

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

1 INCORPORATION AND PRINCIPAL ACTIVITIES

United Gulf Bank B.S.C. ("the Bank") is a joint stock company incorporated in the Kingdom of Bahrain in 1980, under Commercial Registration (CR) number 10550, and listed on the Bahrain and Kuwait Stock Exchanges. The address of the Bank's registered office is UGB Tower, Diplomatic Area, P.O. Box 5964, Manama, Kingdom of Bahrain.

The Bank operates in Bahrain under a Wholesale Banking License issued by the Central Bank of Bahrain ("the CBB") formerly known as Bahrain Monetary Agency .

The principal activities of the Bank and its subsidiaries ("the Group") comprise of investment and commercial banking. Investment banking includes asset portfolio management, corporate finance, advisory, investment in quoted and private equity/funds, real estate, capital markets, international banking and treasury functions. Commercial banking includes extending loans and other credit facilities, accepting deposits and current accounts from corporate and institutional customers.

The Bank's parent company is Kuwait Projects Company (Holding) K.S.C. (KIPCO), a company incorporated in the State of Kuwait and listed on the Kuwait Stock Exchange. As at 31 December 2006 KIPCO owned 76% of the Bank's outstanding shares (2005: 74%).

These consolidated financial statements were authorised for issue by the Board of Directors on 11 February 2007.

2.1 BASIS OF PREPARATION

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and are in conformity with the Bahrain Commercial Companies Law and the Central Bank of Bahrain and Financial Institution Law.

New and amended standard and interpretations issued but not yet effective

The following standards and interpretations have been issued but are not yet effective:

- IFRS 7 Financial Instruments : Disclosures and consequent amendments to IAS 1 - Capital Disclosures
- IFRS 8 Operating Segments

The above amendments only impact disclosures and will be effective for 2007 and 2009 respectively.

- IFRIC Interpretation 8 Scope of IFRS 2
- IFRIC Interpretation 9 Reassessment of Embedded Derivatives
- IFRIC Interpretation 11 IFRS 2 - Group and Treasury Share Transactions

Management do not expect these interpretations to have a significant impact on the Group's financial statements when implemented in 2007.

The consolidated financial statements have been presented in US Dollars being the functional currency of the Group.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

2.2 ACCOUNTING CONVENTION

The consolidated financial statements have been prepared under the historical cost convention as modified by the remeasurement at fair value of investments carried at fair value through statement of income, investments available for sale, investment properties and derivative financial instruments.

2.3 SIGNIFICANT ACCOUNTING POLICIES

The accounting policies used in the preparation of these consolidated financial statements are consistent with those used in previous year.

Principles of consolidation

The consolidated financial statements include the financial statements of the Bank and its subsidiaries ("the Group"). Subsidiaries are those entities controlled by the Bank, other than in a fiduciary capacity. Control exists when the Bank has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The financial statements of subsidiaries are included in the consolidated financial statements from the date the control effectively commences until the date it effectively ceases. The purchase method of accounting is used. Equity and net income attributable to minority shareholders' interests are shown separately in the balance sheet and statement of income, respectively. The purchase method involves allocating the cost of business combination to fair value of the assets acquired, liabilities and contingent liabilities assumed at the date of acquisition. Minority interests are measured by the proportion of pre-acquisition carrying amounts of the identifiable assets and liabilities of the subsidiaries thereafter adjusted for net movement in the net assets. Significant intercompany balances and transactions, including intragroup intercompany fees and income, and unrealised profits and losses are eliminated on consolidation. Consolidated financial statements are prepared using similar accounting year and uniform accounting policies for like transactions and for events in similar circumstances.

The principal subsidiaries of the Group are as follows:

| Name of the subsidiary | Country of incorporation | Effective ownership as at 31 December 2006 | Year of Incorporation |
|--|---------------------------------|---|------------------------------|
| Algeria Gulf Bank | Algeria | 83% | 2003 |
| KIPCO Asset Management Company (KAMCO) | Kuwait | 71% | 1998 |
| Tunis International Bank | Tunisia | 77% | 1982 |
| United Gulf Bank Securities Company | Bahrain | 91% | 1998 |
| United Gulf Financial Services Company | Qatar | 88% | 2006 |

Held through KAMCO

| | | | |
|---|---------|------|------|
| Al-Ahlia Arabian Markets Company K.S.C. (Closed) | Kuwait | 96% | 2005 |
| First Arabian Markets Company K.S.C. (Closed) | Kuwait | 96% | 2005 |
| KAMCO Real Estate Company S.P.C. | Bahrain | 100% | 2005 |
| Advantage Management Consulting Company K.S.C. (Closed) | Kuwait | 58% | 2005 |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

Associated companies

An associated company (or associate) is one in which the Group exercises significant influence (but not control) over its operations, generally accompanying, directly or indirectly, a shareholding of between 20% and 50% of the equity share capital and is accounted for by the equity method.

Under the equity method, the investment in an associate is initially recognised at cost and adjusted thereafter for the post-acquisition change in the Group's share of net assets of the investee. The Group recognises in the consolidated statement of income its share of the total recognised profit or loss of the associate from the date that influence or ownership effectively commences until the date that it effectively ceases. Distributions received from an associate reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the Group's share in the associate arising from changes in its equity that have not been recognised in the associate's profit or loss. The Group's share of those changes is recognised directly in equity.

Whenever impairment requirements of IAS 36 indicate that investment in an associate may be impaired, the entire carrying amount of the investment is tested by comparing its recoverable amount with its carrying value. Goodwill is included in the carrying amount of an investment in an associate and, therefore, is not separately tested for impairment.

Unrealised gains on transactions with an associate are eliminated to the extent of the Group's share in the associate. Unrealised losses are also eliminated unless the transaction provides evidence of impairment in the asset transferred. An assessment of an associate is performed when there is an indication that the asset has been impaired, or that impairment losses recognised in prior years no longer exist.

Goodwill

Goodwill represents the excess of the cost of an acquisition over the Group's share of the fair value of the net identifiable assets of the acquired subsidiary or associate at the date of the acquisition. Goodwill arising on the acquisition of a subsidiary is recognised as a separate asset in the balance sheet. Any excess, at the date of acquisition, of the Group's share in the fair value of the net identifiable assets acquired over the cost of the acquisition is recognised as negative goodwill. Negative goodwill arising on an acquisition is recognised immediately in the consolidated statement of income.

Goodwill is stated at cost less impairment losses. Goodwill of subsidiaries is allocated to cash-generating units and is tested annually for impairment. If the recoverable amount of cash generating unit is less than the carrying amount of the unit, the impairment loss is allocated first to reduce the carrying amount of any goodwill allocated to the unit and then to the other assets of the unit prorata on the basis of the carrying amount of each asset in the unit. Any impairment loss recognised for goodwill is not reversed in a subsequent period.

On disposal of a part of a subsidiary, the attributable amount of goodwill is included in the determination of the profit or loss on disposal.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

2.3 SIGNIFICANT ACCOUNTING POLICIES (continued)

Investments

All investments are initially recognised at cost being the fair value of consideration given including, in case of investments not at fair value through profit or loss, incremental acquisition charges associated with the investment. After initial recognition, investments other than investments in associated companies are remeasured using the following policies:

Investments carried at fair value through statement of income

Investments carried at fair value through statement of income comprise securities held for trading and investments in funds. Investments are classified as carried at fair value through statement of income if they are acquired principally for the purpose of selling in the short term or if so designated by management. All subsequent gains and losses arising from remeasurement at fair value are recognised in the consolidated statement of income.

Securities held for trading

All securities held for trading are listed on active markets, therefore, the fair value of these securities is determined by reference to their quoted bid prices. Realised and unrealised gains and losses on securities held for trading are included in the consolidated statement of income. Dividends received are included in dividend income.

Investments in funds

The Group classifies its investments in managed portfolios, as investments in funds. The fair values of the funds that are listed on active markets are determined by reference to their quoted bid prices. The fair values of unlisted funds are determined by the fund manager using the quoted market prices of the underlying assets, if available, or other acceptable methods such as a recent price paid by another investor, the market value of a comparable company or a firm offer from a third party.

Non-trading investments

These are classified as follows:

- Held to maturity
- Available for sale

Held to maturity

The Group classifies investments as held to maturity if the requirements of IAS 39 are met and in particular the Group has the intention and ability to hold these investments to maturity.

After initial recognition, investments held to maturity are carried at amortised cost using the effective interest rate method, less impairment losses, if any.

