

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 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 number 10550 and is 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).

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 and ultimate holding company is Kuwait Projects Company (Holding) K.S.C. (Closed) [KIPCO], a company incorporated in the State of Kuwait and listed on the Kuwait Stock Exchange. As at 31 December 2008 KIPCO owned 91.72% of the Bank's outstanding shares (2007: 88%).

These consolidated financial statements were authorised for issue by the Board of Directors on 25 February 2009.

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards and the relevant provisions of the Bahrain Commercial Companies Law and the Central Bank of Bahrain and Financial Institutions Law.

The consolidated financial statements have been presented in US Dollars being the functional currency of the Bank and rounded to the nearest US\$ thousands except when otherwise indicated.

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.

### Changes in accounting policy and disclosures

The accounting policies used in the preparation of these consolidated financial statements are consistent with those used in the previous year except that the Group has adopted the following new and amended IASB Standards and International Financial Reporting Interpretations Committee (IFRIC) Interpretations during the year.

The following IASB Standards and IFRIC Interpretations have been issued and adopted by the Group during the year:

Amendments to IAS 39:	Financial Instruments (Recognition and Measurement) and IFRS 7: Financial Instruments (Disclosures)
IFRIC 11:	IFRS 2 - Group and Treasury Share Transactions

### ***Amendments to IAS 39: Financial Instruments (Recognition and Measurement) and IFRS 7: Financial Instruments (Disclosures):***

On 13 October 2008, IASB approved and published amendments to IAS 39 and IFRS 7 to allow reclassifications of certain financial instruments held for trading to either held to maturity, loans and receivables or available-for-sale categories with effect from 1 July 2008. As a result, the Group adopted the amendments and reclassified certain financial assets held for trading with a carrying value of US\$ 19.1 million from the 'fair value through statement of income category to the 'available-for-sale' with effect from 1 July 2008 as these investments are no longer held for the purpose of selling or repurchasing in the near term.

The application of IFRIC 11 does not have material impact on the consolidated financial statements of the Group.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

Minority interests represent the portion of statement of income and net assets not owned, directly or indirectly, by the Bank and are presented separately in the consolidated statement of income and within equity in the consolidated balance sheet, separately from parent shareholders' equity. Acquisitions of minority interests are accounted for using the parent entity extension method, whereby, the difference between the consideration and the fair value of the share of the net assets acquired is recognised as goodwill. Any deficiency of the cost of acquisition below the fair values of the identifiable net assets acquired (i.e. a discount on acquisition) is recognised directly in the consolidated statement of income in the year of acquisition.

The principal subsidiaries of the Group are as follows:

Name of the subsidiary	Country of incorporation	Effective ownership as at 31 December 2008	Effective ownership as at 31 December 2007	Year of Incorporation
Algeria Gulf Bank *	Algeria	83%	83%	2003
KIPCO Asset Management Company (KAMCO)	Kuwait	75%	72%	1998
Tunis International Bank (TIB) *	Tunisia	77%	77%	1982
United Gulf Bank Securities Company	Bahrain	93%	92%	1998
United Gulf Financial Services Company	Qatar	90%	89%	2006
Hatoon Real Estate Company	Kuwait	98%	-	2008
Syria Gulf Investment Company	Syria	99%	-	2007
United Gulf Financial Services Company-North Africa	Tunisia	83%	-	2008

### Held through KAMCO

Al-Nuzoul Holding Company K.S.C. (Closed) (Formerly Al-Ahlia Arabian Markets Company K.S.C. (Closed))	Kuwait	60%	60%	2005
Al-Janah Holding Company K.S.C. (Closed) (Formerly First Arabian Markets Company K.S.C. (Closed))	Kuwait	60%	60%	2005
KAMCO Real Estate Company S.P.C.	Bahrain	100%	100%	2005
Advantage Management Consulting Company K.S.C. (Closed)	Kuwait	58%	58%	2005
Al Zad Real Estate W.L.L.	Kuwait	100%	100%	2007
Al Dhiyafa United Real Estate Company W.L.L.	Kuwait	100%	100%	2007
First North Africa Real Estate Co. W.L.L.	Kuwait	100%	100%	2007
Al Raya Real Estate Projects Company W.L.L.	Kuwait	100%	100%	2007
Orange Real Estate Co. W.L.L.	Kuwait	100%	-	2005

\*Classified as held for sale as at 31 December 2008. Refer to note 11 for details.

## **2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)**

### **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 the 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. Unrealised gains and losses resulting from transactions with an associate are eliminated to the extent of the Group's share in the associate.

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. Whenever the impairment requirements of IAS 36 indicate that investment in an associate may be impaired, the entire carrying amount of investment is tested by comparing its recoverable amount with its carrying value. The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use. Goodwill is included in the carrying amount of an investment in associate and, therefore, is not separately tested for impairment.

The reporting dates of the associate and the Group are identical and the associate's accounting policies conform to those used by the Group for like transactions and events in similar circumstances.

### **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 the 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 subsidiary, the attributable amount of goodwill is included in the determination of the profit or loss on disposal.

### **Non-current assets held for sale and discontinued operations**

Non-current assets and disposal group classified as held for sale are measured at the lower of carrying amount and fair value less cost to sell. Non current assets and disposal groups are classified as held for sale if their carrying amounts will be recovered through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the assets or disposal group is available for immediate sale in its present condition. Management must be committed to the sale, which should be expected to qualify for recognition as a completed sale within one year from the date of classification.

In the consolidated statement of income of the reporting period, and of the comparable period of the previous year, income and expenses from the discontinued operations are reported separate from income and expenses relating to continuing operations down to the level of profit after taxes, even when the Group retains a non-controlling interest in the subsidiary after the sale. The resulting profit or loss (after taxes) is reported separately in the consolidated statement of income.

### **Investments**

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

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

### Investments (continued)

#### *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 the 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.

#### *Investments held for trading*

All investments held for trading are recorded in the consolidated balance sheet at fair value and 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 investments held for trading are included in the consolidated statement of income. Dividends are included in dividend income. Interest income is recorded in "gain on investments held for trading".

#### *Investments designated at fair value through statement of income*

The Group classifies its investments in managed portfolios as investments designated at fair value through statement of income. These investments are recorded in the consolidated balance sheet at fair value. 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 based on net asset values which 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 or the market value of a comparable company.

#### *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.

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.

Dividends are included in dividend income. Interest income on the available-for-sale investments is recorded in interest income.

#### *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 including acquisition charges associated with the property.

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

### Investments Properties (continued)

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 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

The Bank makes use of derivative instruments to manage exposure to foreign currency risk and interest rate risk. In order to manage a particular risk, the Bank applies hedge accounting to transactions which meet the specified criteria.

At the inception of the hedging relationship, the Bank formally documents the relationship between the hedged item and the hedging instrument, including the nature of the risk, objective and strategy for undertaking the hedge and the method that will be used to assess the effectiveness of the hedging relationship.

Also at the inception of the hedge relationship, a formal assessment is undertaken to ensure the hedging instrument is expected to be highly effective in offsetting the designated risk in the hedged item. Hedges are formally assessed at each quarter. A hedge is regarded as highly effective if the changes in the fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated are expected to offset in a range of 80% to 125%.

Derivatives are stated at fair values and carried as assets when their fair value is positive and as liabilities when their fair value is negative.

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

#### *Fair value hedge*

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.

#### *Cash flow hedge*

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 the fair value reserve in the consolidated statement of changes in equity. The gain or loss relating to the ineffective portion is recognised in the consolidated statement of income.

#### *Hedge of net investment*

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment, are accounted for in a way similar to cash flow hedges. Gains or losses on the hedging instrument relating to the effective portion of the hedge are recognised directly in equity while any gains or losses relating to the ineffective portion are recognised in the consolidated statement of income. On the disposal of the foreign operation, the cumulative value of any such gains or losses recognised directly in equity is transferred to the consolidated statement of income.

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.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

### Property and equipment

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

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 amortised cost. Transaction costs are amortised over the period of the debt using the effective yield method.

### 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.

### Cash and cash equivalents

Cash and cash equivalents are cash, demand and call deposits and time deposits with original maturities up to ninety days.

### Fiduciary assets

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

### Dividends on ordinary shares

Dividends on ordinary shares are recognised as a liability and deducted from equity when they are approved by the Bank's shareholders. Dividends for the year that are approved after the balance sheet date are disclosed as an event after the 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.

### 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:

- (a) the right to receive cash flows from the asset have expired;
- (b) the Group 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
- (c) the Group 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 Group 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 Group's continuing involvement in the asset.

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

### Offsetting

Financial assets and financial liabilities are only offset and the net amount 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.

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

### 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 Group 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. National 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 Group 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. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated. Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganisation and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults. 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.

For non equity financial assets the carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the consolidated statement of income. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is increased or reduced by adjusting the allowance account. For available-for-sale equity investments no allowance account is used and subsequent increases are reflected as 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, without deduction for transaction cost. The fair value of investments in managed funds or similar investment vehicles, where available, are based on last published bid price.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

### Fair values (continued)

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

The consolidated financial statements have been presented in US Dollars being the functional and presentational currency of the Bank. Each entity in the Group determines its own functional currency and items included in the financial statements of each entity are measured using that functional currency.

Transactions in foreign currencies are initially recorded in the functional currency rate of exchange ruling at the date of transaction.

