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Part 1: Introduction

1. Objective

- 1.1 This Circular addresses the requirements on the application of Financial Reporting Standards (FRS) and disclosure of information in the financial reports for Islamic banks.
- 1.2 The requirements in this Circular comprise three parts namely:
- (i) **Part 1** emphasises the requirement for compliance with FRS approved by the Malaysian Accounting Standards Board (MASB);
 - (ii) **Part 2** consists specific accounting treatment arising from new and revised FRS and requirements on the use of fair value option; and
 - (iii) **Part 3** provides revised requirements for the submission, publication and additional disclosure requirements of annual and interim financial reports and financial statements.
- 1.3 This Circular should be read concurrently with the *Guidelines on Financial Reporting for Licensed Islamic Banks* (GP8-i) issued by the Bank in June 2005.

2. Scope

This Circular is applicable to Islamic banks licensed under section 3(4) of the Islamic Banking Act 1983 (IBA) (thereafter referred to as 'reporting institutions').

3. Legal Provision

This Circular is issued pursuant to section 18, section 19(1) and section 53A of the IBA.

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4. Effective Date

This Circular is effective for the financial years beginning on or after 1 January 2010.

5. Compliance with Accounting Standards

- 5.1 Reporting institutions shall ensure that financial statements are prepared in accordance with the financial reporting standards approved by MASB to the extent that the standards are consistent with Shariah principles¹ and subject to any general or specific direction or other prescription contained in this Circular.
- 5.2 The board of directors are to ensure that the financial statements are drawn up so as to give a true and fair view of the state of affairs and of the results of the reporting institutions. This is consistent with the fiduciary and statutory duties placed on the board as persons responsible for managing the affairs of the reporting institution. Hence, the board shall be satisfied that a sound financial reporting structure is in place to ensure the integrity and credibility of financial statements.
- 5.3 Where a specific accounting treatment is prescribed in this Circular for prudential reasons, reporting institutions shall comply with the prescribed treatment and disclose a statement to that effect.
- 5.4 At all times reporting institutions shall comply with the following key principles on disclosure of information:
- (i) information should be timely, relevant and up-to-date, to avoid undue

¹ Refer to *Statement of Principles (SOP) i-1: Financial Reporting from an Islamic Perspective* issued by the MASB. Paragraph 6 of SOP i-1 provides that "Shariah compliant transactions and events shall be accounted for in accordance with MASB approved accounting standards, unless there is a Shariah prohibition". In line with the MASB's consultative approach, reporting institutions to refer to the MASB when there are divergent practices regarding the accounting for a particular Shariah compliant transaction or event, or when there is doubt about the appropriate accounting treatment and the reporting institutions believe it is important that a standard treatment be established.

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delays in disclosure which may affect the usefulness of the information being disclosed;

- (ii) the scope and content of information disclosed and the level of disaggregation and detail should be sufficient to provide comprehensive, meaningful² and relevant information;
- (iii) adequate disclosures should be provided on areas of uncertainty, in particular information on key estimates and if sensitivity analysis is used, a discussion on the assumptions and the probabilities of the occurrence of various scenarios;
- (iv) disclosures should specify and indicate to what extent the information has been verified by external auditors; and
- (v) disclosures should allow comparisons over time and between institutions.

Part 2: Specific Accounting Treatment & Fair Value Option

6. Specific Accounting Treatment

6.1 Reporting institutions shall measure all financial liabilities³, subsequent to initial recognition, at amortised cost using the effective profit method except for:

- (i) derivatives that are liabilities, which shall be measured at fair value. Derivative liabilities shall be measured at cost if the derivatives are linked to and settled by delivery of unquoted equity instruments whose fair value cannot be reliably measured;

² Given the heterogeneity of users of financial reporting, background information on the wider economic environment a reporting institution operates in is necessary to provide sufficient information to understand the context for specific disclosures. Information should also be useful to support decision-making by users.

³ In view of the international developments which are contemplating changes in this area.

