

16 August 2010

International Accounting Standards Board
(IASB)

Dear Sir/Madam,

Response to ED/2010/6 *Revenue from Contracts with Customers*

1. I thank the IASB for the opportunity to comment on the aforementioned ED. Before I proceed to articulate my views on this ED, I would like to emphasise upfront that the comments that are expressed herein are solely my *personal views* and strictly do *not* reflect those of any organisation to which I may be associated presently and/or previously in various capacities.

2. It is heartening to note that both the IASB and the FASB have come together to jointly issue ED/2010/6, which is aimed at promulgating a common accounting standard for revenue recognition and measurement. This marks a significant milestone in the history of accounting standard-setting as policymakers around the world increasingly acknowledge the imperative need for a single set of high-quality global accounting standards in the post financial crisis era. I therefore wish to take this opportunity to commend the two Boards for the valiant efforts and substantial resources that they have jointly expended in developing a common revenue recognition and measurement framework as part of the ongoing Memorandum of Understanding (MOU) programme to achieve convergence between the IFRS and US GAAP.

3. Nonetheless, a key concern that I have on this ED relates to the paradigm shift in revenue recognition from “risks and rewards” (per IAS 18 and 11) to “control”. A significant paradigm shift, this is likely to ensue in very different reported revenue numbers for entities that have been adopting the percentage-of-completion method in their recognition of revenue (particularly those entities in the construction industry). Traditionally, revenue is a key accounting number that financial statement users refer to when evaluating an entity’s performance, and plays a pivotal role in performance reporting. It is thus critical that the Boards make in-depth and careful deliberations before implementing this paradigm shift. My concern is that the Boards have not laid a strong and sound conceptual foundation for the “control” model to ensure that it is superior and results in more consistent outcomes as compared to the “risks and rewards” model. The notion of “control” is pervasive in the IFRS body of accounting standards, with critical applications to financial statement consolidation (see IAS 27), definition of the reporting entity (see

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ED/2010/2) and revenue recognition. I therefore strongly urge the Boards to “put the horse before the cart” and to initiate a high-level conceptual debate on what “control” generally means in financial reporting, with a view to developing a substantive definition of “control”. This should be done in the context of the joint Conceptual Framework project. Using the definition as a frame of reference, the Boards can then more effectively consider how “control” should be consistently applied in the specific context of individual standards such as revenue recognition.

4. My comments to specific questions posed in the ED can be found in the **Appendix** to this comment letter.

Yours faithfully,

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Appendix

Question	Comments
<p>Question 1: Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether:</p> <p>(a) to combine two or more contracts and account for them as a single contract;</p> <p>(b) to segment a single contract and account for it as two or more contracts; and</p> <p>(c) to account for a contract modification as a separate contract or as part of the original contract.</p> <p>Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?</p>	<p>At a conceptual level, I agree with the proposed principle for determining whether to combine or segment contracts and whether to treat a contract modification as a separate contract for revenue recognition purposes.</p> <p>However, I think that the principle of “price interdependence” - as articulated in paragraph 13 of the ED - is unclear and in need of further refinement. In my view, for contracts to be combined together for revenue recognition purposes, other “non-price” factors such as the nature and inter-relationship between the services or goods supplied under the two or more contracts should also be concomitantly considered by the entity. As such, I would suggest that the Boards consider broadening the principle from “price interdependence” to “interdependence” to duly capture the range of factors that preparers need to take into account when recognising revenue.</p> <p>From a practical standpoint, while combining two or more contracts for revenue recognition should not pose too much of a cost-benefit issue for preparers, I am not sure whether the same can be said in the case where contracts need to be segmented for revenue accounting purposes. However, I would think that situations requiring a single contract to be segmented will be rare in practice.</p>

