annual report 2006

بيت التمويل الكويتي
Kuwait Finance House
Bahrain B.S.C.(c) البحرين ش.م.ب (م)

**HH Shaikh Khalifa bin Salman Al Khalifa**

Prime Minister

**HM Shaikh Hamad bin Isa Al Khalifa**

King of The Kingdom of Bahrain

**HH Shaikh Salman bin Hamad Al Khalifa**

Crown Prince and Commander-in-Chief of the Bahrain Defence Force

P.O.Box 2066
Manama
Kingdom of Bahrain
**www.kfh.com.bh**

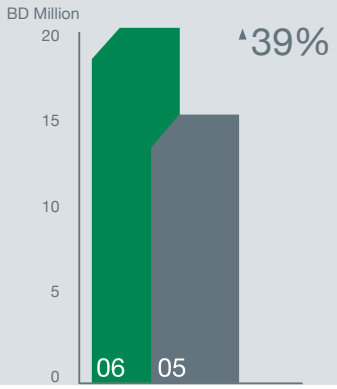
# Mission Statement

With the aim of creating assets for its stakeholders and supporting growth in the economies in which it operates and invests, it is the mission of Kuwait Finance House - Bahrain to deliver excellence and innovation in Islamic commercial and investment banking. Reflecting its unwavering commitment to Islamic values and its ongoing efforts to promote the concept of Islamic banking worldwide, this is achieved through long-term participation in the local and regional markets and the development and introduction of a broad range of unique, shari'a compliant products and services.

# Chairman and Managing Director's Statement

**Bader A. M. Mukhaizeem**

**Net Income**




In the name of Allah, the Beneficent, the Merciful. Praise be to Allah, the Lord of the Worlds, and peace and blessing be upon our Prophet, Mohammed, and on his Companions.

It is with great pleasure that I announce another strong financial year for Kuwait Finance House-Bahrain. Testimony to our reputation as a performance-driven, results orientated organisation.

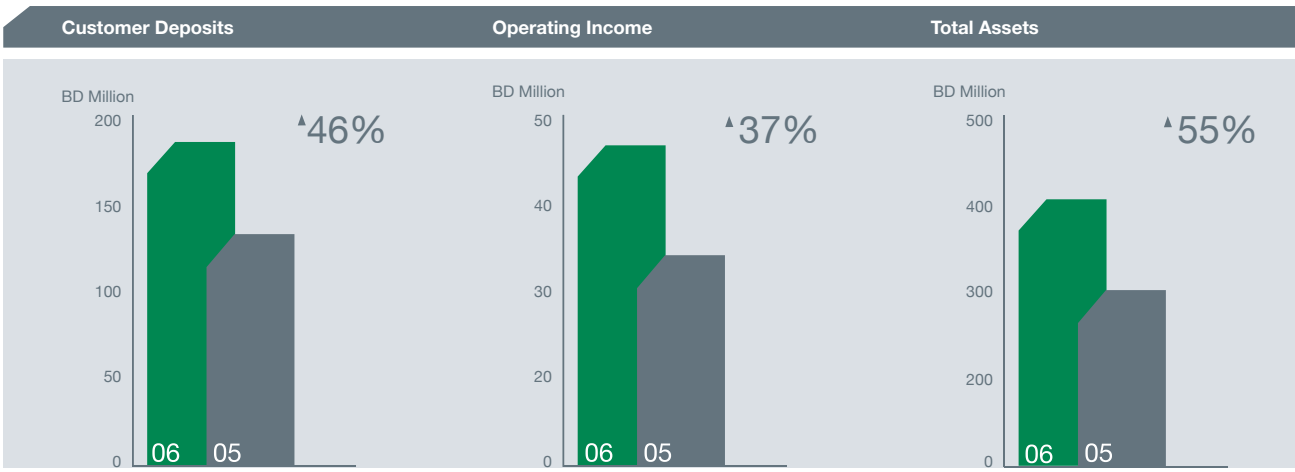
KFH-Bahrain is continuing to move in the direction of strategic change, with an internal drive that is setting the pace in the mission of "Building a better Bahrain". This strategy will contribute to nation building and validate our Bank's status as a financial leader. A globally diversified investment strategy resulting in a portfolio including property development, aerospace, pharmaceuticals, health and life care, visual communications, telecommunications, sports and outdoor clothing continues to drive the business. This diversification not only reduces risk and enhances profitability for our stakeholders but each acquisition is selected for its potential to enable positive change.

Commercially, KFH-Bahrain is also manifesting this change through its innovative product and service offerings. Pioneering Ijara products are being continually enhanced with more innovative personal financing tools set to be rolled out in the coming year.

In 2006 Kuwait Finance House - Bahrain's performance has strengthened pronouncedly with a significant increase in net income at 39%, reaching BD 21.1 million for 2006 against the previous year's net income of BD 15.2 million. At the end of 2006, total customer deposits increased by 46% to a total amount of BD 190.3 million from BD 130.2 million at year end 2005.

This positive effect translates into a 28% return on average equity for 2006 versus a 27% return on average equity in 2005. Operating income increased by 37% from BD 34.6 million in 2005 to BD 47.4 million in 2006. Total assets also increased by 55% to BD 403 million at the end of 2006 versus BD 259 million in 2005.

The trend reflects a year-on-year growth profile, and early indicators show this to continue at robust rates in 2007. To further enhance KFH-Bahrain's ability to facilitate investments, we intend to increase our capital by 57% in the coming year,




facilitating the momentum for the future growth of our business and the value of our investments for our stakeholders. We have attained record highs in 2006, and are therefore well positioned to pursue our strategy of diversification. We will continue to bring in new products and introduce the value proposition they offer to the regional and global market.

However, while we continue to grow ourselves, we remain tightly aligned to our business objectives. The acquisitions, and the gains which KFH-Bahrain has attained in the previous year, will serve as a benchmark in setting our performance aspirations and charting our direction in the coming financial year.

With gratitude from our Bank, our Board of Directors and all of our stakeholders, I conclude by paying tribute to the vision, support and confidence inspired in this Kingdom and its future by His Majesty King Hamad Bin Isa Al Khalifa, King of The Kingdom of Bahrain, His Highness Shaikh Khalifa Bin Salman Al Khalifa, the Prime Minister, and His Highness Shaikh Salman Bin Hamad Al Khalifa, the Crown Prince and Commander-in-Chief of the Bahrain Defence Force. Further, thanks is also due to the Government of Bahrain and the Central Bank of Bahrain, which have continued to set the highest standards and provided enormous support for the elevation of the Islamic banking industry and the region's financial services arena.

I extend my gratitude to our employees, customers and stakeholders for their continued loyalty and confidence in KFH-Bahrain. With the Blessings of Almighty God we will continue to sustain our momentum in our programme of growth and usher in the next stage for development to "Build a better Bahrain" in the new financial year.

Yours sincerely

**Bader A. M. Mukhaizeem**

Chairman and Managing Director

# General Manager's Statement

**Abdulhakeem Y. Alkhayyat**

The agenda towards "Investing in Growth" in the financial year 2005 has evolved in our mission of "Building a better Bahrain" in 2006.

KFH-Bahrain visualises a master plan for development, a transformation of the physical landscape of Bahrain, while addressing national priorities that promote sustained economic growth for the Country and its people.

With the construction boom in Bahrain reaching an all time high, KFH-Bahrain distinguishes itself from the crowd with our development mantra of "building quality that lasts", cementing the Bank's reputation as one of the Kingdom's foremost visionary developers.

A series of commercial and leisure developments by KFH-Bahrain has greatly contributed to the growth of the economy and to the advancement of the way of life of Bahrain's people. Developments such as Durrat Al Bahrain, Diyaar Al Muharraq and Meena Towers will promote and highlight features of distinction, enhancing our country's competitive advantages to the global market. The flagship of our real estate portfolio is the breathtaking Durrat Al Bahrain Project. Changing the physical landscape as well as shaping our economy the massive resort city is projected to be a major contributor to our revenue in the coming years. Featuring a world class master plan incorporating residential, leisure and commercial components, Durrat Al Bahrain will engineer the Kingdom's transformation into a key business and leisure destination while enhancing the future of Bahrainis through the generation of a significant number of jobs and lifestyle offerings.

These landmark developments are only the beginning for KFH-Bahrain and a number of equally impressive Projects are scheduled for the coming year.

Apart from its activities in real estate, KFH-Bahrain continues to partner with other innovative companies from a diverse range of industries.

Working closely with the management of our portfolio companies, we have endeavored to enhance stakeholder value through rationalisation and optimisation of our capital structure, management and operations. 2006 has seen some strategic initiatives led by KFH-Bahrain resulting in a much higher level of positioning than was originally invested. We will continue to closely monitor the progress of these companies to ensure that high level investment returns continue and that every component of our diverse business portfolio remains geared towards the improvement of the quality of life of our people and the future betterment of Bahrain as a nation.

KFH-Bahrain's Future Headquarters

Reinforcing our commitment to these values is the restructuring of KFH-Bahrain's home financing tools. The Ijara mortgage scheme has been extended to 25 years, facilitating first home buying for young Bahrainis wishing to enter into the real estate market.

This core value is not only apparent throughout our business activities but is also embedded in our community interaction. KFH-Bahrain lends full support to a number of educational programmes such as, the Crown Prince's International Scholarship Fund, the Youth Arab Leaders Bahrain Chapter (YAL), Bahrain Task Force, the Sophia Antipolis Science Park Mentorship Programme and supporting the health care industry.

Supported by strong economic trends, a dynamic management team and a solid reputation as a financial leader we will continue with our growth strategy in order to increase development opportunities for KFH-Bahrain and anticipate the fiscal year 2007 to continue with record results and increased stakeholder value.

In this regard, I would like to extend my sincere appreciation to our partner institutions, which have provided us all the support and framework for the further advancement of KFH-Bahrain. Our sincere gratitude is extended to the Central Bank of Bahrain,the Bahrain Economic Development Board and the Ministry of Commerce and Industry

I also wish to thank all of KFH-Bahrain employees, partners and stakeholders for their continued support as we pursue our mission to contribute towards "Building a better Bahrain".