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- (ii) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies;
 - (iii) financial guarantee contracts⁴;
 - (iv) commitments to provide a loan at below-market profit rate; and
 - (v) financial liabilities that are designated as hedged items and subject to hedge accounting requirements under the applicable FRS.
- 6.2 Except as provided for under paragraph 6.1 (i) to (v), reporting institutions are not allowed to designate any financial liabilities at fair value through profit or loss.
- 6.3 For the purpose of disclosures of non-compliance with externally imposed capital requirements, the capital adequacy requirements prescribed under paragraph 5.1 of the *Guidelines on Risk-Weighted Capital Adequacy Framework and Capital Adequacy Framework for Islamic Banks (General Requirements and Capital Components)* shall apply.
- 6.4 Reporting institutions shall also comply with disclosure requirements specified by Perbadanan Insurans Deposit Malaysia.
- 6.5 Reporting institutions that apply the transitional provision under paragraph 12.7 of the *Guidelines on Classification and Impairment Provisions for Loans/Financing* for the assessment of collective impairment provisions shall disclose that fact in the interim and annual financial statements.
- 6.6 Where a reporting institution had previously classified as 'held-to-maturity' investments in equity holdings in organisations which are set up for specific socio-economic reasons (e.g. equity interests in Cagamas, MEPS, RAM and

⁴ As defined in paragraph 9 of FRS 139 *Financial Instruments: Recognition and Measurement*.

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CGC) or equity instruments received as a result of loan restructuring or loan conversion, the reclassification of these instruments to 'Available-for-sale' shall not be subject to the 'tainting' rules when the requirement under FRS 139 Financial Instruments: Recognition and Measurement are first applied.

- 6.7 Notwithstanding the restatement or adjustments to the opening balances at the beginning of the financial year in which this Circular and/or applicable FRS are first applied, retrospective restatement of the statutory reserves maintained in compliance with section 15 of IBA is not required.
- 6.8 Reporting institutions are encouraged to subject any restatement or adjustment to the opening balances to a review by the external auditor before the first quarter⁵ financial reports for the financial year 2010 are submitted to the Bank.

7. Requirements on the use of Fair Value Option

- 7.1 FRS 139 specified that a financial asset shall be classified as *financial asset at fair value through profit or loss*⁶ if the financial asset is either classified as *held-for-trading*, or upon initial recognition it is *designated* as at fair value through profit or loss (thereafter referred as 'fair value option'). The requirements in this section refer to financial assets designated at fair value under the fair value option.
- 7.2 Reporting institutions are required to provide a one-time notification to the Bank of the intention to apply fair value option and the scope of the fair value application on financial assets as approved by the board, at least 1 month before the option is first applied. The notification shall be signed-off by the Chairman of the Audit Committee of reporting institutions.

⁵ As an example, first quarter ending 31 March 2010 for a reporting institution with the financial year ending on 31 December.

⁶ Refer to (b) *Definitions of Four Categories of Financial Instruments* under paragraph 9 of FRS 139 *Financial Instruments: Recognition and Measurement*.

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- 7.3 Reporting institutions applying the fair value option for portfolios of financial assets and individual financial assets shall do so in a manner that is consistent with both applicable financial reporting standards and the reporting institution's risk management and controls framework.
- 7.4 Reporting institutions should ensure that the effect on the use of the fair value option is understood by the board and its use is managed, monitored and reported to the senior management and the board in an effective and transparent manner.
- 7.5 The use of the fair value option must be supported by a sound governance structure, risk management systems and related risk management policies and procedures which ensure that:
- (i) there is an appropriate segregation of duties between those responsible for fair values used in the financial statements and those in the risk-taking functions;
 - (ii) the use of the fair value option is consistent with the way the reporting institution measures and manages risk;
 - (iii) the circumstances and conditions under which the fair value option is exercised by reporting institution are within the defined parameters and risk limits established and approved by its board for the use of the fair value option;
 - (iv) appropriate valuation methods are being used;
 - (v) fair values are reliable for instruments in the fair value option category;
 - (vi) risk management and control policies, as approved by the board, relating to the use of the fair value option and related valuation methodologies are consistently applied and complied with; and

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(vii) appropriate information is provided periodically to the board or the audit committee on the use of the fair value option in particular where the fair value option is applied to illiquid instruments, and its impact on the bank's financial condition and performance. Documented procedures should be in place for the escalation of issues and exceptions to the board or the audit committee.

