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Reike technology: revenue recognition and “pay-when-Paid” clauses

Li-Xin Pan, Ying Yu, and Lei Li wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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In December 2013, David Lee, manager of Business Department No. 3 at Reike Technology Co. Ltd. (Reike), sat at his desk in the company office in Zhongguancun, Beijing, feeling upset. He and his team should have been pleased because they had completed the main part of a project after more than a year of hard work. However, Lee had lost his usual self-confidence after a troubling call from the finance department. The previous year, Lee had signed a CN¥15 million[[1]](#footnote-1) service contract on behalf of Reike with Shenghui Co. Ltd. (Shenghui), a well-known multinational software company. Although almost 80 per cent of the project work was complete, Shenghui had not confirmed the project schedule on which payment was based. Lee had received calls from the finance department once a month for almost a year, asking him if there was any revenue that could be recognized. Unfortunately, Lee had to say no every time—a headache that just would not go away. When the situation began to affect the processing of project costs and performance assessment, Lee decided to consult Reike’s general manager.

company background

Reike Technology Co. Ltd. was an information technology (IT) consulting and outsourcing company. Founded in 1995 with less than 50 people, it became one of the largest IT companies in China, with over 23,000 employees and approximately ¥500 million in annual revenue. In 2005, it successfully made an initial public offering on the Shanghai Stock Exchange. Reike’s headquarters were in Beijing, with four branches in Shanghai, Shenzhen, Xi’an, and Ningbo.

Reike’s core competitive strength was its rich experience in IT solutions—from localization, testing, and development services to system level design. Since its launch, the company had accumulated experience in the high tech, telecommunications, financial services, manufacturing, retail, and distribution industries. In the 1990s, more and more western software companies were entering the Chinese market. Localization was the first thing they all had to face. Reike took the opportunity to build partnerships with Fortune 500 software companies and continuously earned contracts as these companies expanded their business in China. This strategy helped Reike gradually increase its reputation in the software outsourcing industry. By 2011, the company had become one of the largest professional software outsourcing service providers in China. It had also built strong co-operative partnerships with some large international companies.

China’s IT Outsourcing Industry

In the previous 20 years, the global information industry had gone through a gradual transition from a hardware-dominated industry to a software- and service-dominated one. Human resource cost was the key profitability factor for software service enterprises and accounted for 70 per cent of software development costs. An effective way to reduce software development costs was to outsource services to developing countries. Consequently, the main employers of the global software outsourcing business in North America, Western Europe, Japan, and other developed countries transferred their outsourcing services to Asia Pacific and other low-cost developing countries.

According to a Gartner report, global spending on IT outsourcing (ITO) was around $251 billion in 2012[[2]](#footnote-2) and reached $288 billion in 2013,[[3]](#footnote-3) a 14.7 per cent growth. China was playing an emerging role in this global market. According to China’s Ministry of Commerce, China’s whole outsourcing market—including ITO, business process outsourcing, and knowledge process outsourcing—grew [from $2 billion to $4.47 billion in contract size from 2009 to 2011](http://www.mofcom.gov.cn/aarticle/ae/ai/201211/20121108424341.html),[[4]](#footnote-4) for an almost 50 per cent average annual growth. ITO was the mainstream in the outsourcing market. By 2013, China’s ITO offshore market had reached $3.11 billion, with a year-on-year growth of 36.8 per cent.[[5]](#footnote-5)

Meanwhile, in China’s domestic software and services market, most industries’ IT systems were built using popular products from big western software companies. However, facing huge market demand as well as the great pressure of human resource cost, international software providers could focus only on their own products, not services. In other words, when selling products to an end customer, they needed local partners to do most of the customer development and maintenance work. This situation provided huge market opportunities for Chinese ITO companies.

Business Department NO. 3: Lee’s partnership with Shenghui

Lee was the manager of Reike’s Business Department No. 3. He had graduated from a famous university, and had both technical and managerial talents to reach sound decisions. He joined Reike from another software company in 2010. Under Lee’s leadership, the performance of Business Department No. 3 improved rapidly. The department created a lot of profit for the company, which was attributed largely to the co-operation with Shenghui.