Yours sincerely

**Abdulhakeem Y. Alkhayyat**
General Manager

# Board of Directors

**Bader A. M. Mukhaizeem**
Chairman and Managing Director

**Mohamed bin Sh. Eshaq**
Vice Chairman

**Mohammed Suliman Al Omar**
Board Member

**Yaqoob Yousef Majed**
Board Member

**Mohamed Isa Alwazzan**
Board Member

**Adel Ahmed Al Banwan**
Board Member

# Management team

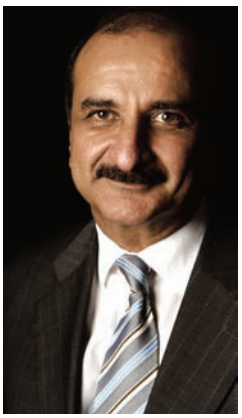
**Abdulhakeem Y. Alkhayyat**
General Manager

**Paul Mercer**
Executive Manager

**Abdul Razak Jawahery**
Executive Manager

**Waleed Rashdan**
Executive Manager

**Ahmad Saeed**
Senior Manager
Investment



**Hisham Al-Moayyed**
Senior Manager
Real Estate

**Jalal Haji**
Senior Manager
Operations

**Khalid Rafea**
Senior Manager
Consumer Finance

**Lilian Le Falher**
Senior Manager
Treasury

**Sattam Algosaibi**
Senior Manager
Corporate Finance

**Jameel Al-Khaja**

Manager
Credit

**Jehad Al Wardi**

Manager
Administration

**Majed Mahmood**

Manager
Priority Banking

**Mohammed Hamad**

Manager
Investment

**Osama Al-Khajah**

Manager
Project Development

**Salah Al-Majthoob**

Manager
Information Technology

**Waleed Ahmadi**

Manager
Human Resources

**Yousif Al Hammadi**

Manager
Financial Control

Investment Placement Team

## GLOBAL INVESTMENT GROWTH IN 2006

A vision of global investment strategies has propelled KFH-Bahrain forward in the last few years, moving it at a rapid pace in 2006 and opening a range of opportunities for our clients.

There are several drivers which have pushed us to the forefront of the investment and finance sectors, nurturing the success of our Projects in the financial year 2006 enabling further investment in diverse sectors of the economy. Amidst the enormous construction and infrastructure phase the Kingdom is experiencing,

KFH-Bahrain has invested and developed a variety of major property developments. As well as supporting the economy and infrastructure in the Kingdom, KFH-Bahrain is continuously partnering with innovative companies to produce cutting-edge products and services.

## INVESTMENTS

Led by a team of qualified professional managers, KFH-Bahrain's Investment department is dedicated to the execution of KFH-Bahrain's investment strategy. Aiming to increase stakeholder value the department closely monitors global economic change while procuring and structuring investment opportunities for its valuable high net-worth clients.

The investment department is actively monitoring the current investment portfolio through close interaction with the operating companies' management and the board representatives from KFH, as well as obtaining feedback from leading industry consultants. This process results in value enhancement for the underlying investments increasing the likelihood of future profitable exits.

Consumer Finance Team

## CONSUMER FINANCE

Whether it be the introduction of the "Ijara" 25-year home financing scheme, or the "Ijara Card", continued product innovation, a wider branch network and technological enhancement of banking services ensure that KFH-Bahrain Consumer Finance services and products have become an industry benchmark.

As well as our Ijara products, customers can also benefit from an extensive choice of Islamic financing tools for a wide range of goods and commodities. Competitive profit margins and flexible auto financing help our customers stay on the move.

Whatever your financial needs may be, the Consumer Finance Team are ready to help you achieve your goals.

Corporate Finance Team

## CORPORATE FINANCE

Combining a superior product and service offering with the value of expert advice, KFH-Bahrain's Corporate Finance Department helps small and medium-sized organisations to large corporates grow and expand their operations through Shari'a compliant resources and strategies.

Among the services available to businesses across all industry sectors are Real-Estate Financing, Project Financing, Working Capital Financing, and Trade Financing through the provision of Import / Export Letters of Credit, Letters of Guarantee and Documentary Collections.

**The following is a brief overview of KFH-Bahrain's investment portfolio including an update on significant developments with respect to operational and investment activity.**


## LIBERTY AEROSPACE, INC.

| | |
|---|---|
| Country | USA |
| Sector | General Aviation |
| Year of acquisition | 2005 |
| Group Holding* | 75% |

Liberty Aerospace, Inc. is a significant acquisition by KFH-Bahrain, whereby the Bank and its investors collectively hold an indirect ownership interest of 75% in Liberty.

Liberty is a Company specialised in the design, production, marketing and support of the first new two-seater single-engine, piston powered aircraft to receive US FAA Part 23 Type Certification in over 30 years.

Year 2006 witnessed several milestones for this company as it was awarded an FAA Production Certificate, continued to grow its clients base and concluded several substantial sales orders within the US and elsewhere. With the Production Certificate, Liberty is now suitably poised to deliver on its growing order book that has been generated over this period. Liberty is actively working to conclude an arrangement to produce parts and assemble the aircraft in the People's Republic of China in order to meet the growing demand of this market.

** Including investor.*

## ASTRON CLINICA

| | |
|---|---|
| Country | UK |
| Sector | Skin Imaging |
| Year of acquisition | 2005 |
| Group Holding* | 47% |

KFH-Bahrain increased its holding of Astron Clinica to 47% from 39% in 2006. Astron Clinica is poised to play a critical role in the Skin Imaging sector with Spectrophotometric Intracutaneous Analysis or SIAscopy, a revolutionary approach to skin imaging. Through continuous product development, Astron Clinica is opening up a wide range of diagnostic and treatment procedures for skin cancer and other skin conditions. Astron Clinica is based in Cambridge UK with a wholly-owned subsidiary in Australia, and several distributors across Canada, Europe, Middle East, Australia and New Zealand.

To enable the general public to get a basic understanding of the technology, Astron Clinica, in partnership with Procter & Gamble, placed SIAscope skin imaging devices at Olay counters in various countries. This is a significant milestone for Astron Clinica.

Astron Clinica was recently recognised with the prestigious "Frost & Sullivan European Technology Innovation of the Year" Award for pioneering efforts in developing a healthcare technology product.

## AL-KINDI PHARMACEUTICAL INDUSTRIES PLC

| | |
|---|---|
| Country | Jordan |
| Sector | Pharmaceutical |
| Year of acquisition | 2003 |
| Group Holding* | 54.8% |

KFH-Bahrain owns a 55% share in Al-Kindi Pharmaceutical Industries PLC, a specialised pharmaceutical company which serves as the nucleus for biotechnology development in Jordan and the Middle East region. Al-Kindi is a specialised manufacturer and distributor of Human-Based Insulin, a range of intravenous solutions and Haemodialysis Solutions under license from major international pharmaceutical companies. It fully complies with European Union, FDA and Jordan Food and Drugs Association manufacturing standards. Al-Kindi was established in response to the demand for specialised and affordable locally manufactured drugs.

While nearing commercial production, Al-Kindi has been setting up expansion plans that will double production capacity and augment its product lines to meet the demands of a growing market in the MENA region. During 2006, Al-Kindi secured its first order to supply labelled insulin to Syria, Palestine and Iraq through a United Nations sponsored programme.

## RADIUS HEALTH GROUP LIMITED

| | |
|---|---|
| Country | New Zealand |
| Sector | Health Care |
| Year of acquisition | 2004 |
| Group Holding* | 63% |

Radius Health Group is a diversified health sector investment company of which KFH-Bahrain and New Zealand Private Equity Fund (NZAPEF), together own a 63% equity holding. It is committed to providing a wide spectrum of quality health and life care services on a commercial basis. These include residential care centres, medical centres and pharmacies as well as various lifestyle and community care products and services.

Since its acquisition by KFH and NZAPEF, Radius Health Group has continued its expansion in New Zealand. In 2006, the Radius Group pursued its mission to generate increased market awareness, enhance its product lines and achieve further growth in revenues through acquisitions of medical centres, pharmacies and residential care centres.

** Includes New Zealand Australia Private Equity Fund investment.*

## CANTERBURY LIMITED


| | |
|---|---|
| Country | New Zealand |
| Sector | Apparel |
| Year of acquisition | 2004 |
| Group Holding* | 60% |

KFH-Bahrain and New Zealand Private Equity Fund (NZAPEF) together own a 60% stake in Canterbury Limited. Canterbury has created a niche in the global market as a leading rugby wear brand. From its initial positioning as an official provider of rugby outfits, the brand is being successfully adapted to other sports such as cricket, football and golf. This will enable the Company to diversify into the outdoor and sports wear market. A major restructuring of operations in previous years widened the reach of its global operations and introduced the Canterbury brand into casual wear. With intensified marketing and sales activities spanning over fifteen countries from Australasia, South Africa, Europe and North America, the Company is well poised to achieve significant growth in sales.

The Company has focused on the European fashion apparel market during the last year. This resulted in the presence of CCC products across premiere European outlets.

** Includes New Zealand Australia Private Equity Fund.*

## NEXTWINDOW LIMITED


| | |
|---|---|
| Country | New Zealand |
| Sector | Technology |
| Year of acquisition | 2005 |
| Group Holding* | 29% |

NextWindow, a leading firm in touch-screen technology design and development, is one of the private equity investments within New Zealand Australia Private Equity Fund (NZAPEF) which holds an ownership interest of 29% in the Company. KFH-Bahrain's interest in the Company lies principally on its enormous growth prospects. The Flat Panel Display (FPD) market, which is the target for NextWindow, is diverse and is growing at a rapid pace. It is widely used by leading companies around the world across a wide range of industries, including telecommunications, tourism, retail, real estate and public information.

NextWindow large touch screen technology is currently installed in over 3,000 locations globally, with distributors in USA, Australia, UK and parts of Europe. Integrators for large touch screens also exists in Korea and Taiwan. In the volume markets, the Company has successfully partnered with one of the leading computing equipment blue-chip companies to develop a specialised product and is now in mass production through its contract manufacturer in Thailand. This will enable the company to be recognised as a specialised supplier of FPD technology.


## WOOSH WIRELESS

| | |
|---|---|
| Country | New Zealand |
| Sector | Telecommunications |
| Year of acquisition | 2004 |
| Group Holding* | 53% |

A private equity investment within New Zealand Australia Private Equity Fund (NZAPEF), Woosh Wireless was acquired in 2004. KFH and NZAPEF collectively hold an indirect ownership interest of 53%. The Company currently provides wireless broadband data and voice services in New Zealand.

The Company is positioned to be a strong and leading player in the New Zealand telecommunication market having its focus on increased coverage and a carefully thought out merger plan with the smaller players. In 2006 Woosh announced the acquisition of Quicksilver, an Internet Service Provider ('ISP') with 10,000 billing customers. This effectively makes Woosh a full service telecommunications company with dial-up, broadband and toll customers.

Currently, the company is embarking on a major marketing drive to increase its network coverage and existing subscriber base in Auckland, Wellington, Christchurch and Southland to other major cities in New Zealand.

** Includes New Zealand Australia Private Equity Fund investment.*

## MENA TELECOM

| | |
|---|---|
| Country | Bahrain |
| Sector | Telecommunications |
| Year of acquisition | 2003 |
| Group Holding* | 100% |

Mena Telecom is a 100% subsidiary of KFH-Bahrain. During the past year the company transformed itself from a reseller to a telecom operator. The company opened to the public its first retail outlet in Bahrain to enable easy access to its product lines which include international calling cards, fixed line for international calls (CPS), fixed line for domestic calls and two-way satellite service.

Mena Telecom has won one of the two National Fixed Wireless Services (NFWS) licenses in Bahrain which were opened for financial bid by the Telecommunications Regulatory Authority (TRA). This license gives the company the opportunity to step up into the first tier of infrastructure based telecom provider in Bahrain. The license permits the provision of national fixed wireless services bringing about numerous benefits to the company from a strategic and value enhancement perspective. Mena Telecom's goal is to provide telecommunications services through its own independent network.