7.6 Reporting institutions shall not apply the fair value option to instruments where reliable estimates of fair values cannot be made or where the valuation methodology has proven to be unreliable.

7.7 Reporting institutions should also establish procedures for approving the use of the fair value option for new items, products or transactions and related controls. When determining whether to apply the fair value option to a particular new instrument or class of instruments, a reporting institution should ascertain whether reliable fair values can be determined for those instruments. Existing risk management policies, procedures, and controls (including those related to valuation) may need to be revised or expanded to address the characteristics and risks of the new items, products or transactions to which the fair value option will be applied. New approvals must be consistent with the reporting institution's established parameters for using the fair value option.

7.8 Financial assets designated at fair value under the fair value option should be captured in the reporting institution's risk measurement systems. The resulting exposure amounts should be included in internal reports that compare actual overall exposure to approved overall risk management limits.

7.9 Reporting institutions should ensure sufficient documentation to support the use of the fair value option. In particular, the policies for measurement and management of risk and reliable valuation should be well documented and applied to individual (and portfolios of) financial assets designated at fair value through profit and loss. Where reporting institutions use supplementary

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risk management information that is not based on FRS principles (e.g. Value-at-Risk) for internal risk management purposes and significant differences arise between the measurement and management of risk and FRS, this should be properly documented and deliberated by the board or audit committee.

- 7.10 Reporting institutions shall assign specific responsibility for the determination of fair values used in the financial statements to persons outside the risk-taking functions. Assets designated at fair value under the fair value option should be subject to the same rigorous valuation policies and practices applicable to other financial assets measured at fair value. However, when applying the fair value option to illiquid instruments, reporting institutions should employ a more rigorous valuation process than is used for liquid instruments, including documenting the process for estimating fair value and reliability of valuation.
- 7.11 Where models are used (including changes to a valuation model) to value assets designated at fair value under the fair value option, these should be verified by a qualified function (e.g. Model Verification Group) that is independent of risk-taking activities as part of a regular cycle of model validation. The validation process should include an assessment of the stability of models used in terms of performance over a variety of conditions and back-testing of model outputs. Model validation should be performed at regular intervals (e.g. annually) with regular reporting to senior management and the board.
- 7.12 The use of the fair value option should be monitored by a function that is independent of the risk-taking activities (e.g. the finance or control functions) within the reporting institution. The function should undertake the review of accounting policies and practices to ensure consistency with applicable financial reporting standards. Testing of individual transactions should also be taken to verify compliance with approved policies for the use of the fair value

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option. An independent process should be in place for approving and monitoring valuation adjustments for consistency and appropriateness. The results of independent reviews performed (including price verification differences and valuation adjustments and any changes to the method of determining such adjustments) should be documented and reported to senior management.

- 7.13 Where fair value is a critical component of financial performance, reporting institutions should establish a process for the review and reporting to senior management on profit or loss and the resulting impact on the overall financial condition at sufficiently frequent intervals during the financial reporting cycles (e.g. daily or weekly).
- 7.14 The appropriateness of a reporting institution's use of the fair value option, including the adequacy of the independent price verification procedures and controls, should be subject to a periodic review (e.g. annually) by internal audit. Reporting institutions shall promptly address any deficiencies identified in the use of the fair value option by internal and external auditors.
- 7.15 The Bank may require reporting institutions to submit supplemental information (including related risk management and valuation policies and practices) for the purpose of assessing the impact of the use of fair value option on risk, earnings and capital adequacy.
- 7.16 The Bank may also require any reporting institution to obtain an independent validation from an external auditor on the institution's compliance with the expectations under this Circular. This may be exercised after taking into consideration the risk management systems, policies and procedures for the estimation of fair values or where the Bank has reason to believe that expectations under this Circular have not been fully or satisfactorily met.

