NOTES TO THE FINANCIAL STATEMENTS

1. Principal activities

The Company is an investment holding company and its subsidiaries are principally engaged in the provision of banking and related financial services in Hong Kong.

The Company is a limited liability company incorporated and listed in Hong Kong. The address of its registered office is 52/F, Bank of China Tower, 1 Garden Road, Hong Kong.

2. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below.

These policies have been consistently applied to all the years presented, unless otherwise stated.

2.1 Basis of preparation

The consolidated financial statements of the Group have been prepared in accordance with Hong Kong Financial Reporting Standards (HKFRSs is a collective term which includes all applicable individual Hong Kong Financial Reporting Standards, HKASs and Interpretations) issued by the HKICPA, accounting principles generally accepted in Hong Kong and the requirements of the Hong Kong Companies Ordinance. These financial statements also comply with the requirements set out in the guideline on "Financial Disclosure by Locally Incorporated Authorized Institutions" under the Supervisory Policy Manual issued by the HKMA and the applicable disclosure provisions of the Rules Governing the Listing of Securities on the Stock Exchange.

The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale securities, financial assets and financial liabilities (including derivative financial instruments) at fair value through profit or loss, investment properties which are carried at open market value and premises which are carried at open market value or revalued amount less accumulated depreciation and accumulated impairment losses.

The preparation of financial statements in conformity with HKFRSs requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 3.

Application of merger accounting

The Company purchased a 51% equity interest in BOC Life from BOC Insurance on 1 June 2006 for HK$900 million in cash. BOC Life and the Company are both under the common control of BOC before and after the combination. The Group has applied the Accounting Guideline No.5 – "Merger Accounting for Common Control Combinations", using the principles of merger accounting, in accounting for the combination with BOC Life as though the business of BOC Life had always been carried out by the Group. The consolidated financial statements represent the consolidated results, consolidated cash flows and consolidated financial position of the Group as if the combination had occurred from the date when the Company and BOC Life first came under the control of BOC.

2. Summary of significant accounting policies (continued)

2.1 Basis of preparation (continued)

Application of merger accounting (continued)

An uniform set of accounting policies is adopted by the Group. The Group recognises the assets, liabilities and equity of BOC Life at the carrying amounts in the consolidated financial statements of BOC prior to the purchase of the company. Comparative amounts are presented as if the entities had been combined at the previous balance sheet date. No adjustment has been made to align inconsistent accounting policies between the Group and BOC Life before the combination as the effect on net assets and net profit or loss is not significant.

The excess of consideration over carrying value at the time of combination is treated as a merger reserve in equity. The effects of all transactions between the Group and BOC Life, whether occurring before or after the combination, are eliminated in preparing the consolidated financial statements of the Group. The transaction costs for the combination were expensed in the income statement.

Newly adopted HKFRSs

In 2006, the Group adopted the revised HKFRSs as set out below, which are relevant to its operations.

- HKAS 39 (Amendment) Financial Guarantee Contracts
- HKAS 39 (Amendment) The Fair Value Option

The adoption of the above revised standards did not result in substantial changes to the Group's accounting policies and have no significant impact on its results of operations and financial position. No restatement of comparative figures was made as the amounts were immaterial. In summary:

(1) Financial Guarantee Contracts

In prior years, financial guarantee contracts were accounted for under HKAS 37 "Provisions, Contingent Liabilities and Contingent Assets" as contingent liabilities and were disclosed as off-balance sheet items.

With effect from 1 January 2006 and in accordance with the above amendment, financial guarantee contracts issued are recognised as financial liabilities and reported under "Other accounts and provisions". Financial guarantees are recognised initially at fair value and subsequently measured at the higher of (i) the amount recognised under HKAS 37, and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised over the life of the guarantee on a straight-line basis.

Financial liabilities related to financial guarantee contracts recorded under "Other accounts and provisions" at 31 December 2006 and 31 December 2005 were immaterial.

(2) The Fair Value Option

The fair value option refines the condition for which financial instruments can be classified as financial assets or financial liabilities at fair value through profit or loss provided that financial assets and liabilities are managed together for internal risk management and investment strategy purposes or accounting mismatches can be eliminated. It also stipulates the condition for which a hybrid contract embedded with derivatives can be entirely designated as at fair value through profit or loss. There is no difference in the Group's practice when compared with the prior year.

2. Summary of significant accounting policies (continued)

2.1 Basis of preparation (continued)

The adoption of HKFRS 4 "Insurance Contracts"

The standard is adopted due to the purchase of an insurance subsidiary during the year. No revenue, expenses, assets and liabilities related to insurance contracts was recognised in last year's financial statements. As merger accounting is adopted to account for the common control combination, comparative figures are prepared as if HKFRS 4 has been adopted in the previous periods. Details of the accounting policies on insurance contracts are disclosed in Note 2.19.

Interpretations to existing standards early adopted by the Group

- HK(IFRIC)-INT 9 "Reassessment of Embedded Derivatives" (effective for annual periods beginning on or after 1 June 2006). HK(IFRIC)-INT 9 requires an entity to assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. This interpretation does not have any impact on the Group's financial statements; and

- HK(IFRIC)-INT 10 "Interim Financial Reporting and Impairment" (effective for annual periods beginning on or after 1 November 2006). HK(IFRIC)-INT10 prohibits the impairment losses recognised in an interim period on goodwill, investments in equity instruments and investments in financial assets carried at cost to be reversed at a subsequent balance sheet date. This interpretation does not have any impact on the Group's financial statements.

Standards, amendments and interpretations effective in 2006 but not relevant to the Group's operations

The following standards, amendments and interpretations are mandatory for accounting periods beginning on or after 1 January 2006 but are not relevant to the Group's operations:

• HKAS 19 (Amendment)	Actuarial Gains and Losses, Group Plans, and Disclosures
• HKAS 21 (Amendment)	Net Investment in a Foreign Operation
• HKAS 39 (Amendment)	Cash Flow Hedge Accounting of Forecast Intragroup Transactions
• HKFRS 1 (Amendment)	First-time Adoption of Hong Kong Financial Reporting Standards
• HKFRS 6	Exploration for and Evaluation of Mineral Resources
• HKFRS-INT 4	Determining whether an Arrangement contains a Lease
• HKFRS-INT 5	Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
• HK(IFRIC)-INT 6	Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment

2. Summary of significant accounting policies (continued)

2.1 Basis of preparation (continued)

A standard that is not yet effective and has not been early adopted by the Group

The Group has chosen not to early adopt the following standard that was issued but not yet effective for accounting periods beginning on 1 January 2006:

- HKFRS 7 "Financial Instruments: Disclosures" and the Amendment to HKAS 1 "Presentation of Financial Statements – Capital Disclosures", are effective for annual accounting periods beginning on or after 1 January 2007. HKFRS 7 introduces certain new disclosures relating to financial instruments while incorporating many of the requirements presently in HKAS 32. HKFRS 7 will supersede HKAS 30 "Disclosures in the Financial Statements of Banks and Similar Financial Institutions", and the disclosure requirements of HKAS 32 "Financial Instruments: Disclosure and Presentation". The Group has assessed the impact of HKFRS 7 and the amendment to HKAS 1 and concluded that the key impact will be more qualitative and quantitative disclosures primarily related to fair value measurement and risk management. Accordingly the adoption of this standard will have no effect on the Group's results of operations or financial position. The Group will apply HKFRS 7 and the amendment to HKAS 1 from annual periods beginning 1 January 2007.

Interpretations to existing standards that are not yet effective and have been assessed to be not relevant to the Group's operations

- HK(IFRIC)-INT 7 "Applying the Restatement Approach under HKAS 29, Financial Reporting in Hyperinflationary Economies" (effective for annual periods beginning on or after 1 March 2006). HK(IFRIC)-INT 7 provides guidance on how to apply requirements of HKAS 29 in a reporting period in which an entity identifies the existence of hyperinflation in the economy of its functional currency, when the economy was not hyperinflationary in the prior period. As none of the group entities have a currency of a hyperinflationary economy as its functional currency, HK(IFRIC)-INT 7 is not relevant to the Group's operations;

- HK(IFRIC)-INT 8 "Scope of HKFRS 2" (effective for annual periods beginning on or after 1 May 2006). HK(IFRIC)-INT 8 requires consideration of transactions involving the issuance of equity instruments – where the identifiable consideration received is less than the fair value of the equity instruments issued – to establish whether or not they fall within the scope of HKFRS 2. As the Group has not issued equity instruments for payment except those exempted under HKFRS 2, HK(IFRIC)-INT 8 is not relevant to the Group's operations;

- HK(IFRIC)-INT 11 "HKFRS 2 Group and Treasury Share Transactions" (effective for annual periods beginning on or after 1 March 2007). HK(IFRIC)-INT 11 addresses how the share-based payment arrangement should be accounted for in the financial statements for the subsidiary that receives services from the employees. As the Group has not issued equity instruments for payment except those exempted under HKFRS 2, HK(IFRIC)-INT 11 is not relevant to the Group's operations.

2. Summary of significant accounting policies (continued)

2.2 Consolidation

(1) Subsidiaries

Subsidiaries, are all entities (including special purpose entities) over which the Group controls the composition of the Board of Directors, controls more than half of the voting power or holds more than half of the issued capital that entitle the Group to govern the financial and operating policies of the entities. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are de-consolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group except for acquisition of a company under common control which will apply the merger accounting method mentioned above. The cost of an acquisition of a company not under common control is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed as of the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values as of the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the Group's share of the identifiable net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Inter-company transactions, balances and unrealised gains on transactions between group companies are eliminated; unrealised losses are also eliminated unless the transaction provides evidence of impairment of the assets transferred. Where necessary, accounting policies of subsidiaries have been changed to ensure consistency with the policies adopted by the Group.

In the Company's balance sheet the investments in subsidiaries are stated at cost less allowance for impairment losses. The results of subsidiaries are accounted for by the Company on the basis of dividend received and receivable.

The gain or loss on the disposal of a subsidiary represents the difference between: a) the proceeds of the sale and, b) the Group's share of its net assets including goodwill on acquisition net of any accumulated impairment loss and any related accumulated foreign currency translation difference.

Minority interest represent the interests of outside shareholders in the operating results and net assets of subsidiaries.

2. Summary of significant accounting policies (continued)

2.2 Consolidation (continued)

(2) Associates

Associates are all entities over which the Group has significant influence but not control, generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for using the equity method of accounting and are initially recognised at cost. The Group's investment in associates includes goodwill, net of accumulated impairment loss and any related accumulated foreign currency translation difference.

The Group's share of the post-acquisition profits or losses of associates is recognised in the income statement, and its share of post-acquisition movements in reserves is recognised in reserves. The cumulative post-acquisition movements are adjusted against the cost of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, the Group does not recognise further losses unless the Group has incurred obligations or made payments on behalf of the associates.

Unrealised gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates; unrealised losses are also eliminated unless the transaction provides evidence of impairment of the asset transferred.

In the Company's balance sheet the investments in associates are stated at cost less allowance for impairment losses. The results of associates are accounted for by the Company on the basis of dividends received and receivable.

2.3 Segmental reporting

A business segment is a group of assets and operations engaged in providing products and services and that is subject to risks and returns that are different from those of other business segments. A geographical segment is a group of assets and operations engaged in providing products and services within a particular economic environment and that is subject to risks and returns that are different from those of segments operating in other economic environments.

2.4 Foreign currency translation

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the "functional currency"). The consolidated financial statements are presented in Hong Kong dollars, which is the Company's functional and presentation currency.

Foreign exchange gains and losses resulting from the settlement of foreign currency transactions are recognised directly in the income statement. Monetary assets and liabilities denominated in foreign currencies are translated at the rate of exchange at the balance sheet date. Non-monetary assets and liabilities that are measured in terms of historical cost are translated using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value are translated using the rate of exchange at the date the fair value was determined. Income and expenses denominated in foreign currencies are translated at average exchange rates or the exchange rates prevailing at the dates of the transactions. The differences arising from translation are recognised in the income statement except for translation differences on non-monetary items classified as available-for-sale financial assets which are included in the fair value change reserve in equity.

2. Summary of significant accounting policies (continued)

2.4 Foreign currency translation (continued)

The results and financial position of all group entities that have a functional currency different from Hong Kong dollars are translated into Hong Kong dollars as follows:

- assets and liabilities are translated at the closing rate at the balance sheet date;
- income and expenses are translated at average exchange rates; and
- all resulting exchange differences are recognised in the currency translation reserve in equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, and of borrowings and other currency instruments designated as hedges of such investments are taken to shareholders' equity. When a foreign entity is sold, such exchange differences are recognised in the income statement, as part of the gain or loss on sale.

2.5 Derivative financial instruments and hedge accounting

Derivatives are initially recognised at fair value on the date the derivative contract is entered into and are subsequently re-measured at fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and through the use of valuation techniques, including discounted cash flow models and options pricing models, as appropriate. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

Derivatives are categorised as held for trading under fair value through profit or loss unless they are designated as hedges and are effective hedging instruments, then they are subject to measurement under the hedge accounting requirements.

The best evidence of the fair value of a derivative at initial recognition is the transaction price (i.e., the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Group may recognise profits on the date of transaction.

Certain derivatives embedded in other financial instruments, such as the conversion option in a convertible bond, are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in fair value recognised in the income statement.

The Group designates certain derivatives as hedges of the fair value of recognised assets or liabilities or firm commitments (fair value hedge). Hedge accounting is used for derivatives designated in this way.

2. Summary of significant accounting policies (continued)

2.5 Derivative financial instruments and hedge accounting (continued)

The Group documents at inception the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The Group also documents its assessment, both at the hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values of hedged items. These criteria should be met before a hedge can be qualified to be accounted for under hedge accounting.

Changes in the fair value of derivatives that are designated and qualified as effective fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

If the hedge no longer meets the criteria for hedge accounting, the adjustment to the carrying amount of a hedged item for which the effective interest method is used is amortised to profit or loss over the period to maturity. The adjustment to the carrying amount of a hedged equity security remains in retained earnings until the disposal of the equity security.

For derivative instruments held for trading and those that do not qualify for hedge accounting, changes in their fair value are recognised immediately in the income statement.

2.6 Offsetting financial instruments

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

2.7 Interest income and expense and fees and commission income and expense

Interest income and expense are recognised in the income statement for all instruments measured at amortised cost using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows considering all contractual terms of the financial instrument (e.g. prepayment options) but does not consider future credit losses. The calculation includes fees, premiums or discounts and basis points paid or received between parties to the contract, and directly attributable origination fees and costs which represent an integral part of the effective yield are amortised as interest income or expense over the expected life of the financial instrument.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised on the written down value using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. Subsequent unwinding of the discount allowance is recognised as interest income.

2. Summary of significant accounting policies (continued)

2.7 Interest income and expense and fees and commission income and expense (continued)

Fees and commissions that are not an integral part of the effective yield are recognised on an accrual basis ratably over the period when the related service has been provided. Fees and commission income related to credit commitments are amortised on a straight-line basis over the commitment period. Loan syndication fees are recognised as revenue when the related syndication arrangement has been completed and the Group has retained no part of the loan package for itself or has retained a part at the same effective interest rate as that of other participants.

2.8 Financial assets

The Group classifies its financial assets into the following categories: financial assets at fair value through profit or loss; loans and receivables; held-to-maturity investments and available-for-sale financial assets. Management determines the classification of investments at initial recognition. The classification depends on the purpose for which the financial assets were held. All financial assets are recognised initially at fair value. Except for financial assets carried at fair value through profit or loss, all transaction costs of financial assets are included in their amortised costs.

(1) Financial assets at fair value through profit or loss

This category has two sub-categories: financial assets held for trading, and those designated at fair value through profit or loss at inception.

A financial asset which has been acquired or incurred principally for the purpose of selling in the short term or is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking is classified as held-for-trading. Derivatives are also classified as held for trading unless they are designated as effective hedges.

A financial asset, other than one held for trading, will be designated as a financial asset at fair value through profit or loss, if it meets the criteria set out below, and is so designated by management:

- eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring the financial assets or financial liabilities or recognising the gains and losses on them on different bases; or
- applies to a group of financial assets, financial liabilities or both that is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about that group of financial instruments is provided internally on that basis to the key management; or
- relates to financial instruments containing one or more embedded derivative that significantly modifies the cash flow resulting from those financial instruments.

These assets are recognised initially at fair value, with transaction costs taken directly to the consolidated income statement, and are subsequently re-measured at fair value.

Gains and losses from changes in the fair value of such assets (excluding the interest component) are reported in net trading income. The interest component is reported as part of interest income.

2. Summary of significant accounting policies (continued)

2.8 Financial assets (continued)

(2) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, including placements with banks and other financial institutions, investment debt securities without an active market and loans and advances to customers. They arise when the Group provides money, goods or services directly to a debtor with no intention of trading the receivable. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest rate method less allowances for impairment losses.

(3) Held-to-maturity

Financial assets classified as held-to-maturity are those traded in active markets, with fixed or determinable payments and fixed maturities that the Group's management has both the positive intention and the ability to hold to maturity. Were the Group to sell other than an insignificant amount of held-to-maturity assets, the entire category would be tainted and reclassified as available-for-sale. They are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method less allowances for impairment losses.