## DURRAT AL BAHRAIN

| | |
|---|---|
| Country | Bahrain |
| Sector | Real Estate |
| Year of acquisition | 2003 |
| Group Holding* | 50% |

The highlight of KFH-Bahrain's investment portfolio is the Durrat Al Bahrain Project, a world-class residential, leisure, commercial and tourist destination. Durrat Al Bahrain is owned by the Durrat Khaleej Al Bahrain Company, in which the Government of the Kingdom of Bahrain and Kuwait Finance House – Bahrain (together with its investors) each hold a 50 percent stake. Durrat Al Bahrain, a 20 square kilometer area of pristine waters and untouched beaches, once complete, is expected to be approximately the size of Manama, Bahrain's Capital City.

Land reclamation on the 12 islands was finished in 2006, and the entire development is slated for phased completion in 2010. During the past year, the Durrat Al Bahrain Project witnessed tremendous progress in terms of reclamation, dredging, infrastructure and construction of villas and landscape. The construction of villas for Phase 1 is in progress and is expected to be ready by the end of 2007. Piling work to the bridges was completed in November 2006 and the contractor has commenced demobilisation.

In August 2006, Durrat Al Bahrain confirmed acceptance and approval to the master plan for the Crescent Island, the commercial heart of the Project. Currently, the master plan for the crescent and the mainland is being enhanced to create more value for the Project. A concept master plan and draft business plan has also been produced for the golf course area.

Durrat Khaleej Al Bahrain Company and Al Khaleej Development Company ("Tameer") have formed a Joint Venture Company in Bahrain for the acquisition and development of the "Marina Island".

Durrat Al Bahrain continued to increase its marketing activities to raise awareness of and promote the landmark Project locally and internationally.

By supporting numerous community and social activities, Durrat Al Bahrain has continued to reach out to the local community to ensure that the Project not only touches the lives of its potential residents and visitors, but all members of the community – young and old alike. Durrat Al Bahrain's marketing team are working actively towards promoting the Durrat Al Bahrain Project to fulfill the management's vision of making it one of the elite Projects in the GCC region.

** Including KFH-Bahrain's investors' share.*


## DIYAAR AL MUHARRAQ

Diyaar Al Muharraq

| | |
|---|---|
| Country | Bahrain |
| Sector | Real Estate |
| Year of acquisition | 2006 |
| Group Holding* | 50% |

During 2006, KFH-Bahrain acquired a 50% equity stake in Diyaar Al Muharraq Company, a company incorporated to undertake the development of the Diyaar Project.

Diyaar Al Muharraq will consist of a mix of residential, commercial and retail components for the medium to high net-worth market. The Project lies just off the coast of Muharraq, the northern island and historical city centre of the Kingdom of Bahrain, which is in close proximity to the international airport. This area is playing a significant role in the expansion of the country with a number of reclamation Projects for new residential communities including Amwaj Islands, the expansion of West Hidd/Arad and West Busaiteen. Diyaar Al Muharraq shall comprise a total area of 12.2 million square meters. Once completed, the Project will be a self contained city combining modern amenities with traditional design.

## MIRACLE GRAPHICS

ميراكل miracle

| | |
|---|---|
| Country | Bahrain |
| Sector | Design & Printing |
| Year of acquisition | 2003 |
| Group Holding* | 70% |

Since its acquisition by KFH-Bahrain in 2003 with a holding of 70%, Miracle Graphics has seen stable growth in its revenues and operating performance. Miracle Graphics encompasses four primary divisions within the visual communications sector, namely, Design, Publishing, Big Prints and Digital. In Bahrain, it has pioneered in reprographic and pre-press production services.

Through its offering of comprehensive media solutions, Miracle has acquired a roster of loyal clients from local and multinational business communities and has thus generated steady revenue growth for the company.

Miracle secured significant business during the campaign drive for the local parliamentary elections held in November 2006.

** Including other investors.*

Meena 7 Towers

## ISHBILIYA VILLAGE

| | |
|---|---|
| Country | Bahrain |
| Sector | Real Estate |
| Year of acquisition | 2005 |
| Group Holding* | 100% |

A premier residential development targeted for the middle to high income market and situated on a large plot of land in the prime shopping district, just off the Shaikh Khalifa bin Salman Highway. The Project development team is led by Al Enma'a House for Real Estate.

Ishbiliya Village will offer affordable but quality housing to the fast growing local population. The development will provide a new lifestyle of choice for this market segment, in a fully master-planned community. The Project envisages to build 300 villas and 500 apartments of varying sizes alongside high class commercial and leisure facilities, modern infrastructure and community essentials such as schools, parks and a mosque. The Project is within close proximity to Manama City Centre.

## MEENA TOWERS COMPANY

| | |
|---|---|
| Country | Bahrain |
| Sector | Real Estate |
| Year of acquisition | 2003 |
| Group Holding* | 60% |

With a holding of 60%, KFH-Bahrain entered into a business venture with other notable investors in Bahrain to form the Meena Towers Company for the purpose of developing Meena 7 real estate Project. The design is conceptualised by world famous architects, creating a structure blending modern and intricate designs reflecting the Arabic architectural heritage.

A successful marketing and sales campaign resulted in almost 66% of the Project being sold. The development, to be completed at an estimated cost of BD 15.4 Million, will consist of a total of 240 apartment units in a cluster of 7 residential towers in the south side of the Town Centre of the Al Marsa Floating City residential marina, at the Amwaj Islands in Bahrain. First phase of the Project is scheduled to be delivered to buyers during the first half of 2007.

Fortis & KFH-Bahrain MOU Signing


## RESTRICTED MUDARABA INVESTMENT ACCOUNTS

KFH-Bahrain has developed a Shari'a compliant Asset Management product in the form of Restricted Mudaraba Investment Accounts, whereby private investors are provided an opportunity to co-invest with KFH-Bahrain for participation in corporate (private equity and real estate) financing transactions for KFH investment portfolio companies and Projects.

The market response was very positive from a diversified set of investors including institutions. As an Islamic Asset Management product, it offers KFH-Bahrain's clients various features in terms of Investment choice and a diverse range of returns and cash flows as per investor appetite. KFH-Bahrain employs and actively pursues an international investment strategy that allows investors access to a diverse range of local, regional and international investment opportunities - all of which are designed to deliver strong returns and enhance the reach and profile of the Islamic Banking Industry.

## SHARI'A COMPLIANT OVERNIGHT FUND (SCOF)

During 2006, KFH-Bahrain's Treasury Department developed a Shari'a Compliant Overnight Fund (SCOF). The Fund, registered in Luxembourg, aims to capture Islamic Investors' short term funds which could not be invested due to lack of products with very short maturity. Based on Ijarah, the Fund allows investors to receive daily rents from prime European properties with the option of redemption on a daily basis.

The underlying Real Estate Fund is sponsored by Fortis Bank S.A, who effectively protects the payment of rent and Principle to the investors. The (SCOF) is co-managed by Fortis and KFH-Bahrain, and is available for investment on all USD business days. The fund is due for launch in 2007.

# Risk Management

The Risk Management function continued receiving serious consideration at the Board level and worked across a range of responsibilities not confined to traditional management or internal audit functions. Management will in 2007 provide the Board inputs for it to finalise KFH-Bahrain's Risk Charter and Risk Policies. KFH-Bahrain will then carry through a structured programme to ensure that resources are allocated to those areas which need them. This will produce the results in line with the risk appetite and strategy of the Bank. The Banking Industry has recognised that Risk Management needs to be at the very core of the business. The Bank ranks Risk Management high up on the Corporate Governance framework.

KFH-Bahrain continued to build on the earlier work on Risk Management. In 2006 the Bank focused on preparing the ground for Risk Management through the development of credit scoring and rating. This will eventually assist in quantifying all banking risks, such as credit risk, liquidity risk and sensitivity to profit rates on the Bank's portfolio. Given the volume of data and range of services, the first emphasis was on providing a systematic structured approach to the credit risk. To support the Asset Liability Management ("ALM"), a specialised IT system was tested and selected for implementation.

The first stage referred to as Static ALM is in its final stages and will be operational by the first quarter in 2007, followed by dynamic ALM. Secondly a similar exercise for system identification and evaluation of credit Risk Management led to finalisation of an appropriate software which will be implemented in 2007. The need to quantify and measure risks wherever possible led to major exercise revision of credit risk score measurements this year. Key credit risk drivers were identified and discussed and old credit scoring models were revised to provide more accurate new credit ratings. The rating process has been automated this year and is being tested at present. A more enhanced operational Risk Management framework is due for development in 2007.

The challenge of modern Risk Management has resulted from the need to invest in its total functional capability. Specialists have been recruited. This was recognised as very critical for the Bank. The top management have selected a team of experts who are undertaking a major Project covering Risk Management strategy, policies and procedures.

In 2006 the Bank continued its adoption of the guidelines of the Central Bank of Bahrain. KFH-Bahrain participated in the task force which submitted its final findings on Basle 2 Implementation, which are currently being incorporated in the Central Bank's Rule Book for Islamic Banks. The Bank carried out an evaluation of the impact of the new proposed guidelines on the Bank's financials and submitted a detailed feedback highlighting the areas of concern to the Central Bank of Bahrain. KFH-Bahrain continued to involve itself in industry-wide issues and worked closely with the Bahrain Bankers Society and with the Central Bank of Bahrain to ensure the effective interpretation and adoption of the latest directives originating as a result of Basle II accord and the consequent IFSB standards on capital adequacy.

KFH-Bahrain is seeking a comprehensive and robust Risk Management framework to address the complete range of risks faced by the Bank.

The growing complexity of Islamic products, particularly the refinement being seen in the use of Sukuks, Musharakas, as well as Istisna'a products in combination has extended the capability and range of these contracts and products. There has been a realisation that while basically adequate for business, the existing transaction recording and tracking systems do not always support Risk Management. The technology is now becoming available to address the latest requirements of effective Central Risk Management. KFH-Bahrain has decided to invest in acquiring these new systems. A related need is to train and have people who can use the growth of statistical techniques to the Risk Management process. KFH-Bahrain has taken up the challenge and the coming years will see the Bank reporting its steady progress.


**SOPHIA ANTIPOLIS SCIENCE PARK MENTORSHIP PROGRAMME**

KFH-Bahrain plays a crucial role in promoting the educational advancement of Bahrain's youth. Boosting the Kingdom's reputation as a premiere source of world-class talents and professionals. To reinforce this commitment, KFH-Bahrain acquired lead sponsorship for the Sophia Antipolis Science Park Mentorship Programme, an intensive youth leadership and entrepreneurial training activity at the Sophia Antipolis Science and Technology Park in France. Related Projects by KFH-Bahrain include sponsorship of activities by the Young Arab Leaders Bahrain Chapter (YAL), the Bahrain Task Force and the Crown Prince's International Scholarship Fund, which awards scholarships to deserving students at US and UK schools and universities.

# Shari'a Board Statement

In the name of Allah, the Beneficent, the Merciful. Praise be to Allah, the Lord of the Worlds, and peace and blessing be upon our Prophet, Mohammed, and on his Companions.

