22 October 2010
Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David,

AOSSG comments on IASB Exposure Draft ED/2010/6
Revenue from Contracts with Customers

The Asian-Oceanian Standard-Setters Group (AOSSG) is pleased to provide comments on Exposure Draft *Revenue from Contracts with Customers (*ED/2010/6).

The AOSSG currently has 24 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, and Uzbekistan.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Individual member standard setters may also choose to make separate submissions that are 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 individual member standard setters may hold. We attach the separate comments on certain Islamic finance impacts of the proposals in the ED from the Islamic Finance Working Group of AOSSG.

This submission has been circulated to all AOSSG members for their comment after having been initially developed through the AOSSG's Revenue Recognition Working Group. The AOSSG has not received any substantive contrary views from our constituents.

While AOSSG members generally agree with the proposals in the ED, some members have concerns with some of the proposals. Our comments are as follows:

Revenue recognition (relates to Questions 1, 2 and 3)

1 The ED proposes a principle (price interdependence) to help an entity determine whether to segment a single contract and account for it as two or more contracts. Some AOSSG members believe that it is not always necessary to segment a single contract, because the mechanism to identify separate performance obligations in a contract would provide for the systematic recognition of revenue as the entity fulfills its performance obligations. One of the AOSSG members is of the view that allocation of subsequent changes in transaction price could be determined depending on whether the prices of identified separate performance obligations are interdependent, rather than segmenting a single contract. These AOSSG members therefore request the IASB to provide further clarity on the two principles (i.e. segmenting a single contract and identifying separate performance obligations in a contract) as the transaction price to be allocated to each separate performance obligation would be influenced by the principle used.

2 With regard to contract modification that is priced interdependently of the original contract, some AOSSG members do not agree with the outcome of the ED proposals as illustrated in Example 2 scenario 2 of the proposed application guidance. These AOSSG members are of the view that adjusting reported revenue due to a subsequent agreement to provide further services at a lower price would distort reported revenue, and provide users of financial statements with misleading information. They believe that the fact that the service provider has agreed to provide an existing customer with discounted services is not sufficient to justify combined accounting for both contracts. Such an approach fails to recognize the possibility that the service provider may offer its existing preferred customers with preferential rates compared to new or other customers and is inconsistent with paragraph 14 of the ED which proposes that the price of a contract is not interdependent with the price of another contract solely because the customer receives a discount on goods or services in the contract as a result of an existing customer relationship arising from previous contracts.

3 Some AOSSG members are concerned with the proposed principle for determining when a good or service is distinct. Specifically, these AOSSG members are concerned that if another entity sells an identical or similar goods or services separately, the proposal in paragraph 23(a) of the ED would result in more separate performance obligations being identified than the principle proposed in paragraph 23(b) of the ED. Consequently, these AOSSG members propose that only the entity's own business be considered in applying the "distinct" concept. This would be consistent with paragraph 20 of the ED which requires an entity to evaluate the terms of the contract and its

customary business practice to identify all promised goods or services and to determine whether to account for them as separate performance obligations. As alternatives, an AOSSG member suggests that paragraph 23(a) of the ED be confined to industry practice or only when there is widespread availability of price information.

4 In addition, some AOSSG members point out the practical difficulties expected in applying the distinct concept, particularly in the case of highly customized services and in understanding how other goods or services sold in the market may interact with the entity's products.

5 With regard to the proposed guidance for determining when control of a promised good or service has been transferred to a customer:

a) Some AOSSG members request the IASB to clarify the relationship between the four indicators of control proposed in paragraph 30 of the ED. These AOSSG members believe that further clarity on the relative importance of the indicators is important to avoid significant divergence in accounting for similar or identical transactions. In this regard, some AOSSG members are of the opinion that paragraph 30(a) of the ED, namely "the customer has an unconditional obligation to pay", should be given more prominence as these members find it difficult to visualize a situation where a customer has control of the goods or services but is not unconditionally obligated to pay.

b) Some AOSSG members are of the view that paragraph 30(b) of the ED should be expanded to include situations where beneficial interest has passed but not necessarily legal title. This is because the ability of a customer to sell, exchange, use, or pledge a good is predicated on the transfer of beneficial interest, rather than only upon the transfer of legal title at a later date.

c) Some AOSSG members believe that the standard should clarify that the indicators of control serve merely as guidance rather than a checklist of criteria that must be satisfied before control is deemed to have passed. They believed that the overriding principle should be that control is deemed to have passed if the essence of the control model is met.