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Part 3: Revised Requirements

8. Submission Requirements

Annual Financial Reports

- 8.1 Reporting institutions shall submit the audited financial statements to Jabatan Penyeliaan Konglomerat Kewangan or Jabatan Penyeliaan Perbankan, Bank Negara Malaysia, as applicable, within 3 months after the close of each financial year. Unless otherwise notified by the Bank in writing, reporting institutions shall not publish or lay the audited financial statements at its general meeting.
- 8.2 In the submission of the annual financial statements, reporting institutions shall attach the following supporting schedules:
- (i) management letter prepared by the external auditors;
 - (ii) (draft) annual financial reports of the subsidiaries that are major contributors to the group's profits, if applicable;
 - (iii) analysis, both in tabular and narrative form, on the overall assessment of the financial performance. The analysis of the performance, for current and preceding year, of each of the institution in the group, if applicable, at a minimum, shall include the following:
 - (a) total assets (in RM and % of group);
 - (b) profit/(loss) before tax (in RM and % of group);
 - (c) profit/(loss) after tax (in RM and % of group);
 - (d) dividends (if any);
 - (e) ratio of profit/(loss) before tax to average shareholders' funds; and
 - (f) ratio of profit/(loss) before tax to average total assets.
 - (iv) the amount of individual impairment provisions calculated in

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accordance with the parameters specified in Appendix I of the Guidelines on *Classification and Impairment Provisions for Loans/Financing*; and

(v) any other supplementary information as the Bank may specify.

8.3 Reporting institution shall include a note in the Directors' Report in the annual financial statement on compliance with the Bank's expectations on financial reporting, including the Guidelines on *Classification and Impairment Provisions for Loans/Financing*.

Interim Financial Reports

8.4 For interim financial reports prepared on a quarterly (applicable for first and third quarter reporting) basis, reporting institutions are required to submit the interim financial reports to Jabatan Penyeliaan Konglomerat Kewangan or Jabatan Penyeliaan Perbankan, Bank Negara Malaysia, as applicable, not later than 4 weeks after the end of the interim period. Unless otherwise notified by the Bank, reporting institutions shall make available (and/or submit to Bursa Malaysia, in the case of listed reporting institution) the interim financial reports in their respective websites not earlier than 5 working days after submission of the financial reports to the Bank.

8.5 For interim financial reports prepared on a half-yearly basis, reporting institutions are required to submit the interim financial reports to Jabatan Penyeliaan Konglomerat Kewangan or Jabatan Penyeliaan Perbankan, Bank Negara Malaysia, as applicable, not later than 4 weeks after the end of the interim period. Unless otherwise notified by the Bank in writing, reporting institutions shall not make available (and/or submit to Bursa Malaysia, in the case of listed reporting institution) the interim financial reports, prepared on a half-yearly basis, in their respective websites.

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- 8.6 Where there is a proposed special or interim dividend, reporting institutions shall not disclose (and/or submit to Bursa Malaysia, in the case of a listed institution) the interim financial reports in their respective websites unless the proposed dividend has been approved by the Bank.
- 8.7 In the submission of the interim financial reports, reporting institutions shall attach the following supporting schedules:
- (i) interim financial reports of principal subsidiaries;
 - (ii) certification by the officer primarily responsible for the financial management of the reporting institution that the interim financial reports are prepared in conformity with the financial reporting standards in Malaysia;
 - (iii) where an interim dividend is proposed:
 - (a) a certification by the external auditor of the reporting institution;
 - (b) a statement by the board certifying the reporting institution's compliance with the Bank's supervisory expectations on financial reporting, including those applicable under the Guidelines on *Classification and Impairment Provisions for Loans/Financing*;
 - (iv) analysis, both in tabular and narrative form, of the overall assessment of the financial performance. The analysis of performance, for the current interim period and cumulatively for the current financial year to date and comparable interim period (current and year-to-date) of the preceding financial year, of each of the institution in the group, if applicable, shall at a minimum, include the following:
 - (a) total assets (in RM and % of group);
 - (b) profit/(loss) before tax (in RM and % of group);