(4) Available-for-sale

Financial assets classified as available-for-sale are those that are either designated as such or are not classified in any of the other categories. They are intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices.

Available-for-sale financial assets are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at fair value. Unrealised gains and losses arising from changes in the fair value of investments are recognised directly in equity, until the financial asset is derecognised or impaired at which time the cumulative gain or loss previously recognised in equity should be transferred to the consolidated income statement. However, interest which includes the amortisation of premium and discount is calculated using the effective interest method and is recognised in the consolidated income statement. Dividends on equity instruments classified as available-for-sale are recognised in the consolidated income statement when the Group's right to receive payment is established.

2.9 Financial liabilities

The Group classifies its financial liabilities under the following categories: trading liabilities, financial liabilities designated as at fair value through profit or loss, deposits, debt securities in issue and other liabilities. All financial liabilities are classified at inception and recognised initially at fair value.

(1) Trading liabilities

A financial liability is classified as held for trading if it is incurred principally for the purpose of repurchasing in the short term. Derivatives are also classified as held for trading unless they are designated as effective hedges. It is measured at fair value and any gains and losses from changes in fair value are recognised in the income statement.

2. Summary of significant accounting policies (continued)

2.9 Financial liabilities (continued)

(2) Financial liabilities designated as at fair value through profit or loss

A financial liability can be designated as at fair value through profit or loss if it is so designated at inception. Financial liabilities so designated include certain certificates of deposit issued and certain deposits received from customers that are embedded with derivatives. A financial liability is typically so designated if it meets the following criteria:

- eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring the financial assets or financial liabilities or recognising the gains and losses on them on different bases; or

- applies to a group of financial assets, financial liabilities or both that is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about that group of financial instruments is provided internally on that basis to the key management; or

- relates to financial instruments containing one or more embedded derivative that significantly modifies the cash flow resulting from those financial instruments.

Financial liabilities designated at fair value through profit or loss are measured at fair value and any gains and losses from changes in fair value are recognised in the income statement.

(3) Deposits, debt securities in issue and other liabilities

Deposits and debt securities in issue other than those classified as trading liabilities or designated as at fair value through profit or loss, together with other liabilities are carried at amortised cost. Any difference between proceeds net of transaction costs and the redemption value is recognised in the income statement over the period using the effective interest method.

2.10 Recognition and de-recognition of financial instruments

Purchases and sales of financial assets at fair value through profit or loss, available-for-sale and held-to-maturity are recognised on the trade date, the date on which the Group purchases or sells the assets. Loans and receivables (except investment securities without an active market) are recognised when cash is advanced to the borrowers. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Trading liabilities, financial liabilities designated as at fair value through profit or loss and debt securities in issue are recognised on the trade date. Deposits other than trading liabilities are recognised when money is received from customers, other liabilities are recognised when such obligations arise. Financial liabilities are de-recognised from the balance sheet when and only when the obligation specified in the contract is discharged, cancelled or expired. If the Group purchases its own debt, it is removed from the balance sheet, and the difference between the carrying amount of a liability and the consideration paid is included in net trading income.

2. Summary of significant accounting policies (continued)

2.10 Recognition and de-recognition of financial instruments (continued)

Securities and bills sold to a counter-party with an obligation to repurchase at a pre-determined price on a specified future date under a repurchase agreement are referred to as Repos. Securities and bills purchased from a counter-party with an obligation to re-sell to the counter-party at a pre-determined price on a specified future date under a resale agreement are referred to as Reverse repos.

Repos are initially recorded as due to banks, placements from banks and other financial institutions, as appropriate, at the actual amount of cash received from the counter-party. The financial assets used to collateralise repurchase agreements are recorded as investment securities or financial assets at fair value through profit or loss. Reverse repos are initially recorded in the balance sheet as cash and due from banks or placements with banks and other financial institutions, as appropriate, at the actual amount of cash paid to the counter-party. The financial assets received as collateral under reverse repurchase agreements are not recorded on the balance sheet. The difference between sale and repurchase price is recognised as interest income or interest expense over the life of the agreements using the effective interest method.

2.11 Determination of fair value of financial instruments

The fair values of financial assets and financial liabilities that are quoted in active markets are based on current bid prices and current ask prices respectively. If the market for financial assets and financial liabilities is not active (such as unlisted securities), the Group establishes fair value by using valuation techniques. These include the use of recent arm's length transactions, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

2.12 Precious metals

Precious metals comprise gold, silver and other precious metals. Precious metals are initially recognised at fair value and subsequently re-measured at their respective market prices as of the balance sheet date. Mark-to-market gains or losses on precious metals are included in net trading income.

2.13 Impairment of financial assets

(1) Assets carried at amortised cost

The Group assesses as of each balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event") and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the Group about the following loss events:

(i) significant financial difficulty of the issuer or obligor;

(ii) a breach of contract, such as a default or delinquency in interest or principal payments;

(iii) the Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a concession that the lender would not otherwise consider;

2. Summary of significant accounting policies (continued)

2.13 Impairment of financial assets (continued)

(1) Assets carried at amortised cost (continued)

(iv) it becoming probable that the borrower will enter into bankruptcy or other financial reorganisation;

(v) the disappearance of an active market for that financial asset because of financial difficulties; or

(vi) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

- adverse changes in the payment status of borrowers in the group; or

- national or local economic conditions that correlate with defaults on the assets in the group.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment together with all other financial assets that are not individually significant or for which impairment has not yet been identified. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement. If a loan or held-to-maturity investment has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract. As a practical expedient, the Group may measure impairment on the basis of an instrument's fair value using an observable market price.

The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral.

2. Summary of significant accounting policies (continued)

2.13 Impairment of financial assets (continued)

(1) Assets carried at amortised cost (continued)

For the purposes of a collective assessment of impairment, financial assets are grouped on the basis of similar and relevant credit risk characteristics. Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets in the group and historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently.

When a loan is uncollectible, it is written off against the related allowance for impairment losses. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of impairment losses in the income statement.

If, in a subsequent period, the amount of allowance for impairment losses decreases and the decrease can be related objectively to an event occurring after the impairment loss was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in the income statement.

(2) Assets carried at fair value

The Group assesses as of each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. In the case of equity investments classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the assets are impaired. If any such evidence exists for available-for-sale financial assets, the cumulative losses, measured as the difference between the acquisition cost or amortised cost and the current fair value, less any impairment loss on that financial asset previously recognised in the consolidated income statement, is removed from equity and recognised in the income statement. If, in a subsequent period, the fair value of a debt instrument classified as available-for-sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement. With respect to equity instruments, such reversals are made through the reserve for fair value change of available-for-sale securities within equity.

2. Summary of significant accounting policies (continued)

2.14 Financial guarantee contracts

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a contract between the holder and the debtor.

Financial guarantees are initially recognised as financial liabilities and reported under "Other accounts and provisions" in the financial statements at fair value on the date that the guarantee was given. Subsequent to initial recognition, the Group's liabilities under such guarantees are measured at the higher of (i) the amount determined in accordance with HKAS 37 Provisions, Contingent Liabilities and Contingent Assets and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised over the life of the guarantee on a straight-line basis. Any changes in the liability relating to financial guarantees are taken to the income statement.

2.15 Impairment of investment in subsidiaries and associates and non-financial assets

Assets that have an indefinite useful life or are not yet available for use are not subject to amortisation, but are tested annually for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash generating units). Assets that suffered impairment are reviewed for possible reversal of the impairment at each reporting date.

2.16 Fixed assets

(1) Premises, equipment, fixtures and fittings

Premises comprise primarily branches and offices. Premises are shown at open market value based on periodic, but at least triennial, valuations by external independent valuers less subsequent depreciation. Any accumulated depreciation at the date of revaluation is eliminated against the gross carrying amount of the asset and the net amount is restated to the revalued amount of the asset. In the intervening years, the directors review the carrying value of premises, by reference to the open market value of similar properties, and adjustments are made when there has been a material change. All equipment, fixtures and fittings are stated at historical cost less accumulated depreciation and impairment. Historical cost includes expenditures that are directly attributable to the acquisition and installation of the items.

Subsequent costs are included in an asset's carrying amount or are recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance costs are charged to the income statement during the financial period in which they are incurred.

2. Summary of significant accounting policies (continued)

2.16 Fixed assets (continued)

(1) Premises, equipment, fixtures and fittings (continued)

Increases in the carrying amount arising on revaluation of premises are credited to the premises revaluation reserve in shareholders' equity. Decreases that offset previous increases of the same individual asset are charged against premises revaluation reserve directly in equity; all other decreases are expensed in the income statement. Any subsequent increases are credited to the income statement up to the amount previously debited, and then to the premises revaluation reserve. Upon disposal of premises, the relevant portion of the premises revaluation reserve realised in respect of previous valuations is released and transferred from the premises revaluation reserve to retained earnings.

Depreciation is calculated on the straight-line method to write down the cost or revalued amount of such assets over their estimated useful lives as follows:

- Premises — Over the remaining period of lease
- Equipment, fixtures and fittings — 3-15 years

The useful lives of assets are reviewed, and adjusted if appropriate, as of each balance sheet date.

At each balance sheet date, both internal and external sources of information are considered to determine whether there is any indication that premises, equipment, fixtures and fittings are impaired. If any such indication exists, the recoverable amount of the asset is estimated and where relevant, an impairment loss is recognised to reduce the asset to its recoverable amount. Such impairment loss is recognised in the income statement except where the asset is carried at valuation and the impairment loss does not exceed the revaluation surplus for that same asset, in which case it is treated as a revaluation decrease. The recoverable amount is the higher of the asset's fair value less costs to sell and value in use. Impairment loss is reversed through the premises revaluation reserve or income statement as appropriate.

Gains and losses on disposals are determined by comparing proceeds with carrying amount, relevant taxes and expenses. These are included in the income statement.

(2) Property under development

Property under development represents assets under construction or being installed and is stated at cost less impairment losses. Cost includes equipment cost, cost of development, construction, installation, interest and other direct costs attributable to the development. Items classified as property under development are transferred to premises or investment properties when such assets are ready for their intended use, and the depreciation charge commences from the month such assets are transferred to premises.

Impairment losses are recognised for idle projects with respect to which management has determined that resumption in the foreseeable future is not probable. The impairment loss is equal to the extent to which the estimated recoverable amount of a specific project is less than its carrying amount. The recoverable amount is the asset's fair value less costs to sell. Impairment losses or reversals are charged to the income statement.

2. Summary of significant accounting policies (continued)

2.17 Investment properties

Properties that are held for long-term rental yields or for capital appreciation or both, and that are not occupied by the companies in the Group, are classified as investment properties. Properties leased out within group companies are classified as investment properties in individual companies' financial statements and as premises in consolidated financial statements. Land held under operating lease is classified and accounted for as investment property when the rest of the definition of investment property is met. The operating lease is accounted for as if it is a finance lease.

Investment properties are recognised initially at cost, including related transaction costs. After initial recognition, investment properties are measured at fair value assessed by professional valuers on the basis of open market value.

Subsequent expenditure is charged to the asset's carrying amount only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance costs are expensed in the income statement during the financial period in which they are incurred.

Any changes in fair value are reported directly in the income statement. Deferred income tax is provided on revaluation surpluses of investment properties in accordance with HKAS-Int 21 "Income Taxes – Recovery of Revalued Non-Depreciable Assets" on HKAS 12 "Income Taxes".

If an investment property becomes owner-occupied, it is reclassified as premises, and its fair value at the date of reclassification becomes its cost for accounting purposes. If an item of premises becomes an investment property because its use has changed, any difference resulting between the carrying amount and the fair value of this item at the date of transfer is recognised in equity as a revaluation of premises under HKAS 16 "Property, Plant and Equipment". However, if a fair value gain reverses a previous revaluation loss or impairment loss, the gain is recognised in the income statement up to the amount previously debited.

2.18 Leases

(1) Operating leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. The total payments made under operating leases (net of any incentives received from the lessor) which include land use rights with payments that are separately identifiable at inception of the lease are charged to the income statement on a straight-line basis over the period of the lease.

When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

Where the Group is a lessor, the assets subject to the operating lease are accounted for as investment properties. Rental income from operating leases is recognised on a straight-line basis over the lease term.

2. Summary of significant accounting policies (continued)

2.18 Leases (continued)

(2) Finance leases on properties

Where the land and buildings elements of leasehold properties held for own use can be split reliably at inception of the lease, leasehold land and land use rights are recognised as operating leases if they have indefinite economic lives. The up-front prepayments made or other costs incurred for acquiring the leasehold land and land use rights are expensed in the income statement on a straight-line basis over the period of the lease. Where there is impairment of the up-front prepayments, the impairment is expensed in the income statement immediately. Where the land and buildings cannot be split reliably at inception of the lease, the land and buildings elements will continue to be treated as finance leases and measured at fair value.

Separate measurement of the land and buildings elements is not required when the Group's interest in both land and buildings is classified as investment properties as if it is finance lease and is measured at fair value.

Pursuant to the Bank of China (Hong Kong) Limited (Merger) Ordinance ("Merger Ordinance") 2001, all assets and liabilities of the designated branches and subsidiaries, and the shares of certain entities of the legacy Bank of China Group in Hong Kong were effectively transferred to BOCHK, which was immediately owned by the then newly formed BOC Hong Kong (Holdings) Limited ("the Merger"). This was a significant event and the Group has therefore adopted the valuation at the date of the Merger as the deemed cost for its leasehold properties to reflect the circumstances at the time of the Merger.

On adoption of the deemed cost at the date of Merger, the Group made reference to the independent property valuation conducted as at 31 August 2001 for the purpose of the Merger, which did not split the values of the leasehold properties between the land and buildings elements. Any means of subsequent allocation of the valuation of the leasehold properties at the date of Merger between the land and buildings elements would be notional and therefore would not represent reliable information. It is determined that the values of the land and buildings elements of the Group's leasehold properties cannot be reliably split and the leasehold properties are treated as finance leases. The Group has also adopted the revaluation model under HKAS 16 "Property, Plant and Equipment" by which assets held for own use arising under these finance leases are measured at fair value less any accumulated depreciation and impairment losses.

2. Summary of significant accounting policies (continued)

2.19 Insurance contracts

(1) Insurance contracts classification, recognition and measurement

The Group's insurance subsidiary issues insurance contracts that transfer significant insurance risk. As a general guideline, the Group defines significant insurance risk as the possibility of having to pay benefits on the occurrence of an insured event that are at least 10% more than the benefit payable if the insured event did not occur. The Group's insurance subsidiary issues long term business insurance contracts, which insure events associated with human life (for example death, or total permanent disability) over a long duration. A liability for contractual benefits that are expected to be incurred in the future is recorded when premiums are recognised.

For linked long term insurance contracts with embedded derivatives (which are closely related to the host insurance contracts) linking payments on the contract to units of an investment fund set up by the Group with the consideration received from the contract holders, the liability is adjusted for all changes in the fair value of underlying assets, and includes a liability for contractual benefits that are expected to be incurred in the future which is recorded when the premiums are recognised.

Retirement scheme management category III, as defined in the Insurance Companies Ordinance, insurance contracts insure events associated with human life under retirement schemes. The portion of the premium received on in-force contracts that relates to unexpired risks at the balance sheet date is reported as the unearned premium liability.

Premiums are recognised as revenue when they become payable by the contract holders before the deduction of commissions. Benefits and claims are recorded as an expense when they are incurred.

The Group does not separately measure embedded derivatives that meet the definition of an insurance contract or options to surrender insurance contracts for a fixed amount (or an amount based on a fixed amount and an interest rate).

(2) Liability adequacy test

At each balance sheet date, liability adequacy tests are performed to ensure the adequacy of the insurance contract liabilities. Any deficiency is immediately charged to the consolidated income statement, with a provision established for losses arising from the liability adequacy test.

2.20 Cash and cash equivalents

For the purposes of the consolidated cash flow statement, cash and cash equivalents comprise balances with original maturity less than three months from the date of acquisition, including cash, balances with banks and other financial institutions, short-term bills and notes classified as investment securities and certificates of deposit.

2. Summary of significant accounting policies (continued)

2.21 Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

2.22 Employee benefits

(1) Retirement benefit costs

The Group contributes to defined contribution retirement schemes under either recognised ORSO schemes or MPF schemes that are available to the Group's employees. Contributions to the schemes by the Group and employees are calculated as a percentage of employees' basic salaries for the ORSO schemes and in accordance with the MPF rules for MPF schemes. The retirement benefit scheme costs are charged to the income statement as incurred and represent contributions payable by the Group to the schemes. Contributions made by the Group that are forfeited by those employees who leave the ORSO scheme prior to the full vesting of their entitlement to the contributions are used by the Group to reduce the existing level of contributions or to meet its expenses under the trust deed of the ORSO schemes.

The assets of the schemes are held in independently-administered funds separate from those of the Group.

(2) Leave entitlements

Employee entitlements to annual leave and sick leave are recognised when they accrue to employees. A provision is made for the estimated liability for unused annual leave and the amount of sick leave expected to be paid as a result of services rendered by employees up to the balance sheet date.

Compensated absences other than annual leave and sick leave are non-accumulating; they lapse if the current period's entitlement is not used in full and do not entitle employees to a cash payment for unused entitlement on leaving the Group. Such compensated absences are recognised when the absences occur.