6 Some AOSSG members are concerned that the proposed control-based revenue recognition model is very prescriptive and not decision-useful to users, and would like to draw the IASB's attention to the following two examples of situations where the

model is, in their view, not appropriate:

(i) Collective control situations

In a collective control situation, each buyer owns a specific fraction of a pool of owners' rights but does not have "full control" over that fraction by virtue of the fact that he is likely to be bound by a collective agreement. This is particularly pertinent in multi-unit real estate developments, which are prevalent in the Asia-Oceania region. In such a situation, the individual buyer of a specific unit will not have "full control" of the unit even after the transfer of the unit from the seller notwithstanding that the buyer has fully assumed all owner rights. Control criteria that are predicated on the conveyance of a good lead to confusion as to whether revenue can be recognized only upon the ability to exercise unfettered rights over the good, when in fact the owner never acquires such unfettered rights. In other words, at no point in time was control passed from one single party to another single party. Consequently, these AOSSG members believe that the "transfer of control" model proposed in the ED by itself would not result in consistent revenue recognition that faithfully reflects the economic substance of the underlying transaction.

(ii) Service contracts

Some AOSSG members also believe that based on the proposals in the ED, it is difficult to determine when control of a service is transferred to a customer (e.g. audit, valuation, legal and other expert services). This difficulty is amplified in paragraph 31 of the ED which highlights that two out of four proposed indicators of control (i.e. physical possession and legal title) would not be relevant to services. These AOSSG members are concerned that the control notion as currently defined is not appropriate for service contracts and could result in significant diversity in practice.

In essence, these AOSSG members believe that in situations where simple transfer of control from one party to another single party is not applicable or obvious, other pertinent factors such as the assumption of predominant risks and rewards similar to those of an owner should be considered as indication of such control. These AOSSG members would therefore request the IASB to re-consider the proposed conditions/indicators for revenue recognition so as to ensure that they are rooted in broad and robust principles that can be applied to all types of contracts with customers.

7 Furthermore, some AOSSG members are of the view that the control-based model as currently defined would not result in decision-useful information for long-term or service contracts. For such contracts, where the asset is transferred to the customer at the end of the contract, instead of on a continuous basis, the model as currently defined

would result in revenue recognition at a single point of time at the end of the contract because of difficulties in applying the concept of continuous transfer of control (which, for example, in law is determined by the balance of respective rights in the particular context). These AOSSG members believe that the guidance and indicators of control proposed in the ED are not rigorous enough to provide sufficient clarity as to whether control is transferred continuously. For example, two of the proposed indicators of control, legal title and physical possession, would not be relevant in assessing if control transfers continuously for such contracts as legal title to and physical possession of the asset are transferred to the customer only at the end of the contract. Without meaning to abandon this concept, the standard should provide a clear definition of "continuous transfer of control" as well as guidance that makes it easier to apply the concept, by drawing on the indicators that would apply in determining the continuous transfer of control. For example, where an asset is under construction, and it can be proven that the buyer has the ability to sell his beneficial interest in the underlying asset at any point during construction, or there are professionally certified milestones that crystallize the unconditional and irrevocable liability of the buyer to make specified payments, and the buyer has made all such payments, all these should be recognized as indicators of continuous transfer of control especially when they are present in combination. These AOSSG members would therefore request the IASB to provide a clear definition of continuous transfer of control and to augment the control model with indicators of the concept of continuous transfer of such control.

In addition, these AOSSG members are of the view that Example 17 in the proposed application guidance is overly simplistic and unhelpful as the indicators of control used in the example (i.e. the customer's ability to specify major structural changes to the design of the apartment, and the transfer of physical possession/legal title of the apartment) are not relevant in assessing if control transfers continuously for a contract for the sale of an apartment in a multi-unit real estate development that is under construction.

8 Some AOSSG members are also concerned that the ED places too much emphasis on the physical delivery of a good or service which inappropriately forces an entity to account for separate performance obligations based on sales of analogous physical goods and services, and ignores the rights of the customer which may arise before delivery and the rights (and obligations) of the supplier that arise as specialised assets are constructed.

Measurement of revenue (relates to Questions 4, 5, 6 and 7)

9 With regard to the proposal that an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated, some AOSSG members are of the view that probability-weighted estimates of the possible transaction price would not be appropriate if the entity is reasonably certain to receive only one of the many possible considerations, as it would result in a transaction price that is not the possible outcome in accordance with the contract. These AOSSG members believe that the IASB should allow the use of the "most likely" approach. Some AOSSG members are also concerned that the use of the probability-weighted approach would be highly subjective and judgmental.