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<p>Question 2: The boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?</p>	<p>Generally, I agree with the Boards' proposed approach to identify separate performance obligations within a contract on the basis of whether the promised good or service is distinct. The ED has also articulated a fairly rigorous set of conditions for determining whether a promised good or service in a contract is distinct.</p> <p>However, I think that the condition in paragraph 23(a) that the entity should consider whether "another entity" sells an identical or similar good or service separately is too broad and should be qualified to "another entity <i>within the same industry</i>". In practice, when an entity applies the condition in paragraph 23(a) to identify separate performance obligations in its contracts with customers, it would be neither practical nor appropriate for that entity to look at the business practices of entities in a different industry. Rather, it would be more practical and appropriate for that entity to take reference from the norms of its own industry.</p>
<p>Question 3: Do you think that the proposed guidance in paragraphs 25–31 and related application guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?</p>	<p>The proposed "control" model for revenue recognition in the ED signifies a significant paradigm shift from the existing "risks and rewards" model espoused in IAS 18 and IAS 11. In my view, this paradigm shift is likely to ensue in very different reported revenue numbers for entities that have been adopting the percentage-of-completion method in their recognition of revenue (particularly those entities in the construction industry). Traditionally, revenue is a key accounting number that financial statement users refer to when evaluating an entity's performance, and plays a pivotal role in</p>

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	<p>performance reporting. It is thus critical that the Boards make in-depth and careful deliberations before implementing this paradigm shift.</p> <p>My concern is that the Boards have not laid a strong and sound conceptual foundation for the “control” model to ensure that it is superior and results in more consistent outcomes as compared to the “risks and rewards” model. The notion of “control” is pervasive in the IFRS body of accounting standards, with critical applications to financial statement consolidation (see IAS 27), definition of the reporting entity (see ED/2010/2) and revenue recognition. I therefore strongly urge the Boards to “put the horse before the cart” and to initiate a high-level conceptual debate on what “control” generally means in financial reporting, with a view to developing a substantive definition of “control”. This should be done in the context of the joint Conceptual Framework project. Using the definition as a frame of reference, the Boards can then more effectively consider how “control” should be consistently applied in the specific context of individual standards such as revenue recognition.</p> <p>Aside from approach, I also observe that the Boards are proposing to consider “control” for revenue recognition purposes from the perspective of the customer (paragraph 25 and BC63). I see some merit in the Boards’ argument that this minimises revenue</p>

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	<p>recognition abuses by the reporting or selling entity. However, my sense is that applying the “control” notion from the customer’s perspective will pose practical problems for the reporting or selling entity, and magnify the complexity of the revenue accounting process. Firstly, the reporting or selling entity may not be privy to the customer’s specific circumstances (e.g. the customer may have entered into another contract that prevents it from deriving economic benefits from the good or service delivered). Secondly, an evaluation of “control” from the customer’s perspective would be difficult to apply in more complicated transactions where the entity paying for the promised good or service is different from the entity receiving and using the promised good or service. Thus, I would think that it would be more practical for the “control” notion to be evaluated from the reporting or selling entity’s perspective (i.e. in terms of whether it has lost its “control” over the promised good or service).</p> <p>A final point that I would like to raise concerns paragraph 30(d). Specifically, I do not agree with the argument that the fact that a promised good or service is tailored to the customer’s requirements and has no alternative use for the selling entity is indicative of the customer obtaining control of the said good or service. Moreover, from my reading of the segment “... it is likely that the entity would require the customer to obtain control of the asset...”, it seems to me that the “control” notion is now being applied more from the</p>

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	<p>reporting or selling entity’s perspective than the customer’s perspective. I suggest that the Boards review the wording and intent of paragraph 30(d) to ensure that it is consistent with the “control” revenue recognition model that is being proposed in the ED.</p>
<p>Question 4: The boards propose that if the amount of consideration is variable, an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.</p> <p>Do you agree that an entity should recognise revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?</p>	<p>I concur with the ED’s proposal that revenue should be recognised using an estimated transaction price in situations where transactions entail variable consideration. To pre-empt earnings manipulation, the price estimation must be based on verifiable assumptions based on experience with similar contracts. I am satisfied that this point has been adequately captured in the criteria in paragraph 38.</p> <p>I further note that the “probability-weighted” measurement approach that is proposed in the ED is conceptually consistent with the approach that the IASB is adopting in its ongoing project to revamp IAS 37.</p>
<p>Question 5: Paragraph 43 proposes that the transaction price should reflect the customer’s credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer’s credit risk should affect <i>how much</i> revenue an entity recognises when it satisfies a performance obligation rather than <i>whether</i> the entity recognises revenue? If not, why?</p>	<p>I agree with the proposal that the customer’s credit risk should be reflected in terms of the amount of revenue recognised when the entity fulfils the performance obligation, and not in terms of whether the entity recognises revenue at all.</p> <p>I observe that this is consistent with the approach that the IASB is taking in its IAS 37 revamp project at the principles level. That is, risk and uncertainty should be reflected in the measurement - rather than the recognition - of liabilities or assets.</p>