(3) Bonus plans

The expected cost of bonus payments are recognised as a liability when the Group has a present legal or constructive obligation as a result of services rendered by employees and a reliable estimate of the obligation can be made. Liabilities for bonus plans are expected to be settled within twelve months and are measured at the amounts expected to be paid when they are settled.

2. Summary of significant accounting policies (continued)

2.23 Deferred income taxes

Deferred income tax is provided in full, using the balance sheet liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates and laws that have been enacted or substantially enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

The principal temporary differences arise from asset impairment provisions, depreciation of property and equipment, revaluation of certain assets including available-for-sale securities and properties, and tax losses carried forward. However, the deferred income tax is not recognised if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss.

Deferred income tax liabilities are provided in full on all taxable temporary differences and deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

Income tax payable on profits, based on the applicable tax law in each jurisdiction, is recognised as an expense in the period in which profits arise.

Deferred income tax is charged or credited in the income statement except for deferred income tax that relating to fair value re-measurement of available-for-sale investments and revaluation of premises which are charged or credited directly to equity, in which case the deferred income tax is also credited or charged directly to equity and is subsequently recognised in the income statement together with the realisation of the deferred gain and loss.

2.24 Repossessed assets

Repossessed assets are initially recognised at the lower of their fair value or the amortised cost of the related outstanding loans on the date of repossession. The related loans and advances together with the related impairment allowances are then derecognised from the balance sheet. Subsequently, repossessed assets are measured at the lower of their cost or net realisable value and are reported as 'Non-current assets held for sale' under 'Other assets'.

2.25 Fiduciary activities

The Group commonly acts as a trustee, or in other fiduciary capacities, that result in its holding or managing assets on behalf of individuals, trusts and other institutions. These assets and any income or losses arising thereon are excluded from these financial statements, as they are not assets of the Group.

2. Summary of significant accounting policies (continued)

2.26 Contingent liabilities and contingent assets

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group. It can also be a present obligation arising from past events that is not recognised because it is not probable that an outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognised as a provision but is disclosed in the notes to the financial statements. When a change in the probability of an outflow occurs so that outflow is probable, it will then be recognised as a provision.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the Group.

Contingent assets are not recognised but are disclosed in the notes to the financial statements when an inflow of economic benefits is probable. When the inflow is virtually certain, it will be recognised as an asset.

2.27 Related parties

For the purposes of these financial statements, a party is considered to be related to the Group if the Group has the ability, directly and indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control. Related parties may be individuals or entities.

3. Critical accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Areas susceptible to changes in essential estimates and judgements, which affect the carrying value of assets and liabilities, are set out below. The effect of changes to either the key assumptions or other estimation uncertainties will be presented below if it is practicable to determine. It is possible that actual results may require material adjustments to the estimates referred to below.

3.1 Impairment allowances on loans and advances

The Group reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the income statement, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans and advances before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group (e.g. payment delinquency or default), or economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when estimating expected future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

3. Critical accounting estimates and judgements in applying accounting policies (continued)

3.2 Fair values of financial instruments

The fair values of financial instruments that are not quoted in active markets are determined by using valuation techniques. Valuation techniques used include discounted cash flows analysis and models with built-in functions available in externally acquired financial analysis or risk management systems widely used by the industry. To the extent practical, models use only observable data. However, in case of missing data, the Group uses interpolation or extrapolation methods to estimate the data required. Changes in assumptions about these factors could affect reported fair value of financial instruments.

3.3 Held-to-maturity investments

The Group follows the guidance of HKAS 39 in classifying certain non-derivative financial assets with fixed or determinable payments and fixed maturity as held-to-maturity. This classification requires significant judgement. In making this judgement, the Group evaluates its intention and ability to hold such investments to maturity. If the Group fails to hold these investments to maturity other than for specific circumstances defined in HKAS 39, such as selling an insignificant amount close to maturity, it will be required to reclassify the entire portfolio of assets as available-for-sale. The investments would then be measured at fair value and not amortised cost. As at 31 December 2006, the fair value of the entire portfolio of held-to-maturity investments is approximately equal to its amortised cost.

3.4 Estimate of future benefit payments and premiums arising from long term insurance contracts

In determining the long term business liabilities, the Group follows the Insurance Companies Ordinance (Determination of Long Term Liabilities) Regulation and makes prudent assumptions which include appropriate margins for adverse deviation of the relevant factors. Estimates are made as to the expected number of deaths for each of the years in which the Group is exposed to risk. The Group bases these estimates on standard industry and recent historical mortality experience, adjusted where appropriate to reflect the Group's own experience. For contracts that insure the risk of longevity, appropriate prudent allowances are made for expected mortality improvements. The estimated number of deaths determines the value of the benefit payments and the value of the valuation premiums. The main source of uncertainty is that epidemics such as AIDS, SARS, avian flu and wide-ranging lifestyle changes, such as in eating, smoking and exercise habits, could result in future mortality being significantly worse than in the past for the age groups in which the Group has significant exposure to mortality risk. However, continuing improvements in medical care and social conditions could result in improvements in longevity in excess of those allowed for in the estimates used to determine the liability for contracts where the Group is exposed to longevity risk.

Were the number of deaths in future years to differ by 10% from management's estimate, the liability would increase by approximately HK$36.8 million, which accounts for 0.27% of the liability. In this case, it is assumed there is no relief arising from reinsurance contracts held.

For linked long term insurance contracts with a life cover component, it is assumed that the Group will be able to increase mortality risk charges in future years in line with emerging mortality experience.

Estimates are also made as to future investment income arising from the assets backing long term insurance contracts. These estimates are based on current market returns as well as expectations about future economic and financial developments. Were the average future investment returns to differ by 50 basis points from management's estimates, the insurance liability would increase by approximately HK$617 million. In this case, there is no relief arising from reinsurance contracts held.

4. Financial risk management

This note summarises the Group's control of credit risk, market risk, interest rate risk and liquidity risk, and presents financial information about the exposure to the use of financial instruments.

Credit risk management

Credit risk is the risk that a customer or counterparty will be unable to or unwilling to meet a commitment it has entered into with the Group. RMD, under the supervision of the CRO, provides centralised management of credit risk within the Group. Different credit approval and control procedures are adopted according to the level of risk associated with the customer or transaction. Corporate credit applications are independently reviewed and objectively assessed by risk management units. A credit scoring system is used to process retail credit transactions, including residential mortgage loans, personal loans and credit cards. The Credit Risk Assessment Committee comprising experts from credit and other functions of the Group is responsible for making an independent assessment of all credit facilities which require the approval of Deputy Chief Executives or above.

The Group adopts an eight-grade facility grading structure according to HKMA's loan classification requirement. RMD provides regular credit management information reports and ad hoc reports to the Management Committee, RC, AC and Board of Directors.

Market risk management

Market risk is the risk of loss that results from movements in market rates and prices. The Group's market risk arises from customer-related business and proprietary trading. Trading positions are subject to daily marked-to-market valuation. Market risk is managed within the risk limits approved by the RC. The overall risk limits are divided into sub-limits by reference to different risk factors, including interest rate, foreign exchange rate, commodity price and equity price.

RMD is responsible for the oversight of the Group's market risk to ensure that overall and individual market risks are within the Group's risk tolerance. Risk exposures are monitored on a day-to-day basis to ensure that they are within established risk limits.

Interest rate risk management

The Group's interest rate risk exposures are mainly structural. The major types of interest rate risk from structural positions are:

repricing risk	–	mismatches in the maturity or repricing periods of assets and liabilities
basis risk	–	different pricing basis for different transactions so that yield on assets and cost of liabilities may change by different amounts within the same repricing period

The Group's ALCO maintains oversight of interest rate risk and RC sanctions the interest rate risk management policies formulated by ALCO. The interest rate risk is identified and measured on a daily basis. The Treasury Department manages the interest rate risk according to the established policies. The Finance Department closely monitors the related risks and the results are reported to RC and ALCO regularly.

4. Financial risk management (continued)

Interest rate risk management (continued)

Gap analysis is one of the tools used to measure the Group's exposure to repricing risk. This provides the Group with a static view of the maturity and repricing characteristics of its balance sheet positions. The Group uses interest rate derivatives to hedge its interest rate exposures and in most cases, plain vanilla interest rate swaps are used.

Sensitivities of earnings and economic value to interest rate changes (Earnings at Risk and Economic Value at Risk) are assessed through a hypothetical interest rate shock of 200 basis points across the yield curve on both sides. Earnings at Risk and Economic Value at Risk are controlled respectively within an approved percentage of the projected net interest income for the year and the latest capital base as sanctioned by RC. The results are reported to ALCO and RC on a regular basis.

The impact of basis risk is gauged by the projected change in net interest income under scenarios of imperfect correlation in the adjustment of the rates earned and paid on different instruments. Ratios of assets to liabilities with similar pricing basis are established to monitor such risk.

Liquidity risk management

The aim of liquidity management is to enable the Group to meet, even under adverse market conditions, all its maturing repayment obligations on time and to fund all its asset growth and strategic opportunities without forced liquidation of its assets at short notice.

The Group funds its operations principally by accepting deposits from retail and corporate depositors. In addition, the Group may issue certificates of deposit to secure long-term funds. Funding may also be secured through adjusting the asset mix in the Group's investment portfolio. The Group uses the majority of funds raised to extend loans, to purchase debt securities or to conduct interbank placements.

The Group monitors the liquidity risks using cash flow analysis and by examining deposit stability, concentration risk, mismatch ratios, loan-to-deposit ratio and liquidity profile of the investment portfolio. The primary objective of the Group's asset and liability management strategy is to achieve optimal returns while ensuring adequate levels of liquidity and capital within an effective risk control framework and ALCO is responsible for establishing these policy directives (including the liquidity contingency plan), and RC sanctions the liquidity management policies. The Treasury Department manages the liquidity risk according to the established policies. The Finance Department monitors the Group's liquidity risks and reports to the management and ALCO regularly.

4. Financial risk management (continued)

(A) Geographical concentrations of assets, liabilities and off-balance sheet items

The following note incorporates the requirements on risk disclosures of HKAS 32 and geographical concentrations of risk of HKAS 30, based on the location of the subsidiary, associate or branch in which the related item is recorded.

Capital expenditure is shown by the geographical area in which the buildings and equipment are located.

	2006				
	Total assets HK$'m	**Total liabilities HK$'m**	**Contingent liabilities and commitments HK$'m**	**Net operating income before loan impairment allowances HK$'m**	**Capital expenditure HK$'m**
Hong Kong	**912,699**	**833,480**	**172,404**	**20,679**	**726**
Mainland China	**15,525**	**8,122**	**15,189**	**609**	**9**
Others	**729**	**711**	**188**	**21**	**1**
	928,953	**842,313**	**187,781**	**21,309**	**736**

	2005				
	Total assets HK$'m	Total liabilities HK$'m	Contingent liabilities and commitments HK$'m	Net operating income before loan impairment allowances HK$'m	Capital expenditure HK$'m
Hong Kong	808,614	744,413	146,072	17,650	562
Mainland China	21,838	4,508	15,498	500	7
Others	550	368	112	24	–
	831,002	749,289	161,682	18,174	569

4. Financial risk management (continued)

(B) Currency risk

Tables below summarise the Group's exposure to foreign currency exchange rate risk as at 31 December. Included in the tables are the Group's assets and liabilities at carrying amounts in HK$ equivalent, categorised by the original currency.

	2006							
	Renminbi HK$'m	US Dollars HK$'m	HK Dollars HK$'m	EURO HK$'m	Japanese Yen HK$'m	Pound Sterling HK$'m	Others HK$'m	Total HK$'m
Assets								
Cash and balances with banks and other financial institutions	24,474	3,365	2,676	126	183	56	93	30,973
Placements with banks and other financial institutions	707	35,142	89,781	947	497	768	2,794	130,636
Trading securities and other financial instruments at fair value through profit or loss	–	8,598	17,644	1,041	–	–	1,011	28,294
Derivative financial instruments	–	203	7,190	–	–	–	–	7,393
Hong Kong SAR Government certificates of indebtedness	–	–	34,750	–	–	–	–	34,750
Advances and other accounts	4,559	54,737	285,796	2,505	1,678	1,001	2,582	352,858
Available-for-sale securities	–	58,627	29,012	4,200	–	2,118	6,432	100,389
Held-to-maturity securities	–	98,960	45,780	3,815	–	1,790	15,243	165,588
Loans and receivables	–	2,556	32,909	–	–	302	347	36,114
Interests in associates	–	–	60	–	–	–	–	60
Properties, plant and equipment	69	1	19,670	–	–	–	–	19,740
Investment properties	–	–	7,481	–	–	–	–	7,481
Other assets (including deferred tax assets)	59	294	13,818	99	122	85	200	14,677
Total assets	29,868	262,483	586,567	12,733	2,480	6,120	28,702	928,953
Liabilities								
Hong Kong SAR currency notes in circulation	–	–	34,750	–	–	–	–	34,750
Deposits and balances of banks and other financial institutions	17,198	16,587	12,590	1,112	415	97	1,035	49,034
Trading liabilities and other financial instruments at fair value through profit or loss	–	3,342	9,287	–	–	–	–	12,629
Derivative financial instruments	–	450	3,602	–	–	–	–	4,052
Deposits from customers	10,994	143,913	485,066	5,893	3,609	11,968	33,248	694,691
Certificates of deposit issued	–	987	1,511	–	–	–	–	2,498
Insurance contract liabilities	–	2,130	12,109	–	–	–	–	14,239
Other accounts and provisions (including current and deferred tax liabilities)	451	8,369	20,497	274	131	92	606	30,420
Total liabilities	28,643	175,778	579,412	7,279	4,155	12,157	34,889	842,313
Net on-balance sheet position	1,225	86,705	7,155	5,454	(1,675)	(6,037)	(6,187)	86,640
Off-balance sheet net notional position*	54	(83,503)	77,982	(5,501)	1,817	6,012	6,433	3,294
Contingent liabilities and commitments	2,666	42,196	137,875	2,643	527	117	1,757	187,781

* Off-balance sheet net notional position represents the net notional amounts of foreign currency derivative financial instruments, which are principally used to reduce the Group's exposure to currency movements.

4. Financial risk management (continued)

(B) Currency risk (continued)

	2005							
	Renminbi HK$'m	US Dollars HK$'m	HK Dollars HK$'m	EURO HK$'m	Japanese Yen HK$'m	Pound Sterling HK$'m	Others HK$'m	Total HK$'m
Assets								
Cash and balances with banks and other financial institutions	22,730	4,752	2,697	153	154	103	115	30,704
Placements with banks and other financial institutions	262	35,833	82,389	371	–	3,064	3,943	125,862
Trading securities and other financial instruments at fair value through profit or loss	–	6,549	11,099	1,209	–	–	1,508	20,365
Derivative financial instruments	–	874	4,310	–	–	–	–	5,184
Hong Kong SAR Government certificates of indebtedness	–	–	32,630	–	–	–	–	32,630
Advances and other accounts	1,961	47,896	279,042	3,738	2,423	831	2,512	338,403
Available-for-sale securities	–	26,033	19,283	2,414	–	1,011	3,502	52,243
Held-to-maturity securities	–	101,694	57,640	4,003	243	1,288	13,653	178,521
Loans and receivables	–	1,704	9,778	–	–	–	1,598	13,080
Interests in associates	–	–	61	–	–	–	–	61
Properties, plant and equipment	61	–	18,430	–	–	–	–	18,491
Investment properties	–	–	7,626	–	–	–	–	7,626
Other assets (including deferred tax assets)	19	744	7,025	–	–	9	35	7,832
Total assets	25,033	226,079	532,010	11,888	2,820	6,306	26,866	831,002
Liabilities								
Hong Kong SAR currency notes in circulation	–	–	32,630	–	–	–	–	32,630
Deposits and balances of banks and other financial institutions	14,150	9,245	12,507	247	3,389	63	1,054	40,655
Trading liabilities and other financial instruments at fair value through profit or loss	–	2,746	5,178	–	–	–	–	7,924
Derivative financial instruments	–	840	3,353	–	–	–	–	4,193
Deposits from customers	9,210	132,105	427,160	6,787	2,693	13,199	41,504	632,658
Certificates of deposit issued	–	1,325	2,640	–	–	–	–	3,965
Insurance contract liabilities	–	1,019	6,949	–	–	–	–	7,968
Other accounts and provisions (including current and deferred tax liabilities)	629	5,879	11,253	222	131	196	986	19,296
Total liabilities	23,989	153,159	501,670	7,256	6,213	13,458	43,544	749,289
Net on-balance sheet position	1,044	72,920	30,340	4,632	(3,393)	(7,152)	(16,678)	81,713
Off-balance sheet net notional position	(5)	(68,875)	48,257	(4,575)	3,392	7,146	16,811	2,151
Contingent liabilities and commitments	1,558	34,600	121,423	1,945	812	50	1,294	161,682

4. Financial risk management (continued)

(C) Interest rate risk

Tables below summarise the Group's exposure to interest rate risk as at 31 December. Included in the tables are the Group's assets and liabilities at carrying amounts, categorised by the earlier of contractual repricing or maturity dates. The carrying amounts of derivative financial instruments which are principally used to reduce the Group's exposure to interest rate movements are under the column captioned 'Non-interest bearing'.