10 Some AOSSG members are concerned that the proposals in paragraphs 38 and 39 of the ED could create an inappropriate accounting outcome as it may give rise to a situation where an entity is unable to recognize revenue even though it has satisfied a performance obligation as the entity does not have the necessary experience to be able to reasonably estimate the transaction price. In addition, these AOSSG members believe that the proposals are too prescriptive and are inconsistent with the IASB's approach to measurement uncertainty elsewhere (e.g. in the financial instruments project where an entity is required to measure financial instruments at fair value based on estimates except in exceptional circumstances).

11 With regard to the proposal that the transaction price should reflect the customer's credit risk, there are mixed views from AOSSG members. AOSSG members who disagree with the proposal are of the opinion that the customer's credit risk should be recognized as an impairment of the receivable, instead of being adjusted against revenue.

12 AOSSG members generally agree with the proposal 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.

13 With respect to the proposal that an entity should allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each of those performance obligations, some AOSSG members are concerned that a single prescribed method for allocating the transaction price is too prescriptive and may result in an outcome which is not reflective of the economic reality of the transaction.

14 In particular, some AOSSG members observe that a consequence of the proposed

allocation method is that any discount in the contract would be allocated to all performance obligations. This could result in a "day one" loss for some performance obligations assuming onerous test is carried out at the performance obligation level. These AOSSG members recommend that the IASB considers refining the transaction-price-allocation approach to take into account an entity's pricing methodologies or strategies, or alternatively, to allow the discount to be allocated to each performance obligation in proportion to the stand-alone profit margins of the underlying goods or services as suggested by an AOSSG member.

15 Furthermore, some AOSSG members disagree with the IASB's proposal to carry out an onerous test at the performance obligation level. They believe the test should be carried out at the contract level as it would not be appropriate to recognize a loss on a performance obligation which is part of a profitable contract. In addition, applying the onerous test at the performance obligation level may result in a day one loss. These AOSSG members believe the proposed approach is not appropriate since in many industries, goods and services are often bundled to achieve a desired overall level of net profitability.

Contract costs (relates to Questions 8 and 9)

16 Some AOSSG members do not agree that the costs of obtaining a contract should always be expensed as incurred as proposed in the ED. They propose that incremental costs which result directly from, and are essential to, acquiring a contract and which would not be incurred had the contract not been entered into be recognized as an asset rather than be expensed off. They believe that this would be consistent with the accounting for transaction costs in ED Financial Instruments: Amortised Costs and Impairment, the accounting for initial direct costs in ED Leases, the accounting for incremental acquisition costs in ED Insurance Contracts, and the current requirements in IAS 11 Construction Contracts.

17 In addition, some AOSSG members believe that the accounting for contract costs should be covered under IAS 38 or IAS 2 Inventories (or another standard) instead of this ED and if the requirements in these standards are inadequate, they should be enhanced.

18 Some AOSSG members share the same concerns over the probability-weighted approach proposed by the IASB for the measurement of costs required to satisfy a performance obligation as those highlighted under the "Measurement of revenue" section above.

Disclosure (relates to Questions 10, 11 and 12)

19 Some AOSSG members are concerned that the proposed disclosure requirements are onerous and excessive, and may put undue burden and costs, including investment in information system, on the preparers.

Effective date and transition (relates to Question 13)

20 AOSSG members are in general agreeable with the retrospective application of the proposed requirements, with the proviso that the effective date of the standard is set at a date that would give preparers enough time to implement the proposals. One of the AOSSG members recommends that the IASB considers limiting the retrospective application of the proposed requirements to contracts with customers that are uncompleted at the effective date of the standard.

Application guidance (relates to Questions 14, 15, and 16)

21 Some AOSSG members are of the view that the proposed application guidance does not provide sufficient clarity on how the principles in the ED should be applied. In particular, some AOSSG members request the IASB to provide further guidance for the assessment of continuous transfer of control of goods or services, particularly for contracts for the sale of real estate and service contracts.

22 Some AOSSG members have expressed concern that a proposed standard which is supplemented by numerous pages of mandatory application guidance (which would form an integral part of the proposed standard) is too prescriptive for a principles-based standard. AOSSG members believe that application guidance should not be used to supplement principles that are not clearly articulated in the standard. Where the principles are not clear, the IASB should clarify the principles rather than provide application guidance that is mandatory.

23 AOSSG members are concerned that it may be difficult for entities to distinguish clearly between latent defects and post-delivery faults. To address this practical difficulty, some AOSSG members propose that the separate performance obligation approach be applied to both types of product warranties. That is, all latent defects and post-delivery faults should be accounted for as separate performance obligations. Other AOSSG members think that warranties which cover latent defects should be accounted for as liabilities in accordance with IAS 37 rather than as unsatisfied performance obligations.