Investments available for sale

Investments available for sale are those non-derivative financial assets that are designated as available for sale or are not classified as investment at fair value through statement of income, investment held to maturity or loans and advances.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

After initial recognition, investments available for sale are measured at fair value with gains and losses being recognised as a separate component of equity until the investment is derecognised or until the investment is determined to be impaired at which time the cumulative gain or losses previously reported in equity is recognised in the statement of income. Investments whose fair value cannot be reliably measured are carried at cost less impairment losses, if any.

Investment properties

All properties held for rental or for capital appreciation purposes or both are classified as investment properties. Where a property is partially occupied by the Group and the portions could be sold separately, the Group accounts for the portions separately either as an investment property or property and equipment, as appropriate. If the portions cannot be sold separately, the property is classified as an investment property only if an insignificant portion is held for use for administrative purposes.

All investment properties are initially recorded at cost, being the fair value of the consideration given and including acquisition charges associated with the property.

Subsequent to initial recognition, all investment properties are remeasured at fair value and changes in fair value are recognised in the consolidated statement of income.

Loans and Advances

Debt instruments which do not meet the definition of held to maturity and which have fixed or determinable payments but are not quoted in an active market are classified as loans and advances. Loans and advances are carried at amortised cost, less any amount written off, and net of any provision for impairment.

Derivatives

Derivatives are stated at fair values.

For the purpose of hedge accounting, hedges are classified into two categories: (a) fair value hedges which hedge the exposure to changes in the fair value of a recognised asset or liability; and (b) cash flow hedges which hedge exposure to variability in cash flows of a recognised asset or liability or a forecasted transaction.

In relation to fair value hedges that qualify for hedge accounting, any gain or loss from remeasuring the hedging instrument to fair value, as well as related changes in fair value of the item being hedged, are recognised immediately in the consolidated statement of income.

In relation to cash flow hedges, the effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised directly in fair value reserve in the consolidated statement of changes in equity. The gain or loss relating to the ineffective portion is recognised immediately in the consolidated statement of income.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

2.3 SIGNIFICANT ACCOUNTING POLICIES (continued)

For hedges which do not qualify for hedge accounting, any gains or losses arising from changes in the fair value of the hedging instrument are taken directly to the consolidated statement of income for the year.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. For discontinued fair value hedges of financial instruments with fixed maturities, any adjustment arising from hedge accounting is amortised over the remaining term to maturity. For discontinued cash flow hedges, any cumulative gain or loss on the hedging instrument recognised in equity remains in equity until the hedged transaction occurs. If the hedged transaction is no longer expected to occur, the net cumulative gain or loss recognised in equity is transferred to the consolidated statement of income.

Property and equipment and related depreciation

Property and equipment are stated at cost less accumulated depreciation and impairment losses. When assets are sold or retired, their cost and accumulated depreciation are eliminated from the accounts and any gain or loss resulting from disposal is included in the consolidated statement of income.

All items of property and equipment are initially recorded at cost. Depreciation is computed on a straight-line basis over estimated useful lives of 3 to 20 years on all property and equipment other than freehold land which is deemed to have an indefinite life. Expenditure for maintenance and repairs is expensed as incurred.

Loans, murabaha payable, bonds and subordinated debt

These are stated at cost. Transaction costs are amortised over the period of the debt.

Treasury shares and treasury share reserve

Treasury shares are stated at cost. Any gain or loss arising on reissuance of treasury shares is taken directly to treasury share reserve in the statement of changes in equity and the net gain so included is not available for distribution.

Cash and cash equivalents

Cash and cash equivalents are cash, demand and call deposits, and time deposits with an original maturity upto 90 days from the date of acquisition.

Fiduciary assets

Assets held in a fiduciary capacity are not treated as assets of the Group in the consolidated balance sheet.

Taxes

There is no tax on corporate income in the Kingdom of Bahrain. Taxation on foreign operations is provided in accordance with the fiscal regulations of the respective countries in which the Group operates.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

Financial instruments

Financial assets and financial liabilities carried on the balance sheet include demand and call deposits, time deposits with banks, investments carried at fair value through statement of income, non trading investments, loans and advances, accounts receivable, due from customers, due to banks and other financial institutions, deposits from customers, loans and murabaha payable, subordinated debt, bonds and accounts payable.

Financial instruments are classified as liabilities or equity in accordance with the substance of the contractual arrangement. Interest, dividends, gains and losses relating to a financial instrument classified as a liability, are reported as expense. Distributions to holders of financial instruments classified as equity are charged directly to equity.

Financial assets and liabilities are measured initially at fair value (transaction price) plus, in the case of a financial asset or financial liability not at fair value through statement of income, directly attributable transaction costs. Transaction costs on financial assets and financial liabilities at fair value through statement of income are expensed immediately, while on other financial assets transaction costs are shown as part of the financial assets and for other financial liabilities, transaction costs are amortised over the period of the debt.

Derecognition

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognised when:

- (i) the right to receive cash flows from the asset have expired;
- (ii) the Bank retains the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a 'pass through' arrangement; or
- (iii) the Bank has transferred its rights to receive cash flows from the asset and either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

When the Bank has transferred its rights to receive cash flows from an asset and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognised to the extent of the Bank's continuing involvement in the asset.

A financial liability is derecognised when the obligation specified in the contract is discharged, cancelled or expired.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

2.3 SIGNIFICANT ACCOUNTING POLICIES (continued)

Offsetting

Financial assets and financial liabilities are only offset and the net amount is reported in the consolidated balance sheet when there is a legally enforceable right to set off the recognised amounts and the Group intends to either settle on a net basis, or to realise the asset and settle the liability simultaneously.

Trade and settlement date accounting

All "regular way" purchases and sales of financial assets are recognised on the settlement date, i.e. the date the asset is delivered to the counterparty.

Employees' benefits

The Bank provides for end of service benefits to all its employees. Entitlement to these benefits is usually based upon the employees' length of service and the completion of a minimum service period. The expected costs of these benefits are accrued over the period of employment. Bahraini employees are also covered by the General Organisation of Social Insurance scheme and the Bank's obligations are limited to the amount contributed to the scheme.

The Bank operates an equity-settled, share-based Employee Stock Option Plan (ESOP). Under the terms of the plan, share options are granted to permanent employees, which are exercisable in a future period. The fair value of the options is recognised as an expense over the vesting period with a corresponding credit to equity. The fair value of the options is determined using Black-Scholes option pricing model.

The proceeds received are credited to share capital (nominal value) and share premium when the options are exercised.

Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) arising from a past event and the costs to settle the obligation are both probable and reliably measurable.

Impairment of financial assets

An assessment is made at each balance sheet date to determine whether there is objective evidence that a specific financial asset may be impaired. If such evidence exists, an impairment loss is recognised in the consolidated statement of income. Impairment is determined as follows:

- (a) for assets carried at fair value, impairment loss is the difference between carrying value and fair value;
- (b) for assets carried at amortised cost, impairment is based on estimated future cash flows discounted at the original effective interest rate;
- (c) for assets carried at cost, impairment is present value of future cash flows discounted at the current market rate of return for a similar financial asset.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

For available for sale equity investments, reversal of impairment losses are recorded as increases in cumulative changes in fair value through equity.

In addition, a provision is made to cover impairment for specific groups of assets where there is a measurable decrease in estimated future cash flows.

Fair values

For financial instruments traded in an active market, fair value is determined by reference to quoted market bid prices for assets and quoted market offer prices for liabilities. The fair value of investments in mutual funds, managed funds, unit trusts or similar investment vehicles, where available, are based on last published bid price.

For financial instruments where there is no active market, fair value is normally based on one of the following:

- brokers' quotes
- recent transactions
- the expected cash flows discounted at current rates applicable for items with similar terms and risk characteristics
- option pricing models

The estimated fair value of deposits with no stated maturity, which includes non-interest bearing deposits, is the amount payable on demand.

Foreign currencies

Translation of foreign currency transactions

Exchange differences arising on the retranslation of monetary items, are included in consolidated statement of income for the year. Exchange differences arising on the retranslation of non-monetary investments carried at fair value through statement of income are included in the consolidated statement of income for the period. Exchange differences arising on the retranslation of available for sale investments, other than those which are carried at cost, are recognised directly in a fair value reserve in the consolidated statement of changes in equity.