	2006						
	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Non-interest bearing HK$'m	Total HK$'m
Assets							
Cash and balances with banks and other financial institutions	24,894	–	–	–	–	6,079	30,973
Placements with banks and other financial institutions	74,263	47,717	8,656	–	–	–	130,636
Trading securities and other financial instruments at fair value through profit or loss	4,623	4,729	1,829	3,243	11,977	1,893	28,294
Derivative financial instruments	–	–	–	–	–	7,393	7,393
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	34,750	34,750
Advances and other accounts	303,273	32,873	11,096	2,487	420	2,709	352,858
Available-for-sale securities	5,578	14,102	5,402	27,529	47,728	50	100,389
Held-to-maturity securities	25,050	38,721	32,265	41,105	28,447	–	165,588
Loans and receivables	2,429	12,753	20,932	–	–	–	36,114
Interests in associates	–	–	–	–	–	60	60
Properties, plant and equipment	–	–	–	–	–	19,740	19,740
Investment properties	–	–	–	–	–	7,481	7,481
Other assets (including deferred tax assets)	–	–	–	–	–	14,677	14,677
Total assets	440,110	150,895	80,180	74,364	88,572	94,832	928,953
Liabilities							
Hong Kong SAR currency notes in circulation	–	–	–	–	–	34,750	34,750
Deposits and balances of banks and other financial institutions	44,271	955	2,692	–	–	1,116	49,034
Trading liabilities and other financial instruments at fair value through profit or loss	6,025	3,603	2,946	55	–	–	12,629
Derivative financial instruments	–	–	–	–	–	4,052	4,052
Deposits from customers	565,717	77,894	21,891	996	18	28,175	694,691
Certificates of deposit issued	–	–	514	1,984	–	–	2,498
Insurance contract liabilities	–	–	–	–	–	14,239	14,239
Other accounts and provisions (including current and deferred tax liabilities)	6,298	99	–	–	–	24,023	30,420
Total liabilities	622,311	82,551	28,043	3,035	18	106,355	842,313
Interest sensitivity gap	(182,201)	68,344	52,137	71,329	88,554	(11,523)	86,640

4. Financial risk management (continued)

(C) Interest rate risk (continued)

	2005						
	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Non-interest bearing HK$'m	Total HK$'m
Assets							
Cash and balances with banks and other financial institutions	26,846	–	–	–	–	3,858	30,704
Placements with banks and other financial institutions	78,240	40,141	7,479	–	–	2	125,862
Trading securities and other financial instruments at fair value through profit or loss	3,243	3,908	2,015	3,495	7,348	356	20,365
Derivative financial instruments	–	–	–	–	–	5,184	5,184
Hong Kong SAR Government certificates of indebtedness	–	–	–	–	–	32,630	32,630
Advances and other accounts	276,408	40,833	12,770	4,715	474	3,203	338,403
Available-for-sale securities	4,976	7,574	1,930	20,547	17,160	56	52,243
Held-to-maturity securities	27,990	46,049	34,953	53,587	15,942	–	178,521
Loans and receivables	3,466	3,351	6,263	–	–	–	13,080
Interests in associates	–	–	–	–	–	61	61
Properties, plant and equipment	–	–	–	–	–	18,491	18,491
Investment properties	–	–	–	–	–	7,626	7,626
Other assets (including deferred tax assets)	–	–	–	–	–	7,832	7,832
Total assets	421,169	141,856	65,410	82,344	40,924	79,299	831,002
Liabilities							
Hong Kong SAR currency notes in circulation	–	–	–	–	–	32,630	32,630
Deposits and balances of banks and other financial institutions	34,444	1,709	3,015	–	–	1,487	40,655
Trading liabilities and other financial instruments at fair value through profit or loss	1,725	2,097	1,310	2,792	–	–	7,924
Derivative financial instruments	–	–	–	–	–	4,193	4,193
Deposits from customers	454,663	131,904	21,937	1,478	–	22,676	632,658
Certificates of deposit issued	–	250	2,378	1,337	–	–	3,965
Insurance contract liabilities	–	–	–	–	–	7,968	7,968
Other accounts and provisions (including current and deferred tax liabilities)	4,911	–	–	–	–	14,385	19,296
Total liabilities	495,743	135,960	28,640	5,607	–	83,339	749,289
Interest sensitivity gap	(74,574)	5,896	36,770	76,737	40,924	(4,040)	81,713

4. Financial risk management (continued)

(C) Interest rate risk (continued)

Tables below summarise the effective interest rate by major currencies for monetary financial instruments not carried at fair value through profit or loss subject to interest rate risk as at 31 December:

	2006					
	Renminbi %	US Dollars %	HK Dollars %	EURO %	Japanese Yen %	Pound Sterling %
Assets						
Cash and balances with banks and other financial institutions	**1.00**	**3.25**	**0.96**	**2.11**	**0.09**	**2.04**
Placements with banks and other financial institutions	**1.87**	**5.23**	**4.06**	**3.63**	**0.32**	**5.34**
Advances to customers	**5.86**	**6.25**	**5.21**	**4.92**	**1.61**	**5.17**
Advances to banks and other financial institutions	**–**	**5.57**	**4.12**	**3.78**	**0.72**	**–**
Available-for-sale securities	**–**	**5.62**	**3.99**	**3.47**	**–**	**5.19**
Held-to-maturity securities	**–**	**4.91**	**4.17**	**3.57**	**–**	**5.50**
Loans and receivables	**–**	**5.30**	**3.90**	**–**	**–**	**4.70**
Liabilities						
Deposits and balances of banks and other financial institutions	**1.25**	**5.11**	**3.64**	**3.60**	**0.24**	**5.23**
Deposits from customers	**0.75**	**3.78**	**3.01**	**2.01**	**–**	**3.68**
Certificates of deposit issued	**–**	**3.39**	**3.63**	**–**	**–**	**–**

	2005					
	Renminbi %	US Dollars %	HK Dollars %	EURO %	Japanese Yen %	Pound Sterling %
Assets						
Cash and balances with banks and other financial institutions	0.99	3.34	0.83	0.82	–	1.35
Placements with banks and other financial institutions	1.05	4.22	4.10	2.40	–	4.58
Advances to customers	5.01	5.17	5.32	3.30	1.22	4.74
Advances to banks and other financial institutions	–	4.38	4.31	–	0.27	–
Available-for-sale securities	–	4.92	3.81	2.91	–	4.61
Held-to-maturity securities	–	4.12	4.03	2.92	0.23	4.68
Loans and receivables	–	4.15	3.92	–	–	–
Liabilities						
Deposits and balances of banks and other financial institutions	0.96	4.03	3.79	2.35	0.05	4.28
Deposits from customers	0.65	3.02	3.04	1.16	–	3.05
Certificates of deposit issued	–	3.02	3.05	–	–	–

4. Financial risk management (continued)

(D) Liquidity risk

Tables below analyse assets and liabilities of the Group as at 31 December into relevant maturity groupings based on the remaining period at balance sheet date to the contractual maturity date.

	2006							
	On demand HK$'m	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Undated HK$'m	Total HK$'m
Assets								
Cash and balances with banks and other financial institutions	30,973	–	–	–	–	–	–	30,973
Placements with banks and other financial institutions	–	74,263	47,717	8,656	–	–	–	130,636
Trading securities and other financial instruments at fair value through profit or loss								
– debt securities								
– certificates of deposit held	–	10	104	279	875	1,454	–	2,722
– others	–	1,331	2,345	3,717	5,462	11,719	675	25,249
– equity securities	–	–	–	–	–	–	323	323
Derivative financial instruments	6,218	537	217	109	274	38	–	7,393
Hong Kong SAR Government certificates of indebtedness	34,750	–	–	–	–	–	–	34,750
Advances and other accounts								
– advances to customers	28,497	8,085	15,471	39,287	136,122	116,931	1,594	345,987
– trade bills	76	1,670	1,030	350	–	–	2	3,128
– advances to banks and other financial institutions	–	–	156	940	2,647	–	–	3,743
Available-for-sale securities								
– debt securities								
– certificates of deposit held	–	157	–	2,512	5,479	–	–	8,148
– others	–	1,735	5,643	4,101	30,893	49,819	–	92,191
– equity securities	–	–	–	–	–	–	50	50
Held-to-maturity securities								
– debt securities								
– certificates of deposit held	–	1,600	1,205	3,176	3,386	–	–	9,367
– others	–	3,759	7,700	35,308	79,067	30,387	–	156,221
Loans and receivables	–	2,429	12,753	20,932	–	–	–	36,114
Interests in associates	–	–	–	–	–	–	60	60
Properties, plant and equipment	–	–	–	–	–	–	19,740	19,740
Investment properties	–	–	–	–	–	–	7,481	7,481
Other assets (including deferred tax assets)	4,185	9,773	2	247	131	163	176	14,677
Total assets	104,699	105,349	94,343	119,614	264,336	210,511	30,101	928,953
Liabilities								
Hong Kong SAR currency notes in circulation	34,750	–	–	–	–	–	–	34,750
Deposits and balances of banks and other financial institutions	20,982	24,405	955	2,692	–	–	–	49,034
Trading liabilities and other financial instruments at fair value through profit or loss	–	1,922	1,810	5,443	3,152	302	–	12,629
Derivative financial instruments	2,963	231	86	90	590	92	–	4,052
Deposits from customers	289,650	304,216	77,585	22,272	950	18	–	694,691
Certificates of deposit issued	–	–	–	514	1,984	–	–	2,498
Insurance contract liabilities	–	–	–	–	–	14,239	–	14,239
Other accounts and provisions (including current and deferred tax liabilities)	13,919	9,615	1,226	1,253	3,963	–	444	30,420
Total liabilities	362,264	340,389	81,662	32,264	10,639	14,651	444	842,313
Net liquidity gap	(257,565)	(235,040)	12,681	87,350	253,697	195,860	29,657	86,640

4. Financial risk management (continued)

(D) Liquidity risk (continued)

	2005							
	On demand HK$'m	Up to 1 month HK$'m	1-3 months HK$'m	3-12 months HK$'m	1-5 years HK$'m	Over 5 years HK$'m	Undated HK$'m	Total HK$'m
Assets								
Cash and balances with banks and other financial institutions	30,704	–	–	–	–	–	–	30,704
Placements with banks and other financial institutions	–	78,251	40,145	7,466	–	–	–	125,862
Trading securities and other financial instruments at fair value through profit or loss								
– debt securities								
– certificates of deposit held	–	–	114	60	963	761	–	1,898
– others	–	140	1,320	2,001	7,502	7,172	–	18,135
– equity securities	–	–	–	–	–	–	332	332
Derivative financial instruments	4,576	198	227	54	98	31	–	5,184
Hong Kong SAR Government certificates of indebtedness	32,630	–	–	–	–	–	–	32,630
Advances and other accounts								
– advances to customers	25,368	6,710	16,133	31,534	132,520	118,015	2,029	332,309
– trade bills	101	1,125	1,460	353	–	–	–	3,039
– advances to banks and other financial institutions	102	164	267	376	2,146	–	–	3,055
Available-for-sale securities								
– debt securities								
– certificates of deposit held	–	101	200	356	3,521	–	–	4,178
– others	–	1,609	2,598	1,673	23,680	18,449	–	48,009
– equity securities	–	–	–	–	–	–	56	56
Held-to-maturity securities								
– debt securities								
– certificates of deposit held	–	884	3,846	4,430	5,117	202	–	14,479
– others	–	1,005	6,088	27,278	111,417	18,254	–	164,042
Loans and receivables	–	3,466	3,351	6,263	–	–	–	13,080
Interests in associates	–	–	–	–	–	–	61	61
Properties, plant and equipment	–	–	–	–	–	–	18,491	18,491
Investment properties	–	–	–	–	–	–	7,626	7,626
Other assets (including deferred tax assets)	6,014	1,389	–	239	111	–	79	7,832
Total assets	99,495	95,042	75,749	82,083	287,075	162,884	28,674	831,002
Liabilities								
Hong Kong SAR currency notes in circulation	32,630	–	–	–	–	–	–	32,630
Deposits and balances of banks and other financial institutions	21,112	15,479	1,049	3,015	–	–	–	40,655
Trading liabilities and other financial instruments at fair value through profit or loss	–	641	1,411	1,750	3,560	562	–	7,924
Derivative financial instruments	2,601	427	146	239	616	164	–	4,193
Deposits from customers	247,534	229,779	131,900	21,939	1,506	–	–	632,658
Certificates of deposit issued	–	–	–	2,336	1,629	–	–	3,965
Insurance contract liabilities	–	–	–	–	–	7,968	–	7,968
Other accounts and provisions (including current and deferred tax liabilities)	12,034	1,602	1,034	1,045	3,131	1	449	19,296
Total liabilities	315,911	247,928	135,540	30,324	10,442	8,695	449	749,289
Net liquidity gap	(216,416)	(152,886)	(59,791)	51,759	276,633	154,189	28,225	81,713

4. Financial risk management (continued)

(D) Liquidity risk (continued)

The above maturity classifications have been prepared in accordance with the guideline on "Financial Disclosure by Locally Incorporated Authorized Institutions" under the Supervisory Policy Manual issued by the HKMA. In accordance with the guideline, the Group has reported assets such as advances and debt securities which have been overdue for not more than one month as "Repayable on demand". In the case of an asset that is repayable by different payments or instalments, only that portion of the asset that is actually overdue is reported as overdue. Any part of the asset that is not due is reported according to the residual maturity unless the repayment of the asset is in doubt in which case the amount is reported as "Undated". The above assets are stated after deduction of provisions, if any.

The analysis of debt securities by remaining period to maturity is disclosed in order to comply with the guideline on "Financial Disclosure by Locally Incorporated Authorized Institutions" under the Supervisory Policy Manual issued by the HKMA. The disclosure does not imply that the securities will be held to maturity.

(E) Fair values of financial assets and liabilities

Fair value estimates are made at a specific point in time based on relevant market information and information about various financial instruments. The following methods and assumptions have been used to estimate the fair value of each class of financial instrument as far as practicable.

Balances with banks and other financial institutions and Trade bills

The maturities of these financial assets and liabilities are within one year and the carrying value approximates fair value.

Advances to customers, banks and other financial institutions

Substantially all the advances to customers, banks and other financial institutions are on floating rate terms, bear interest at prevailing market interest rates and their carrying value approximates fair value.

Held-to-maturity securities

Fair value for held-to-maturity securities is based on market prices or broker/dealer price quotations. Where this information is not available, fair value has been estimated using quoted market prices for securities with similar credit, maturity and yield characteristics. Their carrying value approximates fair value.

Loans and receivables and Certificates of deposit issued

A discounted cash flow model is used based on a current yield curve appropriate for the remaining term to maturity and their carrying value approximates fair value.

Deposits from customers

Substantially all the deposits from customers mature within one year from balance sheet date and their carrying value approximates fair value.

4. Financial risk management (continued)

(F) Fiduciary activities

The Group provides custody, trustee and investment management services to third parties which involve the Group providing both settlement functions and book keeping services to the beneficiaries. Those assets that are held in a fiduciary capacity are not included in these financial statements. As at 31 December 2006, the Group had a balance of securities custody accounts amounting to approximately HK$224,000 million (2005: HK$175,412 million).

5. Net interest income

	2006 **HK$'m**	2005 HK$'m
Interest income		
Cash and due from banks and other financial institutions	**6,915**	3,963
Advances to customers	**18,871**	13,177
Listed investments	**2,463**	2,044
Unlisted investments	**11,449**	6,354
Others	**573**	639
	40,271	26,177
Interest expense		
Due to banks, customers and other financial institutions	**(23,256)**	(12,298)
Debt securities in issue	**(112)**	(112)
Others	**(1,068)**	(643)
	(24,436)	(13,053)
Net interest income	**15,835**	13,124

Included within interest income is HK$88 million (2005: HK$128 million) of interest with respect to income recognised on advances classified as impaired for the year ended 31 December 2006.

Included within interest income and interest expense are HK$39,167 million (2005: HK$25,806 million) and HK$23,646 million (2005: HK$12,763 million) for financial assets and financial liabilities that are not recognised at fair value through profit or loss respectively.

6. Net fees and commission income

	2006 HK$'m	2005 HK$'m
Fees and commission income		
Securities brokerage	**1,488**	834
Credit cards	**807**	737
Bills commissions	**537**	532
Loan commissions	**273**	263
Payment services	**418**	381
Insurance	**142**	205
Asset management	**317**	203
Trust services	**118**	107
Guarantees	**44**	43
Others		
– safe deposit box	**181**	169
– currency exchange	**117**	102
– low deposit balance accounts	**42**	45
– BOC cards	**29**	32
– dormant accounts	**24**	25
– agency services	**14**	12
– postage and telegrams	**28**	27
– information search	**39**	37
– correspondent banking	**31**	19
– RMB business	**77**	43
– sundries	**259**	190
	4,985	4,006
Fees and commission expenses	**(1,268)**	(1,061)
Net fees and commission income	**3,717**	2,945

7. Net trading income

	2006 HK$'m	2005 HK$'m
Net gain/(loss) from:		
– foreign exchange and foreign exchange products	**1,114**	1,414
– interest rate instruments	**563**	(40)
– equity instruments	**133**	20
– commodities	**78**	52
	1,888	1,446

Foreign exchange net trading income includes gains and losses from forward and futures contracts, options, swaps and translation of foreign currency assets and liabilities.

