2011-230
Comment Letter No. 301

asian-oceanian standard-setters group

20 March 2012

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Mr. Hoogervorst,

AOSSG Comments on IASB Exposure Draft, ED/2011/6
Revenue from Contracts with Customers

The Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide its comment on Exposure Draft ED/2011/6 *Revenue from Contracts with Customers*, a revision of ED/2010/6 *Revenue from Contracts with Customers* (the "2010 exposure draft").

The AOSSG currently has 25 member standard-setters from the Asian-Oceanian region: Australia*, Brunei Darussalam, Cambodia, China*, Dubai, Hong Kong*, India, Indonesia*, Iraq, Japan*, Kazakhstan, Korea*, Macao*, Malaysia*, Mongolia, Nepal, New Zealand*, Pakistan, Philippines, Saudi Arabia, Singapore*, Sri Lanka, Thailand, Vietnam, and Uzbekistan. Members with an asterisk (*) are also members of the AOSSG Revenue Recognition Working Group.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Each member standard-setter may also choose to make a separate submission that is consistent or otherwise with aspects of this submission. The intention of the AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that each member standard-setter may hold. This submission has been circulated to all AOSSG members for their comment after having been initially developed through the AOSSG Revenue Recognition Working Group. The AOSSG has not received any substantive contrary views from our constituents.

General comment

The AOSSG appreciates the IASB's efforts to reach out to various constituents within the Asian-Oceanian region in the development of a single revenue recognition model for all transactions across industries and regional boundaries. Information gained through these outreach activities have been reflected in our comments.

We agree with the IASB's objective 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. To achieve this objective, the revised proposals should be operational and increase comparability of revenue recognition practices among different entities and industries.

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Performance obligations satisfied over time criteria

The AOSSG supports the introduction of the criteria to determine whether a performance obligation is satisfied over time. Some of the AOSSG members' previous concerns relating to the lack of robustness of the control-based revenue recognition model proposed in the 2010 exposure draft to address collective control situations, long-term contracts and service contracts have largely been resolved. However, some remaining concerns are noted in the response to question 1 of the revised proposals. The AOSSG is pleased that the IASB had considered our recommendations to augment the control-based model with the criteria for the continuous transfer of control.

Assessment of the revised proposals from the customer's perspective

The AOSSG notes that the revised proposals often take the perspective of the customer in determining whether a requirement is satisfied; for instance, step 2 of the revised proposals to identify separate performance obligations and step 5 of the revised proposals to determine when a performance obligation is satisfied. We note that the assessment from these two perspectives may not result in the same outcome in some situations, as the IASB acknowledged in the Basis for Conclusions. Broadly, the AOSSG believes that the IASB should strive for internal consistency within the overall standard by taking an entity's perspective in determining the satisfaction of the requirements of the revised proposals, given that financial statements are prepared for the entity rather than the customer.

Other specific areas of concern

The AOSSG notes that several changes have been made to the exposure draft and we appreciate that some of our comments on the 2010 exposure draft have been reflected in the revised proposals. However, we still request your consideration of the following areas with which we have concerns or with which we disagree.

Presentation of customer's credit risk

The majority of AOSSG members disagree with the proposal to present the uncollectible amount of consideration as a separate line item adjacent to the revenue line item, because such presentation would imply a nexus with current period revenue that may not be valid.

Scope of onerous test

The majority of AOSSG members disagree with the proposed scope limitation of the onerous test, mainly due to the concern that a material onerous liability and expense, if any, would not be recognized for performance obligations satisfied within one year or less.

Interim disclosures

The AOSSG does not support the proposed interim disclosure requirements because, taken as a whole, the proposed requirements appear to be excessive and appear to follow a rule-based approach to interim reporting.

Our detailed responses to the questions in ED/2011/6 are set out in Appendix A. Appendix B presents other issues raised by AOSSG members for the IASB's consideration. In addition, we attach a separate comment letter on certain Islamic finance issues relating to ED/2011/6 prepared by the AOSSG Islamic Finance Working Group in Appendix C.

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We hope you find these comments useful and would be pleased to provide any further information you might require. If you have any queries regarding any matters in this submission or need further discussions on our comments, please contact either one of us.

Yours sincerely,

Kevin M. Stevenson
Chair of the AOSSG

Ikuo Nishikawa
Co-Leader of the AOSSG
Revenue Recognition Working Group

Michael Lim

Co-Leader of the AOSSG

Revenue Recognition Working Group

Attachment:

- Appendix A – AOSSG's responses to questions in ED/2011/6
- Appendix B – Other comments
- Appendix C – AOSSG Islamic Finance Working Group comments on IASB Exposure Draft ED/2011/6 *Revenue from Contracts with Customers*

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Appendix A – AOSSG's responses to questions in ED/2011/6

1 While AOSSG members generally agree that the revised proposals are an improvement over the 2010 exposure draft, we have concerns with certain aspects of the revised proposals. Our responses to the questions included in ED/2011/6 are summarised in the following paragraphs.

Question 1:

Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognises revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?

2 The AOSSG agrees with the principle that an entity is able to transfer control of a good or service over time. Generally, there is broad support from the AOSSG on the introduction of the criteria to determine when an entity satisfies a performance obligation over time. The majority of AOSSG members agree that the four criteria listed in paragraph 35 are appropriate and support the introduction and retention of these criteria by the IASB in the final standard.