### Translation of foreign currency transactions

Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. Exchange differences arising on the retranslation of monetary items, are included in consolidated statement of income for the year. Non-monetary items measured at fair value in a foreign currency are retranslated using the exchange rates at the date when the fair value was determined. Exchange differences arising on the retranslation of non-monetary investments carried at fair value through the statement of income are included in the consolidated statement of income for the period. Exchange differences arising on the retranslation of available for sale equity 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.

On disposal of a foreign operation, the deferred cumulative amount in equity related to that particular foreign operations is recognised in the consolidated statement of income.

### Recognition of income and expenses

Interest income and related fees are recognised using the effective yield method, which is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or financial liability. The calculation takes into account all contractual terms of the financial instrument and includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective interest rate, but not future credit losses. The carrying amount of the financial asset or financial liability is adjusted if the Group revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate and the change in carrying amount is recorded as interest income or expense.

Commission income and other fees is 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.

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

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), which is subject to risks and rewards that are different from those of other segments.

### **Judgments**

In the process of applying the Group's accounting policies, management has made the following judgments, 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.

#### ***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 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 judgment.

#### ***Impairment of goodwill***

The Group determines whether goodwill is impaired at each reporting. 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.

#### ***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 judgment 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 judgment 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.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

### Estimation uncertainty (continued)

#### *Collective impairment provisions on loans and advances (continued)*

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.

## 3 FINANCIAL ASSETS AND LIABILITIES

The table below summarises the accounting classification of the Group's financial assets and financial liabilities:

	Held for trading US\$ 000	Designated at fairvalue US\$ 000	Available-for-sale US\$ 000	Amortised cost / Loans and receivable US\$ 000	Total US\$ 000
<b>31 December 2008</b>					
Demand and call deposits with banks	-	-	-	27,418	27,418
Time deposits with banks	-	-	-	79,103	79,103
Investments carried at fair value through statement of income	48,466	196,698	-	-	245,164
Non-trading investments	-	-	878,008	-	878,008
Loans and advances	-	-	-	7,770	7,770
Other assets	-	-	-	69,312	69,312
<b>Total financial assets</b>	<b>48,466</b>	<b>196,698</b>	<b>878,008</b>	<b>183,603</b>	<b>1,306,775</b>
Due to banks and other financial institutions	-	-	-	497,795	497,795
Deposits from customers	-	-	-	61,039	61,039
Loans and murabaha payable	-	-	-	588,070	588,070
Other liabilities	-	-	-	65,552	65,552
Bonds	-	-	-	71,630	71,630
Subordinated debt	-	-	-	100,000	100,000
<b>Total financial liabilities</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,384,086</b>	<b>1,384,086</b>

# Notes to the Consolidated Financial Statements

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31 December 2007	Held for trading US\$ 000	Designated at fair value US\$ 000	Available - for - sale US\$ 000	Amortised cost / Loans and receivable US\$ 000	Total US\$ 000
Demand and call deposits with banks	-	-	-	79,613	79,613
Time deposits with banks	-	-	-	459,923	459,923
Investments carried at fair value through statement of income	89,624	266,845	-	-	356,469
Non-trading investments	-	-	565,167	-	565,167
Loans and advances	-	-	-	291,866	291,866
Other assets	-	-	-	64,349	64,349
<b>Total financial assets</b>	<b>89,624</b>	<b>266,845</b>	<b>565,167</b>	<b>895,751</b>	<b>1,817,387</b>
Due to banks and other financial institutions	-	-	-	586,683	586,683
Deposits from customers	-	-	-	438,112	438,112
Loans and murabaha payable	-	-	-	577,549	577,549
Other liabilities	-	-	-	88,215	88,215
Bonds	-	-	-	72,336	72,336
Subordinated debt	-	-	-	100,000	100,000
<b>Total financial liabilities</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,862,895</b>	<b>1,862,895</b>

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 4 INVESTMENTS CARRIED AT FAIR VALUE THROUGH STATEMENT OF INCOME

	2008 US\$ 000	2007 US\$ 000
<b>Investments held for trading</b>		
Quoted equities	48,466	89,624
<b>Investments designated at fair value through statement of income</b>		
Managed funds	196,698	266,845
	<b>245,164</b>	<b>356,469</b>

Managed funds primarily represent private equity 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 in Kuwait and international markets. Please refer to note 29.3 for geographical distribution.

## 5 NON-TRADING INVESTMENTS

Non trading investments comprise of available-for-sale investments as follows:

	2008 US\$ 000	2007 US\$ 000
<b>Quoted</b>		
Equities	88,317	130,353
Debt securities	-	17,497
	<b>88,317</b>	<b>147,850</b>
<b>Unquoted</b>		
Equities	198,693	179,994
Real estate managed funds	20,203	10,677
Other managed funds	210,816	225,181
Debt securities	359,979	1,465
	<b>789,691</b>	<b>417,317</b>
	<b>878,008</b>	<b>565,167</b>

In October 2008, the IASB issued "Reclassification of Financial Assets: Amendments to IAS 39 - Recognition and Measurement and IFRS 7: Disclosures" which permits the reclassification of certain financial assets under such rare circumstances. The deterioration in the financial markets in the third quarter of 2008 has been viewed globally as a rare circumstances to have occurred in the financial sector. Accordingly, the Group has performed the following reclassification.

### *Financial assets classified into the "Available-for-sale" category from "Investments held for trading" category*

	2008 US\$ 000
Carrying value as at date of reclassification	19,082
Carrying value and fair value as at 31 December 2008	13,171
Net losses recognised in the consolidated statement of income upto the date of reclassification	(1,071)
Fair value losses recognised in the cumulative changes in available-for-sale reserve subsequent to reclassification	(3,757)

Investments in other managed funds primarily represents investment in fund of fund structure. The underlying investments of these funds are mainly private equity securities.

Included under unquoted equity investments are unquoted available for sale equity investments amounting to US\$ 161,726 thousand (2007: US\$ 164,993 thousand), 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. Managed funds are carried at their net asset value provided by the fund managers.

## 6 LOANS AND ADVANCES

	2008 US\$ 000	2007 US\$ 000
Commercial loans	10,499	268,892
Overdrafts	-	33,281
Staff loans	2,466	2,973
	12,965	305,146
Less: Provision for doubtful loans	(5,195)	(13,280)
	7,770	291,866

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

	Middle East/ Africa US\$ 000	Europe US\$ 000	Total 2008 US\$ 000	Total 2007 US\$ 000
Corporate businesses and others	12,965	-	12,965	230,947
Banks and financial institutions	-	-	-	74,199
	12,965	-	12,965	305,146
Less: Provision for doubtful loans	(5,195)	-	(5,195)	(13,280)
<b>31 December</b>	<b>7,770</b>	<b>-</b>	<b>7,770</b>	<b>291,866</b>
31 December 2007	287,866	4,000	-	291,866

The movements in provision for doubtful loans are as follows:

	2008 US\$ 000	2007 US\$ 000
At 1 January	13,280	6,486
Relating to assets held for sale	(8,940)	-
Charge for the year	1,000	3,877
Write backs	(891)	(636)
Other adjustments	746	3,553
<b>At 31 December</b>	<b>5,195</b>	<b>13,280</b>

	2008 US\$ 000	2007 US\$ 000
Individual impairment	4,169	8,080
Collective impairment	1,026	5,200
	5,195	13,280
Gross amount of loans, individually determined to be impaired, before deducting any individually assessed impairment allowance	4,169	8,135

The majority of the provision for doubtful loans relates to the commercial loans.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 7 INVESTMENT PROPERTIES

	2008 US\$ 000	2007 US\$ 000
Cost	23,210	25,362
Accumulated fair value adjustments	101	1,453
	<u>23,311</u>	<u>26,815</u>

The movements are as follows:

At 1 January	26,815	17,649
Additions	-	7,426
Disposals	(2,152)	(646)
Change in fair values (note 18)	(1,352)	2,386
<b>At 31 December</b>	<u>23,311</u>	<u>26,815</u>

Investment properties at 31 December consist of the following:

Buildings	15,638	16,109
Land	7,673	10,706
	<u>23,311</u>	<u>26,815</u>

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

## 8 OTHER ASSETS

	2008 US\$ 000	2007 US\$ 000
Accounts receivable	42,864	14,521
Due from customers	19,730	30,903
Prepayments	4,516	10,110
Interest receivable	152	3,451
Others	6,566	15,474
	<u>73,828</u>	<u>74,459</u>

Due from customers is stated net of provision of US\$ 9,682 thousand (2007: US\$ 9,644 thousand). The charge for the year amounted to US\$ 132 thousand (2007: US\$ 9,424 thousand).