**To the Stakeholders of KFH-Bahrain**

Assalam Alaikum Wa Rahmatullah

In compliance with the letter of appointment, we are required to submit the following report:

We have reviewed the principles and the contracts relating to the transactions and applications undertaken by KFH-Bahrain during the period ended 31 December 2006. We have also conducted our review to form an opinion as to whether KFH-Bahrain has complied with Shari'a Rules and Principles and also with the specific fatwas, rulings and guidelines issued by us.

KFH-Bahrain's management is responsible for ensuring that KFH-Bahrain conducts its business in accordance with Shari'a Rules and Principles. It is our responsibility to form an independent opinion, based on our review of the operations of KFH-Bahrain, and to report to you.

We conducted our review which included examining, on a test basis, each type of transaction, the relevant documents and procedures adopted by KFH-Bahrain.

We planned and performed our view so as to obtain all the information and explanations which we consider necessary in order to provide us with sufficient evidence to give reasonable assurance that KFH-Bahrain has not violated the Shari'a Rules and Principles.

**In our opinion:**

a) The contracts, transactions, and dealings entered into by KFH-Bahrain during the year ended 31 December 2006 that we have reviewed are in compliance with the Shari'a Rules and Principles;

b) The allocation of profits and losses relating to investment accounts conform to the basis that had been approved by us in accordance with Shari'a Rules and Principles;

c) All earnings that have been realised from sources or by means prohibited by Shari'a Rules and Principles, have been disposed of to charitable causes; and

d) The calculation of Zakat is in compliance with Shari'a Rules and Principles.

This opinion is rendered based on what has been presented to us by KFH-Bahrain's General Manager and its in-house Shari'a Advisor. We pray to Allah the Almighty to grant us success and the path of straight-forwardness.

Wassalam Alaikum Wa Rahmat Allah. Wa Barakatuh.

**Ahmad Bazie Al-Yaseen**
Chairman

**Mohammed Fawzi Faidullah**
Member

**Khalid Mathkour Al-Mathkour**
Member

**Ajeel Jasem Al-Nashmi**
Member

**Anwar Shuaib Abdulsalam**
Member

**Mohammed Abdul Razaq Al-Tabtabaee**
Member

# Auditors' Report
to the Shareholders of Kuwait Finance House (Bahrain) B.S.C. (c)

We have audited the accompanying consolidated financial statements of Kuwait Finance House (Bahrain) B.S.C. (c) [the "Bank"] and its subsidiaries [together the "Group"] which comprise the consolidated balance sheet as at 31 December 2006 and the consolidated statement of income, the consolidated statement of cash flows, the consolidated statement of changes in equity and the consolidated statement of restricted investment accounts for the year then ended and a summary of significant accounting policies and other explanatory notes.

**Board of Directors' Responsibility for the Financial Statements**

The Board of Directors is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with both the Financial Accounting Standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions, to operate in accordance with Islamic Shari'a and International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

**Auditors' Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with both the International Standards on Auditing and Auditing Standards for Islamic Financial Institutions. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the consolidated financial statements are free from material misstatement. In addition the International Standards of Auditing require that we comply with relevant ethical requirements.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate for the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal controls. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board of Directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as of 31 December 2006 and of its financial performance, its cash flows for the year then ended in accordance with Financial Accounting Standards issued by the Accounting and Auditing organisation for Islamic Financial Institutions and the Islamic Shari'a Rules and Principles as determined by the Shari'a Supervisory Board of the Bank.

In addition, in our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as of 31 December 2006 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

**Other Regulatory Matters**

We confirm that, in our opinion, proper accounting records have been kept by the Group and the consolidated financial statements, and the contents of the Report of the Board of Directors relating to these consolidated financial statements, are in agreement therewith. We further report, to the best of our knowledge and belief, that no violations of the Bahrain Commercial Companies Law, nor of the Central Bank of Bahrain and Financial Institutions Law, nor of the memorandum and articles of association of the Group have occurred during the year ended 31 December 2006 that might have had a material adverse effect on the business of the Group or on its consolidated financial position, and that the Bank has complied with the terms of its banking licence.

Ernst + Young

30 January 2007

Manama, Kingdom of Bahrain

# Consolidated Balance Sheet
at 31 December 2006

| | Notes | 2006 BD 000s | 2005 BD 000s |
|---|---|---|---|
| **ASSETS** | | | |
| Cash and balances with banks and Central Bank of Bahrain | 5 | **21,383** | 8,615 |
| Murabaha and Mudaraba contracts with banks | 6 | **66,654** | 45,119 |
| Murabaha, Istisna'a and Ijarah Muntahia Bittamleek contracts relating to customers | 7 | **161,956** | 110,153 |
| Non-trading investments | 8 | **83,063** | 41,995 |
| Investment held for sale | | **-** | 2,667 |
| Investments in associates | 9 | **15,385** | 14,873 |
| Investment properties | 10 | **27,623** | 14,737 |
| Receivables and prepayments | 11 | **11,268** | 8,574 |
| Goodwill and intangibles | | **2,508** | 2,843 |
| Premises and equipment | | **13,204** | 11,040 |
| **TOTAL ASSETS** | | **403,044** | 260,616 |
| **LIABILITIES AND EQUITY** | | | |
| **LIABILITIES** | | | |
| Murabaha contracts with banks | 12 | **110,366** | 56,344 |
| Murabaha contracts with non-banks | 13 | **99,345** | 68,179 |
| Customers' current accounts | 14 | **46,549** | 31,182 |
| Other liabilities | 16 | **12,875** | 7,525 |
| | | **269,135** | 163,230 |
| Unrestricted investment accounts | 17 | **44,375** | 30,807 |
| **EQUITY ATTRIBUTABLE TO SHARE HOLDERS OF PARENT** | | | |
| Issued capital | 18 | **44,560** | 38,500 |
| Share premium | 18 | **760** | - |
| Statutory reserve | 19 | **5,098** | 2,985 |
| General reserve | 18 | **13,800** | - |
| Investment revaluation reserve | 10 | **12,058** | 3,992 |
| Retained earnings | | **10,827** | 18,325 |
| | | **87,103** | 63,802 |
| **MINORITY INTEREST** | | **2,431** | 2,777 |
| | | **89,534** | 66,579 |
| **TOTAL LIABILITIES AND EQUITY** | | **403,044** | 260,616 |
| **CREDIT COMMITMENTS AND CONTINGENT ITEMS** | 25 | **31,003** | 35,731 |
| **RESTRICTED INVESTMENT ACCOUNTS** | | **19,109** | 11,007 |

**Bader A. M. Mukhaizeem**
Chairman and Managing Director

**Mohamed bin Sh. Eshaq**
Vice Chaiman

**Abdulhakeem Y. Alkhayyat**
General Manager

The attached notes 1 to 34 form part of these consolidated financial statements.

# Consolidated Statement of Income

Year ended 31 December 2006

| | Notes | 2006 BD 000s | 2005 BD 000s |
|---|---|---|---|
| Income from investment activities | 20 | **28,180** | 22,815 |
| Income from retail and corporate banking activities | 21 | **17,819** | 9,505 |
| Share of income of associates | 9 | **512** | 778 |
| Other income | | **864** | 1,547 |
| | | **47,375** | 34,645 |
| Less: Profit on Murabaha contracts | | **9,039** | 3,876 |
| | | **38,336** | 30,769 |
| Staff costs | | **6,438** | 5,651 |
| Other operating expenses | 22 | **6,158** | 3,883 |
| Depreciation | | **1,493** | 1,820 |
| Provisions | | **2,284** | 3,216 |
| | | **16,373** | 14,570 |
| **NET INCOME BEFORE PROFIT ON UNRESTRICTED INVESTMENT ACCOUNTS** | | **21,963** | 16,199 |
| Profit on unrestricted investment accounts | 17 | **1,200** | 1,081 |
| **INCOME FOR THE YEAR** | | **20,763** | 15,118 |
| Minority interest | | **367** | 48 |
| **INCOME ATTRIBUTABLE TO SHAREHOLDERS OF THE PARENT** | | **21,130** | 15,166 |

The attached notes 1 to 34 form part of these consolidated financial statements.

# Consolidated Statement of Cash Flows

Year ended 31 December 2006

| | Notes | 2006 BD 000s | 2005 BD 000s |
|---|---|---|---|
| **OPERATING ACTIVITIES** | | | |
| Net income for the year before minority interest | | **20,763** | 15,118 |
| Adjustments for: | | | |
| Provisions | | **2,284** | 3,216 |
| Depreciation | | **1,493** | 1,820 |
| Share of income of associates | | **(512)** | (778) |
| Unrealised gain on investment carried at fair value through income statement | 20 | **(6,705)** | - |
| Unrealised gain on investment properties | 20 | **(1,363)** | (2,784) |
| Profit on sale of investment properties | 20 | **(1,875)** | (9,264) |
| Operating income before changes in operating assets and liabilities | | **14,085** | 7,328 |
| Mandatory reserve with Central Bank of Bahrain | | **(1,680)** | (2,330) |
| Murabaha and Mudaraba contracts with banks | | **15,497** | (29,352) |
| Murabaha, Istisna'a and Ijarah Muntahia Bittamleek contracts relating to customers | | **(53,712)** | (38,925) |
| Receivables and prepayments | | **(2,694)** | 4,040 |
| Murabaha contracts with banks (liabilities) | | **54,022** | (10,250) |
| Murabaha contracts with non-banks (liabilities) | | **31,166** | 48,673 |
| Customers' current accounts | | **15,367** | 14,396 |
| Other liabilities | | **5,182** | (1,693) |
| Net cash from (used in) operating activities | | **77,233** | (8,113) |
| **INVESTING ACTIVITIES** | | | |
| Acquisition of subsidiary | | **-** | (3,257) |
| Purchase of investment properties | 10 | **(12,233)** | (4,344) |
| Sale of investment properties | | **2,585** | 26,179 |
| Purchase of premises and equipment | | **(3,657)** | (7,784) |
| Non-trading investments | | **(31,696)** | (15,588) |
| Investment held for sale | | **-** | 11,877 |
| Investments in associates | | **-** | (1,003) |
| Goodwill and intangibles | | **-** | (1,173) |
| Net cash (used in) from investing activities | | **(45,001)** | 4,907 |
| **FINANCING ACTIVITIES** | | | |
| Increase in unrestricted investment accounts | | **13,568** | 15,486 |
| Issue of new shares | | **2,320** | - |
| Net cash from financing activities | | **15,888** | 15,486 |
| **NET CHANGE IN CASH AND CASH EQUIVALENTS** | | **48,120** | 12,280 |
| Cash and cash equivalents at 1 January | | **29,490** | 17,210 |
| **CASH AND CASH EQUIVALENTS AT 31 DECEMBER** | 23 | **77,610** | 29,490 |

The attached notes 1 to 34 form part of these consolidated financial statements.