3 Other AOSSG members, however, are of the view that the criteria in paragraph 35 should be re-expressed to address some common broad areas of concern. In addition, the AOSSG is of the view that the criteria of "right to payment for performance completed to date" and "alternative use" would require further clarification from the IASB on their intended application.

Possible overlap of criteria in paragraph 35

4 The AOSSG notes and agrees with the IASB's intention for entities to recognise revenue over time in cases where the entity's performance does not create an asset with an alternative use to the entity and the customer simultaneously receives and consumes the benefits of the entity's performance as the entity performs, i.e. by satisfying the criterion in paragraph 35(b)(i). However, some AOSSG members note that, if an entity is able to meet the requirement of paragraph 35(b)(i), in almost all cases, the entity would have satisfied the criterion in paragraph 35(a), i.e. the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.

5 As such, these AOSSG members are of the view that paragraph 35(b)(i) should be deleted or combined with paragraph 35(a) so as to remove the "bright line" that currently segregates contracts that involve the creation or enhancement of an underlying Work in Progress (WIP) and contracts that do not.

6 The AOSSG understands that paragraph 35(b)(ii) is intended to address situations where it is less clear that the customer benefits from the entity's performance as it occurs. Specifically, paragraph 35(b)(ii) would apply to accumulating services which do not involve the creation or enhancement of an underlying WIP controlled by the customer, such as transportation services.

7 Some AOSSG members are of the view that the IASB should remove paragraph 35(b)(ii) and include it as application guidance or a separate paragraph below paragraph 35 in the main standard to illustrate that there is transfer of control of the assets to the customer over time for the situation, e.g. transportation service, as articulated by the IASB in

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paragraph BC97 of ED/2011/6. These AOSSG members are concerned that the criterion in paragraph 35(b)(ii) is either unnecessarily complex or redundant if there are no situations in which paragraph 35(b)(ii) can be met without meeting paragraph 35(b)(i) and/or 35(b)(iii) concurrently.

8 Moreover, some AOSSG members are of the view that, if there are any circumstances in which the requirements of paragraph 35(b)(ii) could be met and paragraph 35(b)(i) would not also be met concurrently, they would consider this outcome to be inconsistent with the revenue recognition principle.

9 Nonetheless, the majority of AOSSG members agree with the IASB that paragraph 35(b)(ii) is appropriate on the basis that there could be situations where the receipt and consumption of benefits may not occur simultaneously.

Right to payment for performance completed to date as a criterion for determining whether a performance obligation is satisfied over time

10 The AOSSG understands that paragraph 35(b)(iii) is added by the IASB to address circumstances in which paragraphs 35(b)(i) and 35(b)(ii) will not help an entity in determining whether its performance transfers goods or services over time. The majority of AOSSG members support the introduction of this criterion and are of the view that there is transfer of control of the assets to the customer over time if the entity's performance does not create an asset with an alternative use to the entity and the entity has a right to payment for performance completed to date and it expects to fulfil the contract as promised.

11 However, some AOSSG members are concerned that the requirements of paragraph 35(b)(iii), as currently drafted, contradict the core revenue recognition principle, and may result in revenue recognition being driven by timing of cash payments made, rather than satisfaction of performance obligations.

12 Specifically, these AOSSG members are of the view that the revised proposals are not clear as to whether the right to payment involves a customer receiving a benefit from the entity's performance to date. Although the fact that a customer is receiving a benefit is implied economically, these AOSSG members consider the nexus between the entity's performance to date and the customer receiving a benefit should be explicitly clarified in paragraph 35(b)(iii). Such explicit clarification would help ensure the criterion is consistent with the core revenue recognition principle.

13 The AOSSG therefore recommends that the IASB should explicitly articulate in the main standard how the criterion of paragraph 35(b)(iii) is consistent with the core revenue recognition principle to allay the aforesaid concerns raised by some AOSSG members on the perceived contradiction. On this aspect, some AOSSG members are of the view that the drafting of paragraph 35 could be refined to address this concern, without changing the intended scope of contract situations where it is appropriate to recognise revenue over time.

14 Specifically, these AOSSG members recommend that paragraph 35(b) be structured to contain a single overarching criterion that is consistent with the core revenue recognition principle, for performance obligations for which it may not be clear whether any asset that is created or enhanced is controlled by the customer, or for which the entity's performance does not result in a recognisable asset. These AOSSG members are of the view that the creation of a single over-arching criterion for paragraph 35(b) would address the confusion that paragraph 35(b)(i) currently creates, which is the potential

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interpretation that the satisfaction of paragraphs 35(b)(ii) or 35(b)(iii) does not result in the *customer receiving the benefits of the entity's performance as the entity performs* (since the italicized words are only explicitly included in paragraph 35(b)(i)).

Clarity required on the right to payment for performance completed to date criterion

15 Some AOSSG members are of the view that the right to payment for performance completed to date criterion may lead to confusion or result in various interpretations over its intended meaning. Specifically, some AOSSG members request that the IASB clarify that the right to payment for performance completed to date must survive a customer default under the contract and be substantive. This issue will be particularly relevant to jurisdictions in the Asian-Oceanian region with a deferred payment arrangement for the sale of uncompleted, multi-unit, multi-level real estate, i.e. the customer does not make payments throughout the contract and in practice, the entity only has a right to compensation for potential loss of profit if the contract is terminated by the customer for reasons other than the entity's failure to perform as promised.

16 As such, these AOSSG members urge the IASB to clarify the intent on the application of the right to payment for performance completed to date criterion. This would help address possible future application challenges and possible divergences in practice.