## 9 INVESTMENTS IN ASSOCIATED COMPANIES

Investments in associated companies comprise the following:

	Activity	Carrying value 2008 US\$ 000	Ownership % 2008	Carrying value 2007 US\$ 000	Ownership % 2007
a)	Al-Dhiyfa Holding Company K.S.C. (closed)	49,130	27	50,110	27
b)	Arab Leadership Academy Company K.S.C.	-	20	550	25
c)	Al Sharq Financial Brokerage Company	21,274	20	-	-
d)	Bank of Baghdad *	-	-	58,714	45
e)	Dhow Development Company	-	20	399	20
f)	Jordan Kuwait Bank	-	-	156,788	44
g)	Kuwait Education Fund	6,722	31	6,808	31
h)	Kuwait Private Equity Opportunities Fund	17,748	45	20,910	45
i)	Millennium Finance Corporation	21,703	33	-	-
j)	Manafae Investment Company	25,558	26	24,857	27
k)	North Africa Holding Company	41,455	23	44,842	23
l)	Royal Capital Company P.S.C.	35,634	44	35,941	44
m)	Salem Al-Marzouk & Sabah Abi Hana	1,607	29	1,224	29
n)	Syria Gulf Bank	15,767	28	15,233	28
o)	Syrian Real Estate Development Company	108	40	-	-
p)	United Cable Company	13,364	28	13,494	28
q)	United Medical Services Company K.S.C. (Closed)	-	-	28,391	30
r)	United Real Estate Company Jordan	15,843	27	15,570	27
s)	United Industries Company	114,242	45	143,985	45
t)	United Health Care Company	64,178	20	-	-
u)	United Real Estate Company	181,122	30	171,820	35
v)	United Universal Real Estate Company	725	20	731	20
		626,180		790,367	

\* Classified as held for sale as at 31 December 2008. Please refer note 11 for further details.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 9 INVESTMENTS IN ASSOCIATED COMPANIES (continued)

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

	2008 US\$ 000	2007 US\$ 000
Total assets	3,433,478	5,685,867
Total liabilities	(1,508,992)	(3,705,682)
Net assets	1,924,486	1,980,185
Revenue	160,045	455,788
(Loss) profit for the year	(26,517)	306,426

- a) Al-Dhiyfa Holding Company K.S.C. (Closed) is a closed company incorporated in State of Kuwait during 2005. The Bank directly owns 16.6% (2007: 16.6%) of the associate and indirectly owns additional 10.17% (2007: 10.2%) interest through its subsidiaries KAMCO and TIB.
- c) Al Sharq Financial Brokerage Company is a closed company incorporated in State of Kuwait during 2005. The Bank directly owns 15% (2007: nil) of the associate and indirectly owns additional 4.6% (2007: nil) interest through its subsidiary KAMCO.
- d) Bank of Baghdad (BoB) is a bank incorporated in Iraq in 1992 and listed on the Iraq Stock Exchange. The Bank directly own 46% (2007: 45%) of the associate. During the year, the BoB has been classified as held for sale. Please refer to note 11 for discontinued operation.
- f) Jordan Kuwait Bank (JKB) is a bank incorporated in the Kingdom of Jordan in 1976 and listed on the Amman Stock Exchange. In July 2008, Bank has transferred the JKB ownership to Burgan Bank for US\$ 450 million on which Group has realised a gain of US\$ 284 million (before expenses).
- g) Kuwait Education Fund is a fund with a variable capital of KD 50 million. The Bank directly owns 14.6% (2007: 14.6%) of the associate and indirectly owns additional 16.6% (2007: 16.6%) interest through its subsidiary KAMCO.
- h) The Bank directly owns 15% (2007: 15%) of Kuwait Private Equity Opportunities Fund, a closed company incorporated in Kuwait in 2004, and indirectly owns an additional 30% (2007: 30%) through its subsidiary KAMCO.
- i) Millennium Finance Corporation (MFC) is a closed company incorporated in United Arab Emirates during 2008. The Bank acquired 33% equity stake of MFC in 2008.
- j) The Bank directly owns 1% (2007: 1%) of Manafae Investment Company, a closed company incorporated in State of Kuwait in 2005 and indirectly owns an additional 25.19% (2007: 25.5%) through its subsidiaries KAMCO and TIB.
- k) The Bank directly owns 15.3% (2007: 15.3%) of North Africa Holding Company, a closed company incorporated in State of Kuwait in 2006, and indirectly owns an additional 8% (2007: 8%) through its subsidiary KAMCO.
- l) The Bank directly owns 18% (2007: 18%) of Royal Capital, a closed company incorporated in United Arab Emirates in 2007, and indirectly owns an additional 26% (2007: 25%) through its subsidiaries KAMCO and TIB.
- n) Syria Gulf Bank (SGB) is a commercial bank incorporated in the Syrian Arab Republic. SGB commenced commercial operations in 2007. The Bank directly own 27.5% (2007: 27.5%) of SGB.
- o) Syrian Real Estate Development is a closed company incorporated in Syria in 2008. The Bank directly owns 20% (2007: nil) of the associate and indirectly owns additional 20% (2007: nil) interest through its subsidiary KAMCO.
- p) The Bank directly owns 20.15% (2007: 20.14%) of United Cable Company (UCC), a closed company incorporated in State of Kuwait in 2001, and indirectly owns an additional 8% (2007: 8%) through its subsidiary KAMCO.

## 9 INVESTMENTS IN ASSOCIATED COMPANIES (continued)

- q) During the year, the Bank's subsidiary KAMCO sold its entire equity interest of 30.35% in United Medical Services Company K.S.C. (Closed), an associate, with a carrying value of US\$ 27.9 million (KD 7.47 million) to United Health Care Company (UHC) for a total consideration of US\$ 70.4 million (KD 18.8 million) resulting in total gain of US\$ 34 million (KD 9 million) net of elimination. Profit resulting from the downstream transactions between the Group and UHC is eliminated to the extent of the KAMCO's interest in UHC.
- r) The Bank directly owns 17% (2007: 17%) of United Real Estate Company Jordan, a closed company incorporated in Jordan in 2006, and indirectly owns an additional 10% (2007: 10%) through its subsidiary KAMCO.
- s) The Bank owns 45% (2007: 45%) of United Industries Company (UIC), which is a company incorporated in the State of Kuwait in 1979 and listed on the Kuwait Stock Exchange, through its subsidiary KAMCO.
- t) During the year, the Bank's subsidiary (KAMCO) invested US\$ 75.3 million (KD 20.1 million) for a 20.1% equity interest in United Healthcare Company (UHC).
- u) United Real Estate Company (URC), is a company listed on the Kuwait Stock Exchange. The Bank directly owns 30% (2007: 35%) of URC.

b), e), m) & v) These companies are owned through Bank's subsidiary KAMCO and are incorporated in State of Kuwait.

## 10 GOODWILL

	2008 US\$ 000	2007 US\$ 000
Cost at 1 January	11,409	10,775
Additions	38,074	-
Disposal	(1,830)	-
Exchange adjustment	(1,080)	634
	46,573	11,409

The goodwill is related to the KAMCO (a subsidiary of the UGB) which is considered as the cash generating unit for the Bank. KAMCO is listed on the Kuwait Stock Exchange and the recoverable amount of the KAMCO is determined with reference to its listed price per share as at the balance sheet date.

## 11 DISCONTINUED OPERATIONS

In July 2008, Bank has transferred the Jordan Kuwait Bank (JKB) ownership to Burgan Bank for US\$ 450 million on which Bank has realised a gain of US\$ 284 million (before expenses).

The transfer of ownership of following commercial banks is expected to be completed in 2009 for US\$ 275 million subject to regulatory approvals:

- Algeria Gulf Bank (83% equity stake).
- Bank of Baghdad (46% equity stake).
- Tunis International Bank (77% equity stake).

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 11 DISCONTINUED OPERATIONS (continued)

The Bank has received the approvals from the Central Bank of Bahrain (CBB) and the Central Bank of Kuwait (CBK) to transfer the commercial banks to Burgan Bank. Subsequent to the receipt of the approvals from the CBB and CBK, the Bank has classified the investments in commercial banks as investments held for sale (discontinued operation) in accordance with International Financial Reporting Standard 5 (IFRS 5).

As per the Master Transfer Agreement, Burgan Bank was required to issue 200 million new shares to the Bank within the validity period of Central Bank of Kuwait's (CBK) approval issued to UGB for purchase of Burgan Bank shares. CBK approval for purchase of Burgan Bank share expired on 31 December 2008, therefore UGB is not liable to subscribe for the shares.

The major classes of assets and liabilities of commercial banks (disposal group) classified as held for sale as at 31 December 2008 are as follows:

	31 December 2008		
	Tunis International Bank US\$ 000	Algeria Gulf Bank US\$ 000	Total US\$ 000
<b>ASSETS</b>			
Demand and call deposits with banks	8,768	62,869	71,637
Time deposits with banks	257,565	-	257,565
Non-trading investments	40,305	225	40,530
Loans and advances	129,292	258,660	387,952
Other assets	1,514	10,789	12,303
Investments in associated companies	7,106	-	7,106
Property and equipment	3,245	11,953	15,198
	447,795	344,496	792,291
Investment in associated company - Bank of Baghdad			67,598
<b>Total assets of disposal group classified as held for sale</b>			<b>859,889</b>
<b>LIABILITIES</b>			
Due to banks and other financial institutions	133,961	17,371	151,332
Deposits from customers	241,791	254,147	495,938
Loans and murabaha payable	-	4,265	4,265
Other liabilities	7,666	10,585	18,251
<b>Total liabilities of disposal group classified as held for sale</b>	<b>383,418</b>	<b>286,368</b>	<b>669,786</b>

The fair value reserve and the foreign currency translation reserve of the Group reported in the consolidated statement of changes in equity includes the fair value reserve and foreign currency translation reserve of the disposal group amounting to US\$ (0.9) million and US\$ 7.3 million respectively.