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<p>Question 6: Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?</p>	<p>I am agreeable to the proposal to incorporate the time value of money into the promised consideration amount in contracts with substantial financing elements. I believe that this would provide a more faithful representation of the economics of the earnings process arising from such contracts.</p>
<p>Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?</p>	<p>I agree with the proposal in paragraph 50 on the requirement to allocate the transaction price to all separate performance obligations in a contract on the basis of the stand-alone selling price at contract inception.</p> <p>However, notwithstanding the Boards’ arguments in paragraphs BC127 – BC128, I urge the Boards to re-consider the position on not making an exception for the allocation of discounts in a contract. I am concerned that the mechanical allocation of discounts on the basis of stand-alone selling price may lead to outcomes that may not faithfully reflect the economics of the transaction. A case in point would be in multiple-element arrangements where the entity provides a discount on the high-margin components. In such a situation, allocating the discount pro rata to all components in the contract may result in the entity reporting a loss on other lower-margin components. I do not think that such an outcome would depict a faithful representation of the economics of the transaction, as the lower-margin component is not subject to any discount in the first place.</p> <p>For similar reasons, I further urge the Boards to review the proposed provision in paragraph 53. I believe that a mechanical extension of</p>

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	<p>the same allocation basis - subsequent to contract inception - may not lead to revenue reporting outcomes that faithfully reflect the economics and dynamics of the contractual delivery process.</p>
<p>Question 8: Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 <i>Intangible Assets</i> or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria.</p> <p>Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?</p>	<p>I would like to raise my concern as to whether the asset recognition condition stated in paragraph 57(c) in the ED is consistent with the revised working definition of an asset developed under the joint IASB-FASB Conceptual Framework project. According to the revised definition, “an asset of an entity is a present economic resource to which the entity has a right or other access that others do not have”. This definition does not specify cost recoverability as a condition for an asset to exist. I urge the Boards to review paragraph 57(c) to ensure that there is conceptual consistency with the revised asset definition.</p> <p>Aside from this issue, I think the proposed requirements are largely operational and sufficient.</p>
<p>Question 9: Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognising an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognised for an onerous performance obligation.</p> <p>Do you agree with the costs specified? If not, what costs would you include or exclude and why?</p>	<p>From the conceptual standpoint, I concur with the “full cost” (i.e. direct plus allocated costs) basis for measuring contract costs for capitalisation. I note that this is an established and widely adopted costing approach in many industries.</p> <p>However, I think paragraph 58(c) in the ED is too stringent vis-a-vis the existing provision in IAS 11. Specifically, paragraphs 16(b) and 18 of IAS 11 allow indirect costs attributable to contract activity to be allocated to specific contracts. However, paragraph 58(c) in the ED seems to restrict the inclusion of allocated overheads to only those</p>