8. Net loss on investments in securities

	2006 HK$'m	2005 HK$'m
Net gain/(loss) from early redemption of held-to-maturity securities	**2**	(4)
Net loss from disposal of available-for-sale securities	**(7)**	(104)
Reversal of impairment losses on held-to-maturity securities	**–**	12
	(5)	(96)

9. Net insurance premium income

	2006 HK$'m	2005 HK$'m
Gross earned premiums	**6,203**	3,636
Less: Gross written premiums ceded to reinsurers	**(8)**	(6)
Net insurance premium income	**6,195**	3,630

10. Other operating income

	2006 HK$'m	2005 HK$'m
Dividend income from investments in securities		
– unlisted investments	**21**	14
Gross rental income from investment properties	**213**	196
Less: Outgoings in respect of investment properties	**(56)**	(62)
Reversal of impairment losses on interests in associates	**–**	4
Write-back of restructuring provisions	**–**	209
Net loss on disposal of subsidiaries	**–**	(10)
Others	**156**	136
	334	487

Included in the "Outgoings in respect of investment properties" is HK$9 million (2005: HK$18 million) of direct operating expenses related to investment properties that were not let during the year.

11. Net insurance benefits and claims

	2006 HK$'m	2005 HK$'m
Claims, benefits and surrenders paid	**400**	515
Movement in liabilities	**6,256**	2,848
Gross claims, benefits and surrenders paid and movement in liabilities	**6,656**	3,363
Less: Reinsurers' share of claims, benefits and surrenders paid	**(1)**	(1)
Net insurance claims, benefits and surrenders paid and movement in liabilities	**6,655**	3,362

12. Reversal of loan impairment allowances

	2006 HK$'m	2005 HK$'m
Net reversal of loan impairment allowances		
– Individually assessed	**1,719**	1,377
– Collectively assessed	**71**	1,268
	1,790	2,645
Of which		
– new allowances	**(841)**	(1,315)
– releases	**516**	2,321
– recoveries (Note 29)	**2,115**	1,639
Net credit to income statement (Note 29)	**1,790**	2,645

13. Operating expenses

	2006 HK$'m	2005 HK$'m
Staff costs (including directors' emoluments)		
– salaries and other costs	**3,714**	3,239
– termination benefit	**15**	1
– pension cost	**275**	253
	4,004	3,493
Premises and equipment expenses (excluding depreciation)		
– rental of premises	**308**	252
– information technology	**344**	283
– others	**216**	205
	868	740
Depreciation	**671**	568
Auditors' remuneration		
– audit services	**29**	27
– non-audit services	**8**	8
Other operating expenses	**978**	935
	6,558	5,771

14. Net (loss)/gain from disposal/revaluation of properties, plant and equipment

	2006 HK$'m	2005 HK$'m
Net gain/(loss) on disposal of premises	**9**	(3)
Net loss on disposal of other fixed assets	**(24)**	(14)
Net (loss)/gain on revaluation of premises (Note 35)	**(1)**	63
Reversal of impairment losses on premises (Note 35)	**8**	5
Impairment losses on other fixed assets (Note 35)	**(4)**	(1)
	(12)	50

15. Net gain from disposal of/fair value adjustments on investment properties

	2006 HK$'m	2005 HK$'m
Net gain on disposal of investment properties	**31**	14
Net gain on fair value adjustments on investment properties (Note 36)	**574**	1,386
	605	1,400

16. Taxation

Taxation in the income statement represents:

	2006 **HK$'m**	2005 HK$'m
Hong Kong profits tax		
– current year taxation	**2,632**	2,282
– under/(over)-provision in prior years	**3**	(34)
Deferred tax charge	**152**	359
	2,787	2,607
Attributable share of estimated Hong Kong profits tax losses arising from investments in partnerships	**–**	(3)
	2,787	2,604
Investments in partnerships written off	**–**	3
Hong Kong profits tax	**2,787**	2,607
Overseas taxation	**68**	39
	2,855	2,646

Hong Kong profits tax has been provided at the rate of 17.5% (2005: 17.5%) on the estimated assessable profits arising in Hong Kong during the year. Taxation on overseas profits has been calculated on the estimated assessable profits for the year at the rates of taxation prevailing in the countries in which the Group operates.

The Group has no outstanding investments in aircraft leasing and coupon strip transactions involving special purpose partnerships as at 31 December 2006 (2005: HK$165 million).

The total assets and liabilities of the aforementioned partnerships are as follows:

	2006 **HK$'m**	2005 HK$'m
Assets	**–**	589
Liabilities	**–**	433

16. Taxation (continued)

The taxation on the Group's profit before taxation that differs from the theoretical amount that would arise using the taxation rate of Hong Kong is as follows:

	2006 **HK$'m**	2005 HK$'m
Profit before taxation	**17,139**	16,502
Calculated at a taxation rate of 17.5% (2005: 17.5%)	**2,999**	2,888
Effect of different taxation rates in other countries	**(10)**	(19)
Income not subject to taxation	**(223)**	(184)
Expenses not deductible for taxation purposes	**92**	83
Tax losses not recognised	**1**	10
Utilisation of previously unrecognised tax losses	**(7)**	(98)
Under/(Over)-provision in prior years	**3**	(34)
Taxation charge	**2,855**	2,646
Effective tax rate	**16.7%**	16.0%

17. Profit attributable to equity holders of the Company

The profit of the Company for the year ended 31 December 2006 attributable to equity holders of the Company and dealt with in the financial statements of the Company amounted to HK$9,371 million (2005: HK$8,300 million).

18. Dividends

	2006		2005	
	Per share HK$	**Total HK$'m**	Per share HK$	Total HK$'m
Interim dividend paid	**0.401**	**4,240**	0.328	3,468
Proposed final dividend	**0.447**	**4,726**	0.480	5,075
	0.848	**8,966**	0.808	8,543

At a meeting held on 29 August 2006, the Board declared an interim dividend of HK$0.401 per ordinary share for the first half of 2006 amounting to approximately HK$4,240 million.

At a meeting held on 22 March 2007, the Board proposed to declare a final dividend of HK$0.447 per ordinary share for the year ended 31 December 2006 amounting to approximately HK$4,726 million. This declared final dividend is not reflected as a dividend payable in these financial statements, but will be reflected as an appropriation of retained earnings for the year ending 31 December 2007.

19. Earnings per share for profit attributable to the equity holders of the Company

The calculation of basic earnings per share is based on the consolidated profit attributable to the equity holders of the Company for the year ended 31 December 2006 of approximately HK$14,007 million (2005: HK$13,596 million) and on the ordinary shares in issue of 10,572,780,266 shares (2005: 10,572,780,266 ordinary shares).

There was no dilution of earnings per share as no potential ordinary shares were in issue for the year ended 31 December 2006 (2005: Nil).

20. Retirement benefit costs

The principal defined contribution schemes for the Group's employees are ORSO schemes exempted under the MPF Schemes Ordinance and the BOC-Prudential Easy Choice MPF Scheme. Under the ORSO schemes, employees make monthly contributions to the ORSO schemes equal to 5% of their basic salaries, while the employer makes monthly contributions equal to 5% to 15% of the employees' monthly basic salaries, depending on years of service. The employees are entitled to receive 100% of the employer's contributions upon termination of employment after completing 20 years of service, or at a scale ranging from 20% to 95% for employees who have completed between 3 to 20 years of service, on conditions of retirement, early retirement, permanent incapacity and ill-health or termination of employment other than summary dismissal.

With the implementation of the MPF Schemes Ordinance on 1 December 2000, the Group also participates in the BOC-Prudential Easy Choice MPF Scheme, of which the trustee is BOCI-Prudential Trustee and the investment manager is BOCI-Prudential Manager, which are related parties of the Company.

The Group's total contributions made to the ORSO schemes for the year ended 31 December 2006 amounted to approximately HK$240 million (2005: approximately HK$225 million), after a deduction of forfeited contributions of approximately HK$19 million (2005: approximately HK$23 million). For the MPF Scheme, the Group contributed approximately HK$21 million (2005: approximately HK$15 million) for the year ended 31 December 2006.

21. Share option schemes

(a) *Share Option Scheme and Sharesave Plan*

The principal terms of the Share Option Scheme and the Sharesave Plan were approved and adopted by written resolutions of all the shareholders of the Company dated 10 July 2002.

The purpose of the Share Option Scheme is to provide the participants with the opportunity to acquire proprietary interests in the Company. The Board may, in its absolute discretion, offer to grant options under the Share Option Scheme to any person as the Board may select. The subscription price for the shares shall be determined on the date of grant by the Board as an amount per share calculated on the basis of established rules. An option may be exercised in whole or in part at any time after the date prescribed by the Board and from time to time as specified in the offer and on or before the termination date prescribed by the Board.

The purpose of the Sharesave Plan is to encourage broad-based employee ownership of the shares of the Company. The amount of the monthly contribution under the savings contract to be made in connection with an option shall be the amount which the relevant eligible employee is willing to contribute, which amount shall not be less than 1% and not more than 10% of the eligible employee's monthly salary as at the date of application or such other maximum or minimum amounts as permitted by the Board. When an option is exercised during an exercise period, it may be exercised in whole or in part.

No options were granted pursuant to the Share Option Scheme or the Sharesave Plan during the year 2006 (2005: Nil).

(b) *Pre-Listing Share Option Scheme*

On 5 July 2002, several directors together with approximately 60 senior management personnel of the Group and employees of BOC were granted options by BOC (BVI), the immediate holding company of the Company, pursuant to a Pre-Listing Share Option Scheme to purchase from BOC (BVI) an aggregate of 31,132,600 existing issued shares of the Company. The Group has taken advantage of the transitional provisions set out in paragraph 53 of HKFRS 2 under which the new recognition and measurement policies have not been applied to all options granted to employees on or before 7 November 2002.

21. Share option schemes (continued)

(b) Pre-Listing Share Option Scheme (continued)

Details of the share options outstanding as at 31 December 2006 are disclosed as follows:

	Directors	Senior management	Others*	Total number of share options	Average exercise price (HK$ per share)
At 1 January 2006	**8,459,100**	**8,302,650**	**1,446,000**	**18,207,750**	**8.5**
Less: Share options exercised during the year	**–**	**(4,278,700)**	**–**	**(4,278,700)**	**8.5**
Less: Share options lapsed during the year	**–**	**(43,500)**	**–**	**(43,500)**	**8.5**
At 31 December 2006	**8,459,100**	**3,980,450**	**1,446,000**	**13,885,550**	**8.5**
Exercisable at 31 December 2006	**8,459,100**	**3,980,450**	**1,446,000**	**13,885,550**	**8.5**
At 1 January 2005	8,459,100	10,532,700	1,446,000	20,437,800	8.5
Less: Share options exercised during the year	–	(2,121,550)	–	(2,121,550)	8.5
Less: Share options lapsed during the year	–	(108,500)	–	(108,500)	8.5
At 31 December 2005	8,459,100	8,302,650	1,446,000	18,207,750	8.5
Exercisable at 31 December 2005	6,253,950	5,071,600	1,084,500	12,410,050	8.5

* Represented share options held by ex-directors of the Group.

Share options were exercised on a regular basis throughout the year, the weighted average share price during the year was HK$16.50 (2005: HK$15.01).

The options granted under this scheme can be exercised at HK$8.50 per share in respect of the option price of HK$1.00. These options have a vesting period of four years (25% of the number of shares subject to such options will vest at the end of each year) from the date on which dealings in the shares commenced on the Stock Exchange with a valid exercise period of ten years. No offer to grant any options under the Pre-Listing Share Option Scheme will be made on or after the date on which dealings in the shares commenced on the Stock Exchange.

22. Directors' and senior management's emoluments

(a) Directors' emoluments

Details of the emoluments paid to or receivable by the directors of the Company in respect of their services rendered for managing the subsidiaries within the Group during the year are as follows:

For the year 2006	Directors' fees HK$'000	Basic salaries, allowances and benefits in kind HK$'000	Bonus HK$'000	Total HK$'000
Executive Director				
He Guangbei	**300**	**4,658**	**1,818**	**6,776**
Non-executive Directors				
Xiao Gang	**222**	**–**	**–**	**222**
Sun Changji	**300**	**–**	**–**	**300**
Hua Qingshan	**300**	**–**	**–**	**300**
Li Zaohang	**250**	**–**	**–**	**250**
Zhou Zaiqun	**300**	**–**	**–**	**300**
Zhang Yanling	**250**	**–**	**–**	**250**
Fung Victor Kwok King*	**300**	**–**	**–**	**300**
Koh Beng Seng*	**272**	**–**	**–**	**272**
Shan Weijian*	**350**	**–**	**–**	**350**
Tung Chee Chen*	**300**	**–**	**–**	**300**
Tung Savio Wai-Hok*	**350**	**–**	**–**	**350**
Yang Linda Tsao*	**400**	**–**	**–**	**400**
	3,894	**4,658**	**1,818**	**10,370**

22. Directors' and senior management's emoluments (continued)

(a) Directors' emoluments (continued)

For the year 2005	Directors' fees HK$'000	Basic salaries, allowances and benefits in kind HK$'000	Bonus HK$'000	Total HK$'000
Executive Director				
He Guangbei	331	4,728	1,969	7,028
Non-executive Directors				
Xiao Gang	300	–	–	300
Sun Changji	300	–	–	300
Hua Qingshan	254	–	–	254
Li Zaohang	250	–	–	250
Zhou Zaiqun	254	–	–	254
Zhang Yanling	250	–	–	250
Fung Victor Kwok King*	300	–	–	300
Shan Weijian*	350	–	–	350
Tung Chee Chen*	300	–	–	300
Tung Savio Wai-Hok*	29	–	–	29
Yang Linda Tsao*	263	–	–	263
	3,181	4,728	1,969	9,878

Note:

* Independent Non-executive Directors

In July 2002, options were granted to several directors of the Company by the immediate holding company, BOC (BVI), under the Pre-Listing Share Option Scheme. Full details of the scheme are stated in Note 21(b). During the year, no options were exercised and no benefits arising from the granting of these share options were included in the directors' emoluments disclosed above or recognised in the income statement.

For details of policies on directors' emoluments please refer to the Corporate Governance Report.

22. Directors' and senior management's emoluments (continued)

(b) Five highest paid individuals

The five individuals whose emoluments were the highest in the Group for the year include 1 (2005: 1) director whose emoluments are reflected in the analysis presented above. The emoluments payable to the remaining 4 (2005: 4) individuals during the year are as follows:

	2006 **HK$'m**	2005 HK$'m
Basic salaries and allowances	**13**	12
Discretionary bonuses	**6**	5
Others (including pension contributions)	**1**	1
	20	18

Emoluments of individuals were within the following bands:

	Number of individuals	
	2006	2005
HK$3,000,001 – HK$3,500,000	**–**	1
HK$3,500,001 – HK$4,000,000	**1**	–
HK$4,000,001 – HK$4,500,000	**1**	–
HK$4,500,001 – HK$5,000,000	**–**	2
HK$5,000,001 – HK$5,500,000	**–**	1
HK$5,500,001 – HK$6,000,000	**1**	–
HK$6,000,001 – HK$6,500,000	**1**	–

During the year, no director waived any emoluments and the Group has not paid any emoluments to the directors or any of the five highest paid individuals as an inducement to join or upon joining the Group or as compensation for loss of office.

23. Cash and balances with banks and other financial institutions

	2006 **HK$'m**	2005 HK$'m
Cash	**2,981**	3,032
Balances with banks and other financial institutions	**27,992**	27,672
	30,973	30,704

24. Placements with banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Placements with banks and other financial institutions maturing within one month	**74,263**	78,251
Placements with banks and other financial institutions maturing between one and twelve months	**56,373**	47,611
	130,636	125,862

25. Cash and short-term funds

	2006 HK$'m	2005 HK$'m
Cash and balances with banks and other financial institutions (Note 23)	**30,973**	30,704
Placements with banks and other financial institutions maturing within one month (Note 24)	**74,263**	78,251
Treasury bills	**11,282**	6,821
	116,518	115,776

26. Trading securities and other financial instruments at fair value through profit or loss

	Trading securities		Other financial instruments at fair value through profit or loss		Total	
	2006 HK$'m	2005 HK$'m	**2006 HK$'m**	2005 HK$'m	**2006 HK$'m**	2005 HK$'m
At fair value						
Debt securities						
– Listed in Hong Kong	**262**	409	**908**	775	**1,170**	1,184
– Listed outside Hong Kong	**3,683**	4,181	**2,185**	1,939	**5,868**	6,120
	3,945	4,590	**3,093**	2,714	**7,038**	7,304
– Unlisted	**6,409**	4,569	**14,524**	8,160	**20,933**	12,729
	10,354	9,159	**17,617**	10,874	**27,971**	20,033
Equity securities						
– Listed in Hong Kong	**19**	18	**262**	311	**281**	329
– Unlisted	**42**	–	**–**	3	**42**	3
	61	18	**262**	314	**323**	332
Total	**10,415**	9,177	**17,879**	11,188	**28,294**	20,365

26. Trading securities and other financial instruments at fair value through profit or loss (continued)

Trading securities and other financial instruments at fair value through profit or loss are analysed by type of issuer as follows:

	2006 **HK$'m**	2005 HK$'m
Central governments and central banks	**4,073**	2,525
Public sector entities	**1,958**	2,288
Banks and other financial institutions	**20,020**	13,118
Corporate entities	**2,243**	2,434
	28,294	20,365

Trading securities and other financial instruments at fair value through profit or loss are analysed as follows:

	2006 **HK$'m**	2005 HK$'m
Treasury bills	**3,616**	1,550
Certificates of deposit held	**2,722**	1,898
Other trading securities and financial instruments at fair value through profit or loss	**21,956**	16,917
	28,294	20,365

27. Derivative financial instruments

The Group enters into the following equity, foreign exchange, interest rate and precious metal related derivative financial instruments for trading and risk management purposes:

Currency forwards represent commitments to purchase and sell foreign currency on a future date. Interest rate futures are contractual obligations to receive or pay a net amount based on changes in interest rates or buy or sell interest rate financial instruments on a future date at an agreed price in the financial market under the administration of the stock exchange. Forward rate agreements are individually negotiated interest rate futures that call for a cash settlement at a future date for the difference between a contracted rate of interest and the current market rate, based on a notional principal amount.