24 With regard to the proposal that the pattern of revenue recognition should depend on whether the license is exclusive, there are mixed views from AOSSG members. AOSSG members who disagree with the proposal believe that the exclusivity of a license does not affect the nature of the performance obligation that an entity has once the customer is able to use and benefit from the license. In addition, an AOSSG member points out that it could be difficult to determine to what degree exclusivity exists as the entity could grant the right to use the asset to many parties over the same period given that exclusiveness can be on the basis of time, geography and distribution channel, etc (see paragraph B37 of the ED). Therefore, these AOSSG members consider the distinction between exclusive and non-exclusive license to be artificial and that no clear justification has been set out by the IASB to support this proposal.

Consequential amendments (relates to Question 17)

25 AOSSG members agree with the proposal that in accounting for the gain or loss on the sale of some non-financial assets, an entity should apply the recognition and measurement principles of the proposed revenue model.

If you have any queries regarding any matters in this submission, please contact us.

Yours sincerely,

Ikuo Nishikawa
Chairman of the AOSSG
Leader of the AOSSG
Revenue Recognition Working Group

Euleen Goh
Co-Leader of the AOSSG
Revenue Recognition Working Group

[Attachment]

22 October 2010

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David,

AOSSG Islamic Finance Working Group comments on
IASB Exposure Draft ED/2010/6 *Revenue from Contracts with Customers*

The Asian-Oceanian Standard-Setters Group ("AOSSG") is pleased to provide comments from its Islamic Finance Working Group on IASB ED/2010/6 *Revenue from Contracts with Customers (*ED/2010/6).

The AOSSG's Islamic Finance Working Group ("AOSSG IF WG") 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 AOSSG IF WG comprises staff from the standard-setters of Australia, Dubai, Indonesia, Korea, Malaysia, Pakistan, and Saudi Arabia.

The comments in this letter only concern those aspects of the ED that have implications that are peculiar to Islamic finance, and are additional to the AOSSG comments on IASB ED/2010/6 dated 22 October 2010. The AOSSG IF WG had sought comment and feedback from AOSSG members prior to finalising this letter, and their views have been duly incorporated.

The AOSSG IF WG comments are as follows:

Satisfaction of performance obligations (paragraphs 25-27) and the time value of money (paragraphs 44-45)

Murabaha

One of the classic contracts used in Islamic finance is Murabaha, in which an entity buys a good and resells it to a customer with a (declared) mark-up. This may be used to approximate the effect of a conventional financing. For example, if a customer wants to buy a car, a bank may buy the car and resell it to the customer, at a higher price but on deferred repayment terms.

It would be unacceptable to many in Islamic finance for this to be regarded as "merely" a financing transaction. If, however, it lies within the scope of the ED, then the effect of the paragraphs cited is that revenue must be recognised at the outset (paragraphs 25 – 27), the amount (but not the timing) being dependent on the credit risk of the customer (paragraphs 42-43), and that the effect of the financing component must be shown separately (paragraphs 44-45).

This creates two issues. The first is that the decomposition of one of the classical contracts into (effectively) two conventional contracts offends those who believe in the importance of those classical forms, and cannot be justified on the basis that the substance of the transaction is different from that of the classical contract (for example by virtue of side agreements). Some AOSSG IF WG members would prefer that the last sentence of paragraph 45 be deleted, thus removing the requirement to decompose the contract into a notional sale contract and a financing contract.

The second is that revenue recognition must take place at the outset, despite the fact that credit risk is the dominant business risk associated with the contract. This would be problematic for Islamic banks both in terms of the comparison with their conventional counterparts, and where the returns on customers' Profit Sharing Investment Accounts ("PSIA") depend on Murabaha-based income streams. The 'up-front' revenue recognition would potentially accelerate the distribution of profits to those customers. Currently, many Islamic banks recognise the income from the Murabaha contract, and hence the distribution of profits to the PSIA accountholder, over the period of the Murabaha contract.

We note that paragraph 42 requires an entity to consider collectability in determining the transaction price, with the accompanying application guidance in paragraphs B78 to B80 seeming to indicate that an entity recognises either all revenue up-front, or nothing until cash is collected (i.e. if the amount of consideration cannot be reasonably estimated). Some AOSSG IF WG members have suggested that perhaps the IASB should consider revenue recognition principles based on a transaction model, i.e. where an entity would recognise revenue based on the transaction price excluding the credit risk of the customer, but the timing of recognition would depend on the substance of the transaction. Credit loss (or expected losses) should be recognised separately from the transaction price.

