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Dr. Hamed Hassan Merah
Secretary General
Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI)
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Dear Dr. Merah,

السلام عليكم ورحمة الله وبركاته،،

**CIBAFI Comments on the AAOIFI Exposure Draft on Financial Accounting
Standard (FAS) No. 31: “Investment Agency” (Al-Wakala Bi Al-Istithmar)**

The General Council for Islamic Banks and Financial Institutions (CIBAFI) presents its compliments to the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) and takes this opportunity to express its appreciation of the work that the AAOIFI does to promote and enhance the Islamic financial services industry (IFSI).

CIBAFI is the official umbrella for all Islamic financial institutions, whose services and products comply with the Shariah rules and principles. CIBAFI acts as the voice of the Islamic finance industry, and our members comprise more than 120 Islamic banks and non-bank financial institutions, both large and small, from 32 countries and jurisdictions.

We noted the request for comments on the AAOIFI Exposure Draft on Financial Accounting Standard (FAS) No. 31: “Investment Agency” (Al-Wakala Bi Al-Istithmar), and welcome this opportunity to offer our comments and recommendations. The

comments contained in this letter represent the views of CIBAFI Secretariat and feedback received from our members. We are also attaching more detailed comments in the Appendix of this letter for AAOIFI's kind consideration.

Firstly, we note that the ED maintains that if two contracts or undertakings are separate in Shariah terms, they must also be treated as separate in accounting terms. For example, if an investment agency contract is accompanied by a repurchase undertaking the former cannot be dependent on the latter. These contracts must be accounted separately rather than as a single transaction. As the ED recognises, Wakala (agency) arrangements are utilised by IFIs under different structures, and in many cases the transaction is viewed as a whole for accounting purposes. The ED would require a change in this practice, and it is not clear to us that the consequences of such a change have been analysed. CIBAFI believes that such a change may lead to some problems in practice in some jurisdictions, not only in respect of accounting and auditing, but also in respect of tax, risk management and regulatory treatment.

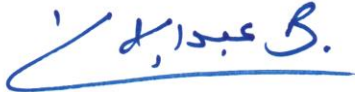
Secondly, IFIs commonly use investment agency for relatively short-term inter-bank placements. CIBAFI and its members have identified a number of issues concerning such placements. One, to which we draw attention here, concerns the proposed disclosures and presentation regarding the investor (**para 28-30**). The ED is unclear on whether these disclosures should be made for all investment agency contracts in force at any time during the reporting period, or only those in force at the end. If the former, then the disclosures could be very extensive and onerous, and it is unclear that they would materially assist users of the accounts.

We offer some more detailed comments on the text in the Appendix to this letter.

We would like to express our thanks to the AAOIFI for its great effort and commitment with respect to developing standards that accommodate the interest of the global Islamic finance industry.

We remain at your disposal should you need any further clarifications on the above or on the attached Appendix.

Yours sincerely,



Abdelilah Belatik
Secretary General

Appendix
Comments on Exposure Draft of the AAOIFI Exposure Draft on Financial Accounting Standard (FAS) No. 31: Investment Agency (Al-Wakala Bi Al-Istithmar)

CIBAFI’s analysis has identified the following comments with regards to the specificities in the FAS 31 Exposure Draft.

Treatment of short-term inter-bank placements

Para 11 establishes that most short-term interbank placements will be treated under the Wakala venture approach, and **para 31** suggests that the normal treatment of these by the receiving bank will be off-balance sheet. However, **paras 32 and 37** indicate possible exceptions to this, but para 37 in particular is very unclear in its drafting. Our members who may be receiving such placements find it very difficult to judge from the text which, under the standard, should be regarded as on or off balance sheet. AAOIFI is requested to provide clarification on this point, preferably supported with examples.

Control and Pass-through Approach

According to the ED (**para 31**), the agent should normally keep the assets off balance sheet, largely on the basis that the principal rather than the agent controls the assets. The definition of control is set out in para 33, and is based on the flow of economic benefits from the asset, and the ability to affect those benefits, rather than formal legal ownership. The ED approach is also to account for other agreements separately (whereas the International Financial Reporting Standard (IFRS) approach would be to take a substance-over-form approach to the transaction as a whole). However, it is possible to conceive transactions (effectively “asset-based” rather than “asset-backed”) in which other related agreements have the effect that the principal’s returns are only loosely, if at all, correlated with the performance of the asset. It is unclear to us how such transactions would in practice be accounted for by the agent, and here too we request greater clarity.