Currency, interest rate and precious metal swaps are commitments to exchange one set of cash flows or commodity for another. Swaps result in an exchange of currencies, interest rates (for example, fixed rate for floating rate), or precious metals (for example, silver swaps) or a combination of all these (i.e. cross-currency interest rate swaps). Except for certain currency swap contracts, no exchange of principal takes place.

Foreign currency, interest rate, equity and precious metal options are contractual agreements under which the seller (writer) grants the purchaser (holder) the right, but not the obligation, either to buy (a call option) or sell (a put option) at or by a set date or during a set period, a specific amount of the financial instrument at a predetermined price. In consideration for the assumption of foreign exchange and interest rate risk, the seller receives a premium from the purchaser. Options are negotiated over-the-counter ("OTC") between the Group and its counterparty or traded through the stock exchange (for example, exchange-traded stock option).

27. Derivative financial instruments (continued)

The contract/notional amounts and fair values of derivative financial instruments held by the Group are set out in the following tables. The contract/notional amounts of these instruments indicate the volume of transactions outstanding at the balance sheet dates and certain of them provide a basis for comparison with fair value instruments recognised on the consolidated balance sheet. However, they do not necessarily indicate the amounts of future cash flows involved or the current fair values of the instruments and, therefore, do not indicate the Group's exposure to credit or market risks. The derivative financial instruments become favourable (assets) or unfavourable (liabilities) as a result of fluctuations in market interest rates, foreign exchange rates or equity and metal prices relative to their terms. The aggregate fair values of derivative financial instruments assets and liabilities can fluctuate significantly from time to time.

The following is a summary of the contract/notional amounts of each significant type of derivative financial instrument:

	2006			2005		
	Trading HK$'m	**Hedging HK$'m**	**Total HK$'m**	Trading HK$'m	Hedging HK$'m	Total HK$'m
Exchange rate contracts						
Spot and forward	**143,859**	**–**	**143,859**	113,672	–	113,672
Swaps	**170,792**	**–**	**170,792**	177,871	–	177,871
Foreign currency option contracts						
– Options purchased	**1,479**	**–**	**1,479**	2,227	–	2,227
– Options written	**3,102**	**–**	**3,102**	1,315	–	1,315
	319,232	**–**	**319,232**	295,085	–	295,085
Interest rate contracts						
Futures	**89**	**–**	**89**	194	–	194
Swaps	**33,362**	**544**	**33,906**	29,310	194	29,504
Interest rate option contracts						
– Swaptions written	**31**	**–**	**31**	1,153	–	1,153
Other contracts						
– Bond options written	**311**	**–**	**311**	465	–	465
	33,793	**544**	**34,337**	31,122	194	31,316
Bullion contracts	**7,330**	**–**	**7,330**	17,808	–	17,808
Equity contracts	**954**	**–**	**954**	567	–	567
Total	**361,309**	**544**	**361,853**	344,582	194	344,776

Note: All derivatives held for hedging are designated as fair value hedges.

27. Derivative financial instruments (continued)

The following table summarises the fair values of each class of derivative financial instrument as at 31 December:

	2006			2005		
	Trading HK$'m	**Hedging HK$'m**	**Total HK$'m**	Trading HK$'m	Hedging HK$'m	Total HK$'m
Fair value assets						
Exchange rate contracts	**6,806**	**–**	**6,806**	4,167	–	4,167
Interest rate contracts	**357**	**7**	**364**	138	3	141
Bullion contracts	**219**	**–**	**219**	873	–	873
Equity contracts	**4**	**–**	**4**	3	–	3
	7,386	**7**	**7,393**	5,181	3	5,184
Fair value liabilities						
Exchange rate contracts	**2,809**	**–**	**2,809**	2,329	–	2,329
Interest rate contracts	**795**	**8**	**803**	1,028	1	1,029
Bullion contracts	**438**	**–**	**438**	833	–	833
Equity contracts	**2**	**–**	**2**	2	–	2
	4,044	**8**	**4,052**	4,192	1	4,193

The replacement costs and credit risk weighted amounts of the above derivative financial instruments, which do not take into account the effects of bilateral netting arrangements are as follows:

	2006	2005	**2006**	2005
	Credit risk weighted amount		**Replacement cost**	
	HK$'m	HK$'m	**HK$'m**	HK$'m
Exchange rate contracts	**525**	415	**789**	246
Interest rate contracts	**47**	49	**91**	85
Bullion contracts	**19**	11	**219**	873
Equity contracts	**16**	9	**4**	3
	607	484	**1,103**	1,207

The credit risk weighted amounts are the amounts that have been calculated in accordance with the Third Schedule of the Banking Ordinance and guidelines issued by the HKMA. The amounts calculated are dependent upon the status of the counterparty and the maturity characteristics of each type of contract.

Replacement cost is the cost of replacing all contracts that have a positive value when marked to market (should the counterparty default on its obligations) and is obtained by marking contracts to market. Replacement cost is a close approximation of the credit risk for these contracts at the balance sheet dates and is calculated in accordance with the guidelines issued by the HKMA. Accrued interest has been excluded in the calculation.

Approximately 61% (2005: 65%) of the Group's transactions in derivative financial instruments contracts are conducted with other financial institutions.

28. Advances and other accounts

	2006 **HK$'m**	2005 HK$'m
Corporate loans and advances	**220,390**	205,705
Personal loans and advances	**126,700**	128,318
Advances to customers	**347,090**	334,023
Loan impairment allowances		
– Individually assessed	**(546)**	(983)
– Collectively assessed	**(557)**	(731)
	345,987	332,309
Trade bills	**3,128**	3,039
Advances to banks and other financial institutions	**3,743**	3,055
Total	**352,858**	338,403

As at 31 December 2006, advances to customers include accrued interest on gross advances of HK$1,236 million (2005: HK$1,204 million).

Impaired advances to customers are analysed as follows:

	2006 **HK$'m**	2005 HK$'m
Gross impaired advances to customers	**916**	1,872
Loan impairment allowances made in respect of such advances	**546**	983
Gross impaired advances to customers as a percentage of gross advances to customers	**0.26%**	0.56%

Impaired advances to customers are individually assessed loans with objective evidence of impairment. The loan impairment allowances were made after taking into account the value of collateral in respect of such advances.

As at 31 December 2005 and 31 December 2006, no impairment allowance was made in respect of trade bills and advances to banks and other financial institutions.

28. Advances and other accounts (continued)

Classified advances to customers are analysed as follows:

	2006 HK$'m	2005 HK$'m
Gross classified advances to customers	1,988	4,263
Gross classified advances to customers as a percentage of gross advances to customers	0.57%	1.28%

Classified advances to customers included "substandard", "doubtful" and "loss" under the Group's classification of loan quality.

29. Loan impairment allowances

	2006		
	Individual assessment HK$'m	Collective assessment HK$'m	Total HK$'m
At 1 January 2006	983	731	1,714
Credited to income statement (Note 12)	(1,719)	(71)	(1,790)
Loans written off during the year as uncollectible	(706)	(142)	(848)
Recoveries (Note 12)	2,053	62	2,115
Unwind of discount on allowance	(65)	(23)	(88)
At 31 December 2006	546	557	1,103

	2005		
	Individual assessment HK$'m	Collective assessment HK$'m	Total HK$'m
At 1 January 2005	1,887	2,055	3,942
Credited to income statement (Note 12)	(1,377)	(1,268)	(2,645)
Loans written off during the year as uncollectible	(1,067)	(27)	(1,094)
Recoveries (Note 12)	1,639	–	1,639
Unwind of discount on allowance	(99)	(29)	(128)
At 31 December 2005	983	731	1,714

30. Available-for-sale securities

	2006 HK$'m	2005 HK$'m
Debt securities		
– Listed in Hong Kong	**4,800**	3,540
– Listed outside Hong Kong	**13,023**	8,361
	17,823	11,901
– Unlisted	**82,516**	40,286
	100,339	52,187
Equity securities		
– Listed outside Hong Kong	**–**	6
– Unlisted	**50**	50
	50	56
Total	**100,389**	52,243
Available-for-sale securities are analysed by type of issuer as follows:		
Central governments and central banks	**13,180**	9,130
Public sector entities	**6,933**	4,506
Banks and other financial institutions	**34,873**	22,876
Corporate entities	**45,403**	15,731
	100,389	52,243

The movements in available-for-sale securities are summarised as follows:

	2006 HK$'m	2005 HK$'m
At 1 January	**52,243**	32,063
Additions	**107,789**	74,276
Disposals and redemptions	**(61,732)**	(36,675)
Reclassification	**–**	(15,772)
Amortisation	**855**	47
Changes in fair value	**90**	(629)
Exchange differences	**1,144**	(1,067)
At 31 December	**100,389**	52,243
Available-for-sale securities are analysed as follows:		
Treasury bills	**7,566**	5,271
Certificates of deposit held	**8,148**	4,178
Other available-for-sale securities	**84,675**	42,794
	100,389	52,243

31. Held-to-maturity securities

	2006 HK$'m	2005 HK$'m
Listed, at amortised cost		
– in Hong Kong	**3,935**	4,281
– outside Hong Kong	**24,629**	29,889
	28,564	34,170
Unlisted, at amortised cost	**137,024**	144,351
Total	**165,588**	178,521
Market value of listed securities	**28,029**	33,637
Held-to-maturity securities are analysed by type of issuer as follows:		
Central governments and central banks	**1,768**	2,740
Public sector entities	**21,166**	30,741
Banks and other financial institutions	**102,823**	118,851
Corporate entities	**39,831**	26,189
	165,588	178,521

The movements in held-to-maturity securities are summarised as follows:

	2006 HK$'m	2005 HK$'m
At 1 January	**178,521**	178,956
Additions	**55,135**	73,600
Redemptions and maturity	**(69,847)**	(88,789)
Reclassification	**–**	15,772
Amortisation	**(40)**	85
Exchange differences	**1,819**	(1,115)
Provision for impairment	**–**	12
At 31 December	**165,588**	178,521
Held-to-maturity securities are analysed as follows:		
Treasury bills	**100**	–
Certificates of deposit held	**9,367**	14,479
Other held-to-maturity securities	**156,121**	164,042
	165,588	178,521

32. Loans and receivables

	2006 HK$'m	2005 HK$'m
Unlisted, at amortised cost	**36,114**	13,080
Loans and receivables are analysed by type of issuer as follows:		
Public sector entities	**–**	100
Banks and other financial institutions	**36,114**	12,980
	36,114	13,080

The movements in loans and receivables are summarised as follows:

	2006 HK$'m	2005 HK$'m
At 1 January	**13,080**	–
Additions	**80,872**	33,652
Redemptions and maturity	**(59,046)**	(20,779)
Amortisation	**1,109**	331
Exchange differences	**99**	(124)
At 31 December	**36,114**	13,080

33. Investment in subsidiaries

	2006 **HK$'m**	2005 HK$'m
Unlisted shares, at cost	**53,764**	52,864

The particulars of all direct and indirect subsidiaries of the Company are set out in the Appendix of the Annual Report, "Subsidiaries of the Company". The following is a list of principal subsidiaries as at 31 December 2006.

Name	**Country of incorporation & place of operation**	**Particulars of issued share capital**	**Interest held**	**Principal activities**
Bank of China (Hong Kong) Limited	Hong Kong	43,042,840,858 ordinary shares of HK$1 each	*100%	Banking business
BOC Group Life Assurance Company Limited	Hong Kong	86,800,000 ordinary shares of HK$10 each	*51%	Life insurance business
Nanyang Commercial Bank, Limited	Hong Kong	6,000,000 ordinary shares of HK$100 each	100%	Banking business
Chiyu Banking Corporation Limited	Hong Kong	3,000,000 ordinary shares of HK$100 each	70.49%	Banking business
BOC Credit Card (International) Limited	Hong Kong	4,800,000 ordinary shares of HK$100 each	100%	Credit card services
Po Sang Futures Limited	Hong Kong	250,000 ordinary shares of HK$100 each	100%	Commodities brokerage

* Shares held directly by the Company

On 1 June 2006, the Company acquired a 51% shareholding of BOC Life for a total consideration of HK$900 million. The Group has applied the Accounting Guideline No. 5 – "Merger Accounting for Common Control Combinations", using the principles of merger accounting, in accounting for the combination with BOC Life as though the business of BOC Life had always been carried out by the Group.

33. Investment in subsidiaries (continued)

The consolidated balance sheet as at 31 December 2005 is:

	The Group HK$'m	BOC Life HK$'m	Adjustment HK$'m	Consolidated HK$'m
Investment in BOC Life	–	–	–	–
Other assets and liabilities	80,733	980	–	81,713
Net Assets	80,733	980	–	81,713
Share Capital	52,864	868	(868)	52,864
Merger reserve	–	–	443	443
Retained earnings and other reserves	26,571	112	(55)	26,628
	79,435	980	(480)	79,935
Minority interest	1,298	–	480	1,778
	80,733	980	–	81,713

Adjustment:

The above adjustment represents the elimination of the share capital of BOC Life against the merger reserve and HK$443 million has been recognised in the reserve in the consolidated financial statements.

Minority interest is adjusted for the share of the carrying value of BOC Life held by minority shareholders.

The consolidated income statement for the year ended 31 December 2005 is:

	The Group HK$'m	BOC Life HK$'m	Adjustment HK$'m	Consolidated HK$'m
Profit attributable to the equity holders of the Company	13,494	204	(102)	13,596

Adjustment:

The above adjustment represents the adjustment for the minority interest of BOC Life.

33. Investment in subsidiaries (continued)

The consolidated balance sheet as at 31 December 2006 is:

	The Group HK$'m	BOC Life HK$'m	Adjustment HK$'m	Consolidated HK$'m
Investment in BOC Life	900	–	(900)	–
Other assets and liabilities	85,486	1,154	–	86,640
Net Assets	86,386	1,154	(900)	86,640
Share Capital	52,864	868	(868)	52,864
Merger reserve	–	–	(457)	(457)
Retained earnings and other reserves	32,103	286	(141)	32,248
	84,967	1,154	(1,466)	84,655
Minority interest	1,419	–	566	1,985
	86,386	1,154	(900)	86,640

Adjustment:

The above adjustment represents the elimination of share capital and investment cost of BOC Life against the merger reserve and an amount of HK$457 million was debited to the reserve in the consolidated financial statements.

Minority interest is adjusted for the share of the carrying value of BOC Life held by minority shareholders.

The consolidated income statement for the year ended 31 December 2006 is:

	The Group HK$'m	BOC Life HK$'m	Adjustment HK$'m	Consolidated HK$'m
Profit attributable to the equity holders of the Company	13,917	176	(86)	14,007

Adjustment:

The above adjustment represents the adjustment for the minority interest of BOC Life.

34. Interests in associates

	2006 HK$'m	2005 HK$'m
At 1 January	**61**	62
Share of result	**6**	5
Share of tax	**(1)**	(1)
Reversal of provision	**–**	4
Dividend paid	**(4)**	(3)
Dissolution of associates	**–**	(6)
Disposal of an associate	**(2)**	–
At 31 December	**60**	61

The Group's interests in its principal associates, all of which are unlisted, are as follows:

Name	**CJM Insurance Brokers Limited**		**Joint Electronic Teller Services Limited**	
Place of incorporation	**2006** and 2005 **Hong Kong**		**2006** and 2005 **Hong Kong**	
Particulars of issued share capital	**6,000,000 ordinary shares of HK$1 each**		**100,238 ordinary shares of HK$100 each**	
Principal activities	**Insurance broker**		**Operation of a private inter-bank message switching network in respect of ATM services**	
	2006 HK$'000	2005 HK$'000	**2006 HK$'000**	2005 HK$'000
Assets	**66,807**	51,810	**350,912**	345,591
Liabilities	**52,772**	34,764	**75,615**	79,056
Revenues	**11,214**	10,534	**70,921**	63,921
Profit after taxation	**2,866**	2,112	**32,586**	22,912
	2006	2005	**2006**	2005
Interest held	**33.33%**	33.33%	**19.96%**	19.96%

Trilease International Limited commenced members' voluntary winding up in January 2005.