Clarity required on the interpretation of 'alternative use'

17 The AOSSG supports the introduction of the 'alternative use' criterion. However, the majority of AOSSG members believe that the 'alternative use' criterion should be clarified to help prevent divergence in practice in interpreting the term, taking into account that this would be a new concept introduced in IFRSs.

18 The AOSSG notes that the IASB had concluded in paragraph BC 94 in the Basis for Conclusions that the level of customisation of the asset (and hence whether or not an entity would need to incur significant costs to reconfigure the asset for sale to another customer) should not be the determinative factor in considering whether an asset has an alternative use. Some AOSSG members recommend that the IASB could incorporate the discussion around 'customisation' in paragraph BC 94 of ED/2011/6 into the main standard and/or to articulate that the cost of rework is not the only factor to determine whether an entity is practically limited from directing the asset to another customer.

19 Some other AOSSG members believe the IASB should also clarify in the main standard or in another illustrative example the intended scope of the 'contractual limitation' limb of the alternative use criterion to avoid inconsistent interpretation. Specifically, these AOSSG members think it is unclear whether contractual terms, such as agreed-upon performance milestones, for which a specific customer is required to certify completion, are considered 'substantive terms' that would contractually preclude the entity from directing the asset created in such contracts to another customer.

20 In general, some AOSSG members think the IASB should develop application guidance, or another illustrative example (in addition to illustrative example 7), to articulate the application of the alternative use criterion in situations where the entity has to take into account the practical limitations (other than the cost of rework) on the entity's ability to readily redirect the promised asset to another customer. This would most definitely help to prevent difficulty in application or application divergence in practice.

Unit of account for measuring progress towards satisfaction of a performance obligation over time for the sale of multi-unit, multi-level, real estate apartments

21 Some AOSSG members have a specific concern with regard to the measurement of

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progress towards satisfaction of a performance obligation over time for the sale of uncompleted multi-level, multi-unit, real estate apartments. These AOSSG members note it is likely that more contracts for the sale of uncompleted, multi-level, multi-unit, real estate apartments would be accounted for as performance obligations satisfied over time under the revised proposals vis-à-vis current practice. These AOSSG members therefore believe that specific guidance on the appropriate unit of account for measuring progress should be provided by the IASB in the final standard to avoid application divergence.

22 In this regard, the AOSSG notes the IFRS Interpretations Committee had tentatively decided in November 2011 that the unit of account for measuring the progress of construction for each apartment unit is the individual apartment rather than the entire apartment building. Some AOSSG members disagree with this tentative decision and are of the view that it is more appropriate to consider the entire apartment building as the unit of account, as the construction of all the apartment units is intricately linked. Moreover, if the unit of account were the individual apartment, it would be very complex operationally to allocate the costs of the entire multi-unit, multi-level, apartment building to each individual apartment. As such, these AOSSG members urge the IASB to take cognizance of the unique single seller, multi-level, multi-buyers scenario to allay practical challenges entities would face to allocate cost on a reasonable and systematic basis to each individual apartment when recognising revenue for such performance obligations over time.

Question 2:

Paragraphs 68 and 69 state that an entity would apply IFRS 9 (or IAS 39, if the entity has not yet adopted IFRS 9) or ASC Topic 310 to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?

23 The majority of AOSSG members agree with the proposal to apply IFRS 9 (or IAS 39) to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk and to present the impairment losses on contract assets and receivables (both initial and subsequent changes) as expenses in a separate line item in profit or loss.

24 The majority of AOSSG members do not agree that the separate line item for impairment losses should be presented adjacent to the revenue line item because such a presentation appears to imply a nexus with current period revenue that is not valid. The impairment expense recognised in any particular period does not necessarily relate to the revenue of that period, as different customers may be the source, respectively, of the revenue and impairment losses.

25 Some AOSSG members, however, believe that initial credit loss and subsequent impairment adjustment should be separately presented, although it might be impractical in some situations.

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Question 3:

Paragraph 81 states that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognises to date should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount allocated to satisfied performance obligations only if the entity has experience with similar performance obligations and that experience is predictive of the amount of consideration to which the entity will be entitled. Paragraph 82 lists indicators of when an entity's experience may not be predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations. Do you agree with the proposed constraint on the amount of revenue that an entity would recognise for satisfied performance obligations? If not, what alternative constraint do you recommend and why?

26 The majority of AOSSG members agree with the proposed constraints on the cumulative amount of revenue recognised. However, these AOSSG members request that the IASB further clarify the 'reasonably assured' notion.

27 Some AOSSG members, however, disagree with the proposal because such a constraint is inappropriate in a principles-based standard, given the explanations in paragraph BC198 of ED/2011/6. Moreover, a reference to 'constraining the cumulative amount of revenue recognised' introduces a conservative bias to the recognition of revenue. The concept of 'reliability of measurement' underpins the recognition of assets, liabilities, revenue and expenses in the *Framework*, and the *Framework* is neutral in its application of the concept to those elements. Accordingly, these AOSSG members think the proposed constraint on the amount of revenue that an entity would recognise for satisfied performance obligations should be replaced with requirements based on the *Framework* criteria for the recognition of revenue, i.e. revenue should be recognised if it is probable that any future economic benefit associated with the satisfaction of the performance obligation will flow to the entity and the amount can be measured reliably.