# Consolidated Statement of Changes in Equity

Year ended 31 December 2006

| | Notes | Attributable to the share holders of the parent | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Issued Capital BD 000s | Share premium BD 000s | Statutory reserve BD 000s | General reserve BD 000s | Investment revaluation reserve BD 000s | Retained earnings BD 000s | Total BD 000s | Minority interest BD 000s | Total equity BD 000s |
| Balance at 31 December 2004 | | 35,000 | - | 1,468 | - | 6,327 | 5,961 | 48,756 | 389 | 49,145 |
| Income for the year | | - | - | - | - | - | 15,166 | 15,166 | (48) | 15,118 |
| Transfer to investment revaluation reserve | 20 | - | - | - | - | 2,784 | (2,784) | - | - | - |
| Transfer to retained earnings on sale of investments | | - | - | - | - | (5,119) | 5,119 | - | - | - |
| Directors' remuneration | | - | - | - | - | - | (120) | (120) | - | (120) |
| Net movement in minority interests | | - | - | - | - | - | - | - | 2,436 | 2,436 |
| Bonus shares issued | | 3,500 | - | - | - | - | (3,500) | - | - | - |
| Transfer to statutory reserve | | - | - | 1,517 | - | - | (1,517) | - | - | - |
| Balance at 31 December 2005 | | 38,500 | - | 2,985 | - | 3,992 | 18,325 | 63,802 | 2,777 | 66,579 |
| Income for the year | | - | - | - | - | - | 21,130 | 21,130 | (367) | 20,763 |
| Transfer to investment revaluation reserve | | - | - | - | - | 11,738 | (11,738) | - | - | - |
| Transfer to retained earnings on sale of investments | | - | - | - | - | (3,672) | 3,672 | - | - | - |
| Directors' remuneration | | - | - | - | - | - | (149) | (149) | - | (149) |
| Net movement in minority interests | | - | - | - | - | - | - | - | 21 | 21 |
| Transfer to general reserve | 18 | - | - | - | 18,300 | - | (18,300) | - | - | - |
| Bonus shares issued | 18 | 4,500 | - | - | (4,500) | - | - | - | - | - |
| Issue of new shares | 18 | 1,560 | 760 | - | - | - | - | 2,320 | - | 2,320 |
| Transfer to statutory reserve | | - | - | 2,113 | - | - | (2,113) | - | - | - |
| **Balance at 31 December 2006** | | **44,560** | **760** | **5,098** | **13,800** | **12,058** | **10,827** | **87,103** | **2,431** | **89,534** |

Note: Included in retained earnings is a non-distributable reserve amounting to BD 33 thousand (2005: BD 23 thousand) relating to a subsidiary of the Bank.

The attached notes 1 to 34 form part of these consolidated financial statements.

| | 2006<br>BD 000s | 2005<br>BD 000s |
|---|---|---|
| Investment at 1 January | **11,007** | - |
| Deposits and issues | **9,624** | 10,831 |
| Liquidation and withdrawals | **(1,795)** | - |
| Investment profit | **273** | 176 |
| Investment at 31 December | **19,109** | 11,007 |

The attached notes 1 to 34 form part of these consolidated financial statements.

## 1 INCORPORATION AND ACTIVITIES

Kuwait Finance House (Bahrain) B.S.C. (c) ["the Bank"] is a closed joint stock company incorporated in the Kingdom of Bahrain on 22 January 2002 under the Bahrain Commercial Companies Law No. 21/2001 and is registered with the Ministry of Industry and Commerce under commercial registration (CR) number 48128. The Bank is regulated and supervised by the Central Bank of Bahrain (CBB) [formerly Bahrain Monetary Agency] and has a retail Islamic banking license and is operating under Islamic principles, and in accordance with all the relevant regulatory guidelines for Islamic banks issued by the CBB. The address of the Bank's registered office is Building 121, Government Avenue, Block 304, Manama, Kingdom of Bahrain.

The Bank offers a full range of Islamic banking services and products. The activities of the Bank include accepting Shari'a money placements/deposits, managing Shari'a profit sharing investment accounts, offering Shari'a financing contracts, dealing in Shari'a compliant financial instruments as principal/agent, managing Shari'a compliant financial instruments and other activities permitted for under the CBB's Regulated Banking Services as defined in the licensing framework. The activities of the Bank's subsidiaries are mentioned in note 4.

The Bank is a subsidiary of Kuwait Finance House K.S.C. ["the Parent Company"], a public company incorporated in the State of Kuwait. The Bank's Shari'a Supervisory Board is entrusted to ensure the Bank's adherence to Shari'a rules and principles in its transactions and activities.

The Bank and its subsidiaries (together the "Group") operate in the Kingdom of Bahrain and Hashemite Kingdom of Jordan.

The consolidated financial statements were authorized for issue in accordance with a resolution of the Board of Directors on 30 January 2007.

## 2 BASIS OF PREPARATION

The consolidated financial statements have been prepared in accordance with Financial Accounting Standards [FAS] issued by the Accounting and Auditing Organisation for Islamic Financial Institutions [AAOIFI], International Financial Reporting Standards [IFRS] and in conformity with the Bahrain Commercial Companies Law and the Central Bank of Bahrain and Financial Institutions Law.

The consolidated financial statements have been prepared under the historical cost convention as modified for the measurement at fair value of investments and investment properties.

The accounting policies are consistent with those used in the previous year.

The consolidated financial statements have been presented in Bahraini Dinars which is the functional currency of the Group.

### Basis of consolidation

The consolidated financial statements comprise the financial statements of the Group as at 31 December each year. The financial statements of the subsidiaries are prepared for the same reporting year as the Bank, using consistent accounting policies.

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

Subsidiaries are fully consolidated from the date of acquisition, being the date on which the Group obtains control, which is other than fiduciary in nature, and continue to be consolidated until the date that such control ceases.

Minority interests represent the portion of profit or loss and net assets not held by the Group and are presented separately in the consolidated statement of income and within equity in the consolidated balance sheet, separately from parent shareholders' equity.

## 3 SIGNIFICANT ACCOUNTING POLICIES

**IASB Standards and Interpretations issued but not adopted**
The following IASB Standards and Interpretations have been issued but are not yet mandatory, and have not yet been adopted by the Group:

- IFRS 7 *Financial Instruments: Disclosures*
- IFRIC *Interpretation 8 Scope of IFRS 2*
- IFRIC Interpretation 11 *IFRS 2 – Group and Treasury Share Transactions*

The application of IFRS 7, which will be effective for the year ending 31 December 2007 will result in amended and additional disclosures relating to financial instruments and associated risks. The application of IFRIC 8 and 11 which are also effective for 2007 is not expected to have a material impact on the consolidated financial statements of the Group.

The significant accounting policies adopted in the preparation of the consolidated financial statements are set out below:

**Financial contracts**
Financial contracts consist of Murabaha (net of deferred profits) and Mudaraba investments. Balances relating to these contracts are stated at cost, less any amounts written-off and provision for impairment.

**Non-trading investments**
These are classified as follows:

- Carried at fair value through income statement
- Held to maturity
- Available for sale

All non-trading investments are initially recognised at cost being the fair value of consideration given including acquisition charges associated with the investment. After initial recognition, non-trading investments are remeasured using the policies given below:

*Carried at fair value through income statement*
Investments are classified as fair value through income statement if the fair value of the investment can be reliably measured and the classification as fair value through income statement is as per the documented strategy of the Bank. Investments classified as “Investments carried at fair value through income statement” upon initial recognition are remeasured at fair value with all changes in fair value being recorded in the income statement.

*Held to maturity*
Investments classified as held to maturity have fixed or determinable payments and fixed maturity and are intended to be held to maturity. They are carried at amortized cost using the effective profit rate method, less provision for impairment.

*Available for sale*
Other investments are classified as “available for sale” and are remeasured at fair value, unless fair value cannot be reliably determined in which case they are measured at cost less impairment. Fair value changes are reported as a separate component of equity until the investment is derecognised or the investment is determined to be impaired. On derecognition or impairment the cumulative gain or loss previously reported as “cumulative changes in fair value” within equity, is included in the consolidated statement of income for the year.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### Fair values

For investments quoted in an active market, fair value is determined by reference to quoted market prices. Bid prices are used for assets and offer prices are used for liabilities. The fair value of investments in managed funds is based on net asset values provided by fund managers.

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

(a) recent transactions

(b) brokers' quotes

(c) the expected cash flows discounted at current rates applicable for items with similar terms and risk characteristics

(d) valuation models

### Premises and equipment

All items of premises and equipment are initially recorded at cost. Depreciation is provided on a straight-line basis over the estimated useful lives of all premises and equipment, other than freehold land which is deemed to have an indefinite life.

### Ijarah Muntahia Bittamleek

Ijarah Muntahia Bittamleek comprises assets, mainly land and buildings, leased to third parties, under terms that would transfer the ownership of the assets to third parties at the end of the lease period.

Ijarah assets are recorded at cost. Depreciation is provided on all Ijarah assets at rates calculated to write off the cost of each asset over the period of the lease.

### Istisna'a

Istisna'a comprises direct costs of producing 'al-masnoo' and indirect costs relating to the contract allocated on an objective basis. Istisna'a costs incurred during the year are recognised as an asset.

### Investment in associates

The Group's investment in its associate is accounted for under the equity method of accounting. An associate is an entity in which the Group has significant influence and which is neither a subsidiary nor a joint venture.

Under the equity method, the investment in the associate is carried in the balance sheet at cost plus post- acquisition changes in the Group's share of net assets of the associate. Goodwill relating to an associate is included in the carrying amount of the investment and is not amortized. After application of the equity method, the Group determines whether it is necessary to recognise any additional impairment loss with respect to the Group's net investment in the associate. The consolidated statement of income reflects the share of the results of operations of the associate. Where there has been a change recognised directly in the equity of the associate, the Group recognises its share of any changes and discloses this, when applicable, in the consolidated statement of changes in equity.

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

### Investment properties

Investment properties are those held to earn rentals and/or for capital appreciation. These are initially recorded at cost, including acquisition charges associated with the property.

Subsequent to initial recognition, all investment properties are remeasured at fair value and changes in fair value are recognised in the statement of income as unrealized gain or loss in investment properties. The fair value of the investment properties is determined based on valuations made by independent valuers. Realized gains or losses are disclosed as profit or loss on sale of investment properties.

**3 SIGNIFICANT ACCOUNTING POLICIES** (continued)

**Investment revaluation reserve**
Unrealized gains resulting from revaluation of non-trading investments and investment properties, related to shareholders' funds, are appropriated to investment revaluation reserve and are not available for distribution to shareholders. Upon disposal of these investments, the related cumulative gain is transferred to retained earnings and is available for distribution.

**Goodwill**
Goodwill acquired in a business combination is initially measured at cost being the excess of the cost of the business combination over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is reviewed for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Group's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the Group are assigned to those units or groups of units. Each unit or group of units to which the goodwill is the lowest level within the Group at which the goodwill is monitored for internal management purposes.

Impairment is determined by assessing the recoverable amount of the cash-generating unit (group of cash- generating units), to which the goodwill relates. Where the recoverable amount of the cash-generating unit (group of cash-generating units) is less than the carrying amount, an impairment loss is recognised. Where goodwill forms part of a cash-generating unit (group of cash-generating units) and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the cash-generating unit retained.

**Intangibles**
Intangibles include the value of patent and license rights. The cost of intangibles is their fair value as at the date of acquisition of the business combination. Following initial recognition, intangibles are carried at cost less any accumulated amortisation and any accumulated impairment losses.