## 11 DISCONTINUED OPERATIONS (continued)

The results of commercial banks (disposal group) are as follows:

	2008 US\$ 000	2007 US\$ 000
Investment income	2,973	5,983
Interest income	34,619	30,001
Fees and commissions	23,619	12,900
Foreign exchange revaluation gains, net	5,051	3,331
Share of results of discontinued associates:		
Bank of Baghdad	6,306	3,081
Jordan Kuwait Bank	17,995	27,875
<b>Total income</b>	<b>90,563</b>	<b>83,171</b>
Interest expense	(11,616)	(13,607)
<b>Operating income before expenses and provisions</b>	<b>78,947</b>	<b>69,564</b>
Salaries and benefits	(6,763)	(5,570)
General and administrative expenses	(14,949)	(8,292)
<b>Operating income before provisions</b>	<b>57,235</b>	<b>55,702</b>
Provision for doubtful loans, guarantees and other assets - net	(3,415)	(2,987)
<b>Profit for the year from discontinued operations</b>	<b>53,820</b>	<b>52,715</b>
The net cash flows incurred by disposal group subsidiaries are as follows:		
Net cash from operating activities	39,305	100,042
Net cash used in investing activities	(9,307)	(8,025)
Net cash used in financing activities	(11,671)	(4,782)
<b>Net cash from disposal group</b>	<b>18,327</b>	<b>87,235</b>
<b>Earnings per share from discontinued operations</b>		
Basic (US cents)	5.96	5.92
Diluted (US cents)	5.91	5.84

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 12 LOANS AND MURABAHA PAYABLE

Total loans and murabaha payables outstanding at **31 December 2008**

	Currency	Parent US\$ 000	Subsidiary US\$ 000	Total US\$ 000
<b>Floating rate loans</b>				
Loan due on 17 June 2009	KWD	-	27,202	27,202
Loan due on 20 June 2009	US\$	41,500	-	41,500
Loan due on 20 September 2009	KWD	-	29,015	29,015
Loan due on 30 November 2009	US\$	12,870	-	12,870
Loan due on 28 August 2010	US\$	-	50,051	50,051
Loan due on 2 April 2011	KWD	-	45,336	45,336
Loan due on 30 June 2011	US\$	115,000	-	115,000
Loan due on 2 July 2012	US\$	200,000	-	200,000
<b>Fixed rate loans</b>				
Loan due on 08 January 2009	KWD	-	9,067	9,067
Loan due on 15 January 2009	KWD	-	10,880	10,880
Loan due on 18 January 2009	KWD	-	12,694	12,694
Loan due on 3 February 2009	KWD	-	5,440	5,440
Loan due on 30 April 2009	KWD	-	3,627	3,627
Loan due on 30 April 2009	KWD	-	16,321	16,321
Loan due on 20 September 2009	KWD	-	2,720	2,720
Loan due on 20 September 2009	KWD	-	2,720	2,720
Loan due on 20 September 2009	KWD	-	3,627	3,627
		369,370	218,700	588,070
Total loans and murabaha payables outstanding at 31 December 2007		395,000	182,549	577,549

## 13 OTHER LIABILITIES

	2008 US\$ 000	2007 US\$ 000
Accrued expenses	21,563	16,190
Staff related payables	18,373	17,538
Interest payable	12,651	17,612
Due to customers and other payables	11,022	35,199
Dividends payable	1,939	1,112
Others	4	564
	65,552	88,215

## 14 BONDS

	2008 US\$ 000	2007 US\$ 000
Bonds - issued by a subsidiary	71,630	72,336

In June 2004, the Bank's subsidiary KAMCO issued floating rate bonds of KD 10 million and fixed rate bonds of KD 10 million each for a term of 5 years. In 2007, KD 250,000 of the issued bonds were redeemed prior to their maturity date. The remaining bonds will mature at their principal amount on 21 June 2009.

## 15 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 five 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 to repurchase the notes at par value.

## 16 EQUITY

### Share capital

The authorised share capital as of 31 December 2008 comprised 1 billion shares of US\$ 0.25 each (2007: 1 billion shares of US\$ 0.25 each).

The issued and fully paid up share capital as of 31 December 2008 comprised 824,930,155 shares of US\$ 0.25 each (2007: 814,989,567 shares of US\$ 0.25 each). The increase is due to exercise of share options by employees under the employee share option plan.

### Share premium

Share premium represents a non-distributable reserve arising from the exercise of the Bank's employee share 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

During the year, the Bank purchased 14,180,953 shares (2007: nil) and sold 4,000,000 shares (2007: nil). At the end of the year the Bank held 11,056,255 shares (2007: 875,302 shares). These treasury shares do not carry any voting rights and are not entitled to dividends. The net gain or loss on reissuance of treasury shares is taken to treasury share reserve in the consolidated statement of changes in equity and is not available for distribution. The value of treasury shares based on the last bid price as of 31 December 2008 is US\$ 16.9 million (2007: US\$ 1.4 million).

### Statutory reserve

In accordance with the Bahrain Commercial Companies Law and the Bank's articles of association, 10% of the profit 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 profit of the Group for the year to general reserve in accordance with the Bank's Articles of Association. The transfer is subject to shareholder's approval at the forthcoming Annual General Meeting. 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.

### Dividend paid and proposed

During the year, the Bank paid final dividend of 2007 for US cents 16.25 per issued share (2006: US cents 8.71) for a total amount of US\$ 132,520 thousand (2006: US\$ 69,758 thousand).

The Board of Directors have recommended to the Annual General Meeting (AGM) to be held on 31 March 2009 a dividend of US cents 18.50 (2007: US cents 16.25) per issued share of US cents 25 each. Dividend would be paid to the shareholders who hold the shares on the date of the AGM.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 17 FAIR VALUE RESERVE

	2008 US\$ 000	2007 US\$ 000
<b>Non-trading investments</b>		
Balance at 1 January	52,405	68,937
Transferred to consolidated statement of income on sale related to continuing operations (note 18)	(23,975)	(93,635)
Transferred to consolidated statement of income on sale related to the disposal group	(1,707)	(6,162)
Transferred to consolidated statement of income on impairment	56,651	-
Net movement in unrealised fair value during the year	(68,130)	83,265
<b>Balance at 31 December</b>	<b>15,244</b>	<b>52,405</b>
<b>Cash flow hedge</b>		
Balance at 1 January	339	2,297
Net movement in unrealised fair value during the year	(13,208)	(1,958)
<b>Balance at 31 December</b>	<b>(12,869)</b>	<b>339</b>
	<b>2,375</b>	<b>52,744</b>

## 18 INVESTMENT INCOME

	2008 US\$ 000	2007 US\$ 000
(Loss) gain on investments designated at fair value through statement of income	(90,618)	61,181
(Loss) gain on investments held for trading	(24,531)	19,534
Dividend income	22,707	16,696
Gain (loss) on sale of associates and subsidiaries.	346,077	(2,106)
Gain on sale of investments available-for-sale (note 17)	23,975	93,635
Rental income from investment properties	1,186	1,101
Gain on sale of investments properties	1,438	-
Changes in fair value of investments properties (note 7)	(1,352)	2,386
Others	2,100	1,685
	<b>280,982</b>	<b>194,112</b>

Gain on sale of available-for-sale investments includes a gain of US\$ 7.8 million (2007: US\$ 7.3 million) on the sale of securities having a carrying value of US\$ 64.9 million (2007: US\$ 12.1 million) that were carried at cost.

## 19 INTEREST INCOME

	2008 US\$ 000	2007 US\$ 000
Time deposits with banks	6,373	9,436
Loans and advances	5,206	2,517
Non-trading investments	4,787	3,061
Demand and call deposits with banks	4,376	1,106
	<b>20,742</b>	<b>16,120</b>

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 22 INTEREST EXPENSE

	2008 US\$ 000	2007 US\$ 000
Loans and murabaha payable	35,262	32,970
Due to banks and other financial institutions	19,398	16,715
Subordinated debt	5,026	6,738
Deposits from customers	4,126	4,060
Bonds	3,596	7,455
	67,408	67,938

## 23 EARNINGS PER SHARE

### *Basic*

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

	2008 US\$ 000	2007 US\$ 000
Profit attributable to equity shareholders of the parent	207,278	220,855
Weighted average number of shares outstanding during the year (in thousands)	818,823	809,192
Basic earnings per share (US cents)	25.31	27.29

### *Diluted*

Diluted earnings per share is calculated by dividing the income attributable to the equity shareholders of the parent, adjusted for the effect of conversion of employees share options, 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 employee's share options. The Bank has outstanding share options, issued under the Employee Stock Options Plan, which have dilutive effect on earnings.

	2008 US\$ 000	2007 US\$ 000
Profit attributable to equity shareholders of the parent	207,278	220,855
Weighted average number of shares outstanding during the year (in thousands)	818,823	809,192
Effect of dilutive potential ordinary shares:		
Share options (in thousands)	6,935	10,804
	825,758	819,996
Diluted earnings per share (US cents)	25.10	26.90

## 24 FUNDS UNDER MANAGEMENT

The Group holds assets amounting to US\$ 9,015 million (2007: US\$ 8,510 million) 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.