Shenghui was a well-known multinational software company. Since starting business in mainland China, it had developed rapidly and gained popularity for its world-class products among government and large companies in various industries. However, along with business expansion came problems. Although Shenghui had a whole research and development, sales, and support team in China, it could not cope with the high business demand. For example, the pre-sales technical support team in Beijing had no more than 50 people, while a large order often required more than a year’s work of over 100 engineers for complex custom development. It was impossible for Shenghui to recruit large numbers of independent engineers, which would result in enormous expenses and management issues.

To solve this problem, Shenghui co-operated with local software outsourcing enterprises such as Reike. Shenghui was responsible for technical solutions as well as project planning and management, while the outsourcer was responsible for sending engineers for the development of specific work. In this way, Shenghui could concentrate on being a business consultant without worrying about managing a large team of engineers, and could put more energy into improving products. The outsourcer could earn commissions and get sound profits by relying on its advantages in having a mature implementation team and lower labour costs. Thus, both sides got what they wanted.

For the projects between Shenghui and Reike, the number of engineers ranged from a few to dozens, and the project cycle time ranged from two months to a year or two. The deliverables were calculated based on the workload per month of each engineer, and the commission was also on a person-month basis of different levels of engineers. The software engineering was complex and unpredictable to some degree, and project delays were common. Even so, the settlement between Reike and Shenghui was generally on a monthly basis according to progress. The two companies had had a good business relationship over the previous few years.

Zhongjiao Project: Accept or Not?

In October 2012, Lee learned that Shenghui had recently received a large order to upgrade the IT system for Zhongjiao International Group (Zhongjiao). Zhongjiao was a large state-owned power generation enterprise established in December 2002. Its net assets were ¥32 billion, and its total assets in 2012 were ¥128 billion. It mainly specialized in managing power energy, organizing power production and sales, manufacturing electric power equipment, and other services. In China, the state retained monopolies in a number of industries, including telecommunications, banking, transportation, and power. The big state-owned firms were guaranteed by the Chinese state, and it was easier for them to get bank loans approved.

Lee felt keenly that it would be a profitable project, and his department was at home when providing such services. He was excited and immediately discussed with the sales manager the idea of lobbying with Shenghui to get a share.

Shenghui usually did not put out project tenders. It kept in touch with a number of outsourcing companies and co-operated with the company that could form a satisfactory team. However, Shenghui relied heavily on several particular companies such as Reike. Therefore, when Lee came to visit Shenghui about the new project, the business executive who maintained frequent contact with Reike was pleased to entertain him. At dinner, he generously said that there would be no problems co-operating on the new project, but there would be other partners involved besides Reike because the project was large. He also said that Reike could help with some urgent tasks and the formation of the team could begin right away.

However, before Lee’s face could light up, the business executive changed topic and said that the contract would be modified because the Shenghui headquarters had some new requirements for subcontracts in the Chinese market. In the new contract, the commission would not be calculated according to a person‑month rate, but would instead be settled based on the percentage of the project completed. For example, if a project was expected to be completed in 10 months, when two months of the workload was complete, 20 per cent of progress payments would be paid. When five months of the workload was complete, 50 per cent of progress payments would be paid, and so on. If the project was delayed, a separate additional contract would be signed.

Lee was confused about the need for a new payment scale because the project was no different from previous contracts. Anyway, the contract would be reviewed by the legal staff and financial personnel in both companies, so these changes would not be a great concern. Back home, Lee called in some personnel immediately to form a new project team. Soon, he received the new contract from Shenghui (see Exhibit 1). The contract amount was ¥15 million, and the contract period was 18 months. However, the settlement terms seemed doubtful, and read as follows: “According to the provisions of service contents, standards, and progress check, the project is divided into the milestones of 20 per cent, 50 per cent, 80 per cent, 95 per cent, 100 per cent; after Shenghui receives the corresponding proportion of payments from the owner, it will pay to Reike Technology.”