During the year, the Group disposed of its entire interest in Charleston Investments Company Limited to BOC Group Investment Limited. Please refer to Note 53 for details.

35. Properties, plant and equipment

	Premises HK$'m	Property under development HK$'m	Equipment, fixtures and fittings HK$'m	Total HK$'m
Net book value at 1 January 2006				
As previously reported	**16,820**	**11**	**1,485**	**18,316**
Effect of merger of a commonly controlled entity	**169**	**–**	**6**	**175**
Net book value at 1 January 2006, restated	**16,989**	**11**	**1,491**	**18,491**
Additions	**–**	**–**	**736**	**736**
Disposals	**(186)**	**(7)**	**(25)**	**(218)**
Revaluation	**1,208**	**–**	**–**	**1,208**
Depreciation for the year	**(303)**	**–**	**(368)**	**(671)**
Reclassification from investment properties (Note 36)	**190**	**–**	**–**	**190**
Reversal of/(provision for) impairment losses (Note 14)	**8**	**(4)**	**–**	**4**
Net book value at 31 December 2006	**17,906**	**–**	**1,834**	**19,740**
At 31 December 2006				
Cost or valuation	**17,906**	**–**	**4,658**	**22,564**
Accumulated depreciation and impairment	**–**	**–**	**(2,824)**	**(2,824)**
Net book value at 31 December 2006	**17,906**	**–**	**1,834**	**19,740**
Net book value at 1 January 2005				
As previously reported	15,184	32	1,280	16,496
Effect of merger of a commonly controlled entity	161	–	8	169
Net book value at 1 January 2005, restated	15,345	32	1,288	16,665
Additions	19	1	549	569
Disposals	(502)	–	(20)	(522)
Revaluation	3,421	–	–	3,421
Depreciation for the year	(242)	–	(326)	(568)
Reclassification to investment properties (Note 36)	(1,057)	–	–	(1,057)
Disposal of subsidiaries	–	(21)	–	(21)
Reversal of/(provision for) impairment losses (Note 14)	5	(1)	–	4
Net book value at 31 December 2005	16,989	11	1,491	18,491
At 31 December 2005				
Cost or valuation	16,997	19	4,166	21,182
Accumulated depreciation and impairment	(8)	(8)	(2,675)	(2,691)
Net book value at 31 December 2005	16,989	11	1,491	18,491

35. Properties, plant and equipment (continued)

	Premises HK$'m	Property under development HK$'m	Equipment, fixtures and fittings HK$'m	Total HK$'m
The analysis of cost or valuation of the above assets is as follows:				
At 31 December 2006				
At cost	**–**	**–**	**4,658**	**4,658**
At valuation	**17,906**	**–**	**–**	**17,906**
	17,906	**–**	**4,658**	**22,564**
At 31 December 2005				
At cost	–	19	4,166	4,185
At valuation	16,997	–	–	16,997
	16,997	19	4,166	21,182

The carrying value of premises is analysed based on the remaining terms of the leases as follows:

	2006 HK$'m	2005 HK$'m
Held in Hong Kong		
On long-term lease (over 50 years)	**11,224**	10,785
On medium-term lease (10 – 50 years)	**6,452**	5,960
On short-term lease (less than 10 years)	**–**	3
Held outside Hong Kong		
On long-term lease (over 50 years)	**54**	55
On medium-term lease (10 – 50 years)	**160**	180
On short-term lease (less than 10 years)	**16**	6
	17,906	16,989

As at 31 December 2006, premises are included in the consolidated balance sheet at valuation carried out at 31 October 2006 on the basis of their open market value by an independent firm of chartered surveyors, Knight Frank Petty Limited (formerly known as Chesterton Petty Limited). Knight Frank Petty Limited also confirmed that there has been no material change in valuations at 31 December 2006.

35. Properties, plant and equipment (continued)

As a result of the above-mentioned revaluations, changes in value of the Group's premises were recognised in the Group's premises revaluation reserves, the income statement and minority interests respectively as follows:

	2006 HK$'m	2005 HK$'m
Increase in valuation credited to premises revaluation reserve	**1,209**	3,325
(Decrease)/increase in valuation credited to income statement (Note 14)	**(1)**	63
Increase in valuation credited to minority interests	**–**	33
	1,208	3,421

As at 31 December 2006, the net book value of premises that would have been included in the Group's consolidated balance sheet had the assets been carried at cost less accumulated depreciation and impairment losses were HK$5,750 million (2005: HK$5,780 million).

36. Investment properties

	2006 HK$'m	2005 HK$'m
At 1 January		
As previously reported	**7,539**	5,381
Effect of merger of a commonly controlled entity	**87**	83
At 1 January, restated	**7,626**	5,464
Disposals	**(529)**	(256)
Fair value gains (Note 15)	**574**	1,386
Reclassification (to)/from properties, plant and equipment (Note 35)	**(190)**	1,057
Disposal of subsidiaries	**–**	(25)
At 31 December	**7,481**	7,626

As at 31 December 2006, investment properties are included in the consolidated balance sheet at valuation carried out at 31 October 2006 on the basis of their open market value by an independent firm of chartered surveyors, Knight Frank Petty Limited. Knight Frank Petty Limited also confirmed that there has been no material change in valuations at 31 December 2006.

36. Investment properties (continued)

The carrying value of investment properties is analysed based on the remaining terms of the leases as follows:

	2006 **HK$'m**	2005 HK$'m
Held in Hong Kong		
On long-term lease (over 50 years)	**6,687**	6,856
On medium-term lease (10 – 50 years)	**545**	574
On short-term lease (less than 10 years)	**40**	39
Held outside Hong Kong		
On long-term lease (over 50 years)	**4**	14
On medium-term lease (10 – 50 years)	**201**	143
On short-term lease (less than 10 years)	**4**	–
	7,481	7,626

37. Other assets

	2006 **HK$'m**	2005 HK$'m
Repossessed assets	**201**	250
Precious metals	**1,534**	1,669
Accounts receivable and prepayments	**12,873**	5,845
	14,608	7,764

38. Hong Kong SAR currency notes in circulation

The Hong Kong SAR currency notes in circulation are secured by deposit of funds in respect of which the Hong Kong SAR Government certificates of indebtedness are held.

39. Trading liabilities and other financial instruments at fair value through profit or loss

	2006 **HK$'m**	2005 HK$'m
Structured deposits (Note 40)	**9,085**	6,373
Short positions in Exchange Fund Bills (Note 41)	**3,544**	1,551
Per consolidated balance sheet	**12,629**	7,924
Certificates of deposit issued – at fair value through profit or loss (per consolidated balance sheet)	**2,498**	3,829
	15,127	11,753

The Group designated on initial recognition HK$11,583 million (2005: HK$10,202 million) of financial liabilities at fair value through profit or loss. The amount of change in their fair values is attributable to changes in a benchmark interest rate. The carrying amount as at 31 December 2006 is less than the amount that the Group would be contractually required to pay at maturity to the holder of these financial liabilities by HK$96 million (2005: HK$140 million).

40. Deposits from customers

	2006 HK$'m	2005 HK$'m
Current, savings and other deposit accounts (per consolidated balance sheet)	**694,691**	632,658
Structured deposits reported as trading liabilities and other financial instruments at fair value through profit or loss (Note 39)	**9,085**	6,373
	703,776	639,031
Analysed by:		
Demand deposits and current accounts		
– corporate customers	**24,624**	23,854
– individual customers	**6,355**	5,094
	30,979	28,948
Savings deposits		
– corporate customers	**67,806**	60,975
– individual customers	**188,847**	155,565
	256,653	216,540
Time, call and notice deposits		
– corporate customers	**114,039**	102,666
– individual customers	**302,105**	290,877
	416,144	393,543
	703,776	639,031

41. Assets pledged as security

As at 31 December 2006, liabilities of the Group amounting to HK$3,544 million (2005: HK$1,551 million) were secured by assets deposited with central depositories to facilitate settlement operations. The amount of assets pledged by the Group to secure these liabilities was HK$3,564 million (2005: HK$3,702 million) included in "Trading securities" and "Available-for-sale securities".

In addition, the Group had no liability as at 31 December 2006 which was secured by debt securities related to sale and repurchase arrangements (2005: HK$473 million).

42. Insurance contract liabilities

	2006		
	Gross HK$'m	**Reinsurance HK$'m**	**Net HK$'m**
At 1 January 2006	**7,968**	**–**	**7,968**
Benefits paid	**(235)**	**–**	**(235)**
Claims incurred and movement in liabilities	**6,506**	**–**	**6,506**
At 31 December 2006	**14,239**	**–**	**14,239**

	2005		
	Gross HK$'m	Reinsurance HK$'m	Net HK$'m
At 1 January 2005	5,139	–	5,139
Benefits paid	(459)	–	(459)
Claims incurred and movement in liabilities	3,288	–	3,288
At 31 December 2005	7,968	–	7,968

43. Deferred taxation

Deferred tax is recognised in respect of the temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements in accordance with HKAS 12 "Income taxes".

The major components of deferred tax assets and liabilities recorded in the consolidated balance sheet, and the movements during the year are as follows:

	2006					
	Accelerated tax depreciation HK$'m	**Asset revaluation HK$'m**	**Losses HK$'m**	**Provisions HK$'m**	**Other temporary differences HK$'m**	**Total HK$'m**
At 1 January 2006	**357**	**2,941**	**(72)**	**(127)**	**(112)**	**2,987**
Charged to income statement	**44**	**49**	**1**	**38**	**20**	**152**
Charged to equity	**–**	**165**	**–**	**–**	**18**	**183**
At 31 December 2006	**401**	**3,155**	**(71)**	**(89)**	**(74)**	**3,322**

43. Deferred taxation (continued)

	2005					
	Accelerated tax depreciation HK$'m	Asset revaluation HK$'m	Losses HK$'m	Provisions HK$'m	Other temporary differences HK$'m	Total HK$'m
At 1 January 2005	315	2,215	(16)	(348)	(7)	2,159
Charged/(credited) to income statement	42	214	(56)	221	(62)	359
Charged/(credited) to equity	–	512	–	–	(43)	469
At 31 December 2005	357	2,941	(72)	(127)	(112)	2,987

Deferred tax assets and liabilities are offset on an individual entity basis when there is a legal right to set off current tax assets against current tax liabilities and when the deferred taxation relates to the same authority. The following amounts, determined after appropriate offsetting, are shown in the consolidated balance sheet:

	2006 HK$'m	2005 HK$'m
Deferred tax assets	**(69)**	(68)
Deferred tax liabilities	**3,391**	3,055
	3,322	2,987

	2006 HK$'m	2005 HK$'m
Deferred tax assets to be recovered after more than twelve months	**(69)**	(67)
Deferred tax liabilities to be settled after more than twelve months	**3,434**	3,128
	3,365	3,061

The deferred tax charged to equity during the year is as follows:

	2006 HK$'m	2005 HK$'m
Fair value reserves in shareholders' equity:		
– premises	**165**	512
– available-for-sale securities	**18**	(43)
	183	469

44. Share capital

	2006	2005
	HK$'m	HK$'m
Authorised:		
20,000,000,000 ordinary shares of HK$5.00 each	**100,000**	100,000
Issued and fully paid:		
10,572,780,266 ordinary shares of HK$5.00 each	**52,864**	52,864

45. Reserves

(a) Group

The Group's reserves and the movements therein for the current and prior years are presented in the consolidated statement of changes in equity on pages 90 to 91 of the financial statements.

(b) Company

Included in the Company's retained earnings was a final dividend of HK$4,726 million (2005: HK$5,075 million) which was proposed by the Board after the balance sheet date.

46. Notes to consolidated cash flow statement

(a) Reconciliation of operating profit to operating cash inflow before taxation

	2006 HK$'m	2005 HK$'m
Operating profit	**16,541**	15,048
Net loss on disposal of subsidiaries	**–**	10
Reversal of impairment losses on interests in associates	**–**	(4)
Depreciation	**671**	568
Reversal of loan impairment allowances	**(1,790)**	(2,645)
Unwind of discount on impairment	**(88)**	(128)
Advances written off net of recoveries	**1,267**	545
Change in placements with banks and other financial institutions with original maturity over three months	**(1,099)**	70,210
Change in trading securities and other financial instruments at fair value through profit or loss	**(7,771)**	(6,123)
Change in derivative financial instruments	**(2,350)**	(1,462)
Change in advances and other accounts	**(13,844)**	(24,598)
Change in available-for-sale securities	**(45,180)**	(18,304)
Change in held-to-maturity securities	**13,856**	1,253
Change in loans and receivables	**(23,034)**	(13,080)
Change in other assets	**(6,844)**	137
Change in deposits and balances of banks and other financial institutions repayable over three months	**447**	27
Change in trading liabilities and other financial instruments at fair value through profit or loss	**4,705**	4,132
Change in deposits from customers	**62,033**	2,949
Change in certificates of deposit issued	**(1,467)**	114
Change in other accounts and provisions	**10,549**	(1,465)
Change in insurance contract liabilities	**6,271**	2,830
Exchange difference	**4**	1
Operating cash inflow before taxation	**12,877**	30,015

(b) Analysis of the balances of cash and cash equivalents

	2006 HK$'m	2005 HK$'m
Cash and balances with banks and other financial institutions	**30,973**	30,704
Placements with banks and other financial institutions with original maturity within three months	**88,861**	85,186
Treasury bills with original maturity within three months	**6,782**	3,456
Certificates of deposit held with original maturity within three months	**1,641**	818
Deposits and balances of banks and other financial institutions with original maturity within three months	**(45,081)**	(37,149)
	83,176	83,015

46. Notes to consolidated cash flow statement (continued)

(c) Disposal of subsidiaries

	2006 HK$'m	2005 HK$'m
Net assets disposed of:		
– Cash and short-term funds	–	26
– Other assets	–	17
– Investment properties	–	25
– Properties, plant and equipment	–	21
– Loss on disposal	–	(10)
	–	79
Satisfied by:		
– Cash	–	79
Analysis of net inflow of cash and cash equivalents in respect of the disposal of subsidiaries:		
– Cash consideration	–	79
– Accounts receivable	–	(18)
	–	61

47. Contingent liabilities and commitments

The following is a summary of the contractual amounts of each significant class of contingent liability and commitment and the corresponding aggregate credit risk weighted amount:

	2006 HK$'m	2005 HK$'m
Direct credit substitutes	**1,285**	1,027
Transaction-related contingencies	**7,150**	5,982
Trade-related contingencies	**20,942**	18,936
Other commitments with an original maturity of		
– under one year or which are unconditionally cancellable	**113,059**	105,983
– one year and over	**45,345**	29,754
	187,781	161,682
Credit risk weighted amount	**30,076**	21,415

The calculation basis of credit risk weighted amount has been set out in Note 27 to the financial statements.

48. Capital commitments

The Group has the following outstanding capital commitments not provided for in the financial statements:

	2006 HK$'m	2005 HK$'m
Authorised and contracted for but not provided for	**162**	185
Authorised but not contracted for	**5**	16
	167	201

The above capital commitments mainly relate to commitments to purchase computer equipment and software, and to renovate the Group's premises.

49. Operating lease commitments

(a) *The Group as lessee*

The Group has commitments to make the following future minimum lease payments under non-cancellable operating leases:

	2006 HK$'m	2005 HK$'m
Land and buildings		
– not later than one year	**280**	204
– later than one year but not later than five years	**273**	192
– later than five years	**1**	2
	554	398
Computer equipment		
– not later than one year	**1**	1

Certain non-cancellable operating leases included in the tables above were subject to renegotiation and rent adjustment with reference to market rates prevailing at specified agreed dates.

(b) *The Group as lessor*

The Group has contracted with tenants for the following future minimum lease receivables under non-cancellable operating leases:

	2006 HK$'m	2005 HK$'m
Land and buildings		
– not later than one year	**216**	151
– later than one year but not later than five years	**219**	162
	435	313

The Group leases its investment properties (Note 36) under operating lease arrangements, with leases typically for a period from one to three years. The terms of the leases generally require the tenants to pay security deposits and provide for periodic rent adjustments according to the prevailing market conditions. None of the leases includes contingent rentals.

50. Litigation

The Group is currently being served a number of claims and counterclaims by various independent parties. These claims and counterclaims are in relation to the normal commercial activities of the Group.

No material provision was made against these claims and counterclaims because the directors believe that the Group has meritorious defences against the claimants or the amounts involved in these claims are not expected to be material.

51. Segmental reporting

The Group engages in many businesses in several regions. For segmental reporting purposes, information is solely provided in respect of business segments. Geographical segment information is not presented because over 90% of the Group's revenues, profits before tax and assets are derived from Hong Kong.

With the merger of BOC Life in the first half of 2006, the Group's business became more diversified and an additional business segment "Insurance" has been introduced in segmental reporting. The Group's business was segmented as Retail Banking, Corporate Banking, Treasury and Insurance.