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	<p>that relate directly to the contract or contract activities. I am not sure whether this is an issue of semantics or whether it is indeed the Boards' intention to restrict the permissible range of allocated overheads for capitalisation. As such, I would urge the Boards to provide further clarification in this regard, though I am more inclined towards the prevailing IAS 11 provisions.</p>
<p>Question 10: The objective of the boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?</p>	<p>I observe that the proposed disclosure requirements are substantially more extensive and detailed than the existing ones in IAS 18 and IAS 11. Some of the disclosure requirements are new to preparers. Preparers will probably need to evaluate whether their existing financial reporting systems are capable of providing the necessary information for compliance with the proposed disclosures. There will thus be implementation costs involved in terms of system changes.</p> <p>While the disclosure requirements are theoretically sound, I envisage that preparers will find it a tall order to integrate these detailed disclosure requirements within the notes to the financial statements in a manner that is decision-useful to users without being excessively lengthy. It remains to be seen whether entities' implementation of the disclosure requirements will actually translate into more decision-useful information for investors and other financial statement users.</p> <p>On a conceptual note, I am pleased that the Boards recognise the value of "principle-based disclosure requirements" (see paragraph BC171). I would like to take this opportunity to urge the Boards to consider adopting a more holistic approach to principle-based disclosures through the development of a Disclosure Framework.</p>

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	<p>The present absence of a Disclosure Framework has resulted in the IFRS disclosure requirements being developed on a standard-by-standard basis, without reference to a unifying set of principles espousing disclosure objectives and the extent to which disclosures should support the numbers reported in the financial statements. Going forward, I hope to see the Boards adding a project to develop a Disclosure Framework for Financial Reporting in their future technical agenda.</p>
<p>Question 11: The boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year.</p> <p>Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?</p>	<p>In principle, I agree with the Boards' proposed disclosure requirement for a maturity analysis of remaining performance obligations in longer-term contracts exceeding a year.</p> <p>However, I do not agree with the provisions in paragraphs 78(a) – (d) in the ED. This is because I do not see the need to prescribe specific time-bands for the aforesaid maturity analysis. I think this is inconsistent with the principle-based disclosure approach that the Boards are taking for this ED (as expressed in paragraph BC171).</p> <p>Allow me to also highlight that the proposed time-bands are at variance with other existing prospective disclosure requirements in the IFRS. For instance, paragraphs 39(a) – (b) in IFRS 7 require preparers to exercise judgement in determining the appropriate time-bands for a liquidity risk maturity analysis of financial liabilities. IAS 17, on the other hand, requires the disclosure of future minimum lease payments for operating leases for the next five years for both lessees and lessors [see paragraphs 35(a) and 56(a) in IAS 17]. In my opinion, such inconsistencies arise within the IFRS because of the</p>

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	lack of a Disclosure Framework (see my comments to Question 10).
<p>Question 12: Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not, why?</p>	<p>Yes, I agree with the proposal relating to revenue disaggregation as articulated in paragraph 74 in the ED.</p> <p>Specifically, I support the Boards' position that the disclosure of revenue disaggregation should be driven fundamentally by economic factors affecting the entity's revenue and cash flow streams. Unlike the proposed disclosure on maturity analysis of outstanding performance obligations (see paragraph 78 in the ED and my comments to Question 11), this disclosure requirement is consistent with the principle-based disclosure approach that the Boards are adopting for this ED (vide paragraph BC171).</p>
<p>Question 13: Do you agree that an entity should apply the proposed requirements retrospectively (ie as if the entity had always applied the proposed requirements to all contracts in existence during any reporting periods presented)? If not, why?</p> <p>Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.</p>	<p>I support the Boards' proposal for full retrospective application of the new revenue recognition model. Consistent with the requirements of IAS 8, I believe that only a full retrospective application of the new revenue recognition model would ensure comparability of the revenue numbers between the current and comparative periods, thereby providing financial statement users with decision-useful information.</p> <p>From a practical standpoint, I appreciate that a full retrospective application of the new standard could impose onerous compliance burden for preparers, particularly those whose business operations entail long-term contracts with customers (a case in point being the construction industry). Furthermore, as expressed in my comments to Question 10, the extensive disclosure requirements in the ED may</p>