Reike followed a rigorous review process for business contracts. Before a new project contract was signed, there had to be joint approval by the legal, business, finance, and operation departments. For such unusual contract terms, Lee did not dare figure it out alone. He immediately sent the contract to the legal department and copied the business, finance, and operation departments.

As expected, when the manager of the legal department read the contract, she pointed out the infamous “pay-when-paid” clause. She said, “It is very risky because there is serious information asymmetry between us and the general contractor. If we sign the contract, after a year’s work, the general contractor may refuse to pay us on the grounds that they have not received the payment from the owner, or even default.” The company would suffer major losses under these circumstances. Signing such a contract was asking for trouble.

Lee was further cautioned by his colleagues in the operation department, who reminded him that “Although a pay-when-paid clause is not a new thing in software outsourcing industry, there are indeed examples that outsourcers suffered from such terms. How do you assess the risk of this contract? What are the reasons to support it?”

Finally, Lee reported to the business director for a decision. This was the first time that the director made such a decision. He called in several other managers who had co-operated with Shenghui and discussed the contract with them. Since Shenghui was a reputable company and had never repudiated a debt, they all agreed that they should accept the contract, even though there was a risk. The Zhongjiao project was a large amount of business, and everyone wanted a share. If they did not accept the contract, other outsourcing companies would. If Reike turned down the project, not only would it miss an opportunity to earn money, but the relationship between Shenghui and Reike would also be directly affected.

The director made his decision to support the project. However, he directed Lee to keep the team on a small scale. In this way, the project was approved with reservations.

After the project was approved, Lee immediately began recruiting new engineers and building the team. This was routine work for Lee, who felt very much at home. In the next month, the Zhongjiao project team, comprising a dozen engineers, began to carry out work on schedule led by Shenghui’s senior architecture design and management team. These engineers had an average of three years’ work experience, so the labour costs were relatively high.

Revenue Recognition at the End of the First Year

When the Zhongjiao project contract was signed, Jeff Young, Reike’s finance manager, was away on business. The contract was reviewed by his deputy together with other departments. Young only learned about the major new order after he returned.

Previously, after Reike was listed, the finance department had set up a ledger for all approved projects. Project expenditures, revenues, related creditor rights, and debt were registered and monitored in real time. However, for the Zhongjiao project, it was not until the end of the year that Linda Zhang, the project accountant, asked Young whether the revenue for the Zhongjiao project should be recognized. Young told Zhang to handle it in the same way as in previous years. She explained that the revenue from Business Department No. 3 was based on labour income and commissions over the past few years, while the Zhongjiao project revenue was accounted for using project milestones. The first milestone, 20 per cent of the project, had not come yet.

Young called Lee and asked him for proof of the project completion schedule, which should have been confirmed by Shenghui. After that, the revenue could be recognized according to the progress. Lee said that the payment for the Zhongjiao project was in accordance with milestones, and the first milestone was not complete. According to the contract, Shenghui had no obligation to identify and confirm the progress, so it was a bit much to require Shenghui to do so. Lee asked if it was possible that Business Department No. 3 provide proof of the project completion schedule by itself.

Young asked Zhang for her opinion on this matter. Zhang said that Business Department No. 3 had done its job. The team believed that Shenghui was a large international company that had good credibility and was not likely to default. Moreover, Business Department No. 3 had no bad debts in its dealing with Shenghui, so in her opinion, they could recognize part of the revenue in accordance with Lee’s recommendations. Besides, the labour costs for the Zhongjiao project during the two months were nearly ¥0.9 million and recorded in the labour cost account for the project. When revenue was recognized, the labour costs could be recognized as operating costs.

Young did not respond but waited for Zhang to forward him a copy of the contract for the Zhongjiao project. He glanced at the contract and took a deep breath when he saw the “pay-when-paid” clause. Young was glad that he had not let Zhang handle the business before seeing the contract! He called Lee again. After hearing the explanation from Lee, Young reminded him about the finance department’s principle of revenue recognition. “Reike is a listed company, and there are countless people staring at the quarter and annual report. The revenue recognition must conform to the accounting criteria. Since the ‘pay-when-paid’ clause for the Zhongjiao project is risky, please communicate with Shenghui and also with the financial department after each milestone is completed,” Young requested. After talking to Lee, Young told Zhang to call Lee every month to keep an eye on the project progress.