Sales-based royalty (paragraph 85 of ED/2011/6)

28 The majority of AOSSG members think that paragraph 85 is inappropriate in a principles-based standard. These AOSSG members do not consider the Boards' justification, outlined in paragraph BC203 of ED/2011/6, to be valid, as the IASB's concerns in relation to factors outside the entity's control would equally apply to other types of contracts that include variable consideration (such as that illustrated in Illustrative Example 14 – *Trailing commission)*. These AOSSG members believe that paragraph 85, if retained in the final standard, will result in inconsistent outcomes for economically similar transactions both within and between entities.

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Question 4:

For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognise a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?

29 The majority of AOSSG members disagree with the proposed scope of the onerous test. In their view, the onerous tests should apply to all performance obligations and limiting the proposed scope of the onerous test could lead to material short-term onerous performance obligations not being recognised by an entity.

30 Furthermore, these AOSSG members are of the view that the recognition of liabilities should be based on the principles outlined in the *Framework*, with consideration given to the materiality of such amounts.

31 Some AOSSG members think that the onerous test should be performed at the contract level. In their view, it would be inappropriate for an entity to recognise a loss on a performance obligation that is part of a profitable contract. These AOSSG members believe that applying the onerous test at the performance obligation level does not provide decision-useful information.

32 Some AOSSG members think it is not clear how the onerous test is to be applied to interim financial reports and this should be clarified in the final standard.

33 Some other AOSSG members think the final standard should clarify the effect of consequential amendment to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* on the scope of the onerous test, i.e. whether or not paragraph 31 of IAS 2 *Inventories* would continue to cover firm sales contracts that are within the scope of the revenue standard. These AOSSG members note the explanation is articulated by the IASB in paragraph BC210 of ED/2011/6 but recommend that this articulation be included in the main standard.

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Question 5:

The boards propose to amend IAS 34 and ASC Topic 270 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial reports. The disclosures that would be required (if material) are:

- The disaggregation of revenue (paragraphs 114 and 115)
- A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117)
- An analysis of the entity's remaining performance obligations (paragraphs 119–121)
- Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123)
- A tabular reconciliation of the movements of the assets recognized from the costs to obtain or fulfill a contract with a customer (paragraph 128).

Do you agree that an entity should be required to provide each of those disclosures in its interim financial reports? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the costs to entities to prepare and audit that information. If you think that the proposed disclosures do not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial reports.

34 The majority of the AOSSG members disagree with the proposed disclosure requirements for interim financial reporting because, taken as a whole, the proposed disclosure requirements appear to be excessive and appear to follow a 'rules-based' approach to interim reporting disclosure, rather than relying on the principles already provided in IAS 34. These AOSSG members are also concerned that the resulting volume of information would obscure other useful information in interim financial reports and that the cost-benefit balance has not been achieved.

Question 6:

For the transfer of a non-financial asset that is not an output of an entity's ordinary activities (for example, property, plant and equipment within the scope of IAS 16 or IAS 40, or ASC Topic 360), the boards propose amending other standards to require that an entity apply (a) the proposed requirements on control to determine when to derecognise the asset, and (b) the proposed measurement requirements to determine the amount of gain or loss to recognise upon derecognition of the asset. Do you agree that an entity should apply the proposed control and measurement requirements to account for the transfer of non-financial assets that are not an output of an entity's ordinary activities? If not, what alternative do you recommend and why?

35 Generally, the majority of the AOSSG members agree with the proposal.

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Appendix B – Other Comments

Input vs. output methods

36 Some AOSSG members have a number of concerns in relation to the application of the methods, particularly the input method, for measuring progress toward satisfaction of a performance obligation, as described in paragraphs 41 and 44 of ED/2011/6.

37 Input methods appear to result in the calculation of a constant margin on cost over the life of the performance obligation, whereas applying an output method might, depending on the circumstances, result in the calculation of an appropriate variable margin over the life of the performance obligation. For some contracts, recognising a variable margin would more accurately reflect the economics of the entity's contractual performance. Therefore, we think it is important for an output method to be required to be used except when the value of output to date cannot be measured reliably.

38 Specifically, these members think the application of an input model is inconsistent with the objective of measuring progress towards satisfaction of performance obligations – that is, determining an entity's performance. As noted in paragraph 45 of ED/2011/6, there may not be a direct relationship between the entity's inputs and the transfer of control of goods or services to the customer. We consider this inability to establish a direct relationship between the measure and the transfer of control to be a fundamental shortcoming of this technique in its application within the revenue recognition model developed by the Boards.

39 In addition, these members think input methods should only be based on costs incurred. Factors such as labour hours expended, time elapsed and machine hours used are inputs for determining the proportion of total expected costs that have been incurred to date. However, costs might not vary in direct proportion to these factors. Therefore, using labour hours expended, time elapsed or machine hours used may cause an entity to inappropriately recognise different margins over the period of satisfying a performance obligation and may cause inter-entity diversity in the pattern of revenue recognition. These members recommend removing these three examples as input methods and including them as inputs to be used for determining the costs incurred to date.

Variable consideration

40 Some AOSSG members disagree with providing the choice of using the expected value or most likely amount to determine the best prediction of the amount of consideration to which the entity will be entitled in a customer contract with variable consideration.

41 These AOSSG members are of the view that the IASB should decide which of those measures is the better predictor of the consideration amount, because the assessment should not vary according to entity-specific considerations. These members think the principle of expected value should be required to be used for the reasons given in paragraphs BC81–BC83 of the 2010 exposure draft. This would not preclude using the most likely amount where there is no evidence that the possible outcomes for an item have other than a normal distribution (because the measure would be the same under either approach) or in other circumstances in which any difference between the results of applying the two approaches would be immaterial.