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- (c) profit/(loss) after tax (in RM and % of group);
 - (d) dividends (if any);
 - (e) ratio of profit/(loss) before tax to average shareholders' funds; and
 - (f) ratio of profit/(loss) before tax to average total assets.
- (v) the amount of individual individual impairment provisions calculated in accordance with the parameters specified in Appendix I of the Guidelines on *Classification and Impairment Provisions for Loans/Financing*; and
- (vi) any other supplementary information as the Bank may specify.

9. Publication Requirements

Annual Financial Reports

9.1 Reporting institutions are required, pursuant to Section 18 of the IBA, to publish (both own and consolidated financial reports, as applicable) within 14 days after the laying of the financial statements at its general meeting, in at least two local daily newspapers (see paragraph 9.3), the following components of the financial reports:

- (i) Statement by Directors;
- (ii) Auditor's Report;
- (iii) Statement of Financial Position;
- (iv) Statement of Comprehensive Income;
- (v) A statement showing either all changes in equity or changes in equity other than those arising from capital transactions with owners and distributions to owners;
- (vi) Statement of Cash Flows; and
- (vii) Accounting policies and explanatory notes.

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9.2 Reporting institutions may publish an abridged format of the annual audited financial reports in the newspapers, provided that the full text of the financial reports are made available in the respective reporting institutions' website. The abridged format of the financial reports (both own and consolidated financial reports, as applicable) to be published in the newspapers shall, at the minimum, consist of the following:

- (i) Statement of Financial Position;
- (ii) Statement of Comprehensive Income;
- (iii) Statement of Changes in Equity;
- (iv) Statement of Cash Flows;
- (v) Auditors' Report; and
- (vi) Following explanatory notes:
 - (a) securities⁷ portfolio;
 - (b) financing, advances and other loans including movements in the impaired financing, advances and other loans and, impairment provision accounts;
 - (c) commitments and contingencies; and
 - (d) capital⁸.

The reporting institutions shall include a note stating that the full set of the financial reports are available in the institutions' website, and to disclose the address of the website. For reporting institutions which do not have a website, the full set of the financial reports may be made available in the corporate website of its parent company provided that the note accompanying the abridged format of the financial reports states clearly that the full set of the

⁷ For example, financial instruments carried at fair value through profit or loss, available-for-sale and held-to-maturity.

⁸ Capital structure as prescribed under the *Guidelines on Risk-Weighted Capital Adequacy Framework and Capital Adequacy Framework for Islamic Banks (General Requirements and Capital Components)*. Disclose breakdown of eligible Tier 1 capital, the amount of Tier 2 capital and total capital base.

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financial reports are available in the parent company's corporate website and to disclose the exact URL that point to the page of the financial reports of the reporting institution.

9.3 The two approved local daily newspapers, one of which shall be in the national language and the other in English, are:

- (i) Berita Harian or Utusan Malaysia; and
- (ii) The New Straits Times or The Star.

9.4 The reporting institution may thereafter exhibit the abridged format of the financial reports at every office of the reporting institutions.

Interim Financial Reports

9.5 Reporting institutions shall make available the interim financial reports (both own and consolidated financial reports, as applicable) prepared on a quarterly (applicable for first and third quarter reporting) and half-yearly basis, in their website, not later than 8 weeks after the close of the interim period. For reporting institutions which do not have a website, the interim financial reports may be made available in the corporate website of its parent company.