Trouble with Project Settlement at Each Milestone

Lee and his team worked day and night, and the Zhongjiao project progressed smoothly. Three months later, the first milestone was reached. As usual, Lee wrote a project progress report and sent it to the Shenghui business executive. If he replied and confirmed, Business Department No. 3 could report the income to the finance department and require an invoice. The money could then be collected within 30 days. A 30-day payment collection period was not only the rule of the industry, but it was also predetermined in the contract. The payment collection in Lee’s department was always efficient. Also, Shenghui was a seasoned client, with whom Reike had been happy working together for many years, so Lee had great confidence in the contract payment this time.

However, after a few days, Lee had not received a reply from Shenghui. Wondering whether the company had forgotten to reply, he sent the report again and called the business executive at the same time. The executive politely said that the current progress had some problems and they had not reached the milestone of 20 per cent. Nevertheless, the problems were not serious, and the payment would be put off until the next month, so Lee was asked to please be patient!

Lee was surprised. Project progress had never before been questioned by a customer. The service quality and standards had not encountered problems. Why had the executive said that the project had not reached 20 per cent completion? Although he was puzzled, Lee had to wait for written confirmation from Shenghui, which unexpectedly took six months. During the wait, Lee experienced great pressure in terms of performance evaluation. Even worse, while forming the project team at the early stage, it had been difficult to recruit qualified engineers in a short time, so he had contracted that part of the business out to another company. Now the subcontractor was requesting its payment. While asking for confirmation from Shenghui, Lee had to dodge the outsourcing company.

When the project reached the 50 per cent milestone, Shenghui again failed to recognize or make the payment. Zhang made her monthly phone call to ask about the project’s revenue. Meanwhile, Lee visited Shenghui repeatedly. In the beginning, the business executive would explain that the problem was due to communication issues between Shenghui and Zhongjiao, and he hoped that Lee would be patient. “We have co-operated for so many years. You should have confidence in Shenghui.” Later, however, he would be blunt and state, “Please go back to read the contract.”

Lee was annoyed. He met over drinks with the sales manager who had helped him set up the project to lament:

I worked hard and finally signed the ¥15 million contract, but now I haven’t seen a penny of it! Shenghui always says the progress is slow, or the owner does not pay, but we all know that these are excuses! We thought we had the money in the bag, for the contract was signed and the work had been actually done. At least it should be accounts receivable. But now, if I can’t get the confirmation by the end of this year, we may have been doing all this for nothing the whole year. The bonus of our team is ruined, and then I’ll have to find another job.

The sales manager, who had been Lee’s partner for a long time, understood Lee’s suffering.

Yeah, if an IT giant such as Shenghui does not follow the provisions, the outsourcing companies have to close. The projects were settled on a monthly basis in the past, and the income was stable every month. We didn’t need to recognize the project’s revenue. However, this is a ‘pay-when-paid’ clause now. If they do not confirm the progress, the financial department will not recognize the project’s revenue, so the big contract is useless. We really have a tough time.

Processing Project Costs

Before long, came the end of 2013. At the end of each year, the accounting supervisor was responsible for checking the company’s asset items to see what assets should be impaired or transferred. When checking the account line “Inventory—costs of project” at the end of 2013, he found that the Zhongjiao project costs were up to ¥8.04 million and the project had not been paid. He met with Zhang and with Young, who was emerging from a day-long meeting, and had a very animated discussion about how to resolve this problem.

The accounting supervisor believed that almost 80 per cent of the project was complete, but Shenghui had not confirmed the project schedule. It now seemed possible that the project funds might never be recovered. He wanted Zhang to immediately estimate the loss for the Zhongjiao project. Otherwise, more than ¥8 million would be treated as a loss the next year, thus creating great pressure on the income statements. However, Zhang did not agree. Referencing International Accounting Standards (see Exhibit 2), she stated:

For such a project as the Zhongjiao project, the revenue can be recognized in accordance with the percentage-of-completion method. If the percentage of completion cannot be confirmed, or the recognition criteria of the revenue cannot be met, it should be considered whether the costs incurred are recoverable. If the costs incurred are expected to be recoverable, revenue can be recognized based on the costs incurred, and no profit is recognized; if costs are not expected to be recoverable, revenue can be recognized only to the extent of costs incurred that are expected to be recoverable and costs can be recognized according to actual expenses.