Intangibles are amortised over the useful economic life. The amortisation period and the amortisation method are reviewed at least at each financial year end. The amortisation expense on the intangibles is recognised in the statement of income.

**Unrestricted investment accounts**
All unrestricted investment accounts are carried at cost less amounts repaid.

**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 able to be reliably measured.

**Offsetting**
Financial assets and financial liabilities are only offset and the net amount reported in the 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.

**Cash and cash equivalents**
Cash and cash equivalents comprise of cash and balances with banks and the Central Bank of Bahrain (excluding mandatory reserve deposits) and murabahas and mudarabas with banks with original maturities of less than 90 days.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### Revenue recognition

*Murabaha*
Where the income is quantifiable and contractually determined at the commencement of the contract, income is recognised on a time-apportioned basis over the period of the contract based on the principal amounts outstanding. Where the income from a contract is not quantifiable, it is recognised when realized. Accrual of income is suspended when the Bank believes that the recovery of these amounts may be doubtful or when the repayments are overdue by 90 days, whichever is earlier.

*Mudaraba*
Income and losses on Mudaraba transactions are recognised when the right to receive is established or these are declared by the Mudarib, whichever is earlier.

*Dividends*
Dividends from investments in equities are recognised when the right to receive the dividend is established.

*Ijarah*
Ijarah income is recognised on a time-apportioned basis over the lease term.

*Istisna*
Istisna income is recognised over the construction period using the percentage completion method.

*Fees and commission income*
Fees and commission income is recognised when earned.

### Allocation of income
Income is allocated proportionately between unrestricted investment accounts and shareholders on the basis of the average balances outstanding during the year and share of the funds invested.

### Foreign currencies
Foreign currency transactions are recorded at rates of exchange prevailing at the dates of transactions. Monetary assets and liabilities in foreign currencies and equity investments carried at fair value are translated into Bahraini Dinar at rates of exchange prevailing at the balance sheet date. Any gains or losses on translation of monetary assets, liabilities and equity investments classified as trading are taken to the consolidated statement of income. Gains or losses on equity investments classified as available for sale are taken to a separate component of equity.

### Trade and settlement date accounting
Purchases and sales of financial assets are recognised on the trade date, i.e. the date that the Group commits to purchase or sell the asset.

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

### Restricted investment accounts
Restricted investment accounts represents assets held in trust or in a fiduciary capacity by the Group for the benefit of the investment accounts holders. The restricted investment accounts are exclusively restricted for investment in specified projects as directed by the investments account holders.

### Impairment and uncollectability of financial assets
An assessment is made at each balance sheet date to determine whether there is objective evidence that a specific financial asset may be impaired. If such evidence exists, any impairment loss, is recognised in the consolidated statement of income.

**3 SIGNIFICANT ACCOUNTING POLICIES** (continued)

Impairment is determined as follows:

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

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

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

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

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

*Impairment of investments*
The Group treats available for sale equity investments as impaired when there has been a significant or prolonged decline in the fair value below its cost or where other objective evidence of impairment exists. In addition, the Group evaluates other factors, including normal volatility in share price for quoted equities and the future cash flows and the discount factors for unquoted equities.

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

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

*Collective impairment provisions on financial contracts*
In addition to specific provisions against individually significant financial contracts the Group also makes a collective impairment provision against financial contracts which although not specifically identified as requiring a specific provision have a greater risk of default than when originally granted. This collective provision is based on any deterioration in the internal grade of the financial contract since it was granted (acquired). The amount of the provision is based on the historical loss pattern for other contracts within each grade and is adjusted to reflect current economic changes.

These internal grading 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.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

*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; or
- other valuation models.

The Group calibrates the valuation techniques periodically and tests these for validity using either prices from observable current market transactions in the same instrument or other available observable market data. Nonetheless, the actual amount that is realised in a future realisation transaction may differ from the current valuation and may still be different from the management's estimates, given the inherent uncertainty surrounding valuations of unquoted equity investments.

## 4 INVESTMENT IN SUBSIDIARIES

Key subsidiaries, all of which have 31 December as their year end, are as follows:

| Subsidiary | Activities | Year of incorporation | Country of incorporation | Ownership % |
|---|---|---|---|---|
| Mena Telecom W.L.L. | The company is a licensed telecommunications company and a Satellite Access Service Provider. | 2003 | Kingdom of Bahrain | 100.00 |
| Miracle Graphics Company W.L.L. | The company is engaged in the business of designing, big format printing, reprographics and publishing. | 2003 | Kingdom of Bahrain | 70.00 |
| Baytik Investment Advisory W.L.L. | The principal activity of the company is providing advisory services to the Bank and its affiliates. | 2003 | Kingdom of Bahrain | 100.00 |
| Bayan Group for Investment Properties W.L.L. | The principal activity of the company is to buy, sell and lease properties and to undertake joint ventures with other companies engaged in similar activities. | 2004 | Kingdom of Bahrain | 100.00 |
| Al Kindi Pharmaceutical Industries (Public Shareholding Company) | The company is engaged in the manufacture of drugs in all their pharmaceutical dosage forms and the manufacturing of semi-pharmaceutical products specialised for skin care, cosmetics and others. | 1997 | Hashemite Kingdom of Jordan | 55.00 |

## 5 CASH AND BALANCES WITH BANKS AND CENTRAL BANK OF BAHRAIN

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Cash | **1,276** | 1,461 |
| Nostro balances | **9,519** | 720 |
| Balances with Central Bank of Bahrain | **10,588** | 6,434 |
| | **21,383** | 8,615 |

## 6 MURABAHA AND MUDARABA CONTRACTS WITH BANKS

| | Europe | | Middle East | | Total | |
|---|---|---|---|---|---|---|
| | 2006 BD 000s | 2005 BD 000s | 2006 BD 000s | 2005 BD 000s | **2006 BD 000s** | 2005 BD 000s |
| Murabaha contracts with banks - international commodities | - | - | 62,226 | 36,665 | **62,226** | 36,665 |
| Deferred profits | - | - | (472) | (214) | **(472)** | (214) |
| | - | - | 61,754 | 36,451 | **61,754** | 36,451 |
| Mudaraba contract with banks | 4,900 | 8,668 | - | - | **4,900** | 8,668 |
| | 4,900 | 8,668 | 61,754 | 36,451 | **66,654** | 45,119 |

## 7 MURABAHA, ISTISNA'A AND IJARAH MUNTAHIA BITTAMLEEK CONTRACTS - RELATING TO CUSTOMERS

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Murabaha contracts | **72,620** | 61,683 |
| Deferred profits | **(7,295)** | (6,466) |
| | **65,325** | 55,217 |
| Ijarah Muntahia Bittamleek | **72,601** | 47,921 |
| Istisna'a contracts | **30,695** | 11,771 |
| | **168,621** | 114,909 |
| Provisions | **(6,665)** | (4,756) |
| | **161,956** | 110,153 |

## 7 MURABAHA, ISTISNA'A AND IJARAH MUNTAHIA BITTAMLEEK CONTRACTS - RELATING TO CUSTOMERS (continued)

Movement is Ijarah Muntahia Bittamleek assets is as follows:

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Opening balance | **47,921** | 21,035 |
| Additions during the year | **28,508** | 28,849 |
| Ijarah assets depreciation - net | **(3,828)** | (1,963) |
| Net book value | **72,601** | 47,921 |

The rentals received against Ijarah Muntahia Bittamleek are included in income from commercial banking activities. During the year, BD 2,358 thousand (2005: BD 1,354 thousand) has been provided as depreciation. Certain Ijarah have completed the contracted period whose accumulated depreciation amounted to BD 493 thousand.

The composition of the Murabaha, Istisna'a and Ijarah Muntahia Bittamleek contracts, net of deferred profits and provision, based on the status of the customer to the contract, is as follows:

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Commercial and business | **23,632** | 21,538 |
| Real estate | **63,078** | 69,977 |
| Private individuals | **75,246** | 18,638 |
| | **161,956** | 110,153 |

95% of the above are with customers based in the Middle East.

The movements in provisions were as follows:

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| At 1 January | **4,756** | 1,540 |
| Charge for the year | **1,909** | 3,216 |
| At 31 December | **6,665** | 4,756 |

At 31 December 2006 Murabaha, Istisna'a and Ijarah Muntahia Bittamleek contracts on which profit is not being accrued amounted to BD 336 thousand (2005: BD 336 thousand). Unrecognised profit relating to such contracts amounted to BD 47 thousand (2005: BD 47 thousand).

## 8 NON-TRADING INVESTMENTS

At 31 December 2006, the Bank has the following un-quoted investments:

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Carried at fair value through income statement - equities | **51,139** | 3,996 |
| Carried at fair value through income statement - managed funds | **8,648** | 7,698 |
| Available for sale - Government sukuk | **7,773** | 14,704 |
| Available for sale - other sukuk | **3,770** | - |
| Available for sale - equities | **11,733** | 15,597 |
| | **83,063** | 41,995 |

Available-for-sale investments, acquired recently, are carried at cost which at the year end best reflect the estimate of the fair values.

The composition of the investment portfolio is as follows:

| | New Zealand Australia BD 000s | Middle East BD 000s | Others BD 000s | Total 2006 BD 000s | Total 2005 BD 000s |
|---|---|---|---|---|---|
| Commercial and technology | 2,137 | 165 | 2,756 | **5,058** | 4,206 |
| Real estate development | - | 35,670 | - | **35,670** | 8,080 |
| Others | 18,234 | 20,548 | 3,553 | **42,335** | 29,709 |
| | 20,371 | 56,383 | 6,309 | **83,063** | 41,995 |

## 9 INVESTMENTS IN ASSOCIATES

The Group has investments in the following associates:

| | 2006 % | 2005 % |
|---|---|---|
| **Al-Enma Real Estate** | **33.33** | 33.33 |
| A company, incorporated in the Kingdom of Bahrain, engaged in property management of commercial, industrial and residential buildings in the Kingdom of Bahrain. | | |
| **Durrat Al-Bahrain** | **37.70** | 37.70 |
| A company, incorporated in the Kingdom of Bahrain, currently engaged in developing Durrat Al-Bahrain Island, a real estate project in the Kingdom of Bahrain. | | |

## 9 INVESTMENTS IN ASSOCIATES (continued)

The following table illustrates summarised financial information of the Group in the associates:

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Carrying amount of investments in associates at 1 January | **14,873** | 13,092 |
| Additional investment in an associate | **-** | 1,003 |
| Share of results | **512** | 778 |
| Carrying amount of investments in associates at 31 December | **15,385** | 14,873 |
| Share of associates' balance sheet | | |
| Current assets | **17,800** | 24,125 |
| Non current assets | **26,396** | 17,955 |
| Current liabilities | **(5,149)** | (13,005) |
| Non current liabilities | **(30,489)** | (21,679) |
| Net assets | **8,558** | 7,396 |
| Share of associates' revenue and income | | |
| Revenue | **6,805** | 6,614 |
| Income for the year | **512** | 778 |

## 10 INVESTMENT PROPERTIES

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| **Cost** | | |
| At the beginning of the year | **11,068** | 18,477 |
| Additions | **12,233** | 4,344 |
| Disposals | **(710)** | (11,753) |
| **At 31 December** | **22,591** | 11,068 |
| **Fair value adjustment** | | |
| At the beginning of the year | **3,669** | 6,004 |
| Gain on fair value adjustment | **3,017** | 2,827 |
| Relating to disposals | **(1,654)** | (5,162) |
| | **5,032** | 3,669 |
| **Total** | **27,623** | 14,737 |

## 10 INVESTMENT PROPERTIES (continued)

Investment properties at 31 December consist of the following:

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Buildings in Bahrain | **6,211** | 6,195 |
| Land in Bahrain | **21,412** | 8,542 |
| | **27,623** | 14,737 |

Investment properties were revalued as of dates close to the balance sheet date, by independent consultants who have reasonable and sufficient experience in the location and category of the properties being valued.