9.6 Where the audited financial reports for the preceding financial year has yet to be published by end of the eighth week after the close of the interim period, reporting institutions may make available the first quarter interim financial reports in their website on the same day or not later than 3 days after the publication of the annual audited financial reports.

10. Disclosure Requirements

10.1 The illustrations and guidance notes under the GP8-i on the annual financial reports and interim financial reports (Appendix B) are to be updated and revised to reflect the disclosures in accordance with the requirements of the

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FRS and additional information required by the Bank, amongst others include:

- (i) change in nomenclature:
 - (a) Balance Sheet to Statement of Financial Position;
 - (b) Income Statement to Statement of Comprehensive Income; and
 - (c) Cash Flow Statement to Statement of Cash Flows.

- (ii) reporting institutions shall present a Statement of Financial Position that groups assets and liabilities by maturity, listed in an order that reflects the relative liquidity of the groups of assets and liabilities. Similarly, a Statement of Comprehensive Income should reflect income and expenses grouped by nature, quantifying the principal types of income and expenses;

- (iii) guidance notes pertaining to financing, advances and other loans (pages 42 and 46) and other financial disclosures (pages 50, 67 and 73-74) shall be amended in accordance with the Guidelines on *Classification and Impairment Provisions for Loans/Financing* and revised disclosure requirements under this Circular; and

- (iv) additional information specified under paragraph 10.2 of this Circular.

10.2 In addition to the information required under the GP8-i, the explanatory notes to be included in the annual financial statements of reporting institutions shall include the following information:

- (i) deposits from customers with a breakdown by maturity structures of investment deposits⁹ (e.g. < 6 months, 6-12 months, 1-3 years);

⁹ Including investment deposits and negotiable instruments of deposits.

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- (ii) financing, advances and other loans with a breakdown by:
- (a) Measurement basis (e.g. amortised cost, fair value)
 - For fair value through profit or loss, show separately those designated as fair value upon initial recognition, and those classified as held-for-trading;
 - (b) Geographical distribution; and
 - (c) Residual contractual maturity (e.g. up to 1 year, 1-5 years, > 5 years).
- (iii) impaired¹⁰ financing, advances and other loans with separate disclosures of:
- (a) A movement schedule showing separately the amount classified during the year as impaired, amount reclassified as non-impaired, amount recovered and amount written off;
 - (b) A movement schedule of impairment provisions segregated between individual impairment and collective impairment and showing separately the amount charged and the amount utilised to write off impaired loans during the year; and
 - (c) A breakdown of impaired financing, advances and other loans by geographical area and by sector or economic purposes.
- (iv) profit income and profit distributable with a breakdown by categories of financial assets or liabilities. Profit income recognised for impaired financing, advances and other loans should be disclosed separately;
- (v) CEO and Directors' remuneration with a breakdown of types of remunerations¹¹ (e.g. salary, fees, bonus, benefits-in-kind, retirement benefits), disclosed separately for the CEO and each individual director, distinguishing between executive and non-executive directors;

¹⁰ Refer to paragraph 11.1 of the Guidelines on *Classification and Impairment Provisions for Loans/Financing*.

¹¹ Alternatively, to disclose under the Statement of Corporate Governance.

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- (vi) reserves with a breakdown by type (e.g. statutory reserves¹²) and purpose of reserves maintained. A movement schedule shall also be disclosed; and
- (vii) liquidity risk information¹³ incorporating an analysis of assets and liabilities in the relevant maturity tenures based on remaining contractual maturities. Reporting institutions may also provide the analysis of assets and liabilities in the relevant maturity tenures based on their behavioural profile.

10.3 Appendix A: Accounting for securities of the GP8-i is no longer applicable.

¹² Statutory reserves maintained in compliance with section 15 of IBA.

¹³ Disclosures should be in line with Principle 13 of the *Principles for Sound Liquidity Risk management and Supervisions, Basel Committee on Banking Supervisions, September 2008*.