Zhang thought that although Shenghui did not sign off on the progress report at each milestone, it had a business reputation, so the recovery of receivables was simply a matter of time. The company cautiously assigned ¥12 million in revenue based on the percentage of completion, with business revenue of ¥8.04 million and labour expenses of ¥8.04 million tagged as operating costs (see Exhibit 3).

The accounting supervisor retorted:

From the perspective whether expenses are expected to be recoverable, there are also guidelines like this. ‘If all costs incurred are not expected to be recoverable, the revenue should not be recognized, and the costs incurred should be recognized as period expenses.’ Zhongjiao project has been carried out for more than a year, but Shenghui does not recognize even 20 per cent of the project’s progress. Even if Shenghui has a reputation, the owner may delay! In my opinion, the income cannot be recognized. The ¥8.04 million should be included in this year’s expenses. This is a really cautious accounting processing.

“Do you mean [to say that] Zhongjiao international Group will be deadbeats?” asked Zhang. “Then, they will meet Shenghui in court. Zhongjiao is a large state-owned enterprise. It’s impossible that they lack money.”

The debate continued until Young waved his hand and said, “Hold on please. Let me think about it.”

Performance Assessment at the End of the Second Year

At Reike, each department had its own bonus policies, but the general procedure was the same. A certain amount of money (about 3 per cent of the total revenue) was identified from the revenue and set aside as commissions and bonuses. Each department could set its own rate according to the amount of revenue. At the end of each fiscal year, the management team in each department would discuss how to allocate the bonus amounts: either as small bonuses to everyone or large bonuses to only some people. Usually, large bonuses were given, so the team had to decide who deserved bonuses (other than the management team) and how much should be given. Qualified people would be paid a one-time bonus after an annual performance review was conducted in person.

Although a bonus was never assured in the salary package at Reike, managers tried their best to retain core team members by offering bonuses. In recent years, Lee and his team had consistently been the company’s performance stars. However, at the end of 2013, with a low bonus pool, Lee worried that he could not please all of his core team members, so he would likely lose some of them. Lee’s bonus would be assessed by the higher management team. Although he had done a good job in delivering the whole project, the loss was likely to prevent him from receiving a satisfactory bonus.

Lee heard that a neighbouring company also provided services for Shenghui and that dozens of people worked for a year but got nothing. With the net loss of several millions, the company was preparing to prosecute Shenghui. Lee hoped that it would not reach such a situation, but wondered how he would deal with it if it really happened. There were almost 3,000 people engaged in the Shenghui and Reike partnership. How would the company survive if it were to sue Shenghui—its *god of wealth*? Lee stayed late at the office, gloomily considering the situation.

While Lee was on pins and needles, Young was also having a hard time. The personnel department had asked the finance department to provide performance data. When it came to Business Department No. 3, Young hesitated. According to Zhang’s proposal, the project revenue for the Zhongjiao project should offset labour costs; therefore, the department reaped nothing that year. On the other hand, according to the proposal, the predicted loss for the Zhongjiao project was more than ¥8 million that year, which meant that Business Department No. 3 not only had no profits, but should also be responsible for the loss.

Lee felt that he had not signed the contract alone, so why should the loss be borne only by him and Business Department No. 3? Moreover, “pay-when-paid” contracts were not uncommon in the industry. Should the company have undertaken such a project? How could the financial department avoid a similar difficult situation in the future? How would the company fairly handle performance appraisals at the end of the year? Bothered by these problems, Lee decided to talk to the general manager the next day.