## 20 FEES AND COMMISSIONS

	2008 US\$ 000	2007 US\$ 000
Management fees from fiduciary activities	40,510	47,044
Advisory fees	14,352	19,377
Credit related fees and commission	1,389	1,145
Other fees received	-	918
	56,251	68,484

## 21 SHARE OF RESULTS OF ASSOCIATED COMPANIES

	2008 US\$ 000	2007 US\$ 000
Al-Dhiyfa Holding Company K.S.C. (Closed)	540	-
Arab Leadership Academy Company K.S.C.	(545)	-
Dhow Development Company	(546)	-
Kuwait Education Fund	67	71
Kuwait Private Equity Opportunities Fund	(1,197)	3,874
Millennium Finance Corporation	(4,297)	-
Manafae Investment Company	1,571	4,512
North Africa Holding Company	(3,298)	1,322
Royal Capital Company P.S.C.	497	-
Salem Al-Marzouk & Sabah Abi Hana	656	519
Syria Gulf Bank	(795)	(482)
United Cable Company	-	(3,831)
United Medical Services Company K.S.C. (Closed)	(618)	13,986
United Real Estate Company Jordan	14	-
United Industries Company	(17,904)	45,502
United Health Care Company	273	-
United Real Estate Company	7,745	12,743
United Universal Real Estate Company	3	-
United Warehousing and Cooling	-	(2,239)
	(17,834)	75,977

## 25 CASH AND CASH EQUIVALENTS

	2008 US\$ 000	2007 US\$ 000
Time deposits with original maturities of ninety days or less	77,539	432,151
Demand and call deposits with banks	27,418	79,560
	<u>104,957</u>	<u>511,711</u>

## 26 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 2008** was as follows:

	Continuing operations		Discontinued operations		Total US\$ 000
	Investment banking US\$ 000	Commercial banking US\$ 000	Total US\$ 000	Commercial banking US\$ 000	
Share of results of associated companies	(17,039)	(795)	(17,834)	24,301	6,467
Total income	342,205	(812)	341,393	90,563	431,956
Operating income before provisions	218,327	(863)	217,464	57,235	274,699
Impairment loss on non trading investments	(56,651)	-	(56,651)	-	(56,651)
Provision for doubtful loans, guarantees and other assets - net	(16)	-	(16)	(3,415)	(3,431)
Segment result	161,660	(863)	160,797	53,820	214,617
Income attributable to equity shareholders of the parent					207,278
Income attributable to minority					7,339
<b>OTHER INFORMATION</b>					
Investments in associated companies	610,413	15,767	626,180	67,598	693,778
Segment assets	1,991,333	17,901	2,009,234	859,889	2,869,123
Segment liabilities	1,383,787	299	1,384,086	669,786	2,053,872

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 26 SEGMENTAL INFORMATION (continued)

Segmental information for the year ended 31 December 2007 was as follows:

	Continuing operations			Discontinued operations	
	Investment banking US\$ 000	Commercial banking US\$ 000	Total US\$ 000	Commercial banking US\$ 000	Total US\$ 000
Share of results of associated companies	76,772	(795)	75,977	30,956	106,933
Total income	358,112	(36)	358,076	83,171	441,247
Operating income before provisions	228,871	(160)	228,711	55,702	284,413
Impairment loss on non trading investments	(3,831)	-	(3,831)	-	(3,831)
Provision for doubtful loans, guarantees and other assets - net	(9,319)	-	(9,319)	(2,987)	(12,306)
Segment result	215,721	(160)	215,561	52,715	268,276
Income attributable to equity shareholders of the parent					220,855
Income attributable to minority					47,421
					268,276
<b>OTHER INFORMATION</b>					
Investments in associated companies	775,134	15,233	790,367	-	790,367
Segment assets	2,650,359	17,274	2,667,633	-	2,667,633
Segment liabilities	1,862,750	145	1,862,895	-	1,862,895

### Secondary segment information

#### Geographic

The Group operates in four geographic markets: Middle East/Africa, Europe, North America and Asia. The following tables show the distribution of the Group's total income, total assets and total liabilities by geographical segment, allocated based on the location in which the assets and liabilities are located, for the years ended 31 December 2008 and 2007:

	Middle East/ Africa US\$ 000	Europe US\$ 000	North America US\$ 000	Asia US\$ 000	Total US\$ 000
<b>31 December 2008</b>					
Total income	456,555	(13,090)	(11,425)	(84)	431,956
Total assets	2,523,027	215,755	129,899	442	2,869,123
Total liabilities	1,676,724	346,923	6,725	23,500	2,053,872
<b>31 December 2007</b>					
Total income	404,329	22,779	14,099	40	441,247
Total assets	2,216,058	286,374	164,543	658	2,667,633
Total liabilities	1,452,885	374,627	4,133	31,250	1,862,895

## 27 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	Other related parties US\$ 000	Total 2008 US\$ 000	Total 2007 US\$ 000
Gain (loss) on investments carried at fair value through statement of income	3,754	(18)	(18,417)	(14,681)	18,336
Loss on sale of non-trading investments	-	-	(859)	(859)	-
Gain on sale of investment in associated companies	-	-	276,918	276,918	-
Fees and commissions income	10,749	9,365	12,756	32,870	31,283
Dividend income	410	75	2,581	3,066	2,517
Interest income	429	36	10,514	10,979	3,641
Interest expense	(1,059)	(606)	(14,993)	(16,658)	(8,701)
Others	-	1,936	(153)	1,783	(6,653)

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

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 27 RELATED PARTY TRANSACTIONS (continued)

	Major shareholders US\$ 000	Associates US\$ 000	Other related parties US\$ 000	Total 2008 US\$ 000	Total 2007 US\$ 000
Demand and call deposits with banks	26	118	10,095	10,239	11,403
Time deposits with banks	-	-	18,134	18,134	45,000
Investments carried at fair value through statement of income	7,755	399	56,563	64,717	42,715
Investments, carried at fair value through statement of income, in funds managed by related party	-	-	13,663	13,663	13,869
Non-trading investments	6,030	-	423,723	429,753	109,047
Loans and advances	-	-	6,116	6,116	1,895
Other assets	2,337	2,160	4,810	9,307	10,791
Due to banks and other financial institutions	-	10,374	172,044	182,418	122,823
Deposits from customers	720	14	6,629	7,363	12,480
Loans taken by a subsidiary (KAMCO)	-	-	110,619	110,619	39,373
Murabaha payable	-	-	36,250	36,250	31,250
Other liabilities	-	-	3,586	3,586	5,790
Letters of credit	-	-	20,614	20,614	13,079
Guarantees	-	-	825	825	-
Funds managed or advised by the Group (included in funds under management)	-	-	115,144	115,144	173,222

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

	2008 US\$ 000	2007 US\$ 000
Short term employee benefits	18,439	19,016
Share based payments	1,019	3,072
Total compensation	19,458	22,088

## 27 RELATED PARTY TRANSACTIONS (continued)

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

The above related party transactions include amounts of disposal group subsidiaries.

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

	2008 US\$ 000	2007 US\$ 000
Carrying value of associate sold to an associated company	-	40,308

## 28 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.

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:

	2008 US\$ 000	2007 US\$ 000
<b>Credit related</b>		
Letters of credit	25,319	31,651
Guarantees	209,476	119,286
	234,795	150,937
<b>Investment related *</b>	107,592	28,036
	342,387	178,973

All credit related commitments mature within one year. It also includes the letter of credit and guarantees of the disposal group subsidiaries.

\* Investment related commitments represent commitments for capital calls of fund of fund structures. These commitments can be called during the investment period of the fund which normally is 1 to 5 years.

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

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 28 OFF BALANCE SHEET ITEMS (continued)

### 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.

	Positive fair value US\$ 000	Negative fair value US\$ 000	Notional amounts by term to maturity			
			Notional amount Total US\$ 000	Within 3 months US\$ 000	3 - 12 months US\$ 000	1 - 5 years US\$ 000
<b>31 December 2008</b>						
Derivatives held for trading						
Forward foreign exchange contracts*	2,160	(472)	346,851	219,187	127,664	-
Derivatives held for hedging						
Forward foreign exchange contracts	36,861	-	1,089,020	296,246	792,774	-
Interest rate swap	-	(12,868)	325,000	-	75,000	250,000
<b>31 December 2007</b>						
Derivatives held for trading						
Forward foreign exchange contracts*	3	(73)	305,482	305,482	-	-
Derivatives held for hedging						
Interest rate swap	339	-	75,000	-	50,000	25,000

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.

\* The Group has undertaken these forward foreign exchange transactions for hedging purposes but as these did not qualify for hedge accounting under IAS 39, these are accounted as derivatives held for trading. It includes forward foreign exchange contracts undertaken by the disposal group subsidiaries.

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.

### Fair value hedges

Fair value hedges are used by the Bank to protect against changes in fair value of the financial assets due to movement in the exchange rates. The Bank uses forward foreign exchange contracts to hedge against specifically identified currency exchange risk.

For the year ended 31 December 2008, the Bank recognised a net gain of US\$ 4.2 million (2007: nil), representing the gain on the hedging instrument. The total loss on the hedged items attributable to the hedged risk amounted to US\$ 2.3 million (2007: nil).

### Cash flow hedges

The Group is exposed to variability in interest cash flows on liabilities which bear interest at a variable rate. The Group uses interest rate swaps as cash flow hedges of these interest rate risks. A schedule indicating as at 31 December 2008 the periods when the net cash flows are expected to occur and when they are expected to affect the consolidated statement of income is as follows:

	Within	
	1 year US\$ 000	1-5 years US\$ 000
Net Cash outflows (Liabilities)	10,413	21,287
Income statement	(449)	(12,419)

The ineffectiveness on cash flow hedges on reclassification from equity to consolidated statement of income is not material.