42 Some AOSSG members, however, agree with the IASB that the provision of a choice between the use of either the expected value or the most likely amount is appropriate. These AOSSG members consider that their views articulated in the AOSSG's comment

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letter to the 2010 exposure draft with regard to the use of the most likely amount remain relevant. These AOSSG members also agree with the IASB's conclusion in paragraph BC136 of ED/2011/6 that the use of the expected amount may not always be predictive of the consideration to which an entity will be entitled and, in these cases, the most likely amount would be necessary to estimate the transaction price.

Contract costs and IAS 2

43 Some AOSSG members believe that the proposed accounting and disclosure requirement relating to costs to fulfil a contract should be included as consequential amendments to the relevant standards, such as IAS 2 *Inventories*, rather than in the final standard itself. These AOSSG members feel that the proposals are counter-intuitive and result in an unnecessary complication of the IFRS literature structure since paragraph 91 is drafted as a fall-back if any 'costs to fulfill' are not included in any other IFRS.

44 Accordingly, these AOSSG members suggest that:

- The principles set out in paragraph 91 and the disclosure requirement in paragraph 128 relating to costs to fulfil a contract should be included in IAS 2,
- Any of the other guidance in paragraphs 92 and 93, which is not already stated in IAS 2, should be included in IAS 2,
- The disclosure requirement in paragraph 128 should apply only to the costs of obtaining a contract, and
- The proposal to amend IAS 2 to delete the guidance relating to the work-in-progress of service providers should be dropped.

Licensing and right to use

45 Some AOSSG members do not agree with the revised proposals. In their view, the final standard should not include specific accounting requirements for certain classes of transactions or arrangements such as license arrangements. Rather, these AOSSG members are of the view that an entity should apply the general criteria for recognising revenue as specified in the final standard. These AOSSG members further request that the IASB clarify how the revised proposal is more consistent with the principles in existing standards and current practice as articulated by the Boards in paragraph BC316 of ED/2011/6 considering that the revised proposal may result in significant change from current practice under IAS 18 *Revenue*.

Unit of account – Combination of contracts

46 Some AOSSG members believe the final standard should include additional guidance on how to combine, or not combine, contracts with different multiple customers because there might be a case where one performance obligation relates to multiple contracts with different customers and these contracts are better combined as a linked transaction.

Transition provision

47 Some AOSSG members believe that retrospective application of the proposed standard as proposed under paragraphs C2 to C3 of ED/2011/6 is excessively burdensome and will reduce the lead time for an entity to prepare its systems for change. In addition, it may require running dual systems for transition processing and/or it may require excessive amounts of manual re-work.

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48 As a compromise between providing relief and ensuring comparability across accounting periods, these AOSSG members strongly recommend that full retrospective application should be limited to those contracts which remain unfulfilled as at the date of initial adoption. In other words, entities should not be required to restate prior periods in respect of any contracts that have been completed before the date of initial application of the standard. This would provide more extensive relief than the proposed relief in paragraph C3(a) which currently only provides relief to contracts 'that begin and end within the same annual reporting period.'

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Appendix C – Comment Letter from the AOSSG Islamic Finance Working Group

20 March 2012

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Mr Hoogervorst,

AOSSG Islamic Finance Working Group
Comments on IASB ED/2011/6 *Revenue from Contracts with Customers*
(A revision of ED/2010/6 *Revenue from Contracts with Customers*)

The Islamic Finance Working Group of the Asian-Oceanian Standard Setters Group (AOSSG) is pleased to provide our comments on IASB ED/2011/6 *Revenue from Contracts with Customers* (ED/2011/6).

The Working Group was set up to provide input and feedback on the adequacy and appropriateness of proposed and existing IFRS to Islamic financial transactions and events. The Working Group comprises staff from the standard-setters of Australia, China, Dubai, Korea, Malaysia, Pakistan, and Saudi Arabia.

These comments are additional to those in the letter developed by the AOSSG Revenue Working Group dated 20 March 2012, and focus only on issues specific to Islamic finance. The Working Group had sought comment and feedback from other AOSSG members before finalising this letter, and none of those members have expressed significant disagreements.

The comments comprise five (5) issues; of which three (3) were highlighted in our earlier comment letter to ED/2010/6 and two (2) are newly identified issues arising from the re-drafted wordings of ED/2011/6.

Issues highlighted in our earlier comment letter

In our comments on ED/2010/6 dated 21 October 2010, we explained how the earlier ED's wordings left gaps in guidance for Islamic finance transactions. We find that these issues have not been satisfactorily resolved in ED/2011/6. In particular:

- The requirement to recognise revenue when an entity satisfies a performance obligation at a point in time, but eliminating IAS 18's requirement to measure a financing element in accordance with IAS 39, could result in inconsistent recognition and measurement of revenue in a deferred payment sale. (Paragraphs 31, 37 and 58-62)
- The application guidance's emphasis on 'unconditional rights and obligations' in assessing repurchase agreements (repos), should encompass rights and obligations that are enforceable either by law or through other customs and conventions. (Paragraphs 13 and B38-B48)
- We mentioned` that a single economic effect can be achieved through a series of Islamic sales among multiple unrelated parties. In most cases, we consider these should be treated as a

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combination of contracts, but note that they may not be treated as such under the current wordings of ED/2011/6. (Paragraph 17)

We would like to reiterate the issues and offer our suggestions for improvement.

ISSUE 1:

The ED could result in a sale that is a financing transaction being reported differently from other financings under IAS 39. (Paragraphs 31, 37 and 58-62)

Selling items on deferred payment is a core business for many Islamic banks. For example, if a customer wishes to own a car, the bank would buy the car (either from a subsidiary trading in cars or from a third party car dealer) and re-sell it to the customer at a mark-up. The customer would pay the bank in instalments. In many cases, such transactions approximate conventional consumer financing and, intuitively, the accounting treatment should be the same. Indeed, the current IAS 18 explicitly requires this transaction to be treated as financing and measured in accordance with IAS 39:

" … When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:

(a) The prevailing rate for a similar instrument of an issuer with a similar credit rating; or

(b) A rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with IAS 39."

– Paragraph 11, IAS 18.

We are concerned about the loss of this explicit requirement, in particular:

- ED/2011/6 clearly explains when a financing component arises (paragraph 58) and how to determine whether the financing component is significant to the contract (paragraph 59). Unfortunately, it does not clearly tell readers what to do when the contract effectively is a financing transaction. IAS 18 does.

  As reproduced above, IAS 18 requires a contract that is effectively a financing transaction to be treated as financing in accordance with IAS 39 – where it would most likely be measured at amortised cost using the effective interest method.

  ED/2011/6, conversely, does not discuss a sale that is a mode of financing. We presume that paragraph 61 of ED/2011/6 would also apply to sale-based financing; hence the sale consideration must be adjusted by using "the discount rate that would be reflected in a separate financing transaction between the entity and its customer at inception".

  Some working group members are concerned that if Islamic sale-based financing is measured under paragraph 61 of ED/2011/6, instead of being re-directed to IAS 39, they may not be on the same measurement basis as conventional loans. This may make it difficult for users to compare an Islamic financing contract with conventional loan contracts.

- ED/2011/6 requires the effects of financing to be presented "separately from revenue (as interest expense or interest income) in the statement of comprehensive income" (i.e. paragraph 62) instead of "as interest revenue" (i.e. paragraph 11 of IAS 18). For an Islamic bank, the financing element in a deferred payment sale is often one of the main sources of income arising in the course of its ordinary activities, and hence the financing element should be presented as part of the bank's revenue. Presenting financing income separately from revenue would not reflect the activities of the Islamic bank as a financial institution, but as a trading business. This may make it difficult for

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users to compare the financial statements of an Islamic bank with those of other financial institutions.

- Without the forceful requirement of IAS 18's paragraph 11, it may be possible to construe ED/2011/6 as allowing the bank to (i) recognise the entire selling price – instead of just the financing element - as revenue, and (ii) recognise the entire selling price upfront since the obligation to deliver the asset has been performed, i.e.:

  "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."

  – Paragraph 31, ED/2011/6.

Furthermore, as we noted in our earlier letter, revenue recognition at the outset, despite the fact that credit risk is the dominant business risk associated with the contract, would be problematic for an Islamic bank's profit sharing investment account (PSIA) holders. The 'up-front' revenue recognition could potentially accelerate the distribution of profits to customers, benefitting early PSIA entrants to the detriment of later entrants.

Suggestion for improvement

Not all Shariah-compliant sales are financing in nature. But when they are, they give rise to financial assets and financial liabilities which should be accounted for similar to comparable financing contracts. With regards to the bullet points above, we suggest that the IASB:

- Incorporate the principles of paragraph 11 of IAS 18 for a sale that is effectively a financing contract; in which case, financing revenue would be recognised and measured in accordance with IAS 39/IFRS 9.
- Require that if sale-based financing is an ordinary activity of an entity, then financing income arising from such sales should be presented as revenue, not separate from revenue.
- Add an example in paragraph 25 that the delivery of goods to facilitate a financing transaction does not fulfil the financier's performance obligation as the financier is still required to provide finance services over the period of financing.

ISSUE 2:

The application of 'enforceable' and 'unconditional' in relation to promises to repurchase must be clear. (Paragraphs 13 and B38-B48)

We are heartened that the revised ED now describes a repurchase agreement as "a contract in which an entity sells an asset and also promises … to repurchase the asset". This would indicate that Islamic repurchase agreements are within the ambit of the application guidance.

We think that the terms 'unconditional right' and 'unconditional obligation' in paragraphs B38 to B48 could relate to matters that are either enforceable by law or through other means. In the Islamic context, *wa'd* (or promises) to repurchase are not deemed to be a legal right or obligation. They are, however, morally binding and are customarily carried out. Accordingly, we consider *wa'd* to be enforceable and 'unconditional' in the context of paragraphs B38 to B48 of ED/2011/6, and we think our view is consistent with the main idea conveyed in paragraph 13 of ED/2011/6:

"… Contracts can be written, oral or implied by an entity's customary business practices. The practices, and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. … An entity shall consider those practices and processes in determining when an agreement with a customer creates enforceable rights and obligations of the entity."

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Thus, we think that the second sentence of paragraph 13 of ED/2011/6 "Enforceability is a matter of law" is inconsistent with the rest of paragraph 13 and unhelpful in asserting that *wa'd* are unconditional in relation to repurchase agreements[1].

Suggestion for improvement

We suggest that the IASB delete the sentence "Enforceability is a matter of law" in paragraph 13.

ISSUE 3:

Contracts with multiple unrelated parties can still be 'a single contract'. Also, what constitutes 'a contract' may be interpreted differently in Islamic finance. (Paragraph 17)

We agree with paragraph 17's three criteria for treating a combination of contracts as a single contract. However, we would like to point out that in Islamic finance it is possible to achieve a single economic objective using multiple contracts that are not "with the same customer or related parties".

Additionally, we note that the meaning of 'a contract' for accounting purposes may be broader than what is recognised as a legal contract under Shariah law. Thus, the requirements of paragraph 17 may be interpreted differently within Islamic finance circles.

Combination of contracts with multiple unrelated parties

We have explained how short-term financing can be obtained through a two-party Islamic repurchase agreement, e.g. On Day 1, *A* sells an item to *B* in return for CU5,000,000 cash. *A* promises that, on Day 3, it would buy-back the item from *B*, and *B* makes a reciprocal promise to re-sell the item back to *A* on Day 3. On Day 3, *A* and *B* enter into a sale and purchase contract for CU5,000,000+*i*. The contracts' overall economic effect is that *A* receives financing of CU5,000,000 and incurs a financing cost of *i*. In this case, the two contracts are likely to be considered as a whole under paragraph 17 (and under paragraphs B38-B48).

Now, say instead of *A* selling its own asset, this happens: On Day 1, *B* purchases palm oil from *C* for CU5,000,000 and sells the palm oil to *A* for CU5,000,000+*i* payable on Day 3. Immediately on Day 1, on behalf of the new owner *A*, *B* sells the palm oil to *D* for CU5,000,000 remitted immediately to *A*. Again, the contracts' overall economic effect is for *A* to get financing of CU5,000,000 and incur a financing cost of *i* (with some nominal incidental brokerage). This is an example of organised *tawarruq* or 'commodity *murabahah*'. [We have included a diagram for ease of understanding.]

The series of sales in organised *tawarruq* is meant to achieve a single economic objective such as financing, inter-bank deposit/placement or hedging. However, since the sales contracts are not "with the same customer (or related parties)" we are not sure whether they would be considered "a single contract" under the revised ED.

[1] *Wa'd* are 'promises' to indicate willingness to enter into a contract. Shariah scholars classically prohibit combining two transactions in one legal contract, with the intention of eliminating ambiguity and preventing duress. This prohibition has led to the ubiquitous use of *wa'd* in modern Islamic finance whereby an initial contract is accompanied by promises to enter into successive contracts in order to achieve a single economic objective. It should be noted that the promise itself is not deemed a contract under Shariah law, but is usually carried out in order to achieve the single economic objective. For example, in an Islamic repurchase agreement, an entity sells an item with *wa'd* to repurchase the item at a future date. Although the law cannot usually enforce specific performance of *wa'd*, the promised future transaction will almost always take place. Hence, the working group thinks the promised repurchase should be considered a contract in the context of this ED, even though it is not a contact under law.

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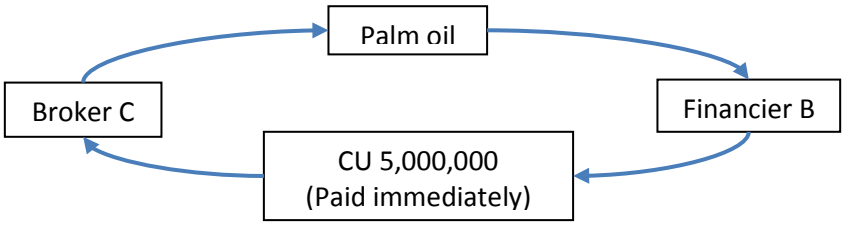
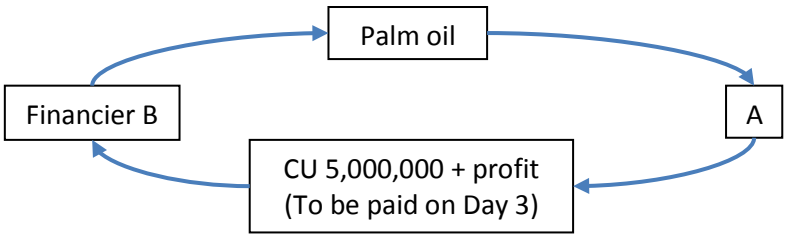
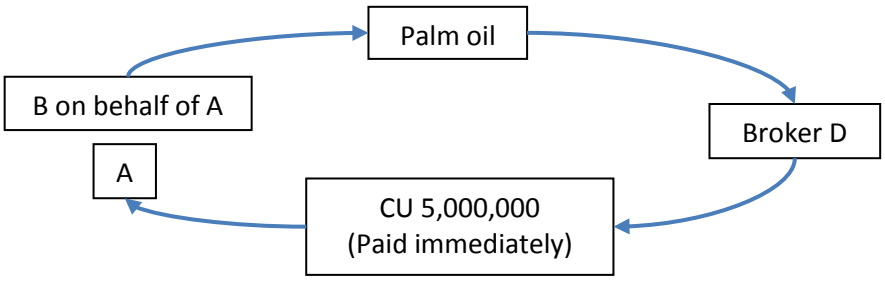
On Day 1



Step 1: Financier B buys palm oil from palm oil broker C for CU 5,000,000.

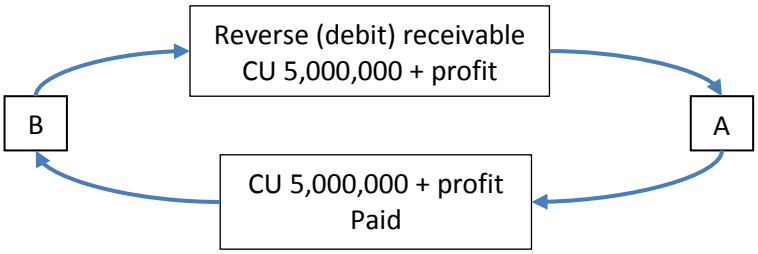


Step 2: Financier B sells palm oil to A for CU 5,000,000 + profit, to be paid on Day 3.



Step 3: B, on behalf of A, sells palm oil to D for CU 5,000,000 which is remitted to A.

On Day 3



Step 4: On Day 3, A pays CU 5,000,000 plus profit to Financier B.

Commodity Murabahah (or Tawarruq)

In the diagram above, the overall economic effect of the multiple sales with multiple parties is for A to receive CU5,000,000 on Day 1, and repay CU5,000,00 plus profit to financier B on Day 3.

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Should* wa'd *(promises) be considered "contracts" in the context of paragraph 17? We think so, but others may disagree.

In Islamic finance, an initial legal contract (*aqad*) is often accompanied by promises (*wa'd*) to enter into subsequent legal contracts in future. While the promises generally occur "at or near the same time" as the initial contract, there may be a considerable time lag between the initial and subsequent legal contracts.

A prime example is *sukuk*. In *sukuk* there is usually an initial sale of beneficial interest in an asset to *sukuk* holders accompanied with promises to redeem/repurchase the asset at a future date. The actual repurchase contract, however, may technically occur years after the initial sale contract. Despite the time lag between the legal contracts, we think the various transactions in *sukuk* should generally be considered as a single contract.

In our opinion, a promise that is unconditional should be considered a "contract" under this ED. However, we note that some in the industry may disagree and interpret "contracts" to mean only *aqad* (legal contracts).

Most working group members think that a series of unconditional promises and/or contracts should be treated as a single contract if it meets the criteria in paragraph 17 regardless of any perceived time lag between contracts, or the number of parties to the contracts. While some working group members are content with the current drafting of paragraph 17, others think that paragraph 17 should be amended to acknowledge that there are circumstances where multiple contracts with the customer and unrelated parties should be accounted for as a single contract.

Suggestions for improvement

Two alternative suggestions were proposed by working group members:

Alternative 1: Maintain current paragraph 17, with an additional clarification on contracts with multiple parties.

Some of us think that the current text of paragraph 17 can be maintained with an additional clarification that a combination of contracts with unrelated parties may still need to be accounted for as a single contract. They suggest the following amendment:

> "An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties) and account for the contracts as a single contract if one or more of the following criteria are met:
>
> (a) the contracts are negotiated as a package with a single commercial objective;
>
> (b) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
>
> (c) the goods or services promised in the contracts (or some goods or services promised in the contracts) are a single performance obligation in accordance with paragraphs 27-30.
>
> <u>In some circumstances contracts entered into with unrelated parties and meeting one or more of these criteria may also be combined if this more accurately reflects the economic substance of the transaction.</u>"

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Alternative 2: Adapt SIC 27[2] principles on linked transactions to address linked contracts.

Others among us would like the IASB to replace the requirement for the contracts to be "entered into at or near the same time with the same customer" with an emphasis on the linkage between contracts. In this regard, paragraph 3 of SIC 27 on determining whether a series of transactions is linked could be adapted as guidance to determine when a series of contracts should be considered a single contract. These working group members suggest that the IASB address linked contracts by amending paragraph 17 to read as follows:

> "An entity shall combine ~~two or more contracts entered into at or near the same time with the same customer (or related parties) and account for the contracts~~ a series of linked contracts and account for the contracts as a single contract if one or more of the following criteria are met:
>
> (d) the contracts are negotiated as a package with a single commercial objective;
>
> (e) the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or
>
> (f) the goods or services promised in the contracts (or some goods or services promised in the contracts) are a single performance obligation in accordance with paragraphs 27-30.
>
> A series of contracts is linked when the overall economic objective can only be understood with reference to the series of contracts as a whole."

Newly identified issues

In addition to the issues we raised in our earlier letter, we think that other aspects of the ED can be improved further. These are explained in the following paragraphs.

ISSUE 4:

The description of a customer in paragraph 10 appears to exclude commercial customers.

Items sold are often procured from a third party and are not necessarily "an output of the entity's ordinary activities". In particular, Islamic banks routinely purchase items from suppliers which they then sell to customers at a mark-up on deferred payment basis. A reading of the current text, however, seems to indicate that such buyers would be excluded from the description of a customer because the buyer obtained an item that is not "an output of the entity's ordinary activities".

Suggestion for improvement

We suggest that the IASB amend the sentence in paragraph 10 to read as follows:

"A customer is a party that has contracted with an entity to obtain goods or services ~~that are an output~~ arising in the course of the entity's ordinary activities."

ISSUE 5:

It would be useful to include an example of a deferred payment sale in the Illustrative Examples.

In real life, we expect that customers are at least as likely to pay on credit terms as they are to pay upfront for later delivery. Hence, the example given in paragraph IE8 of upfront cash payments for

[2] SIC 27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*

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products to be delivered in two and five years, though helpful, may not be representative of the majority of sales.

Suggestion for improvement

We think preparers would appreciate an example of how to account for the financing element that arises in a credit or deferred payment sale, and would like the IASB to consider including one in the Illustrative Examples.

Conclusion

We thank you for this opportunity to share our views. If you have any queries regarding this submission, or require further information on any aspect of Islamic finance, the Working Group would be pleased to offer its assistance.

Yours sincerely,

Mohammad Faiz Azmi
Leader of the AOSSG Islamic Finance Working Group