Exhibit 1: Excerpt from Shenghui Consulting Services subcontract

**Party A (Employer):** Shenghui Co. Ltd.

**Party B (Contractor):** Reike Technology Co. Ltd.

1. **Customer:** The Contractor will work on behalf of Shenghui to perform the following work for its customer Zhongjiao International Group.
2. **Confidentiality:** Both sides acknowledge that all confidential information disclosed to the contractor will be kept confidential for five years in accordance with the request in the customer contracts, and the two sides promise not to disclose customer information within this period.
3. **Services:** The Contractor is responsible for the development, testing, and support of the following contents(excerpt).

**SharePoint Server Upgrade**

Zhongjiao International Group plans to upgrade SharePoint Server 2010 to 2013 companywide. The upgrade plan includes following parts:

* Old feature migration
* All sub sites migrate to 2013. Up to 40 sub sites on SharePoint 2010 across the company should be upgraded to 2013.
* Customized web parts and report pages upgrade to 2013. Customized web parts are used by Finance and HR. They should be upgraded to 2013.
* Content database migration: About 400 GB of content DB should be upgraded to 2013.
* New feature deployment
* Single sign-on with other intranet systems.
* SharePoint workflow development: Finance and HR process changes require workflows to be re‑designed. Six new workflows are needed for customer support and supply chain management.
* UI customization: All report pages re-designed in Silverlight.
* Office Web Apps.

1. **Acceptance criteria:** Inspect services in accordance with the provisions on service contents, standards, and progress of Shenghui.
2. **Period:** All work should be done within 18 months, starting from October 16, 2012.
3. **Employees of contracto**r**:** The contractor shall assign the following employees and subcontractors to carry out work in accordance with the orders, unless the following conditions, employees, and subcontractors cannot be replaced by the contractor: i) expiration of the subcontractor or an employee contract, resignation, or other causes beyond the reasonable control of the Contractor; ii) replacement of the subcontractors or employees upon the requirements of Shenghui due to their inability to work. In this case, the Contractor shall assign new employees or subcontractors that Shenghui can reasonably accept as soon as possible to replace the original employees or subcontractors, and Shenghui will not assume the resulting additional costs.

Exhibit 1 (continued)

1. **The contractor agrees to the following terms and conditions.**

Payment stages of the project are as follows:

|  |  |  |  |
| --- | --- | --- | --- |
| **Milestone** | **Payment Percentage** | **Deadline** | **Deliverables and Conditions** |
| 1 | 20% | 3 months (by 1/15/2013) | Inspect 20% of the workload completed in accordance with the provisions of Shenghui on service contents, standards, and schedule, and Shenghui shall receive a corresponding proportion of payments by customer. |
| 2 | 30% | 6 months (by 7/15/2013) | Inspect 50% of the workload completed in accordance with the provisions of Shenghui on service contents, standards, and schedule, and Shenghui shall receive a corresponding proportion of payments by customer. User acceptance test on membership relationship module is passed. |
| 3 | 30% | 6 months (by 1/15/2014) | Inspect 80% of the workload completed in accordance with the provisions of Shenghui on service contents, standards, and schedule, and Shenghui shall receive a corresponding proportion of payments by customer. User acceptance test on customer satisfaction module is passed. |
| 4 | 15% | 2 months (by 3/15/2014) | Inspect 95% of the workload completed in accordance with the provisions of Shenghui on service contents, standards and schedule, and Shenghui shall receive a corresponding proportion of payments by customer. System integration test is passed. |
| 5 | 5% | 1 month (by 4/15/2014) | Inspect 100% of the workload completed in accordance with the provisions of Shenghui on service contents, standards, and schedule, and Shenghui shall receive a corresponding proportion of payments by customer. System runs for 1 year. |

1. **Costs:** Shenghui agrees to pay the Contractor for the work accepted by Shenghui together with the customer under the above items on work orders:

* Costs (total cost of the project): ¥15 million
* Total cost shall not exceed: ¥15 million
* Overhead (such as expenses for travel, accommodation, etc.): Travel costs are covered by Shenghui.

1. **Terms of notes**
2. The Contractor must submit correct invoices promptly to Shenghui in accordance with the terms of the work orders to ensure Shenghui can submit correct invoices to customers on time. The Contractor shall submit correct invoices per month or within 30 calendar days after the end of the contract (whichever is earlier). The invoices may be submitted according to the methods stipulated in the Shenghui purchase order or developed separately in writing by Shenghui. Other methods of invoice submission shall not be accepted.