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	<p>necessitate significant financial reporting system changes by preparers. For smooth transition to the new revenue standard, I strongly urge the Boards to consider allowing a longer lead time from the issuance of the new standard to its effective date. The Boards should seek the views of the global preparer community before determining an appropriate transition timeline. In my view, a transition time-frame of at least three years from the date of standard issuance should be permitted in order to allow sufficient time for system changes and adjustments.</p>
<p>Question 14: The proposed application guidance is intended to assist an entity in applying the principles in the proposed requirements. Do you think that the application guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?</p>	<p>I acknowledge and welcome the Boards' efforts in developing application guidance to facilitate preparers' understanding and operationalisation of the principles promulgated in the ED.</p> <p>However, I think the standard-setting priority for the Boards should be on ensuring the clarity, conceptual rigour and consistency of the principles espoused in the main text of the proposed revenue standard. The application guidance should not be used as an implement to shore up principles that - in the first place - are vaguely articulated in the main text of the standard. Such an approach would not only be unsustainable in the long run, but also detracts from the quality of the IFRS as a set of accounting standards founded on principles (as opposed to rules).</p>

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<p>Question 15: The boards propose that an entity should distinguish between the following types of product warranties:</p> <p>(a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.</p> <p>(b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.</p> <p>Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?</p>	<p>I note that unlike the existing IAS 18, the ED attempts to make a conceptual distinction between “quality assurance” and “insurance” product warranties for the purpose of determining whether a separate performance obligation exists in the context of the proposed new revenue recognition model.</p> <p>In practice, drawing the distinction may not be a straightforward exercise, as the nature and intent of the product warranty in question may not be explicitly articulated. Significant management judgement may be required.</p> <p>I do not agree with the Boards’ conclusion that all statutory product warranties are to be treated as de facto “quality assurance” product warranties [refer to paragraph B18(a) in the ED and paragraph BC205]. This is tantamount to a rule-based provision and presumes that the Boards have total and authoritative understanding of the existing and future laws and regulations of every jurisdiction in the world. In keeping with a principle-based approach, it is imperative that the determination be made at the reporting entity’s level, taking into consideration the specific laws and regulations of the jurisdiction in which it operates.</p> <p>Paragraph B17 in the ED states that product warranties covering post-delivery faults give rise to separate performance obligations. However, it is silent on how this relates back to the general principle that a separate performance obligation exists only if the good or service is distinct (vide paragraph 22). Thus, in circumstances where the product warranty covering post-delivery faults does not satisfy the</p>

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	<p>“distinct” test, it is unclear whether entities should still treat the said warranty as a separate performance obligation on the basis of paragraph B17. From a principle-based perspective, I would think that the “distinct” test should take precedence over paragraph B17 in determining whether the said warranty is a separate performance obligation. For clarity, perhaps it would be better to position paragraph B17 as a “rebuttable presumption” subject to the “distinct” test for identifying separate performance obligations. I advise the Boards to review and clarify this application issue.</p>
<p>Question 16: The boards propose the following if a licence is not considered to be a sale of intellectual property:</p> <p>(a) if an entity grants a customer an exclusive licence to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the licence; and</p> <p>(b) if an entity grants a customer a non-exclusive licence to use its intellectual property, it has a performance obligation to transfer the licence and it satisfies that obligation when the customer is able to use and benefit from the licence.</p> <p>Do you agree that the pattern of revenue recognition should depend on whether the licence is exclusive? Do you agree with the patterns of revenue recognition proposed by the boards? Why or why not?</p>	<p>In substance, a licence to use an entity’s intellectual property (IP) - if it is not considered to be an IP sale - entails the granting of a “right-to-use” asset by the IP owner to the IP user, and ipso facto, amounts to a leasing arrangement. As such, I think that it would be more appropriate to consider the accounting for IP licences under the scope of the joint Leases project.</p> <p>Hence, I shall reserve my comments on this matter and call on the Boards to re-expose this issue under the joint Leases project.</p>

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<p>Question 17: The boards propose that in accounting for the gain or loss on the sale of some non-financial assets (for example, intangible assets and property, plant and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?</p>	<p>I agree with the proposal to align the accounting for gain or loss on the sale of non-financial assets with the proposed revenue recognition model, if the IASB ultimately decides to issue the ED as a new revenue standard to supersede IAS 18. I support this alignment because it would ensure conceptual consistency within the IFRS.</p>

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