In addition, the ED has permitted some limited exceptions (**paras 35-36**) which are clearly intended to accommodate the regulatory capital sukuk issued by IFIs under a Wakala contract, and which would not serve their intended purpose if they were off-balance sheet. CIBAFI believes that these exceptions seem to involve an implicit breach of AAOIFI's principle of separating different contracts or undertakings within the same transaction. In addition to this, it is unclear why the logic that leads to on-balance sheet treatment in the cases discussed in these paragraphs could not be applied to some other cases. We recommend that AAOIFI look again at whether the approach taken in these cases could also appropriately be applied to other transactions discussed in above sections.

Presentation and disclosures

The ED discusses (in **paras 18-20**) the issues of presentation and disclosure in the pass-through approach. The explanations provided in these sections may be improved. We believe that AAOIFI should provide more detailed and precise explanation on disclosures to be made.

As regards the Wakala venture approach, the investor's disclosures are set out in para 29. As already noted, it is unclear whether the intent is to require these disclosures for all Wakala ventures, or only for those outstanding at the reporting date. However, on either approach, if there are extensive interbank placements, the disclosures required are likely to be extensive and onerous, and it is difficult to see how they would benefit users of the accounts.

ED also discusses presentation and disclosures for principal and agent (in **paras 28-30, 44**). However CIBAFI members believe that presentation and disclosures for principal and agent shall only be based on significance of contracts (Significance is given in context of share of balance sheet or income statement contributors). Hence, they will not become burden for Islamic Financial Institutions.

Treatment of profits and losses under the Wakala Venture Approach

The ED states (**para 21**) that, the investor (principal) should treat a Wakala venture investment as an equity-like investment in a business venture. Profit and loss for the venture should be calculated at the end of the reporting period, and the carrying value adjusted accordingly (**para**

24). However, **para 25** requires the investor to apply the proposed FAS 30 to consider any impairment in the value of the investment at the end of each period, taking into account any settlement (i.e. counterparty) risk. It is unclear how these two requirements interact. Moreover, if it (**Para 24**) is related to short term Wakala placements, it will be a change in existing presentation, under which profit is normally accrued on a time proportion basis and shown under “other receivables” rather than a change in the value of the investment.

Calculation of the share of profit in Wakala venture

Paragraph 24 states that “The investment in a Wakala venture shall be measured at the end of a financial period at carrying amount and shall be adjusted to include the investor’s share in the profit or loss of the Wakala venture”. CIBAFI members believe that it should be made clearer how the share of profit of Wakala venture will be calculated. They note that commonly, the assets (or pool of assets) are not directly identifiable and hence the investor will not have the data to look through to the underlying assets, but will simply record an investment with the agent.

Reporting on gross and net basis

ED states that, reporting of assets, liabilities, income, expenses is on gross basis for the principal under the pass through (**in -paras 12, 18**). However under the Wakala structure, the respective agent’s remuneration shall be recognized periodically, on a net basis (**in para 26**). Some CIBAFI members believe that the reason for using different approach could be clarified for better understanding.

Classification and criteria for applying on-balance sheet approach

ED requires the bank to classify some of Wakala forms (interbank Wakala, murabaha, customers Wakala/deposits) under new category (**in paras 35-36**). However some of our members are (1) treating the interbank Wakala and Murabaha as a joint line in the liability side of the balance sheet, and (2) the customers Wakala/deposits as a standalone line in the liability side of the balance sheet. CIBAFI members believe that the new category which is separating class of equity or subordinated to all liabilities and quasi-equity seems to challenge the concept of segregation between interbank (market funding) and customers deposits (subject to regulatory

protection) in normal banking practice. AAOIFI may provide more details and clarification on this classification.

Sale and purchase of the Wakala venture assets between principal and agent

The ED discusses sale transactions between the agent and the principal, and states that a sale will be recognised at the “mutually agreed value” rather than any form of “fair value” (**paras 45-46**). CIBAFI notes that the agent is acting for both sides, and therefore there may be a possibility that the agent may sell an asset to the principal at overvalue and recognise a gain for itself, while the principal can take the asset at the full sale price. CIBAFI would be grateful if AAOIFI could consider the risks associated with this, though it may be considered as a breach of fiduciary duty, rather than an accounting issue.

Number of paragraphs in the Standard

ED states that (in page 4) “AAOIFI Financial Accounting Standard No. 31 “Investment Agency (Al-Wakala Bi Al-Istithmar)” is set out in paragraphs 1 to 54.”. However it consists of 53 paragraphs. AAOIFI may wish to relook at the count of paragraphs in the standard.