Exhibit 1 (continued)

1. When submitting an invoice, the corresponding time and cost breakdown of the invoice must be submitted to Shenghui by email or fax to be recognized. The invoice must include Shenghui's purchase order number and the name of the subcontractor assigned in this work order.
2. Unless authorized by Shenghui, personnel assigned by the Contractor in the work order must submit working hours weekly at no later than 23:59 local time every Friday. The billing fees must be submitted within 10 business days after the work is incurred. Time and costs shall be submitted to Shenghui’s system through the website, or, if authorized by Shenghui, they can be submitted to the designated contact person via email or fax. To enter the system, the Contractor shall be responsible for applying an account from Shenghui for each relevant staff member.
3. If the time and expense on the invoice submitted are inconsistent with that provided for Shenghui, Shenghui will reject them. Only when Shenghui receives the required information that is consistent with the invoice will it pay the expense on the invoice.
4. If the contractor fails to meet the requirements of the contract, Shenghui may not be able to issue an invoice to the customer, so whole or part of the work payment may not be collected. If the contractor cannot submit the correct invoice in a timely manner, Shenghui reserves the right to refuse payment and adjust the amount payable under this work order reasonably.
5. **Effective date of the contract:** The contract shall become effective from October 20, 2012, or from the date of commencement of services by the Contractor (whichever is earlier). This work order will expire on April 20, 2014, and can be extended upon a written agreement by both parties.

Source: Company documents.

Exhibit 2: Rules For Revenue Recognition of Services

According to IAS 18- Revenue, the recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognized in the accounting periods in which the services are rendered.

For revenue arising from the rendering of services, provided the following criteria are met, revenue should be recognized by reference to the stage of completion of the transaction at the balance sheet date (the percentage-of-completion method):

* the amount of revenue can be measured reliably;
* it is probable that the economic benefits associated with the transaction will flow to the seller;
* the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
* the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

When the above criteria are not met, revenue arising from the rendering of services should be recognized only to the extent of the expenses recognized that are recoverable (a “cost-recovery approach”). As the outcome of the transaction cannot be estimated reliably, no profit is recognized.

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

Source: Deloitte, “IAS 18—Revenue,” IASPlus, accessed June 23, 2017, <https://www.iasplus.com/en/standards/ias/ias18>.

Exhibit 3: Zhongjiao Project expenses in 2012 and 2013 (¥ millions）

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **Personnel** | **Space Cost** | **Commission**  **& Bonus** | **Travel &**  **Entertainment** | **Depreciation**  **& Amortization** | **Others** | **Total** |
| 2012 | 0.78 | 0.04 | 0 | 0.01 | 0.01 | 0.06 | 0.90 |
| 2013 | 6.71 | 0.42 | 0 | 0.04 | 0.09 | 0.78 | 8.04 |

Source: Company documents.

1. ¥ = CNY = Chinese yuan; all currency amounts are in ¥ unless otherwise stated; ¥1.00 = US$0.16 on December 31, 2012. [↑](#footnote-ref-1)
2. “Gartner Says Worldwide IT Outsourcing Services Spending on Pace to Surpass $251 Billion in 2012,” Gartner, August 7, 2012, accessed August 10, 2014, www.gartner.com/newsroom/id/2108715. [↑](#footnote-ref-2)
3. “Gartner Says Worldwide IT Outsourcing Market to Reach $288 Billion in 2013,” Gartner, July 17, 2013, accessed August 10, 2014, www.gartner.com/newsroom/id/2550615. [↑](#footnote-ref-3)
4. “Since the 16th National Congress of Business Achievements, Service Outsourcing Has Developed Rapidly,” Ministry of Commerce of the People’s Republic of China, November 8, 2012, accessed August 10, 2014, www.mofcom.gov.cn/aarticle/ae/ai/201211/20121108424341.html (in Chinese). [↑](#footnote-ref-4)
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