#### ***Hedge of net investments in foreign operations***

The Bank has designated the forward foreign exchange contracts to hedge against changes in the value of investment in subsidiaries and associated companies for an amount of US\$ 472 million (KD 130 million). Gains or losses on the retranslation of these forward foreign exchange contracts are transferred to equity to offset any gains or losses on the translation of the net investments in the subsidiaries and associates.

The ineffectiveness on hedge of net investments in foreign operations on reclassification from equity to statement of income is not material.

## **29 RISK MANAGEMENT**

### **29.1 Introduction**

Risk is inherent in the Group's activities but it is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. This process of risk management is considered critical to the Group's continuing profitability.

The independent risk control process does not include business risks such as changes in the environment, technology and industry. They are monitored through the Group's strategic planning process.

The major risks to which the Group is exposed to while conducting its business and operations, and the means and organisational structure it employs to manage them strategically for building shareholder value, are outlined below.

#### ***Risk management structure***

Each subsidiary of the Bank is responsible for managing its own risks and has its own Board Committees, including Audit and Executive Committees in addition to other management Committees such as Credit / Investment Committee and (in the case of major subsidiaries) ALCO, or equivalent, with responsibilities generally analogous to the Bank's committees.

The Board's role is to approve investment strategies for the Bank. However, it has delegated authority for day-to-day decision making to the Executive Committee so that risk can be effectively managed within the Bank.

The Managing Director of the Bank has overall responsibility for representing the Board in managing the affairs of the Bank. The Board of Directors has delegated the Executive Management of the Bank to the Acting Chief Executive Officer (who is not a Director) and has appointed several Board Committees to work with him and to form and define policies and approve procedures for all spectrums of the Bank's activities.

The Executive Management of the Bank is headed by the Acting Chief Executive Officer who is broadly responsible for the day to day conduct of the Bank's business in line with the Board's approved policies and procedures and complements and facilitates the Board in meeting its responsibility towards all stakeholders. He is assisted by the nine members of management team, each of them are responsible for their respective department. Several management committees have been formed which are chaired by the Managing Director/Acting Chief Executive Officer.

The Executive Committee comprises of four directors including the Chairman, Vice Chairman, Managing Director and another director. It meets in between Board meetings to approve all proposals not within the Investment Committee's risk authority, as well as to act on all matters within the Board's remit.

The Investment Committee is mainly responsible for approving or recommending approval to the Executive Committee limits for individual exposures, investments and concentrations towards banks, countries, industries, risk rating classes, or other special risk asset categories. In addition, the Committee also monitors the overall risk profile of the Bank and recommends provision levels to the Executive Committee. The Investment Committee is constituted by a majority motion passed in the Executive Committee. Currently the Committee consists of five members and is headed by the Managing Director.

The Audit Committee is appointed by the Board and consists of three members who are Directors, including one non-Executive Director. The Board Audit Committee assists the Board in carrying out its responsibilities with respect to assessing (a) the quality and integrity of financial reporting, (b) the audit thereof, (c) the soundness of the internal controls of the Bank, (d) the risk assessment of Bank's activities, and (e) the methods for monitoring compliance with laws, regulations and supervisory and internal policies.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 29 RISK MANAGEMENT (Continued)

### 29.1 Introduction (Continued)

#### *Risk management structure* (Continued)

The Risk and Compliance Committee is responsible for the monitoring and assessment of risks facing the Bank, the review of compliance with internal and external guidelines, the review and recommendation of provisioning requirements, the assessment of the impact on the Bank from new regulatory requirements, and review and ratification of Investment Committee decisions. The Committee is headed by the Acting Chief Executive Officer and includes eight other senior executives of the Bank.

The Asset and Liability Committee establishes policies and objectives for the asset and liability management of the Bank's balance sheet in terms of structure, distribution, risk and return and its impact on profitability. It also monitors the cash flow, tenor and cost/yield profiles of assets and liabilities and evaluates the Bank's balance sheet both from interest rate sensitivity and liquidity points of view, making corrective adjustments based upon perceived trends and market conditions, monitoring liquidity, monitoring foreign exchange exposures and positions. The Committee is headed by the Acting Chief Executive Officer and includes six other senior executives of the Bank.

The Management Committee acts as the steering committee of the Bank as well as a management forum to discuss any relevant issues. It meets on a weekly basis and consists of the Acting Chief Executive Officer and all Department Heads as well as Internal Audit. It also serves to follow up on a weekly basis on the daily conduct of the Bank's business activities. The Committee is headed by the Acting Chief Executive Officer.

The Insider Trading Committee comprises three members constituted from the Board of Director members and the Acting Chief Executive Officer as the alternate member. The Committee is mainly responsible for the supervision of adequacy of compliance with the Central Bank of Bahrain guidelines on insider trading.

Monitoring and controlling risks is primarily performed based on limits established by the Bank. These limits reflect the business strategy and market environment of the Bank as well as the level of risk that the Bank is willing to accept, with additional emphasis on selected geographies and industry sectors. In addition, the Bank monitors and measures the overall risk bearing capacity in relation to the aggregate risk exposure across all risk types and activities.

#### *Risk mitigation*

As part of its overall risk management, the Group uses derivatives and other instruments to manage exposures resulting from changes in interest rates and foreign currency transactions.

The risk profile is assessed before entering into hedge transactions, which are authorised by the appropriate level of seniority within the Group.

Where warranted, the Bank enters into legally enforceable netting arrangements covering its money market and foreign exchange trading activities whereby only net amount may be settled at maturity. In areas where Bank acts as agent for commodity trading on behalf of certain financial institutions, the risk is managed through simultaneous spot and forward trading in commodities through well established financial and commodity trading institutions in the overseas market. With regard to the credit risk in the off balance sheet exposures, third party guarantees are obtained wherever possible as a risk mitigation measure.

#### *Concentration risk*

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 geographical location.

In order to avoid excessive concentrations of risk, the Group's policies and procedures include specific guidelines to focus on country and counter party limits and maintaining a diversified portfolio. Identified concentrations of credit risks are controlled and managed accordingly. Robust limit structures put in place by the Board ensures effective monitoring and control of concentration risk and any limit breaches are immediately rectified and reported to the Board.

## 29.2 Credit risk

Credit risk arises from the extension of credit facilities in the Group's banking and trading activities as well as in the investment activity where there is a possibility that a counterparty may fail to honor its commitment whenever an investment may fail.

Credit risk is mitigated through:

- (i) Establishing an appropriate credit risk environment;
- (ii) Operating under a sound credit and investment approval process;
- (iii) Maintaining appropriate credit administration, measurement and monitoring processes; and
- (iv) Ensuring adequate controls over the credit risk management process.

The Group has well defined policies approved at the Board level. These provide carefully documented guidelines for credit risk management. There is a two tier committee structure to approve and review credit and investment risk. The Investment Committee (IC) includes the Managing Director, Acting Chief Executive Officer, Head of Investment Banking and Asset Management. Exposures beyond IC limits are approved by the Board's Executive Committee or by the full Board.

### **Maximum exposure to credit risk without taking account of any collateral and other credit enhancements**

The table below shows the maximum exposure to credit risk for the components of on and off balance sheet. The maximum exposure shown is gross before effect of mitigation through the use of master netting and collateral arrangements.

	2008 US\$ 000	2007 US\$ 000
Demand and call deposits with banks	27,418	79,613
Time deposits with banks	79,103	459,923
Non-trading investments	359,979	18,962
Loans and advances	7,770	291,866
Other assets	69,312	64,349
Off balance sheet items	23,107	150,937
	<b>566,689</b>	<b>1,065,650</b>

### **Risk concentrations of the maximum exposure to credit risk**

Concentration of risk is managed by client/counterparty, by geographical region and by industry sector. The maximum credit exposure to any single client or counterparty as of 31 December 2008 was US\$ 349 million (2007: US\$ 45.6 million) before taking account of collateral or other credit enhancements.

	Gulf Co operation Council countries (G.C.C.) US\$ 000	Middle East and North Africa (excluding G.C.C.) US\$ 000	European Union countries US\$ 000	Asia US\$ 000	Others US\$ 000	Total US\$ 000
<b>31 December 2008</b>						
Demand and call deposits with banks	25,588	168	944	135	583	27,418
Time deposits with banks	78,286	817	-	-	-	79,103
Non-trading investments	359,979	-	-	-	-	359,979
Loans and advances	5,001	2,769	-	-	-	7,770
Other assets	63,482	5,539	122	-	169	69,312
Off balance sheet items	825	22,282	-	-	-	23,107
<b>Total</b>	<b>533,161</b>	<b>31,575</b>	<b>1,066</b>	<b>135</b>	<b>752</b>	<b>566,689</b>
31 December 2007	343,250	531,299	188,367	164	2,570	1,065,650

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 29 RISK MANAGEMENT (Continued)

### 29.2 Credit risk (Continued)

#### *Risk concentrations of the maximum exposure to credit risk (continued)*

An industry sector analysis of the Group's financial assets, before taking into account collateral held or other credit enhancements, is as follows:

	Trading and manufacturing	Banks and other financial institutions	Construction and real estate	Government and public sector	Individuals	Others	Total
<b>31 December 2008</b>	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000
Demand and call deposits with banks	-	27,418	-	-	-	-	27,418
Time deposits with banks	-	79,103	-	-	-	-	79,103
Non-trading investments	-	359,979	-	-	-	-	359,979
Loans and advances	-	-	2,769	-	5,001	-	7,770
Other assets	-	37,682	45	-	41	31,544	69,312
Off balance sheet items	-	23,107	-	-	-	-	23,107
<b>Total</b>	-	<b>527,289</b>	<b>2,814</b>	-	<b>5,042</b>	<b>31,544</b>	<b>566,689</b>
31 December 2007	172,060	789,849	1,039	7,909	8,979	85,814	1,065,650

#### *Collateral and other credit enhancements*

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty. Guidelines are implemented regarding the acceptability of types of collateral and valuation parameters.