Application Guidance: Sale and repurchase of an asset (paragraphs B47 – B53)

Islamic sale and buy back agreements

In Islamic finance, sale and buy back agreements may be used to indirectly obtain financing whilst adhering to Islamic proscriptions against interest. Typically, an entity would sell an item to a counterparty, whether via the transfer of legal title or beneficial ownership, for a price, x. The sale would be accompanied with a *wa'd*, or promise, that the entity would re-purchase the item from the counterparty at a specified time for a pre-agreed price, $x+p$. The counterparty would make a corresponding promise to re-sell the item to the entity at the specified time for the pre-agreed price. Technically, neither of the promises to re-purchase nor to re-sell is binding in law. However, customarily, the re-purchase / re-sell transaction is

almost always executed. Moreover, to deter breached promises, there may be regulations to penalise a defaulting party and/or protect an aggrieved party.

The underlying item in a sale and buy back agreement is usually a financial instrument, but it could without much difficulty be substituted by a non-financial instrument, e.g. commodities, properties, plant and machinery. Although financial instruments are excluded from the scope of the ED, the use of any other underlying item may place a sale and buy back agreement within the scope of *Revenue from Contracts with Customers*.

Should that be the case, it is of some concern that an entity may be able to recognise as revenue the proceeds from the initial sale, as paragraph 25 states that:

> *"An entity shall recognise revenue when it satisfies a performance obligation identified in accordance with paragraphs 20-24 by transferring a promised good or service to a customer. A good or service is transferred when the customer obtains control of that good or service."*

Indeed, within the context of paragraphs 26-27, between the first and second transactions, the purchaser may be deemed to have control over the item transferred. However, allowing the selling entity to recognise revenue upon the initial sale would be counterintuitive, since the series of transactions is meant to achieve what is in substance financing – its most common use is to mimic conventional repo - despite the transfer of control to the buyer between the first and second 'legs' of the sale and buy back agreement.

We note that there is an attempt to address sales and repurchases which are financing arrangements in paragraphs B47–B53 of Appendix B. However, that section alludes to only two circumstances where a sale and repurchase may be accounted for as financing, i.e. when:

(a) the entity has an unconditional obligation to repurchase the asset (a forward); and

(b) the entity has an unconditional right to repurchase the asset (a call option).

Legally, the *wa'd*, or promise by a selling entity to re-purchase an item, is unlikely to constitute an 'unconditional obligation' or 'unconditional right'. However, in practice, the repurchase transaction is almost always carried out. Thus, while some may argue that, in substance, a *wa'd* is tantamount to an unconditional right or unconditional obligation, others may disagree.

To prevent differing interpretations, we would like to propose that the application guidance be amended to clarify that the terms 'unconditional right' and 'unconditional obligation' pertain to both legal and constructive rights and obligations. We would also like the IASB to consider providing for a sale and repurchase transaction to be accounted for as a financing arrangement when:

(a) it is highly probable that an entity (or another entity acting at its instigation and by prior agreement) will repurchase an asset, and that probability, along with other accompanying circumstances would constrain the purchaser's ability to direct the use of, and receive the benefit from, the asset; and

(b) the entity (or another entity acting at its instigation and by prior agreement) repurchases the asset for an amount that is equal to or more than the original sales price of the asset.

In this context, we note that some Islamic scholars do not accept the relatively simple sale and repurchase transactions described above. Alternative structures have therefore been developed to achieve a similar economic effect. Typically these involve the introduction of one or more additional parties to the transaction. It is therefore important that the amended application guidance should cover these economically equivalent situations. This is what is addressed in the bracketed words in (a) and (b) above. It is also important that the word "asset" should cover any functionally equivalent asset (e.g. when a tonne of aluminium is sold, it does not have to be the **same** tonne of aluminium that is resold).

In addition, we understand that the recognition and measurement aspects of the IASB's derecognition project is currently on hold, nevertheless we hope that this proposal would also be communicated to those responsible for the derecognition project because the issues regarding *wa'd* and the use of multiple parties in a sale are also prevalent in Islamic sale and buy backs of financial instruments, and because oftentimes these transactions are essentially repos.

We thank you for this opportunity to express our concerns, and hope that you would give due consideration to our comments. If you have any queries regarding this submission, please feel free to contact us.

Yours sincerely,

Mohammad Faiz Azmi
Leader of the AOSSG Islamic Finance Working Group