These include certain properties in which the Bank's share is valued at BD 3,300 thousand (2005: BD 1,818 thousand) which are jointly owned with affiliates and/or third parties and are subject to normal conditions applicable to joint ownership.

## 11 RECEIVABLES AND PREPAYMENTS

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Project expenses receivable (Note 24) | **2,978** | 568 |
| Profit receivable | **1,473** | 466 |
| Commission and management fee receivable (Note 24) | **1,448** | 1,130 |
| Accounts receivable for a placement | **1,301** | - |
| Prepaid expenses | **445** | 391 |
| Other assets | **3,623** | 6,019 |
| | **11,268** | 8,574 |

## 12 MURABAHA CONTRACTS WITH BANKS

Murabaha contracts with banks represent funds received from banks on the principles of Murabaha contracts.

## 13 MURABAHA CONTRACTS WITH NON-BANKS

These represent funds received from non-banks on the principles of Murabaha contracts.

## 14 CUSTOMERS' CURRENT ACCOUNTS

These represent customers' accounts which are not entitled to any profit distributions in accordance with the terms of the related agreements.

## 15 FUNDS UNDER MANAGEMENT

At 31 December 2006, clients' funds managed in a fiduciary capacity amounted to BD 97,078 thousand (2005: BD 74,835 thousand).

## 16 OTHER LIABILITIES

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Payable to a related party (Note 24) | **3,221** | - |
| Staff related accruals | **2,320** | 1,792 |
| Payable on account of financing contracts | **1,143** | - |
| Profit payable to unrestricted investment accounts | **946** | 226 |
| Compensating balances received against trade finance facilities | **788** | 593 |
| Profit payable to banks | **576** | 460 |
| Others | **3,881** | 4,454 |
| | **12,875** | 7,525 |

## 17 UNRESTRICTED INVESTMENT ACCOUNTS

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| (a) The composition of these is as follows: | | |
| Customers | 44,375 | 28,922 |
| Financial institution | - | 1,885 |
| | 44,375 | 30,807 |

(b) Profit allocation between unrestricted investment accounts and shareholders is as follows:

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Unrestricted investment accounts | 1,200 | 1,081 |
| Shareholders of the parent and minority interest | 20,763 | 15,118 |
| | 21,963 | 16,199 |

Unrestricted investment account holders' funds are commingled with the Bank's funds for investing in short term highly liquid investments and medium term murabahas, no priority is granted to any party for the purpose of distribution of profits. According to the terms of acceptance of the unrestricted investment accounts, 100% of the funds are invested after deductions of mandatory reserve and sufficient operational cash requirements. The mudarib fee on term deposits ranges from 20% to 35% depending on the investment period of the deposit and in case of saving deposits, where there is no restriction of cash withdrawal, the mudarib fee ranges from 50% to 60%. However, during the year, in addition to depositors share of profit, the bank has distributed profit to investors from its own share of mudarib fee.

The provisions for murabaha contracts is charged to both the shareholders and the holders of the unrestricted investment accounts, considering the allocation of various assets. Any reversal in provision is reversed to the extent it was charged to shareholders or the holders of the unrestricted investment accounts. Expenses are allocated in proportion to average unrestricted investment account to total average assets of the bank.

## 18 SHARE CAPITAL AND GENERAL RESERVE

The authorised, issued and fully paid-up share capital as of 31 December 2006 comprised 44,560,000 shares (2005: 38,500,000 shares) of BD 1 each.

Following resolutions passed by the shareholders of the Bank at an Extraordinary General Meeting (EGM) held on 15 May 2006 :

(a) the Bank has transferred BD 4,500 thousand to share capital from general reserve and BD 18,300 thousand to general reserve from retained earnings.

(b) 3.5% of the Bank's share capital (1,560 thousand shares) were issued at a premium of BD 0.49 per share to an SPV which will hold the shares for an Employee Stock Ownership Plan (ESOP), also approved by the shareholders. Under this ESOP eligible employees were offered to invest in the Bank's shares.

## 19 STATUTORY RESERVE

As required by Bahrain Commercial Companies Law and the Bank's articles of association, 10% of the net income for the year has been transferred to the statutory reserve. The Bank may resolve to discontinue such annual transfers when the reserve totals 50% of paid up share capital. The reserve is not distributable except in such circumstances as stipulated in the Bahrain Commercial Companies Law and following the approval of the Central Bank of Bahrain.

## 20 INCOME FROM INVESTMENT ACTIVITIES

| | **2006 BD 000s** | 2005 BD 000s |
|---|---|---|
| Gain on sale of investment carried at fair value through income statement | **16,893** | 8,449 |
| Unrealised gain on investment carried at fair value through income statement | **5,815** | - |
| Profit on sale of investment properties | **1,875** | 9,264 |
| Unrealised gain on investment properties | **1,363** | 2,784 |
| Unrealised gain on managed funds | **890** | - |
| Income from managed funds | **81** | 227 |
| Other income | **1,263** | 2,091 |
| | **28,180** | 22,815 |

## 21 INCOME FROM RETAIL AND CORPORATE BANKING ACTIVITIES

| | **2006 BD 000s** | 2005 BD 000s |
|---|---|---|
| Income from Murabaha contracts | **6,164** | 4,267 |
| Income from Ijarah and Istisna'a contracts | **7,303** | 3,272 |
| Income from international commodity Murabaha contracts | **4,002** | 1,810 |
| Fees and commission | **350** | 156 |
| | **17,819** | 9,505 |

## 22 OTHER OPERATING EXPENSES

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Administration, professional and others | **3,082** | 1,814 |
| Business development | **1,793** | 1,190 |
| Technology and communication | **871** | 598 |
| Premises - rentals and maintenance | **412** | 281 |
| | **6,158** | 3,883 |

## 23 CASH AND CASH EQUIVALENTS

Cash and cash equivalents included in the consolidated statement of cash flows comprise of the following balance sheet amounts:

| | 2006 BD 000s | 2005 BD 000s |
|---|---|---|
| Cash and balances with banks and Central Bank of Bahrain, excluding mandatory reserve deposits | **15,668** | 4,580 |
| Murabaha contracts | **57,984** | 21,997 |
| Mudaraba contracts | **3,958** | 2,913 |
| | **77,610** | 29,490 |

## 24 RELATED PARTY TRANSACTIONS

Related parties represents associated companies, parent company and its major shareholders, directors and key management personnel of the Bank, and entities controlled, jointly controlled or significantly influenced by such parties. Pricing policies and terms of these transactions are approved by the Bank's management. All the facilities to related parties are performing facilities and are free of any provision for possible credit losses.

**24 RELATED PARTY TRANSACTIONS** (continued)

The following balances arise from transactions entered into with related parties:

| | Associated companies BD 000s | Parent and its major shareholders BD 000s | Directors and key management personnel BD 000s | Other related parties BD 000s | **2006 BD 000s** | 2005 BD 000s |
|---|---|---|---|---|---|---|
| Mudaraba contracts with a bank | - | - | - | 4,900 | **4,900** | 8,668 |
| Murabaha contracts - relating to customers | - | - | - | 622 | **622** | 7,508 |
| Project expenses receivable (Note 11) | 365 | - | - | 2,613 | **2,978** | 568 |
| Commission and management fee receivable (Note 11) | 1,448 | - | - | - | **1,448** | 1,130 |
| Murabaha contracts with banks | - | - | - | 5,278 | **5,278** | 12,433 |
| Murabaha contracts with non-banks | 14,869 | - | - | - | **14,869** | 20,801 |
| Customers' current accounts | 1,886 | 1,713 | 184 | 131 | **3,914** | 4,233 |
| Other liabilities (Note 16) | 3,221 | - | - | 151 | **3,372** | - |
| Unrestricted investment accounts | 2,595 | - | 1,319 | 3,992 | **7,906** | 11,825 |
| Letter of credit | 5,678 | - | - | - | **5,678** | 5,678 |
| Guarantees | - | - | - | 2,451 | **2,451** | - |

The income and expenses in respect of related parties, in addition to those arising from investment transactions, included in the consolidated financial statements are as follows:

| | Associated companies BD 000s | Parent and its major shareholders BD 000s | Directors and key management personnel BD 000s | Other related parties BD 000s | **2006 BD 000s** | 2005 BD 000s |
|---|---|---|---|---|---|---|
| Income from managed funds | - | - | - | 971 | **971** | 227 |
| Other investment banking income | 245 | - | - | 202 | **447** | 96 |
| Income from international commodity murabaha contracts | - | - | - | 480 | **480** | 133 |
| Fee and commission income | 24 | - | - | 66 | **90** | 216 |
| Profit paid on Murabaha contracts from banks and others | 1,090 | - | - | - | **1,090** | - |
| Operating expenses | - | - | - | 594 | **594** | 425 |

**Compensation of key management personnel is as follows:**

| | **2006 BD 000s** | 2005 BD 000s |
|---|---|---|
| Short term employee benefits | **619** | 608 |

## 25 CREDIT COMMITMENTS AND CONTINGENT ITEMS

***Credit related commitments***

These include commitments to enter into contracts which are designed to meet the requirements of the Bank's customers. Commitments represent contractual commitments under Murabaha, Mudaraba and Ijarah Muntahia Bittamleek contracts. Commitments generally have fixed expiration dates, or other termination clauses. Since commitments may expire without being exercised, the total contract amounts do not necessarily represent future cash flow requirements.

Letters of credit and guarantees (including standby letters of credit) commit the Bank to make payments on behalf of customers contingent upon the failure of the customer to perform under the terms of the contract.

The Bank has the following credit related commitments:

| | **2006 BD 000s** | 2005 BD 000s |
|---|---|---|
| ***Commitments on behalf of customers:*** | | |
| Letters of credit | **8,062** | 7,186 |
| Guarantees | **16,893** | 9,409 |
| | **24,955** | 16,595 |
| ***Irrevocable commitments to extend credit:*** | | |
| Original term to maturity of one year or less | **6,048** | 19,136 |
| | **31,003** | 35,731 |

***Capital and operating lease commitments***

At 31 December 2006 the Bank had commitments in respect of non cancellable operating leases amounting to BD 4,532 thousand (2005: BD 320 thousand) relating to leasehold premises. Of the commitments in respect of operating leases BD 150 thousand (2005: BD 137 thousand) expire within one year and the remaining expire within two to five years.