The main types of collateral obtained are as follows:

- For commercial lending, charges over real estate properties, inventory, trade receivables, bank guarantees; and
- For retail lending, mortgages over residential properties, claim over employees' end of service benefits etc.

The Group also obtains guarantees from parent companies for loans to their subsidiaries.

Management monitors the market value of collateral and requests additional collateral in accordance with the underlying agreement, during its review of the adequacy of the allowance for impairment losses.

## 29 RISK MANAGEMENT (Continued)

### 29.2 Credit risk (Continued)

#### *Credit risk exposure for each credit rating*

	Investment grade	Non-investment grade	Unrated	Total
	US\$ 000	US\$ 000	US\$ 000	US\$ 000
<b>31 December 2008</b>				
Demand and call deposits with banks	24,828	117	2,473	27,418
Time deposits with banks	78,014	-	1,089	79,103
Non-trading investments	359,979	-	-	359,979
Loans and advances	-	-	7,770	7,770
Other assets	2,772	-	66,540	69,312
Off balance sheet items		1,669	21,438	23,107
<b>Total</b>	<b>465,593</b>	<b>1,786</b>	<b>99,310</b>	<b>566,689</b>
31 December 2007	459,652	74,268	531,730	1,065,650

It is the Bank's policy to maintain accurate and consistent risk ratings across the credit portfolio. This facilitates focused management of the applicable risks and the comparison of credit exposures across all lines of business, geographic regions and products. All internal risk ratings which are largely subjective are tailored to the various categories and are derived in accordance with the rating policy and practices. The attributable risk ratings are assessed and updated regularly.

#### ***Renegotiated loans***

Where possible, the Group seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated, the loan is no longer considered past due. The carrying amount of the loans whose terms have been renegotiated as at 31 December 2008 and 2007 are not material.

### 29.3 Market risk

Market risk is defined as the risk of losses in the value of on-or-off balance sheet financial instruments caused by a change in market prices or rates, (including changes in interest rates and foreign exchange rates). The Group's policy guidelines for market risk have been vetted by the Board of Directors in compliance with the rules and guidelines provided by the Central Bank of Bahrain. The Central Bank of Bahrain guidelines 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 capital requirement for credit risk.

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

- Interest rate instruments and securities in the trading book.
- Foreign exchange and commodities throughout the banking book.

The Bank has entered into interest rate swaps and forward foreign exchange contracts for hedging purposes and does not actively trade in commodities and derivatives.

#### ***Interest rate risk***

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments. Positions are monitored on a daily basis and hedging strategies are used to ensure positions are maintained within the established limits.

The following table demonstrates the sensitivity to a reasonable possible change in interest rates, with all other variables held constant, of the Group's income statement based on the balance sheet position as of 31 December 2008.

# Notes to the Consolidated Financial Statements

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## 29 RISK MANAGEMENT (Continued)

### 29.3 Market risk (Continued)

<i>Currency</i>	Increase in basis points 2008	Sensitivity of net interest income 2008 US\$ 000
Kuwaiti Dinar	+ 25	3
United States Dollar	+ 25	(1,005)
Euro	+ 25	(260)
Pound Sterling	+ 25	-
Others	+ 25	(63)

The decrease in the basis points will have an opposite impact on the net interest income.

The sensitivity of the income statement is the effect of the assumed changes in interest rates on the net interest income for one year, based on the floating rate financial assets and financial liabilities held at 31 December 2008, including the effect of hedging instruments.

There are no material interest bearing securities in non trading investments, hence no sensitivity of equity has been disclosed.

The following table demonstrates the sensitivity to a reasonable possible change in interest rates, with all other variables held constant, of the Group's income statement based on the balance sheet position as of 31 December 2007.

<i>Currency</i>	Increase in basis points 2007	Sensitivity of net interest income 2007 US\$ 000
Kuwaiti Dinar	+ 25	(421)
United States Dollar	+ 25	(1,517)
Euro	+ 25	68
Pound Sterling	+ 25	(14)
Others	+ 25	116

The decrease in the basis points will have an opposite impact on the net interest income.

## 29 RISK MANAGEMENT (continued)

### 29.3 Market risk (continued)

#### *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 table below indicates the effect on profit before tax and on equity for the positions (including net investments) as at balance sheet date as a result of change in the currency rate with all other variables held constant.

<i>Currency</i>	Change in	Effect on	Effect on	Change in	Effect on	Effect on
	currency rate in % 2008 Increase / (decrease)	profit before tax 2008 US\$ 000	equity 2008 US\$ 000	currency rate in % 2007 Increase / (decrease)	profit before tax 2007 US\$ 000	equity 2007 US\$ 000
Kuwaiti Dinar	1	(2,396)	12,488	1	(1,993)	8,878
Euro	1	(878)	237	1	(257)	333
Jordanian Dinar	1	-	221	1	-	1,786
Kuwaiti Dinar	(1)	2,396	(12,488)	(1)	1,993	(8,878)
Euro	(1)	878	(237)	(1)	257	(333)
Jordanian Dinar	(1)	-	(221)	(1)	-	(1,786)

#### *Equity price risk*

Equity price risk arises from the change in fair values of equity investments. The Group manages this risk through diversification of investments in terms of geographical distribution and industry concentration.

The Group's financial assets available for sale and financial assets at fair value through statement of income by geographical regions are as follows:

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 29 RISK MANAGEMENT (continued)

### 29.3 Market risk (continued)

<i>Geographical distribution</i>	Middle		North		
	East/ Africa 2008 US\$ 000	Europe 2008 US\$ 000	America 2008 US\$ 000	Asia 2008 US\$ 000	Total 2008 US\$ 000
Investments carried at fair value through statement of income					
Equities	40,108	2	8,114	242	48,466
Managed funds	120,323	59,631	16,744	-	196,698
					245,164
Non-trading investments					
Equities - Quoted	88,273	-	44	-	88,317
Equities - Unquoted	137,705	26,060	34,928	-	198,693
Managed funds	169,619	5,332	56,068	-	231,019
					518,029
<b>Total</b>					<b>763,193</b>

Any change in equity price index or the net asset values of the above financial instruments will have a direct impact on income or equity. The majority of the equities in the Middle East/Africa region are quoted in the Kuwait Stock Exchange.

For unquoted investments carried at cost the impact of the changes in the equity prices will only be reflected in the consolidated statement of income when the investment is sold or deemed to be impaired.

	Middle		North		
	East/ Africa 2007 US\$ 000	Europe 2007 US\$ 000	America 2007 US\$ 000	Asia 2007 US\$ 000	Total 2007 US\$ 000
Investments carried at fair value through statement of income					
Equities	80,393	94	8,695	442	89,624
Managed funds	150,779	71,836	44,230	-	266,845
					356,469
Non trading investments - available for sale					
Equities - Quoted	121,914	3,137	5,302	-	130,353
Equities - Unquoted	122,860	21,412	35,722	-	179,994
Managed funds	164,080	10,991	50,110	-	225,181
					535,528
<b>Total</b>					<b>891,997</b>

## 29 RISK MANAGEMENT (continued)

### 29.4 Liquidity risk

#### *Analysis of financial liabilities by remaining contractual maturities*

The table below summarises the maturity profile of the Group's financial liabilities at 31 December 2008 based on contractual undiscounted repayment obligations. Repayments which are subject to notice are treated as if notice were to be given immediately. However, the Group expects that many customers will not request repayment on the earliest date the Group could be required to pay and the table does not reflect the expected cash flows indicated by the Group's deposit retention history.

