its total gross revenues, is to be calculated in accordance with generally accepted accounting principles. The inclusion of this provision would make it clear that for the purpose of the C(T)R, the principles set out in the HKAS (including HKAS 18) would be relevant in calculating the turnover of undertakings which are subject to the accounting standards in Hong Kong. Turnover of undertakings outside Hong Kong will also be calculated in accordance with the corresponding accounting principles.

7. With the proposed new sub-section mentioned in paragraph 6 above, we do not think it is necessary to include specific provisions for the turnover of undertakings like credit institutions, financial institutions and insurance undertakings. As explained in our letter of 13 March 2015, HKAS 18 has provided accounting guidance on revenue arising from rendering of services and included a range of examples to illustrate how various services income would be recognised as revenue. The relevant examples set out in the HKAS 18 are extracted at Annex for reference.

Turnover for pecuniary penalties

8. Section 93 of the Competition Ordinance (“CO”) specifies that the turnover for determining the maximum amount of pecuniary penalty that may be imposed for contravention of a competition rule means the total gross revenues of an undertaking obtained in Hong Kong and the pecuniary penalties should not exceed 10% of such a turnover for not more than 3 years. The provision was modelled on the experience of the Singapore Competition Act. We have explained in the Government’s paper to the Panel on Economic Development’s meeting on 24 November 2014 (LC Paper No. CB(4)166/14-15(03)) that, in practice, the turnover obtained in Hong Kong will include sales of an undertaking to customers in Hong Kong as well as its export

sales made from Hong Kong, which is also the practice in Singapore.

“Sales rebates” and “taxes directly related to the revenues”

9. The wordings concerning “sales rebates” and “taxes directly related to the revenues” in the C(T)R are modelled on the relevant overseas competition law, namely, the Competition Act 1998 (Determination of Turnover for Penalties) Order 2000 of the UK, which uses the phrase “after deduction of sales rebates, value added tax and other taxes directly related to turnover”; and the Singapore Competition (Financial Penalties) Order 2007 which uses the phrase “after deduction of sales rebates, goods and services tax and other taxes directly related to turnover.”. Following overseas experience, we do not consider it necessary to further define “sales rebates” and “taxes directly related to the revenues” in the C(T)R.

Whether “amounts” include both monetary and non-monetary rewards

10. The use of the word “amounts” in the C(T)R does not preclude the measurement of revenue received in non-monetary form, following the generally accepted accounting principles. As such, we will consider whether under section 2(3)(a) of the C(T)R, the expression “any sum” is strictly necessary for “grant, subsidy or similar financial assistance”.

Guidance to be provided by the Competition Commission

11. The Government has communicated with the Competition Commission (“Commission”) when making the C(T)R. While the C(T)R is made having drawn reference from the HKAS and concepts generally used by other competition jurisdictions, the Commission intends to provide further guidance on turnover assessment. Section 131 of the CO provides that the Commission may do all such things as appear to it to be necessary, advantageous or expedient for it to do for, or in connection with, the performance of its functions. Other than the guidelines specifically required under the Ordinance, the Commission will publish, amongst others, guidance notes to facilitate enforcement of the Ordinance, including guidance notes on turnover assessment. We understand that the Commission will work on the basis of the CO and the intent and provisions set out in the C(T)R, as well as making reference to prevailing accounting principles and experience of comparable competition jurisdiction when producing the guidance notes on turnover. The Commission’s guidance notes on turnover will also include practical examples

of how turnover can be determined by reference to typical audited accounts of undertakings.

**Commerce, Industry and Tourism Branch
Commerce and Economic Development Bureau
March 2015**

Rendering of services

10 *Installation fees.*

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

11 *Servicing fees included in the price of the product.*

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

12 *Advertising commissions.*

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

13 *Insurance agency commissions.*

Insurance agency commissions received or receivable which do not require the agent to render further service are recognised as revenue by the agent on the effective commencement or renewal dates of the related policies. However, when it is probable that the agent will be required to render further services during the life of the policy, the commission, or part thereof, is deferred and recognised as revenue over the period during which the policy is in force.

14 *Financial service fees.*

The recognition of revenue for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective interest rate of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act.

(a) *Fees that are an integral part of the effective interest rate of a financial instrument.*

Such fees are generally treated as an adjustment to the effective interest rate. However, when the financial instrument is measured at fair value with the change in fair value recognised in profit or loss, the fees are recognised as revenue when the instrument is initially recognised.

(i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IAS 39 is classified as a financial asset at 'fair value through profit or loss'.*

Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related transaction costs (as defined in IAS 39), are deferred and recognised as an adjustment to the effective interest rate.

- (ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of IAS 39.*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of IAS 39, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related transaction costs (as defined in IAS 39), is deferred and recognised as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. Loan commitments that are within the scope of IAS 39 are accounted for as derivatives and measured at fair value.

- (iii) *Origination fees received on issuing financial liabilities measured at amortised cost.*

These fees are an integral part of generating an involvement with a financial liability. When a financial liability is not classified as 'at fair value through profit or loss', the origination fees received are included, with the related transaction costs (as defined in IAS 39) incurred, in the initial carrying amount of the financial liability and recognised as an adjustment to the effective interest rate. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

- (b) *Fees earned as services are provided.*

- (i) *Fees charged for servicing a loan.*

Fees charged by an entity for servicing a loan are recognised as revenue as the services are provided.

- (ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of IAS 39.*

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of IAS 39, the commitment fee is recognised as revenue on a time proportion basis over the commitment period. Loan commitments that are within the scope of IAS 39 are accounted for as derivatives and measured at fair value.

- (iii) *Investment management fees.*

Fees charged for managing investments are recognised as revenue as the services are provided.

* In *Improvements to IFRSs* issued in May 2008, the Board replaced the term 'direct costs' with 'transaction costs' as defined in paragraph 9 of IAS 39. This amendment removed an inconsistency for costs incurred in originating financial assets and liabilities that should be deferred and recognised as an adjustment to the underlying effective interest rate. 'Direct costs', as previously defined, did not require such costs to be incremental.

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.

Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of equity securities. The provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.

(c) *Fees that are earned on the execution of a significant act.*

The fees are recognised as revenue when the significant act has been completed, as in the examples below.

(i) *Commission on the allotment of shares to a client.*

The commission is recognised as revenue when the shares have been allotted.

(ii) *Placement fees for arranging a loan between a borrower and an investor.*

The fee is recognised as revenue when the loan has been arranged.

(iii) *Loan syndication fees.*

A syndication fee received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants) is compensation for the service of syndication. Such a fee is recognised as revenue when the syndication has been completed.

15 *Admission fees.*

Revenue from artistic performances, banquets and other special events is recognised when the event takes place. When a subscription to a number of events is sold, the fee is allocated to each event on a basis which reflects the extent to which services are performed at each event.

16 *Tuition fees.*

Revenue is recognised over the period of instruction.

17 *Initiation, entrance and membership fees.*

Revenue recognition depends on the nature of the services provided. If the fee permits only membership, and all other services or products are paid for separately, or if there is a separate annual subscription, the fee is recognised as revenue when no significant uncertainty as to its collectibility exists. If the fee entitles the member to services or publications to be provided during the membership period, or to purchase goods or services at prices lower than those charged to non-members, it is recognised on a basis that reflects the timing, nature and value of the benefits provided.

18 *Franchise fees.*

Franchise fees may cover the supply of initial and subsequent services, equipment and other tangible assets, and know-how. Accordingly, franchise fees are recognised as revenue on a basis that reflects the purpose for which the fees were charged. The following methods of franchise fee recognition are appropriate: