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 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 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."

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

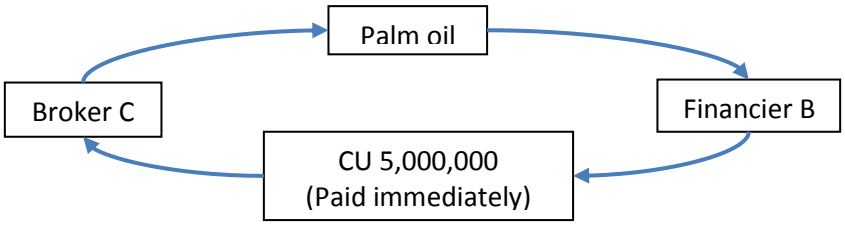
We have explained how short-term financing can be obtained through a two-party Islamic repurchase agreement, e.g. On Day 1, *A* sells an item to *B* in return for CU5,000,000 cash. *A* promises that, on Day 3, it would buy-back the item from *B*, and *B* makes a reciprocal promise to re-sell the item 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.]

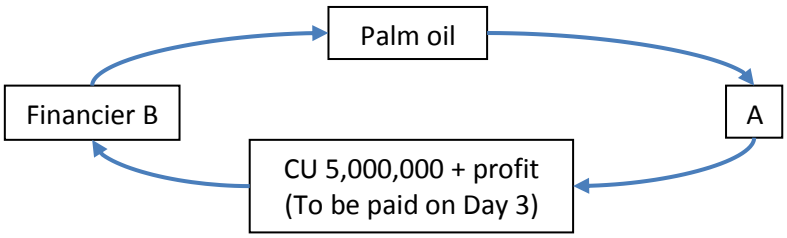
The series of sales in organised *tawarruq* is meant to achieve a single economic objective such as financing, inter-bank deposit/placement or hedging. However, since the sales contracts are not "with the same customer (or related parties)" we are not sure whether they would be considered "a single contract"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

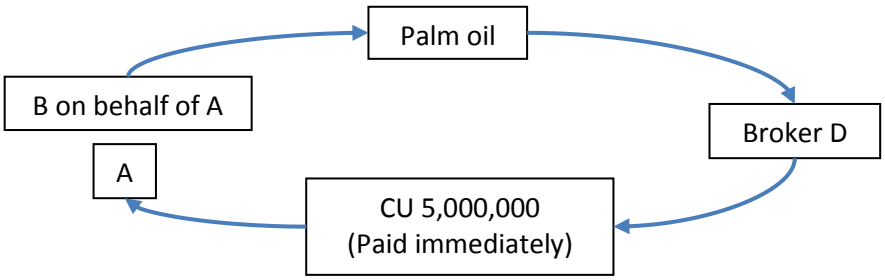
On Day 1



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

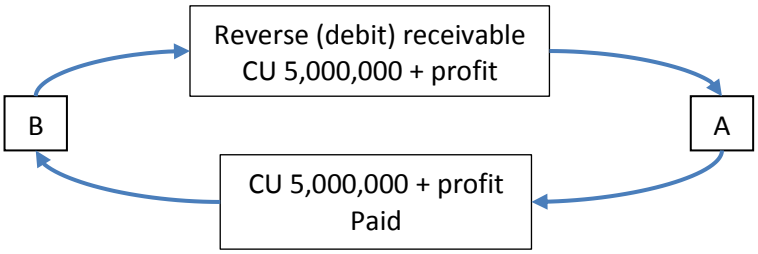


Step 2: Financier B sells palm oil to A for CU 5,000,000 + profit, to be paid on Day 3.



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.

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.
>
> 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."

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*

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