	On demand	1 - 6 months	6 - 12 months	1 - 5 years	5-10 years	Total
<b>At 31 December 2008</b>	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000
Financial liabilities						
Due to banks and other						
financial institutions	318,091	169,449	2,282	-	-	489,822
Deposits from customers	25,446	16,587	-	-	-	42,033
Loans and murabaha payable	74,270	66,747	39,503	227,202	260,355	668,077
Other liabilities	12,651	39,938	12,963	-	-	65,552
Bonds	351	1,698	2,083	69,445	-	73,577
Subordinated debt	564	2,729	3,347	33,223	111,863	151,726
<b>Total non-derivative undiscounted on balance sheet financial liabilities 2008</b>	<b>431,373</b>	<b>297,148</b>	<b>60,178</b>	<b>329,870</b>	<b>372,218</b>	<b>1,490,787</b>
	On demand	1 - 6 months	6 - 12 months	1 - 5 years	5-10 years	Total
<b>At 31 December 2007</b>	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000
Financial liabilities						
Due to banks and other						
financial institutions	461,208	191,050	27,607	-	-	679,865
Deposits from customers	431,295	53,643	1,117	-	-	486,055
Loans and murabaha payable	38,580	11,989	204,646	152,554	308,392	716,161
Other liabilities	43,766	-	26,910	17,539	-	88,215
Bonds	354	1,726	2,104	74,303	-	78,487
Subordinated debt	606	2,954	3,600	35,721	119,895	162,776
<b>Total non-derivative undiscounted on balance sheet financial liabilities 2007</b>	<b>975,809</b>	<b>261,362</b>	<b>265,984</b>	<b>280,117</b>	<b>428,287</b>	<b>2,211,559</b>

The Bank expects that not all of contingent items or commitments will be drawn before expiry of the commitments.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 29 RISK MANAGEMENT (continued)

### 29.4 Liquidity risk (continued)

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 maturity analysis of financial assets and liabilities analysed according to when they are expected to be recovered or settled are as follows:

	Up to 3 months	3 months to 1 year	Sub total less than 12 months	1 to 5 years	Over 5 years	Sub total over 12 months	Total
	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000	US\$ 000
<b>31 December 2008</b>							
Demand and call deposits with banks	27,365	-	27,365	-	53	53	27,418
Time deposits with banks	79,103	-	79,103	-	-	-	79,103
Investments carried at fair value through statement of income	245,164	-	245,164	-	-	-	245,164
Non-trading investments	88,317	-	88,317	610,628	179,063	789,691	878,008
Loans and advances	1,821	2,650	4,471	3,299	-	3,299	7,770
Other assets	1,179	33,694	34,873	693	33,746	34,439	69,312
<b>Total financial assets</b>	<b>442,949</b>	<b>36,344</b>	<b>479,293</b>	<b>614,620</b>	<b>212,862</b>	<b>827,482</b>	<b>1,306,775</b>
Due to banks and other financial institutions	474,826	22,969	497,795	-	-	-	497,795
Deposits from customers	61,039	-	61,039	-	-	-	61,039
Loans and murabaha payable	38,081	139,602	177,683	410,387	-	410,387	588,070
Other liabilities	12,651	39,938	52,589	12,963	-	12,963	65,552
Bonds	-	-	-	71,630	-	71,630	71,630
Subordinated debt	-	-	-	-	100,000	100,000	100,000
<b>Total financial liabilities</b>	<b>586,597</b>	<b>202,509</b>	<b>789,106</b>	<b>494,980</b>	<b>100,000</b>	<b>594,980</b>	<b>1,384,086</b>
<b>Liquidity gap</b>	<b>(143,648)</b>	<b>(166,165)</b>	<b>(309,813)</b>	<b>119,640</b>	<b>112,862</b>	<b>232,502</b>	<b>(77,311)</b>
<b>Cumulative liquidity gap</b>	<b>(143,648)</b>	<b>(309,813)</b>		<b>(190,173)</b>	<b>(77,311)</b>		

## 29 RISK MANAGEMENT (continued)

### 29.4 Liquidity risk (continued)

	Up to 3 months US\$ 000	3 months to 1 year US\$ 000	Sub total less than 12 months US\$ 000	1 to 5 years US\$ 000	Over 5 years US\$ 000	Sub total over 12 months US\$ 000	Total US\$ 000
31 December 2007							
Demand and call deposits							
with banks	79,560	-	79,560	-	53	53	79,613
Time deposits with banks	432,151	23,653	455,804	4,119	-	4,119	459,923
Investments carried at fair value through statement of income	356,469	-	356,469	-	-	-	356,469
Non-trading investments	135,027	2,202	137,229	419,336	8,602	427,938	565,167
Loans and advances	66,385	143,557	209,942	81,924	-	81,924	291,866
Other assets	64,349	-	64,349	-	-	-	64,349
<b>Total financial assets</b>	<b>1,133,941</b>	<b>169,412</b>	<b>1,303,353</b>	<b>505,379</b>	<b>8,655</b>	<b>514,034</b>	<b>1,817,387</b>
Due to banks and other financial institutions	546,978	39,705	586,683	-	-	-	586,683
Deposits from customers	417,384	20,728	438,112	-	-	-	438,112
Loans and murabaha payable	50,361	195,000	245,361	332,188	-	332,188	577,549
Other liabilities	43,766	26,911	70,677	17,538	-	17,538	72,336
Bonds	-	-	-	72,336	-	72,33	71,630
Subordinated debt	-	-	-	-	100,000	100,000	100,000
<b>Total financial liabilities</b>	<b>1,058,489</b>	<b>282,344</b>	<b>1,340,833</b>	<b>422,062</b>	<b>100,000</b>	<b>522,062</b>	<b>1,862,895</b>
<b>Liquidity gap</b>	<b>75,452</b>	<b>(112,932)</b>	<b>(37,480)</b>	<b>83,317</b>	<b>(91,345)</b>	<b>(8,028)</b>	<b>(45,508)</b>
<b>Cumulative liquidity gap</b>	<b>75,452</b>	<b>(37,480)</b>		<b>45,837</b>	<b>(45,508)</b>		

### 29.5 Operational risk

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform operational risk can cause damage to reputation, have legal or regulatory implications, or lead to financial loss. The Bank can not expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Bank is able to manage the risks. Controls include effective segregation of duties, access, authorisation and reconciliation procedures, staff education and assessment processes, including the use of internal audit.

## 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 5, included under non-trading investments are unquoted available for sale investments amounting to US\$ 161,726 thousands (2007: US\$ 164,993 thousands) 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.

## 2 BASIS OF PREPARATION AND SIGNIFICANT ACCOUNTING POLICIES (continued)

### Changes in accounting policy and disclosures (continued)

#### Future changes in accounting policies

The following IASB Standards and IFRIC Interpretations have been issued as at 31 December 2008 but are effective for the financial years beginning on or after the dates mentioned below:

		Effective
IAS 1 Revised	Presentation of Financial Statements. This will result in amendments to the presentation of financial statements.	1 January 2009
Amendment to IAS 16	Property, plant and equipment	1 January 2009
IAS 23	Borrowing cost (Revised)	1 January 2009
IAS 27	Consolidated and separate financial statements (Revised)	1 July 2009
Amendment to IAS 28	Investment in associates	1 January 2009
Amendment to IAS 36	Impairment of assets	1 January 2009
Amendment to IAS 38	Intangible assets	1 January 2009
Amendment to IAS 39	Financial instruments: recognition and measurement	1 January 2009
Amendment to IAS 40	Investment property	1 January 2009
IFRS 2	Share based payments (Revised)	1 January 2009
IFRS 3	Business Combinations (Revised)	1 July 2009
IFRS 8	Operating Segments. This will result in additional disclosures relating to operating segments	1 January 2009
IFRS 16	Hedges of a Net Investment in a Foreign Operation	1 October 2009

The application of the above standards are not expected to have a material impact on the consolidated financial statements as and when they become effective. However, the application of IAS 1 (Revised) will result in amendments to the preparation of the financial statements.

#### Comparatives

The Group has re-presented the consolidated statement of income for the prior period presented relating to discontinued operations. This re-presentation did not affect previously reported profit or the shareholders' equity.

#### 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 reporting dates of the subsidiaries and the Group are identical and the subsidiaries' accounting policies conform to those used by the Group for like transactions and events in similar circumstances.

All intra-group balances, transactions, income and expenses and profits and losses resulting from intra-group transactions are eliminated in full.

Subsidiaries are fully consolidated from the date on which control is transferred to the Group. Control is achieved where the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The results of subsidiaries acquired or disposed of during the year are included in the consolidated statement of income from the date of acquisition or up to the date of disposal, as appropriate.

# Notes to the Consolidated Financial Statements

For the year ended 31 December 2008

## 31 CAPITAL ADEQUACY

The Bank maintains an actively managed capital base to cover risks inherent in the business. The adequacy of the Bank's capital is monitored using, among other measures, the rules and ratios established by the Basel Committee on Banking Supervision ("BIS rules/ratios") and adopted by the CBB.

### Capital management

The primary objectives of the Group's capital management are to ensure that the Group complies with capital requirements of the CBB and that the Group maintains strong credit ratings and healthy capital ratios in order to support its business and to maximise shareholders' value. In order to maintain or adjust the capital structure, the Bank may adjust the amount of dividend payment to shareholders, or issue capital securities.

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

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

	Basel II 2008 US\$ 000	Basel I 2007 US\$ 000
Capital base:		
Tier 1 capital	459,373	572,474
Tier 2 capital	232,132	294,030
Total capital base (a)	691,505	866,504
Credit risk weighted exposure	3,514,705	2,171,150
Market risk weighted exposure	147,525	454,878
Operational risk weighted exposure	366,145	-
Total risk weighted exposure (b)	4,028,375	2,626,028
Capital adequacy (a/b * 100)	17.17%	33%
Minimum requirement	12.0%	12.0%

The above risk asset ratio calculation includes the disposal group subsidiaries.

Regulatory capital consists of Tier 1 capital, which comprises share capital, share premium, statutory reserve, general reserves, treasury share reserve, foreign currency reserve and minority interest less goodwill. The other component of regulatory capital is Tier 2 capital, which includes subordinated long term debt and fair value reserves.