[Attachment]

asian-oceanian
standard-setters group

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