Translation of financial statements of foreign operations

Assets (including goodwill) and liabilities of foreign operations are translated at the exchange rates prevailing at the balance sheet date. Income and expense items are translated at average exchange rates for the relevant period. All resulting exchange differences are taken directly to a foreign currency translation reserve in the consolidated statement of changes in equity.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

2.3 SIGNIFICANT ACCOUNTING POLICIES (continued)

Revenue recognition

Interest income and related fees are recognised using the effective yield method. Commission income and other fees are recognised when earned. Rental income on investment properties is recognised on a straight line basis. Dividend income is recognised when the Group's right to receive dividend is established.

Recognition of interest income is suspended when loans become impaired. Notional interest is recognised on impaired loans and other financial assets based on the rate used to discount future cash flows to their net present value.

Contingent liabilities and contingent assets

Contingent liabilities are not recognised in the financial statements, but are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

Contingent assets are not recognised in the financial statements, but are disclosed when an inflow of economic benefits is probable.

Segment information

A segment is a distinguishable component of the Group that is engaged either in providing products or services (business segment), or in providing products and services within a particular economic environment (geographical segment).

Judgements

In the process of applying the Group's accounting policies, management has made the following judgements, apart from those involving estimations, which have the most significant effect in the amounts recognised in the consolidated financial statements:

Classification of investments

Management decides on acquisition of an investment whether it should be classified as carried at fair value through statement of income, held to maturity, or available for sale.

Classification of investments as fair value through statement of income depends on how management monitors the performance of these investments.

For those deemed to be held to maturity, management ensures that the requirements of IAS 39 are met and in particular the Group has the intention and ability to hold these to maturity.

All other investments are classified as available for sale.

Impairment of investments

The Group treats available for sale equity investments as impaired when there has been a significant or prolonged decline in the fair value below its cost or where other objective evidence of impairment exists. The determination of what is "significant" or "prolonged" requires considerable judgement.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

Impairment of goodwill

The Group determines whether goodwill is impaired at least on an annual basis. This requires an estimation of the value in use of the cash generating units to which the goodwill is allocated. Estimating the value in use requires the Group to make an estimate of the expected future cash flows from the cash-generating unit and also to choose a suitable discount rate in order to calculate the present value of those cash flows.

Estimation uncertainty

The key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below:

Impairment losses on loans and advances

The Group reviews its loans and advances on a quarterly basis to assess whether a provision for impairment should be recorded in the consolidated statement of income. In particular, considerable judgement by management is required in the estimation of the amount and timing of future cash flows when determining the level of provisions required. Such estimates are necessarily based on assumptions about several factors involving varying degrees of judgement and uncertainty, and actual results may differ resulting in future changes to such provisions.

Collective impairment provisions on loans and advances

In addition to specific provisions against individually significant loans and advances, the Group also makes a collective impairment provision against loans and advances, which although not specifically identified against a loan have a greater risk of default than when originally granted. This collective provision is based on any deterioration in the internal grade of the loan since it was granted. The amount of the provision is based on the historical loss pattern for loans within each grade and is adjusted to reflect current economic changes.

These internal gradings take into consideration factors such as any deterioration in country risk, industry, technological obsolescence as well as identified structural weaknesses or deterioration in cash flows.

Valuation of unquoted equity investments

Valuation of unquoted equity investments is normally based on one of the following:

- recent arm's length market transactions;
- current fair value of another instrument that is substantially the same;
- the expected cash flows discounted at current rates applicable for items with similar terms and risk characteristics; and
- other valuation models.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

3 INVESTMENTS CARRIED AT FAIR VALUE THROUGH STATEMENT OF INCOME

| | 2006 US\$ 000 | 2005 US\$ 000 |
|------------------------------------|------------------|------------------|
| Securities held for trading | | |
| Quoted equities | 57,521 | 47,654 |
| Quoted debt securities | 1,432 | 27 |
| | 58,953 | 47,681 |
| Investments in funds | | |
| Managed funds | 285,048 | 143,672 |
| | 344,001 | 191,353 |

Investments in managed funds primarily represent funds invested through unlisted companies and limited partnership interests. The fund managers have created these legal structures for tax efficiency and to meet other investors' requirements. The underlying investments in these funds are primarily in quoted debt and equity instruments.

4 NON-TRADING INVESTMENTS

These are stated at fair value or at cost net of provision for impairment.

| | Held to maturity US\$ 000 | Available for sale US\$ 000 | Total 2006 US\$ 000 | Total 2005 US\$ 000 |
|---------------------------|---------------------------------|-----------------------------------|---------------------------|---------------------------|
| Quoted | | | | |
| Equities | - | 70,413 | 70,413 | 54,297 |
| Debt securities | 13,192 | 11,992 | 25,184 | 21,394 |
| Others | - | 14,091 | 14,091 | 20,255 |
| | 13,192 | 96,496 | 109,688 | 95,946 |
| Unquoted | | | | |
| Equities | - | 221,204 | 221,204 | 172,253 |
| Real estate managed funds | - | 10,301 | 10,301 | 9,582 |
| Other managed funds | - | 176,574 | 176,574 | 159,324 |
| Debt securities | - | 3,518 | 3,518 | 5,173 |
| Others | - | 5,167 | 5,167 | 6,904 |
| | - | 416,764 | 416,764 | 353,236 |
| Total | 13,192 | 513,260 | 526,452 | 449,182 |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

The movement in provision for impairment of non-trading investments (available for sale investments) is as follows:

| | 2006 US\$ 000 | 2005 US\$ 000 |
|-----------------------------|------------------|------------------|
| At 1 January | 15,597 | 22,699 |
| Charge for the year | - | 8,042 |
| Written-off during the year | (460) | (15,144) |
| At 31 December | 15,137 | 15,597 |

Included under non-trading investments are unquoted available for sale investments amounting to US\$ 118.7 million (2005: US\$ 39.1 million), which are carried at cost due to the unpredictable nature of their future cash flows and the lack of other suitable methods for arriving at a reliable fair value for these investments.

5 LOANS AND ADVANCES

| | 2006 US\$ 000 | 2005 US\$ 000 |
|------------------------------------|------------------|------------------|
| Commercial loans | 289,934 | 160,607 |
| Overdrafts | 22,752 | 19,208 |
| Staff loans | 2,080 | 2,938 |
| | 314,766 | 182,753 |
| Less: provision for doubtful loans | (6,486) | (3,864) |
| | 308,280 | 178,889 |

The composition of the loans and advances portfolio is as follows:

| | Middle East/ Africa US\$ 000 | Europe US\$ 000 | North America US\$ 000 | Total 2006 US\$ 000 | Total 2005 US\$ 000 |
|-------------------------------------|------------------------------------|--------------------|------------------------------|---------------------------|---------------------------|
| Corporate businesses and others | 248,925 | - | - | 248,925 | 141,947 |
| Banks and financial institutions | 58,341 | 7,500 | - | 65,841 | 39,898 |
| Government and related institutions | - | - | - | - | 908 |
| | 307,266 | 7,500 | - | 314,766 | 182,753 |
| Less: provision for doubtful loans | (6,486) | - | - | (6,486) | (3,864) |
| 31 December 2006 | 300,780 | 7,500 | - | 308,280 | |
| 31 December 2005 | 170,883 | 8,000 | 6 | | 178,889 |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

5 LOANS AND ADVANCES (continued)

The movements in provision for doubtful loans are as follows:

| | 2006 US\$ 000 | 2005 US\$ 000 |
|-------------------------|------------------|------------------|
| At 1 January | 3,864 | 8,943 |
| Loans written-off | - | (5,607) |
| Charge for the year | 2,635 | 674 |
| Write back of provision | (234) | - |
| Other adjustments | 221 | (146) |
| At 31 December | 6,486 | 3,864 |

At 31 December 2006 loans and advances on which interest income is not being recognised amounted to US\$ 6.4 million (2005: US\$ 6.5 million).

6 INVESTMENT PROPERTIES

| | 2006 US\$ 000 | 2005 US\$ 000 |
|------------------------------------|------------------|------------------|
| Cost | 17,936 | 16,167 |
| Accumulated fair value adjustments | (287) | (1,648) |
| | 17,649 | 14,519 |

The movements are as follows:

| | | |
|---------------------------------|---------------|---------------|
| At 1 January | 14,519 | 14,076 |
| Additions | 1,933 | 135 |
| Disposals | (164) | - |
| Change in fair values (note 15) | 1,361 | 308 |
| At 31 December | 17,649 | 14,519 |

Investment properties at 31 December consist of the following:

| | | |
|-----------|---------------|---------------|
| Buildings | 14,693 | 13,681 |
| Land | 2,956 | 838 |
| | 17,649 | 14,519 |

Investment properties are stated at fair value, which have been determined based on valuations performed by external professional valuers at the year end.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

7 OTHER ASSETS

| | 2006 US\$ 000 | 2005 US\$ 000 |
|---------------------|------------------|------------------|
| Accounts receivable | 16,576 | 11,268 |
| Due from customers | 15,809 | 26,133 |
| Prepayments | 8,023 | 6,405 |
| Interest receivable | 2,256 | 949 |
| Loans and advances | 7,665 | 14,479 |
| | 50,329 | 59,234 |

8 INVESTMENTS IN ASSOCIATED COMPANIES

Investments in associated companies comprise the following:

| | Activity | Carrying value | | Carrying value | |
|----|--|------------------|------------------------|------------------|------------------------|
| | | 2006 US\$ 000 | Ownership 2006 % | 2005 US\$ 000 | Ownership 2005 % |
| a) | Al-Dhiyfa Holding Company | 47,225 | 27 | 1,370 | 40 |
| b) | Bank of Baghdad | 17,977 | 25 | 16,232 | 25 |
| c) | Dhow Development Company | 376 | 20 | - | - |
| d) | Gulf Egypt for Hotels and Tourism Company | - | - | 37,620 | 44 |
| e) | Jordan Kuwait Bank | 138,325 | 44 | 72,210 | 44 |
| f) | Kuwait Private Equity Opportunities Fund | 21,741 | 45 | - | - |
| g) | Manafae Investment Company | 19,229 | 27 | 18,235 | 27 |
| h) | North Africa Holding Company | 36,634 | 21 | - | - |
| i) | Salem Al-Marzouk & Sabah Abi Hana | 1,483 | 30 | 1,132 | 30 |
| j) | Syria Gulf Bank | 7,513 | 26 | - | - |
| k) | United Cable Company | 16,476 | 28 | 16,818 | 28 |
| l) | United Medical Services Company | 13,108 | 30 | 7,181 | 27 |
| m) | United Industries Company | 108,202 | 45 | 76,978 | 44 |
| n) | United Real Estate Company | 147,469 | 35 | 143,491 | 35 |
| o) | United Universal Real Estate Company | 68 | 20 | - | - |
| p) | United Warehousing and Cooling | 4,084 | 25 | 4,104 | 25 |
| | | 579,910 | | 395,371 | |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

8 INVESTMENTS IN ASSOCIATED COMPANIES (continued)

Summarised financial information in respect of the Group's associated companies is set out below:

| | 2006 US\$ 000 | 2005 US\$ 000 |
|---------------------|------------------|------------------|
| Total assets | 4,025,454 | 3,678,251 |
| Total liabilities | 2,810,665 | 2,678,145 |
| Net assets | 1,214,789 | 1,000,106 |
| Revenue | 433,309 | 338,565 |
| Profit for the year | 160,651 | 130,658 |

- a) Al-Dhiyfa Holding Company K.S.C. (Closed) is a closed company incorporated in the State of Kuwait during 2005. The Bank directly owns 16.6% (2005:20%) of the associate and indirectly owns an additional 10.2% (2005:20%) interest through its subsidiaries KAMCO and TIB.
- b) Bank of Baghdad (BoB) is a bank incorporated in Iraq in 1992 and listed on the Iraq Stock Exchange. The fair value of the Bank's investment in BoB as of 31 December 2006 based on the last bid price of BoB was US\$ 19.8 million (2005: US\$ 57.7 million).
- d) Gulf Egypt for Hotels and Tourism Company (GEHT) was sold to Al Dhiyafa Holding Company (an associated undertaking) during the year.
- e) Jordan Kuwait Bank (JKB) is a bank incorporated in the Kingdom of Jordan in 1976 and listed on the Amman Stock Exchange. The fair value of the Bank's investment in JKB as of 31 December 2006 based on the last bid price of JKB was US\$ 303 million (2005: US\$ 263.9 million). During the year, the Group has sold and bought 3.3% of the investment realising a gain of US\$ 13.1 million on sale. During the year the Group also sold 0.4% of the investment realising a gain of US\$ 1.1 million.
- f) The Bank directly owns 15% of Kuwait Private Equity Opportunities Fund, a closed company incorporated in Kuwait in 2004, and indirectly owns an additional 30% through its subsidiary KAMCO.
- g) The Bank directly owns 1% (2005:1%) of Manafae Investment Company, a closed company incorporated in the State of Kuwait in 2005, and indirectly owns an additional 25.5% (2005:25.5%) through its subsidiaries KAMCO and TIB.
- h) The Bank directly owns 14% of North Africa Holding Company, a closed company incorporated in the State of Kuwait in 2006, and indirectly owns an additional 7% through its subsidiaries KAMCO and TIB.
- j) Syria Gulf Bank (SGB) is a new bank incorporated in the Syrian Arab Republic in 2006. SGB has not yet commenced its commercial operations.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

- k) The Bank directly owns 20.14% (2005: 20.14%) of United Cable Company (UCC), a closed company incorporated in the State of Kuwait in 2001, and indirectly owns an additional 8% (2005: 8%) through its subsidiary KAMCO.
- m) United Industries Company (UIC) is a company owned through its subsidiary KAMCO, incorporated in the State of Kuwait in 1979 and listed on the Kuwait Stock Exchange. The fair value of the Group's investment in UIC as of 31 December 2006 based on the last bid price was US\$ 97.9 million (2005: US\$ 139.6 million). During the year, the Group has sold and bought 0.98% of the investment realising a loss of US\$ 140 thousand on sale.
- n) United Real Estate Company (URC) is a company listed on the Kuwait Stock Exchange. The listed price of the Bank's investment in URC as of 31 December 2006 based on the last bid price of URC was US\$ 147.9 million (2005: US\$ 201.9 million).
- c), i), l), o) & p) These companies are owned through the Bank's subsidiary KAMCO, and are all incorporated in the State of Kuwait.

9 LOANS AND MURABAHA PAYABLE

| | Currency | Total 2006 US\$ 000 | Total 2005 US\$ 000 |
|--|----------|---------------------------|---------------------------|
| Commodity Murabaha due on October 2008 | US\$ | 175,000 | 175,000 |
| Loan due on 9 December 2007 | US\$ | 65,000 | 65,000 |
| Loan due on 22 December 2008 | US\$ | 20,000 | - |
| Loan due on 30 June 2009 (note 9.1) | KWD | 51,886 | 51,387 |
| Loan due on 30 June 2009 (note 9.1) | US\$ | 13,002 | 13,004 |
| Loan due on 20 September 2007 (note 9.1) | KWD | 13,837 | - |
| Loan due on 20 September 2009 (note 9.1) | KWD | 27,674 | - |
| Loan due on 4 January 2006 (note 9.1) | KWD | - | 3,436 |
| | | 366,399 | 307,827 |

The effective cost of borrowing on the above facilities is between 3.54% - 8.0% (2005: 3.54% - 7.25%).

9.1 These loans relate to the Bank's subsidiary KAMCO.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

10 OTHER LIABILITIES

| | 2006 US\$ 000 | 2005 US\$ 000 |
|-------------------------------------|------------------|------------------|
| Due to customers and other payables | 22,069 | 20,216 |
| Accrued expenses | 10,164 | 8,312 |
| Staff related payables | 8,288 | 9,879 |
| Interest payable | 9,452 | 6,337 |
| Dividend payable | 1,407 | 848 |
| Provision for guarantees | 758 | 902 |
| | 52,138 | 46,494 |

11 BONDS

| | 2006 US\$ 000 | 2005 US\$ 000 |
|--|------------------|------------------|
| Bonds - issued by the Bank (note 11.1) | 54,990 | 55,033 |
| Bonds - issued by a subsidiary (note 11.2) | 69,183 | 68,517 |
| | 124,173 | 123,550 |

- 11.1 On 30 September 2003, the Bank issued floating rate bonds amounting to US\$ 60 million for a term of 3 years extendable for a further term of 2 years (maximum of 5 years). For the first 3 years bonds carried interest at the rate of 1.0% per annum above the London Inter Bank Offered Rate (LIBOR) for 3 month U.S. dollar deposits. During the year, these bonds have been extended for a further period of 2 years and carry interest at the rate of 1.25% per annum above LIBOR for 3 month U.S. dollar deposits. The above bonds exclude bonds amounting to US\$ 5 million (2005: US\$ 4.967 million) held by a subsidiary, which have been eliminated on consolidation.
- 11.2 On 21 June 2004, the Bank's subsidiary KAMCO issued floating rate bonds of KWD 10 million and fixed rate bonds of KWD 10 million each for a term of 5 years. The floating rate bonds carry interest at the rate of 1.5% per annum above the Kuwait Inter Bank Offered Rate (KIBOR) for 3 month deposits and the fixed rate bonds carry interest at the rate of 5.5% per annum.

12 SUBORDINATED DEBT

On 13 October 2006, the Bank issued floating rate notes amounting to US\$ 100 million for a term of 10 years maturing on 12 October 2016. For the first 5 years the notes carry interest at the rate of 1.8% per annum above the LIBOR for 3 month U.S. dollar deposits and after 13 October 2011 the notes will carry interest at the rate of 2.7% per annum above LIBOR for 3 month U.S. dollar deposits. The notes carry a call option exercisable by the Bank after 5 years from the date of issue.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

13 EQUITY

Share capital

The authorised share capital as of 31 December 2006 comprised 1 billion shares of US\$ 0.25 each (2005: 1 billion shares of US\$ 0.25 each).

The issued and fully paid up share capital as of 31 December 2006 comprised 802,104,874 shares of US\$ 0.25 each (2005: 800,455,063 shares of US\$ 0.25 each). The increase is due to exercise of shares by employees under the employee share option plan and sale of treasury shares.

Share premium

Share premium represents a non-distributable reserve arising from the issue of the Bank's stock options. The reserve is credited with the difference between the proceeds from the exercise of share options and the par value of shares issued.

Treasury shares and treasury shares reserve

At the end of the year the Bank held 875,302 shares (2005: 30.95 million shares). These do not carry any voting rights and are not entitled to dividends. The value of treasury shares based on the last bid price as of 31 December 2006 is US\$ 0.9 million (2005: US\$ 35.3 million). During the year, the Bank has sold 30,080,000 shares at a profit which has been taken to treasury shares reserve.

Statutory reserve

In accordance with the Bahrain Commercial Companies Law and the Bank's Articles of Association, 10% of the income for the year is transferred to a statutory reserve until such time as the reserve reaches 50% of the Bank's paid-up share capital. The reserve is not available for distribution, except in circumstances as stipulated in the Bahrain Commercial Companies Law and following the approval of the CBB.

General reserve

The directors have approved a transfer of 10% of the net profit of the Bank for the year to general reserve in accordance with the Bank's Articles of Association. The general reserve is distributable subject to the approval of the CBB.

Foreign currency translation reserve

The foreign currency translation adjustment represents the net foreign exchange gain (loss) arising from translating the financial statements of the Bank's foreign subsidiaries and associated companies from their functional currencies into United States Dollars.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

14 FAIR VALUE RESERVE

| | 2006 US\$ 000 | 2005 US\$ 000 |
|--|------------------|------------------|
| Available for sale investments | | |
| Balance at 1 January | 36,805 | 9,175 |
| Transferred to income statement on sale | (10,617) | (1,731) |
| Net movement in fair value during the year | 42,749 | 29,361 |
| Balance at 31 December | 68,937 | 36,805 |
| Cash flow hedge | | |
| Balance at 1 January | 2,375 | 535 |
| (Decrease) increase in fair value | (78) | 1,840 |
| Balance at 31 December | 2,297 | 2,375 |
| | 71,234 | 39,180 |

15 INVESTMENT INCOME

| | 2006 US\$ 000 | 2005 US\$ 000 |
|---|------------------|------------------|
| Gain on investments carried at fair value through statement of income | 35,055 | 28,625 |
| Dividend income | 11,214 | 22,311 |
| Gain on sale of non-trading investments | 25,698 | 21,889 |
| Gain on sale of associated companies | 21,524 | 4,149 |
| Rental income from investment properties | 1,113 | 982 |
| Changes in fair value of investments properties (note 6) | 1,361 | 308 |
| Gain on sale of investment properties | 1,086 | - |
| Others | (566) | (51) |
| | 96,485 | 78,213 |

16 SHARE OF RESULTS OF ASSOCIATED COMPANIES

| | 2006 US\$ 000 | 2005 US\$ 000 |
|---|------------------|------------------|
| Jordan Kuwait Bank | 24,312 | 15,916 |
| United Real Estate Company | 11,860 | 14,680 |
| United Industries Company | 10,369 | 19,505 |
| United Medical Services Company | 4,468 | 1,688 |
| Manafae Investment Company | 777 | - |
| Gulf Egypt for Hotels and Tourism Company | - | 751 |
| Salem Al-Marzouk & Sabah Abi Hana | 470 | 21 |
| United Cable Company | (500) | (2,700) |
| Bank of Baghdad | 1,852 | (59) |
| United Warehousing and Cooling | (60) | (235) |
| | 53,548 | 49,567 |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

17 EARNINGS PER SHARE

Basic

Basic earnings per share is calculated by dividing the income attributable to equity of the parent by the weighted average number of shares outstanding during the year as follows:

| | 2006 US\$ 000 | 2005 US\$ 000 |
|--|------------------|------------------|
| Income attributable to equity of the parent | 101,468 | 81,003 |
| Weighted average number of shares outstanding during the year for the purpose of basic earnings per share (in thousands) | 792,013 | 768,346 |
| Basic earnings per share | US cents 12.81 | 10.54 |

Diluted

Diluted earnings per share is calculated by dividing the income attributable to the equity of the parent, adjusted for the effect of conversion, by the weighted average number of ordinary shares outstanding during the year plus the weighted average number of ordinary shares that would be issued on the conversion of all dilutive potential ordinary shares into ordinary shares. The Bank has outstanding share options, issued under the Employee Stock Option Plan which have dilutive effect on earnings.

| | 2006 US\$ 000 | 2005 US\$ 000 |
|--|------------------|------------------|
| Income attributable to equity holders of the parent | 101,468 | 81,003 |
| Decrease in income due to exercise of potential ordinary shares of a subsidiary | (221) | (312) |
| Earnings for the purpose of diluted earnings per share | 101,247 | 80,691 |
| Weighted average number of shares outstanding during the year for the purpose of basic earnings per share (in thousands) | 792,013 | 768,346 |
| Effect of dilutive potential ordinary shares: | | |
| Share options | 5,455 | 3,937 |
| Diluted earnings per share | US cents 12.70 | 10.45 |

18 FUNDS UNDER MANAGEMENT

The Group holds assets amounting to US\$ 6.47 billion (2005: US\$ 5.7 billion) under its management on behalf of third parties. As these are third party funds managed in a fiduciary capacity, without risk or recourse to the Group, these are not included in the assets on the consolidated balance sheet.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

19 CASH AND CASH EQUIVALENTS

| | 2006 US\$ 000 | 2005 US\$ 000 |
|--|------------------|------------------|
| Demand and call deposits with banks | 47,020 | 24,441 |
| Time deposits with maturities of ninety days or less | 435,222 | 324,907 |
| | 482,242 | 349,348 |

20 SEGMENTAL INFORMATION

Primary segment information

For management reporting purposes the Group is organised into two major business segments:

- Investment banking - Principally undertaking, asset portfolio management, corporate finance, advisory, investments in quoted and private equity/funds, real estate, capital markets, international banking and treasury activities.
- Commercial banking - Principally loans and other credit facilities, deposit and current accounts from corporate and institutional customers.

Segmental information for the year ended **31 December 2006** was as follows:

| | Investment banking US\$ 000 | Commercial banking US\$ 000 | Total US\$ 000 |
|--|-----------------------------------|-----------------------------------|-------------------|
| Total income | 205,644 | 36,186 | 241,830 |
| Segment result before provisions | 104,329 | 18,063 | 122,392 |
| Provision/(write back) for doubtful loans and guarantees | 283 | (2,635) | (2,352) |
| Segment result | 104,612 | 15,428 | 120,040 |
| Income attributable to equity holders of the parent | | | 101,468 |
| Income attributable to minority interests | | | 18,572 |
| | | | 120,040 |
| OTHER INFORMATION | | | |
| Segment assets | 1,873,729 | 477,005 | 2,350,734 |
| Segment liabilities | 1,297,876 | 460,007 | 1,757,883 |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

Segmental information for the year ended 31 December 2005 was as follows:

| | Investment banking US\$ 000 | Commercial banking US\$ 000 | Total US\$ 000 |
|---|-----------------------------------|-----------------------------------|-------------------|
| Total income | 175,072 | 23,697 | 198,769 |
| Segment result before provisions and amortisation | 106,660 | 10,461 | 117,121 |
| Provision for non-trading investments | (8,042) | - | (8,042) |
| Provision for doubtful loans and guarantees | (978) | (533) | (1,511) |
| Segment result | 97,640 | 9,928 | 107,568 |

| | |
|---|---------|
| Income attributable to equity holders of the parent before directors' remuneration and donations | 81,003 |
| Income attributable to minority interests | 26,565 |
| | 107,568 |

OTHER INFORMATION

| | | | |
|---------------------|-----------|---------|-----------|
| Segment assets | 1,345,667 | 341,259 | 1,686,926 |
| Segment liabilities | 890,673 | 324,112 | 1,214,785 |

Secondary segment information

Geographic

| | Middle East/ Africa US\$ 000 | Europe US\$ 000 | North America US\$ 000 | Asia US\$ 000 | Total US\$ 000 |
|-------------------------|------------------------------------|--------------------|---------------------------|------------------|-------------------|
| 31 December 2006 | | | | | |
| Total income | 212,473 | 21,295 | 6,711 | 1,351 | 241,830 |
| Total assets | 1,873,663 | 282,928 | 192,443 | 1,700 | 2,350,734 |
| Total liabilities | 1,450,264 | 275,604 | 7,015 | 25,000 | 1,757,883 |
| 31 December 2005 | | | | | |
| Total income | 186,055 | 8,093 | 5,110 | (489) | 198,769 |
| Total assets | 1,346,167 | 177,627 | 159,079 | 4,053 | 1,686,926 |
| Total liabilities | 956,967 | 224,361 | 8,457 | 25,000 | 1,214,785 |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

21 RELATED PARTY TRANSACTIONS

The Group enters into transactions with its parent, major shareholders, associated companies, directors, senior management and entities which are either controlled or significantly influenced by any of the above mentioned parties.

The income and expenses in respect of related parties transacted at commercial terms and included in the consolidated financial statements are as follows:

| | Major shareholders US\$ 000 | Associates US\$ 000 | Others US\$ 000 | Total 2006 US\$ 000 | Total 2005 US\$ 000 |
|--|-----------------------------------|------------------------|--------------------|---------------------------|---------------------------|
| Gain on investment carried at fair value through statement of income | 261 | 43 | 3,573 | 3,877 | 536 |
| Gain on sale of investment in associated companies | 1,068 | 7,376 | - | 8,444 | - |
| Fees and commissions | 5,435 | 1,795 | 2,522 | 9,752 | 18,281 |
| Dividend income | 1,229 | - | 484 | 1,713 | 15,241 |
| Interest income | 2,447 | 183 | 1,721 | 4,351 | 4,122 |
| Other income | 7 | 95 | 1,166 | 1,268 | 2,288 |
| Interest expense | (6,062) | (896) | (288) | (7,246) | (6,383) |

Compensation of the key management personnel and directors' remuneration are as follows:

| | 2006 US\$ 000 | 2005 US\$ 000 |
|------------------------------|------------------|------------------|
| Short term employee benefits | 8,833 | 7,582 |
| Share based payments | 655 | 577 |
| Total compensation | 9,488 | 8,159 |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

The year-end balances in respect of related parties included in the consolidated financial statements are as follows:

| | Major shareholders US\$ 000 | Associates US\$ 000 | Others US\$ 000 | Total 2006 US\$ 000 | Total 2005 US\$ 000 |
|---|-----------------------------------|------------------------|--------------------|---------------------------|---------------------------|
| Demand and call deposits with banks | 5,734 | 234 | - | 5,968 | 7,921 |
| Time deposits with banks | - | - | - | - | 10,000 |
| Investments carried at fair value through statement of income | 14,429 | 2,107 | 30,718 | 47,254 | 11,879 |
| Investments carried at fair value through statement of income in funds managed by related party | - | - | 91,796 | 91,796 | 32,801 |
| Non-trading investments | 11,670 | 1,393 | 163,019 | 176,082 | 104,963 |
| Loans and advances | - | - | 94,558 | 94,558 | 21,774 |
| Other assets | 2,118 | 5,714 | 8,070 | 15,902 | 7,027 |
| Due to banks and other financial institutions | 15,085 | 20,905 | - | 35,990 | 18,865 |
| Deposits from customers | 49,469 | 122 | 8,294 | 57,885 | 18,828 |
| Loans taken by a subsidiary (KAMCO) | 64,889 | - | - | 64,889 | 67,827 |
| Murabaha payable | 20,000 | - | - | 20,000 | 20,000 |
| Other liabilities | 1,115 | 113 | 2,652 | 3,880 | 3,631 |
| Letters of credit | - | - | 27,448 | 27,448 | 16,537 |
| Guarantees | - | 8,531 | - | 8,531 | 24,421 |

Investments in funds managed or advised by the Group at 31 December 2006 amounts to US\$ 147.6 million (2005: US\$ 121.6 million).

All related party exposures are performing and are free of any provision for possible credit losses.

In addition to the above, other transactions with related parties included in the consolidated financial statements are as follows:

| | 2006 US\$ 000 | 2005 US\$ 000 |
|---|------------------|------------------|
| Unlisted shares purchased from the Bank's parent company | - | 27,469 |
| Carrying value of associate sold to an associated company | 40,308 | - |

22 OFF BALANCE SHEET ITEMS

Credit-related commitments

Credit-related commitments include commitments to extend credit, standby letters of credit, guarantees and acceptances which are designed to meet the requirements of the customers.

Letters of credit, guarantees (including standby letters of credit) and acceptances commit the Group to make payments on behalf of customers if certain conditions are made under the terms of the contract.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

22 OFF BALANCE SHEET ITEMS (continued)

Commitments to extend credit represents contractual commitments to make loans and revolving credits. Commitments generally have fixed expiration dates, or other termination clauses. Since commitments may expire without being drawn upon, the total contract amounts do not necessarily represent future cash requirements.

The Group has the following credit and investment related commitments:

| | 2006 US\$ 000 | 2005 US\$ 000 |
|--------------------|------------------|------------------|
| Credit related | | |
| Letters of credit | 26,378 | 30,996 |
| Guarantees | 109,966 | 116,158 |
| | 136,344 | 147,154 |
| Investment related | 36,403 | 46,894 |
| | 172,747 | 194,048 |

The Group does not anticipate any material losses in respect of the above.

Other off balance sheet financial instruments

It is the policy of the Group not to engage in derivatives trading or market-making activities. The main off balance sheet financial instruments used to cover foreign exchange risks are forward foreign exchange purchases and sales contracts. The Group has undertaken certain forward foreign exchange transactions and interest rate swap for hedging purposes but as these do not qualify for hedge accounting, these are classified as derivatives held for trading.

| | Positive fair value US\$ 000 | Negative fair value US\$ 000 | Notional amount Total US\$ 000 | Notional amounts by term to maturity | | | |
|---------------------------------------|------------------------------------|------------------------------------|---|--------------------------------------|------------------------------|----------------------------|-----------------------------|
| | | | | Within 3 months US\$ 000 | 3 - 12 months US\$ 000 | 1 - 5 years US\$ 000 | Over 5 years US\$ 000 |
| 31 December 2006 | | | | | | | |
| <i>Derivatives held for trading:</i> | | | | | | | |
| Forward foreign exchange contracts | 36 | (116) | 314,936 | 314,936 | - | - | - |
| <i>Derivatives held for hedging:</i> | | | | | | | |
| Interest rate swap | 2,297 | - | 75,000 | - | - | 75,000 | - |
| 31 December 2005 | | | | | | | |
| <i>Derivatives held for trading:</i> | | | | | | | |
| Forward foreign exchange contracts | 147 | (132) | 235,133 | 235,133 | - | - | - |
| <i>Derivatives held for hedging:</i> | | | | | | | |
| Interest rate swap | 2,375 | - | 75,000 | - | - | 75,000 | - |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

Forward foreign exchange contracts are contractual agreements to either buy or sell a specified currency, at a specific price and date in the future, and are customised contracts transacted in the over-the-counter market.