The Bank does not expect any material loss in respect of the above.

## 26 CREDIT RISK

Credit risk is the risk that one party to a financial contract will fail to discharge an obligation and cause the other party to incur a financial loss. The Group manages credit risk by setting limits for individual customers, and groups of customers and for geographical and industry segments. The Group also monitors credit exposures and continually assesses the creditworthiness of counterparties. All financing contracts are secured by the continued ownership of the object of the financing contracts until the time the obligations are fully met and personal guarantees of the counterparty, thus the risk of non payment is limited to the opportunity of reinvesting the installments in the cases of non payment on the due date.

For details of the composition of the various assets involving credit risk, refer notes 6, 7, 8 and 10.

## 27 CONCENTRATIONS

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Group's performance to developments affecting a particular industry or geographic location. The Group manages its credit risk exposure through diversification of financing activities to avoid undue concentrations of risks with customers in specific locations or businesses.

## 27 CONCENTRATIONS (continued)

The distribution of assets, liabilities, unrestricted investment accounts and off-balance sheet items by geographic region and industry sector was as follows:

| | Assets | | Liabilities and equity | | Credit commitments and contingent items | |
|---|---|---|---|---|---|---|
| | **2006 BD 000s** | 2005 BD 000s | **2006 BD 000s** | 2005 BD 000s | **2006 BD 000s** | 2005 BD 000s |
| **Geographic region:** | | | | | | |
| Middle East | **373,499** | 241,118 | **308,232** | 191,306 | **31,003** | 35,731 |
| Europe | **6,309** | 2,667 | **-** | - | **-** | - |
| New Zealand / Australia | **20,439** | 12,395 | **-** | - | **-** | - |
| Others | **2,797** | 4,436 | **5,278** | 2,731 | **-** | - |
| | **403,044** | 260,616 | **313,510** | 194,037 | **31,003** | 35,731 |
| Equity | **-** | - | **89,534** | 66,579 | **-** | - |
| | **403,044** | 260,616 | **403,044** | 260,616 | **31,003** | 35,731 |
| **Industry sector:** | | | | | | |
| Trading and business | **36,874** | 44,305 | **14,233** | 1,929 | **31,003** | 35,731 |
| Banks and financial institutions | **99,384** | 71,914 | **155,636** | 54,698 | **-** | - |
| Construction and real estate | **147,254** | 76,864 | **78,426** | 33,553 | **-** | - |
| Individuals | **76,807** | 51,810 | **47,888** | 87,863 | **-** | - |
| Others | **42,725** | 15,723 | **17,327** | 15,994 | **-** | - |
| | **403,044** | 260,616 | **313,510** | 194,037 | **31,003** | 35,731 |
| Equity | **-** | - | **89,534** | 66,579 | **-** | - |
| | **403,044** | 260,616 | **403,044** | 260,616 | **31,003** | 35,731 |

## 28 MARKET RISK

Market risk arises from fluctuations in global yields on financial instruments and foreign exchange rates that could have an indirect effect on the Group's assets value and equity prices. The Board has set limits on the value of risk that may be accepted. This is monitored on a regular basis by the Asset and Liability Committee of the Bank.

## 29 PROFIT RATE RISK

The Group is not exposed to interest rate risk on its financial assets as the Group does not charge interest. However, the fair value of financial assets may be affected by current market forces including interest rates. The Group recognises income on certain of its financial assets on a time-apportioned basis. The following table indicates the profit rate on these at the balance sheet date based on the annualised income to be recognised, expressed as a percentage of the principle outstanding:

## 29 PROFIT RATE RISK (continued)

| | Profit rate % | |
|---|---|---|
| | **2006** | 2005 |
| Murabaha and Mudaraba contracts with banks | **3.80 - 6.50** | 3.20 - 6.41 |
| Murabaha, Istisna'a and Ijarah Muntahia Bittamleek contracts relating to customers | **7.00 - 11.65** | 7.00 - 10.00 |

Income is allocated proportionately between unrestricted investment accounts and shareholders on the basis of average balances outstanding during the year and share of the funds invested, except for the following which are at predetermined rate:

| | Predetermined profit rate % | |
|---|---|---|
| | **2006** | 2005 |
| Murabaha contracts with banks | 4.85 - 6.02 | 3.99 -5.08 |
| Murabaha contracts with non-banks | 3.45 - 5.65 | 2.90 - 3.50 |

## 30 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 views itself as a Bahraini entity, with the Bahrain Dinar as its functional currency. The Board has set limits on positions by currency. Positions are monitored on a periodic basis to ensure positions are maintained within established limits.

Substantial portion of the Group's assets and liabilities are denominated in Bahrain Dinars or US Dollars. US Dollar is pegged to Bahrain Dinar and as such the currency risk is minimal.

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

| | **2006** | 2005 |
|---|---|---|
| | **BD 000s** | BD 000s |
| New Zealand Dollars | **19,143** | 8,416 |
| Pound Sterling | **2,762** | 2,667 |

## 31 LIQUIDITY RISK

Liquidity risk is the risk that the Group will be unable to meet its liabilities when they fall due. To limit this risk, management has arranged diversified funding sources, manages assets with due considerations to liquidity requirements and monitors liquidity on a daily basis. In addition, the bank maintains a mandatory deposit with the Central Bank of Bahrain equal to 5% of non-banking customer deposits.

The table below summarises the maturity profile of the Group's assets and liabilities based on contractual repayment arrangements. The maturities of assets and liabilities have been determined on the basis of the remaining period at the balance sheet date to the contractual maturity date and do not take account of the effective maturities as indicated by the Group's deposit retention expectation and the availability of liquid funds.

**31 LIQUIDITY RISK** (continued)

The assets, liabilities and unrestricted investment accounts maturities are based on contractual repayment arrangements and as such do not take account of effective maturities of deposits as indicated by the Bank's deposit retention records. The maturity profile of the assets, liabilities and unrestricted investment accounts at 31 December 2006 was as follows:

| | Up to 3 months BD 000s | 3 months to 1 year BD 000s | 1 to 5 years BD 000s | 5 to 10 years BD 000s | 10 to 20 years BD 000s | Undated BD 000s | Total BD 000s |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with banks and Central Bank of Bahrain | 15,668 | - | - | - | - | 5,715 | 21,383 |
| Murabaha and Mudaraba contracts with banks | 61,942 | 4,712 | - | - | - | - | 66,654 |
| Murabaha, Istisna'a and Ijarah Muntahia Bittamleek contracts relating to customers | 11,321 | 25,699 | 88,109 | 31,108 | 5,719 | - | 161,956 |
| Non-trading investments | 1,208 | 910 | 9,425 | - | - | 71,520 | 83,063 |
| Investment held for sale | - | - | - | - | - | - | - |
| Investments in associates | - | - | - | - | - | 15,385 | 15,385 |
| Investment properties | - | - | - | - | - | 27,623 | 27,623 |
| Receivables and prepayments | 11,268 | - | - | - | - | - | 11,268 |
| Goodwill and intangibles | - | - | - | - | - | 2,508 | 2,508 |
| Premises and equipment | - | - | - | - | - | 13,204 | 13,204 |
| Total assets | 101,407 | 31,321 | 97,534 | 31,108 | 5,719 | 135,955 | 403,044 |
| **Liabilities and unrestricted investment accounts** | | | | | | | |
| Murabaha contracts with banks | 100,941 | 9,425 | - | - | - | - | 110,366 |
| Murabaha contracts with non-banks | 96,437 | 1,100 | 1,808 | - | - | - | 99,345 |
| Customers' current accounts | 46,549 | - | - | - | - | - | 46,549 |
| Other liabilities | 12,875 | - | - | - | - | - | 12,875 |
| Total liabilities | 256,802 | 10,525 | 1,808 | - | - | - | 269,135 |
| Unrestricted investment accounts | 36,968 | 7,407 | - | - | - | - | 44,375 |
| Total liabilities and unrestricted investment accounts | 293,770 | 17,932 | 1,808 | - | - | - | 313,510 |
| Net liquidity gap | (192,363) | 13,389 | 95,726 | 31,108 | 5,719 | 135,955 | 89,534 |

**31 LIQUIDITY RISK** continued

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

| | Up to 3 months BD 000s | 3 months to 1 year BD 000s | 1 to 5 years BD 000s | 5 to 10 years BD 000s | 10 to 20 years BD 000s | Undated BD 000s | Total BD 000s |
|---|---|---|---|---|---|---|---|
| Assets | | | | | | | |
| Cash and balances with banks and Central Bank of Bahrain | 4,580 | - | - | - | - | 4,035 | 8,615 |
| Murabaha and Mudaraba contracts with banks | 42,857 | 2,262 | - | - | - | - | 45,119 |
| Murabaha, Istisna'a and Ijarah Muntahia Bittamleek contracts relating to customers | 8,610 | 10,929 | 33,476 | 35,024 | 22,114 | - | 110,153 |
| Non-trading investments | 26,398 | - | - | - | - | 15,597 | 41,995 |
| Investment held for sale | - | 2,667 | - | - | - | - | 2,667 |
| Investments in associates | - | - | - | - | - | 14,873 | 14,873 |
| Investment properties | | - | - | - | - | 14,737 | 14,737 |
| Receivables and prepayments | 8,574 | - | - | - | - | - | 8,574 |
| Goodwill and intangibles | - | - | - | - | - | 2,843 | 2,843 |
| Premises and equipment | - | - | - | - | - | 11,040 | 11,040 |
| Total assets | 91,019 | 15,858 | 33,476 | 35,024 | 22,114 | 63,125 | 260,616 |
| Liabilities and unrestricted investment accounts | | | | | | | |
| Murabaha contracts with banks | 37,494 | - | 18,850 | - | - | - | 56,344 |
| Murabaha contracts with non-banks | 68,179 | - | - | - | - | - | 68,179 |
| Customers' current accounts | 31,182 | - | - | - | - | - | 31,182 |
| Other liabilities | 7,525 | - | - | - | - | - | 7,525 |
| Total liabilities | 144,380 | - | 18,850 | - | - | - | 163,230 |
| Unrestricted investment accounts | 22,761 | 8,046 | - | - | - | - | 30,807 |
| Total liabilities and unrestricted investment accounts | 167,141 | 8,046 | 18,850 | - | - | - | 194,037 |
| Net liquidity gap | (76,122) | 7,812 | 14,626 | 35,024 | 22,114 | 63,125 | 66,579 |

## 32 FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is the amount at which an asset could be exchanged or a liability settled in a transaction between knowledgeable, willing parties in an arm's length transaction. Underlying the definition of fair value is the presumption that the Group is a going concern without any intention or requirement to curtail materially the scale of its operation.

The carrying value of financial instruments is not significantly different from the fair values.

## 33 SOCIAL RESPONSIBILITY

The Bank discharges its social responsibilities through donations to charitable causes and organisations approved by Shari'a Supervisory Board.

## 34 ZAKAH

In accordance with the instructions of the Sharia'a Supervisory Board of the Bank, payment of Zakah is the responsibility of the shareholders of the Bank. Accordingly, no Zakah has been charged to these financial statements.