Swaps are contractual agreements between two parties to exchange interest or foreign currency differentials based on a specific notional amount. For interest rate swaps, counterparties generally exchange fixed and floating rate interest payments based on a notional value in a single currency.

23 CREDIT RISK

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss. The Group manages credit risk by setting limits for individual counterparties, and groups of counterparties and for geographical and industry segments. The Group also monitors credit exposures, and continually assesses the creditworthiness of counterparties. In addition, the Group obtains security where appropriate, enters into master netting agreements and collateral arrangements with counterparties, and limits the duration of exposures.

For details of the composition of the assets by geographic segment refer to note 20.

Credit risk in respect of derivative financial instruments is limited to those with positive fair values.

24 CONCENTRATIONS

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Group's performance to developments affecting a particular industry or geographic location.

The distribution of assets and liabilities by geographic region is disclosed in note 20.

25 MARKET RISK

Market risk is defined as the risk of loss in the value of on or off balance sheet financial instruments caused by a change in market prices, including changes in interest rates, foreign exchange rates and equity prices. The Group's market risk calculations derives its basis from the rules and guidelines provided by the CBB.

These guidelines have introduced a risk measurement framework whereby all locally incorporated banks in Bahrain are required to measure and apply capital charges in respect of their market risk in addition to credit risk capital requirement.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

25 MARKET RISK (continued)

The market risk subject to capital charge normally arises from change in value due to market forces in the following exposures:

- Price risk on equities;
- Interest rate instruments and securities in the trading book; and
- Foreign exchange and commodities in the banking book.

The Group does not trade in commodities and derivatives. Thus the Group's market risk capital adequacy requirements cover:

- 1) The securities trading book; and
- 2) The foreign exchange book.

For the measurement of its market risk, the Group has adopted the standardised approach. The capital charge under this approach is the arithmetical sum of the risk measures obtained from the measurement framework.

The Credit and Risk Management Department is responsible for verifying the Group's daily compliance with capital charges for market risk. Should the Group or the Bank fail to meet the minimum regulatory capital requirement for market risk, this is reported to the Board of Directors and the CBB.

26 INTEREST RATE RISK

Interest rate risk arises from the possibility that changes in interest rates will affect future profitability or the fair values of financial instruments. The Group is exposed to interest rate risk as a result of mismatches of interest rate repricing of assets and liabilities. Besides other functions, the Asset-Liability Committee evaluates the balance sheet both from a liquidity and an interest rate sensitivity point of view.

Positions are monitored on a daily basis and hedging strategies used to ensure positions are maintained within established limits.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

The Group's interest sensitivity position is based on maturity dates and contractual repricing arrangements whichever is earlier. As at **31 December 2006** it was as follows:

| | Up to 3 months US\$ 000 | 3 months to 1 year US\$ 000 | Over 1 year US\$ 000 | Non-interest bearing items US\$ 000 | Total US\$ 000 |
|--|-------------------------------|-----------------------------------|----------------------------|--|-------------------|
| Demand and call deposits with banks | 46,239 | - | 53 | 781 | 47,073 |
| Time deposits with banks | 435,222 | 24,072 | - | - | 459,294 |
| Investments carried at fair value through statement of income | 1,432 | - | - | 342,569 | 344,001 |
| Non-trading investments | 25,184 | - | 3,518 | 497,750 | 526,452 |
| Loans and advances | 90,697 | 137,190 | 80,163 | 230 | 308,280 |
| Investment properties | - | - | - | 17,649 | 17,649 |
| Other assets | - | - | - | 50,329 | 50,329 |
| Investments in associated companies | - | - | - | 579,910 | 579,910 |
| Property and equipment | - | - | - | 6,971 | 6,971 |
| Goodwill | - | - | - | 10,775 | 10,775 |
| Total assets | 598,774 | 161,262 | 83,734 | 1,506,964 | 2,350,734 |
| Due to banks and other financial institutions | 496,142 | 225,554 | - | 1,825 | 723,521 |
| Deposits from customers | 373,606 | 7,113 | - | 10,933 | 391,652 |
| Loans and murabaha payable | 240,000 | 126,399 | - | - | 366,399 |
| Other liabilities | - | - | - | 52,138 | 52,138 |
| Bonds | 60,000 | 64,173 | - | - | 124,173 |
| Subordinated debt | 100,000 | - | - | - | 100,000 |
| Equity attributable to shareholders of the parent | - | - | - | 489,161 | 489,161 |
| Minority interests | - | - | - | 103,690 | 103,690 |
| Total liabilities and equity | 1,269,748 | 423,239 | - | 657,747 | 2,350,734 |
| On balance sheet gap | (670,974) | (261,977) | 83,734 | | |
| Off balance sheet gap | 75,000 | - | (75,000) | | |
| Total interest rate sensitivity gap | (595,974) | (261,977) | 8,734 | | |
| Cumulative interest rate sensitivity gap | (595,974) | (857,951) | (849,217) | | |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

26 INTEREST RATE RISK (continued)

The Group's interest sensitivity position is based on maturity dates and contractual repricing arrangements.

As at 31 December 2005 it was as follows:

| | Up to 3 months US\$ 000 | 3 months to 1 year US\$ 000 | Over 1 year US\$ 000 | Non-interest bearing items US\$ 000 | Total US\$ 000 |
|--|-------------------------------|-----------------------------------|----------------------------|--|-------------------|
| Demand and call deposits with banks | 22,144 | - | 53 | 2,297 | 24,494 |
| Time deposits with banks | 324,907 | 32,802 | - | - | 357,709 |
| Investments carried at fair value through statement of income | 27 | - | - | 191,326 | 191,353 |
| Non-trading investments | 21,394 | - | 5,173 | 422,615 | 449,182 |
| Loans and advances | 81,364 | 57,335 | 38,157 | 2,033 | 178,889 |
| Investment properties | - | - | - | 14,519 | 14,519 |
| Other assets | - | 978 | - | 58,256 | 59,234 |
| Investments in associated companies | - | - | - | 395,371 | 395,371 |
| Property and equipment | - | - | - | 5,503 | 5,503 |
| Goodwill | - | - | - | 10,672 | 10,672 |
| Total assets | 449,836 | 91,115 | 43,383 | 1,102,592 | 1,686,926 |
| Due to banks and other financial institutions | 448,844 | 53,310 | - | - | 502,154 |
| Deposits from customers | 178,635 | 20,478 | - | 35,647 | 234,760 |
| Loans and murabaha payable | 307,827 | - | - | - | 307,827 |
| Other liabilities | - | - | - | 46,494 | 46,494 |
| Bonds | 60,000 | 63,550 | - | - | 123,550 |
| Equity attributable to shareholders of the parent | - | - | - | 376,338 | 376,338 |
| Minority interests | - | - | - | 95,803 | 95,803 |
| Total liabilities and equity | 995,306 | 137,338 | - | 554,282 | 1,686,926 |
| On balance sheet gap | (545,470) | (46,223) | 43,383 | | |
| Off balance sheet gap | 75,000 | - | (75,000) | | |
| Total interest rate sensitivity gap | (470,470) | (46,223) | (31,617) | | |
| Cumulative interest rate sensitivity gap | (470,470) | (516,693) | (548,310) | | |

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

Currency wise interest rates are as follows:

| | 2006 % | 2005 % |
|-----------------------------|-------------|-----------|
| United States Dollar | | |
| Assets | 3.25-9.50 | 3.25-9.50 |
| Liabilities | 0.00-6.3875 | 0.00-6.50 |
| Euro | | |
| Assets | 2.50-7.50 | 2.16-6.74 |
| Liabilities | 2.00-4.30 | 1.25-2.96 |
| Kuwaiti Dinar | | |
| Assets | 0.00-8.50 | 0.00-7.00 |
| Liabilities | 0.00-8.00 | 0.00-7.25 |
| Pound Sterling | | |
| Assets | 5.20-5.8525 | 4.50-5.85 |
| Liabilities | 0.00-4.75 | 1.72-4.25 |

27 CURRENCY RISK

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Group considers United States Dollar as its functional currency. Positions are monitored on a daily basis and hedging strategies used to ensure positions are maintained within established limits.

The Group had the following significant net exposures denominated in foreign currencies as of 31 December:

| | equivalent long/(short) position 2006 US\$ 000 | equivalent long/(short) position 2005 US\$ 000 |
|-----------------|--|--|
| Bahraini Dinar | 27,469 | 31,997 |
| Jordanian Dinar | 139,002 | 72,252 |
| Kuwaiti Dinar | 572,837 | 464,888 |
| UAE Dirham | 3,583 | 11,028 |
| Euro | 30,074 | 36,024 |
| Algerian Dinar | 39,241 | 20,949 |
| Iraqi Dinar | 17,977 | 16,232 |
| Others | 4,013 | 5,480 |

The Group does not consider GCC currencies as foreign currency exposure since they are pegged to United States Dollar.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

28 EQUITY PRICE RISK

Equity price risk arises from the change in fair values of equity investments. The Bank manages this risk through diversification of investments in terms of geographical distribution and industry concentration. The majority of the Bank's investments are quoted.

29 LIQUIDITY RISK

In order to ensure that the Group can meet its financial obligations as they fall due, there is a close monitoring of its assets/liabilities position. Besides other functions, the Asset-Liability Committee evaluates the balance sheet both from a liquidity and an interest rate sensitivity point of view. The whole process is aimed at ensuring sufficient liquidity to fund its ongoing business activities and to meet its obligations as they fall due. A diversified funding base has evolved in deposits raised from the interbank market, deposits received from customers and medium term funds raised through syndicated and commodity based murabaha transactions. These, together with the strength of its equity and the asset quality, substantial excess value over cost of its investments in listed subsidiaries and associated companies, ensure that funds are made available at competitive rates.

The table over summarises the maturity profile of the Group's assets and liabilities based on contractual repayment arrangements. The contractual maturities of assets and liabilities have been determined on the basis of the remaining period at the balance sheet date to the contractual maturity date and do not take account of the effective maturities as indicated by the Group's deposit retention history. The maturity periods for investments are based on expected exit dates.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

The maturity profile of the assets and liabilities at **31 December 2006** was as follows:

| | Up to 3 months US\$ 000 | 3 months to 1 year US\$ 000 | 1 to 5 years US\$ 000 | Over 5 years US\$ 000 | Undated US\$ 000 | Total US\$ 000 |
|---|-------------------------------|-----------------------------------|-----------------------------|-----------------------------|---------------------|-------------------|
| Demand and call deposits with banks | 47,020 | - | - | 53 | - | 47,073 |
| Time deposits with banks | 435,222 | 24,015 | 57 | - | - | 459,294 |
| Investments carried at fair value through statement of income | 344,001 | - | - | - | - | 344,001 |
| Non-trading investments | 96,496 | 3,365 | 9,827 | - | 416,764 | 526,452 |
| Loans and advances | 90,697 | 144,805 | 72,549 | 229 | - | 308,280 |
| Investment properties | - | - | - | - | 17,649 | 17,649 |
| Other assets | 22,872 | 20,931 | 1,269 | - | 5,257 | 50,329 |
| Investments in associated companies * | - | - | - | - | 579,910 | 579,910 |
| Property and equipment | - | - | - | - | 6,971 | 6,971 |
| Goodwill | - | - | - | - | 10,775 | 10,775 |
| Total assets | 1,036,308 | 193,116 | 83,702 | 282 | 1,037,326 | 2,350,734 |
| Due to banks and other financial institutions | 486,738 | 177,543 | 59,240 | - | - | 723,521 |
| Deposits from customers | 363,419 | 13,258 | 14,975 | - | - | 391,652 |
| Loans and murabaha payable | - | 79,837 | 286,562 | - | - | 366,399 |
| Other liabilities | 22,752 | 21,097 | 8,289 | - | - | 52,138 |
| Bonds | - | - | 124,173 | - | - | 124,173 |
| Subordinated debt | - | - | - | 100,000 | - | 100,000 |
| Equity attributable to shareholders of the parent | - | - | - | - | 489,161 | 489,161 |
| Minority interests | - | - | - | - | 103,690 | 103,690 |
| Total liabilities and equity | 872,909 | 291,735 | 493,239 | 100,000 | 592,851 | 2,350,734 |
| Liquidity gap | 163,399 | (98,619) | (409,537) | (99,718) | 444,475 | - |
| Cumulative liquidity gap | 163,399 | 64,780 | (344,757) | (444,475) | - | - |

* Includes quoted securities of US\$ 410.1 million.

Consolidated Statement of Income

For the year ended 31 December 2006

29 LIQUIDITY RISK (continued)

The maturity profile of the assets and liabilities at 31 December 2005 was as follows:

| | Up to 3 months US\$ 000 | 3 months to 1 year US\$ 000 | 1 to 5 years US\$ 000 | Over 5 years US\$ 000 | Undated US\$ 000 | Total US\$ 000 |
|---|-------------------------------|-----------------------------------|-----------------------------|-----------------------------|---------------------|-------------------|
| Demand and call deposits | | | | | | |
| with banks | 24,441 | - | - | 53 | - | 24,494 |
| Time deposits with banks | 324,907 | 28,888 | 3,914 | - | - | 357,709 |
| Investments carried at fair value through statement of income | 191,353 | - | - | - | - | 191,353 |
| Non-trading investments | 72,142 | 989 | 9,402 | 2,000 | 364,649 | 449,182 |
| Loans and advances | 93,441 | 43,391 | 40,791 | 1,266 | - | 178,889 |
| Investment properties | - | - | - | - | 14,519 | 14,519 |
| Other assets | 48,332 | 4,711 | 6,191 | - | - | 59,234 |
| Investments in associated companies * | - | - | - | - | 395,371 | 395,371 |
| Property and equipment | - | - | - | - | 5,503 | 5,503 |
| Goodwill | - | - | - | - | 10,672 | 10,672 |
| Total assets | 754,616 | 77,979 | 60,298 | 3,319 | 790,714 | 1,686,926 |
| Due to banks and other financial institutions | 388,800 | 113,354 | - | - | - | 502,154 |
| Deposits from customers | 205,920 | 28,840 | - | - | - | 234,760 |
| Loans and murabaha payable | 67,827 | - | 240,000 | - | - | 307,827 |
| Other liabilities | 35,243 | 3,009 | 8,242 | - | - | 46,494 |
| Bonds | - | - | 123,550 | - | - | 123,550 |
| Equity attributable to shareholders of the parent | - | - | - | - | 376,338 | 376,338 |
| Minority interests | - | - | - | - | 95,803 | 95,803 |
| Total liabilities and equity | 697,790 | 145,203 | 371,792 | - | 472,141 | 1,686,926 |
| Liquidity gap | 56,826 | (67,224) | (311,494) | 3,319 | 318,573 | - |
| Cumulative liquidity gap | 56,826 | (10,398) | (321,892) | (318,573) | - | - |

* Includes quoted securities of US\$ 308.9 million.

Notes to the Consolidated Financial Statements

For the year ended 31 December 2006

30 FAIR VALUE

Financial instruments

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable and willing parties in an arm's length transaction. Consequently, differences can arise between carrying values and fair value estimates.

As explained in note 4, included under non-trading investments are unquoted available for sale investments amounting to US\$ 118.7 million (2005: US\$ 39.1 million) for which fair value cannot be reliably determined. The fair values of other on balance sheet financial instruments are not significantly different from the carrying values included in the financial statements.

Investment in associated companies

| | 2006 US\$ 000 | 2005 US\$ 000 |
|--|------------------|------------------|
| Quoted investments at last bid price | 568,432 | 663,086 |
| Unquoted investments at cost plus share of post acquisition profits | 167,464 | 86,460 |
| | 735,896 | 749,546 |
| Investments carried at cost plus share of post acquisition profits | 579,910 | 395,371 |
| Excess of listed price over carrying value | 155,986 | 354,175 |
| KAMCO (consolidated subsidiary) - Excess of listed price over book value | 115,838 | 245,705 |

31 CAPITAL ADEQUACY

The risk asset ratio calculated in accordance with the capital adequacy guidelines issued by the CBB, for the Group is as follows:

| | 2006 US\$ 000 | 2005 US\$ 000 |
|----------------------------------|------------------|------------------|
| Capital base: | | |
| Tier 1 capital | 497,218 | 421,600 |
| Tier 2 capital | 139,820 | 20,800 |
| Total capital base (a) | 637,038 | 442,400 |
| Credit risk weighted exposure | 1,899,211 | 1,462,300 |
| Market risk weighted exposure | 349,048 | 251,300 |
| Total risk weighted exposure (b) | 2,248,259 | 1,713,600 |
| Capital adequacy (a/b * 100) | 28.3% | 25.8% |
| Minimum requirement | 12.0% | 12.0% |