Both Retail Banking and Corporate Banking segments provide general banking services. Retail Banking mainly serves individual customers and small companies. Corporate Banking mainly deals with medium to large companies. The Treasury segment is responsible for managing the capital, liquidity, and the interest rate and foreign exchange positions of the Group in addition to proprietary trades. The Insurance segment shows business relates to the Group's long-term life insurance products, including traditional and linked individual life insurance and group life insurance products. "Others" refers to those items related to the Group as a whole but independent of the other four business segments, including the Group's holdings of premises, investment properties and interests in associates.

Revenues, expenses, assets and liabilities of any business segment mainly include items directly attributable to the segment. In relation to occupation of the Group's premises, rentals are internally charged on market rates according to the areas occupied. For management overheads, allocations are made on reasonable bases. During the period, the Group has revised the allocation bases and comparative amounts have been reclassified to conform with the current year's presentation. There is no impact on the Group's income statement and balance sheet. Inter-segment funding is charged according to the internal funds transfer pricing mechanism of the Group. The charge on any such funding is mainly made by reference to the corresponding money market rate.

51. Segmental reporting (continued)

	2006							
	Retail HK$'m	Corporate HK$'m	Treasury HK$'m	Insurance HK$'m	Others HK$'m	Subtotal HK$'m	Eliminations HK$'m	Consolidated HK$'m
Net interest income/(expenses)	7,851	4,281	4,286	473	(1,056)	15,835	–	15,835
Net fees and commission income/(expenses)	2,895	1,055	(5)	(206)	36	3,775	(58)	3,717
Net trading income	590	118	759	420	–	1,887	1	1,888
Net (loss)/gain on investments in securities	–	–	(11)	–	6	(5)	–	(5)
Net insurance premium income	–	–	–	6,198	–	6,198	(3)	6,195
Other operating income	49	36	–	9	1,416	1,510	(1,176)	334
Total operating income	11,385	5,490	5,029	6,894	402	29,200	(1,236)	27,964
Net insurance benefits and claims	–	–	–	(6,655)	–	(6,655)	–	(6,655)
Net operating income before loan impairment allowances	11,385	5,490	5,029	239	402	22,545	(1,236)	21,309
(Provision for)/Reversal of loan impairment allowances	(27)	1,817	–	–	–	1,790	–	1,790
Net operating income	11,358	7,307	5,029	239	402	24,335	(1,236)	23,099
Operating expenses	(5,033)	(1,500)	(458)	(65)	(738)	(7,794)	1,236	(6,558)
Operating profit/(loss)	6,325	5,807	4,571	174	(336)	16,541	–	16,541
Net (loss)/gain from disposal/revaluation of properties, plant and equipment	(18)	(3)	(2)	–	11	(12)	–	(12)
Net gain from disposal of/fair value adjustments on investment properties	–	–	–	–	605	605	–	605
Share of profits less losses of associates	–	–	–	–	5	5	–	5
Profit before taxation	6,307	5,804	4,569	174	285	17,139	–	17,139
Assets								
Segment assets	169,595	222,701	497,155	15,804	26,889	932,144	(3,472)	928,672
Interests in associates	–	–	–	–	60	60	–	60
Unallocated corporate assets	–	–	–	–	221	221	–	221
	169,595	222,701	497,155	15,804	27,170	932,425	(3,472)	928,953
Liabilities								
Segment liabilities	578,249	148,353	98,531	14,649	173	839,955	(3,472)	836,483
Unallocated corporate liabilities	–	–	–	–	5,830	5,830	–	5,830
	578,249	148,353	98,531	14,649	6,003	845,785	(3,472)	842,313
Other information								
Additions of properties, plant and equipment	–	–	–	–	736	736	–	736
Depreciation	189	63	38	1	380	671	–	671
Amortisation of securities	–	–	1,924	–	–	1,924	–	1,924

51. Segmental reporting (continued)

	2005							
	Retail HK$'m	Corporate HK$'m	Treasury HK$'m	Insurance HK$'m	Others HK$'m	Subtotal HK$'m	Eliminations HK$'m	Consolidated HK$'m
Net interest income/(expenses)	7,326	3,776	2,428	318	(724)	13,124	–	13,124
Net fees and commission income/(expenses)	2,086	987	(17)	(108)	21	2,969	(24)	2,945
Net trading income/(expenses)	500	121	1,134	(305)	–	1,450	(4)	1,446
Net loss on investments in securities	–	–	(96)	–	–	(96)	–	(96)
Net insurance premium income	–	–	–	3,634	–	3,634	(4)	3,630
Other operating income	46	5	–	9	1,498	1,558	(1,071)	487
Total operating income	9,958	4,889	3,449	3,548	795	22,639	(1,103)	21,536
Net insurance benefits and claims	–	–	–	(3,362)	–	(3,362)	–	(3,362)
Net operating income before loan impairment allowances	9,958	4,889	3,449	186	795	19,277	(1,103)	18,174
Reversal of loan impairment allowances	956	1,689	–	–	–	2,645	–	2,645
Net operating income	10,914	6,578	3,449	186	795	21,922	(1,103)	20,819
Operating expenses	(4,514)	(1,293)	(308)	(56)	(703)	(6,874)	1,103	(5,771)
Operating profit	6,400	5,285	3,141	130	92	15,048	–	15,048
Net (loss)/gain from disposal/revaluation of properties, plant and equipment	(12)	(1)	–	–	63	50	–	50
Net gain from disposal of/fair value adjustments on investment properties	–	–	–	12	1,388	1,400	–	1,400
Share of profits less losses of associates	–	–	–	–	4	4	–	4
Profit before taxation	6,388	5,284	3,141	142	1,547	16,502	–	16,502
Assets								
Segment assets	158,844	211,834	426,791	9,343	25,564	832,376	(1,609)	830,767
Interests in associates	–	–	–	–	61	61	–	61
Unallocated corporate assets	–	–	–	–	174	174	–	174
	158,844	211,834	426,791	9,343	25,799	832,611	(1,609)	831,002
Liabilities								
Segment liabilities	554,244	101,719	82,381	8,365	647	747,356	(1,609)	745,747
Unallocated corporate liabilities	–	–	–	–	3,542	3,542	–	3,542
	554,244	101,719	82,381	8,365	4,189	750,898	(1,609)	749,289
Other information								
Additions of properties, plant and equipment	–	–	–	–	569	569	–	569
Depreciation	186	64	22	2	294	568	–	568
Amortisation of securities	–	–	463	–	–	463	–	463

52. Loans to directors and officers

Particulars of advances made to directors and officers of the Company pursuant to section 161B of the Hong Kong Companies Ordinance are as follows:

	2006 **HK$'m**	2005 HK$'m
Aggregate amount of relevant loans outstanding at year end	**184**	22
Maximum aggregate amount of relevant loans outstanding during the year	**347**	186

53. Significant related party transactions

Related parties are those parties that have the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control. Related parties may be individuals or other entities.

Transactions with related parties, which the Group entered into during the year are summarised as follows:

(a) Sale of certain assets to related parties

Sale of properties

In June 2006, BOC Life completed the disposal of BOCG Insurance Tower, for consideration of HK$255 million, to BOC Insurance. Following the disposal, BOC Life leased back part of the subject property from BOC Insurance at a monthly rental of HK$420,000 to continue the operation of its business.

Sale of an associate

In March 2006, BOCHK completed the disposal of a 40% equity interest in Charleston Investments Company Limited to BOC Group Investment Limited at a total consideration of HK$2 million. Loss on the disposal is insignificant.

Sale of investment security

In March 2006, BOCHK completed the disposal of a 10% equity interest in Yithan Company Limited to BOC Group Investment Limited at a total consideration of HK$8 million. Loss on the disposal is insignificant.

(b) Purchase of a subsidiary from a related party

In June 2006, the Company acquired a 51% equity interest in BOC Life from BOC Insurance at a total consideration of HK$900 million. The principal business of BOC Life is the provision of life insurance policies to customers in Hong Kong. For the impact on financial position of the Group, please refer to Note 33 "Investment in subsidiaries" on pages 149 to 151.

(c) Advances to third parties guaranteed by BOC group companies

As at 31 December 2006, BOC, the intermediate holding company, provided guarantees for loans in favour of the Group amounting to HK$2,522 million (2005: HK$3,255 million) to certain third parties. BOC held equity interests of not more than 20% in these third parties.

53. Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with BOC group companies

The aggregate income and expenses arising from related party transactions with the immediate holding company, the intermediate holding companies, associates of the Company as well as subsidiaries and associates of BOC are summarised as follows:

		2006		
	Notes	Immediate and intermediate holding companies HK$'m	Associates HK$'m	Other related parties[1] HK$'m
Income statement items:				
Interest income	(i)	**602**	**–**	**19**
Interest expense	(ii)	**(679)**	**(4)**	**(234)**
(Insurance premium paid)/insurance commission received (net)	(iii)	**–**	**(2)**	**31**
Administrative services fees received/receivable	(iv)	**33**	**–**	**21**
Rental fees received/receivable	(iv)	**–**	**–**	**17**
Credit card commission paid/ payable (net)	(v)	**(82)**	**–**	**(2)**
Securities brokerage commission paid/payable (net)	(v)	**–**	**–**	**(177)**
Rental, property management and letting agency fees paid/payable	(v)	**–**	**–**	**(79)**
Funds selling commission received	(vi)	**–**	**–**	**54**
Correspondent banking fee received	(vii)	**10**	**–**	**–**
Loan services fees received		**–**	**–**	**9**
Net trading gains/(losses)		**68**	**–**	**(174)**

53. Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

		2005		
	Notes	Immediate and intermediate holding companies HK$'m	Associates HK$'m	Other related parties[1] HK$'m
Income statement items:				
Interest income	(i)	461	–	6
Interest expense	(ii)	(412)	(2)	(95)
Insurance commission received (net)	(iii)	–	–	42
Administrative services fees received/receivable	(iv)	36	–	16
Rental fees received/receivable	(iv)	–	–	15
Credit card commission paid/ payable (net)	(v)	(77)	–	(2)
Securities brokerage commission paid/payable (net)	(v)	–	–	(71)
Rental, property management and letting agency fees paid/payable	(v)	–	–	(80)
Funds selling commission received	(vi)	–	–	45
Correspondent banking fee received	(vii)	11	–	–
Net trading losses		(42)	–	–

53. Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

	Notes	2006 Immediate and intermediate holding companies HK$'m	Associates HK$'m	Other related parties[1] HK$'m
Balance sheet items:				
Cash and balances with banks and other financial institutions	(i)	**4,503**	**–**	**21**
Placements with banks and other financial institutions	(i)	**8,796**	**–**	**102**
Trading securities and other financial instruments at fair value through profit or loss		**1**	**–**	**1,706**
Derivative financial instruments assets	(viii)	**15**	**–**	**–**
Advances and other accounts	(i)	**64**	**–**	**–**
Other assets	(ix)	**54**	**–**	**4,163**
Deposits and balances of banks and other financial institutions	(ii)	**20,722**	**–**	**1,390**
Deposits from customers	(ii)	**157**	**77**	**6,417**
Derivative financial instruments liabilities	(viii)	**13**	**–**	**–**
Other accounts and provisions	(ix)	**88**	**–**	**3,853**

53. Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

	Notes	2005 Immediate and intermediate holding companies HK$'m	2005 Associates HK$'m	2005 Other related parties[1] HK$'m
Balance sheet items:				
Cash and balances with banks and other financial institutions	(i)	4,851	–	19
Placements with banks and other financial institutions	(i)	12,328	–	–
Derivative financial instruments assets	(viii)	4	–	2
Advances and other accounts	(i)	20	–	–
Other assets	(ix)	33	–	574
Deposits and balances of banks and other financial institutions	(ii)	19,596	–	857
Deposits from customers	(ii)	97	91	4,158
Derivative financial instruments liabilities	(viii)	78	–	–
Other accounts and provisions	(ix)	55	–	978

1 Subsidiaries and associates of BOC and post-employment benefit plans for the benefit of employees of the Company are collectively disclosed as other related parties and certain of which are state-controlled entities.

53. Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

Notes:

(i) Interest income

In the ordinary course of business, the Group enters into various transactions with BOC group companies including deposit of cash and balances with banks and other financial institutions, placement of interbank deposits and provision of loans and credit facilities. The transactions were conducted at prices and terms that are no more favourable than those charged to and contracted with other third party customers of the Group.

(ii) Interest expense

In the ordinary course of business, the Group accepts interbank deposits and current, fixed, savings and other deposits from BOC group companies at the relevant market rates at the time of the transactions.

(iii) Insurance premium paid/insurance commission received (net)

In the ordinary course of business, the Group provides insurance agency services to and purchases general insurance policies from BOC group companies at the relevant market rates at the time of the transactions.

(iv) Administrative services fees and rental fees received/receivable

In the ordinary course of business, the Group receives administrative services fees for the provision of various administrative services including internal audit, technology, human resources support and training to BOC group companies mainly on the basis of cost plus a margin of 5%, and receives office premises rental fees from BOC group companies at the relevant market rates at the time of the transactions.

(v) Commission, property management, letting agency fees and rental fees paid/payable

In the ordinary course of business, the Group pays commission fees for credit card administrative and promotional services, securities brokerage services, property management and letting agency fees to BOC group companies. The Group also pays rental fees to BOC group companies. These transactions were priced at the relevant market rates at the time of the transactions.

(vi) Funds selling commission received

In the ordinary course of business, the Group receives commission for engaging in promotion and sale of fund products of a BOC group company to customers of the Group at the relevant market rates at the time of the transactions.

(vii) Correspondent banking fee received

In the ordinary course of business, BOC provides services to the Group's customers including remittance services and advising on and collecting letters of credit issued by the Group. The Group shares the fees paid by its customers with BOC on the basis agreed between the parties from time to time.

53. Significant related party transactions (continued)

(d) Summary of transactions entered into during the ordinary course of business with BOC group companies (continued)

Notes: (continued)

(viii) Derivative financial instruments assets/liabilities

In the ordinary course of business, the Group enters into foreign exchange contracts and interest rate contracts with BOC group companies. As at 31 December 2006 the aggregate notional amount of such derivative transactions amounted to HK$15,918 million (2005: HK$17,583 million) whilst the corresponding derivative financial instruments assets and liabilities amounted to HK$15 million (2005: HK$6 million) and HK$13 million (2005: HK$78 million) respectively. These transactions are executed at the relevant market rates at the time of the transactions.

(ix) Other assets and other accounts and provisions

Included within "Other assets" and "Other accounts and provisions" are receivables from and payables to BOC group companies. The amounts mainly represent the accounts receivables from and payables to a subsidiary of BOC in relation to dealing securities trading transactions on behalf of the Group's customers. The receivables and payables arose from transactions carried out in the normal course of business.

(e) Contingent liabilities and commitments

In the ordinary course of business, the Group provides loan facilities and trade finance services to, and guarantees for the obligations of BOC and its subsidiaries and associates on normal commercial terms. As at 31 December 2006, the total undrawn loan commitments, trade finance-related contingencies and guarantees amounted to HK$3,558 million (2005: HK$1,143 million).

(f) Key management personnel

Key management are those persons having authority and responsibility for planning, directing and controlling the activities of the Group, directly or indirectly, including Directors and Senior Management. The Group accepts deposits from and grants loans and credit facilities to key management personnel in the ordinary course of business. During both the current and prior years, no material transaction was conducted with key management personnel of BOCHK, its holding companies and parties related to them.

The key management compensation for the year ended 31 December 2006 and 31 December 2005 is detailed as follows:

	2006 HK$'m	2005 HK$'m
Salaries and other short-term employee benefits	**34**	33
Post-employment benefits	**1**	1
	35	34

53. Significant related party transactions (continued)

(g) Transactions with Ministry of Finance and The People's Bank of China

The Group enters into banking transactions with these entities in the normal course of business. These include purchases and redemption of treasury bonds and money market transactions. The outstanding balances at the year end, and the related income and expenses for the year are as follows:

(i) Advances to customers/banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Interest income	**10**	–

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**–**	–
Outstanding balance at end of the year	**164**	–

(ii) Treasury bonds

	2006 HK$'m	2005 HK$'m
Interest income	**87**	133

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**2,630**	2,523
Outstanding balance at end of the year	**1,578**	2,630

(iii) Due from banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Interest income	**226**	110

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**21,846**	11,648
Outstanding balance at end of the year	**23,693**	21,846

53. Significant related party transactions (continued)

(g) Transactions with Ministry of Finance and The People's Bank of China (continued)

(iv) Due to banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Interest expense	–	(5)

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	–	–
Outstanding balance at end of the year	–	–

(h) Transactions with Central SAFE and other companies controlled by Central SAFE

Central SAFE is the controlling entity of BOC. Central SAFE is approved by the State Council of the PRC to assume the rights and obligations of the equity owner on behalf of the State. Accordingly, Central SAFE, acting on behalf of the State, has become the ultimate holding company of the Company by virtue of its interest in BOC.

The Group did not have any balances or enter into any transactions with Central SAFE for the year ended 31 December 2006 (2005: Nil).

Central SAFE has controlling equity interests in certain other banks in the PRC. The Group enters into banking transactions with these companies in the normal course of business. These include loans, investment securities and money market transactions. The outstanding balances at the year end, and the related income and expenses for the year are as follows:

(i) Advances to customers/banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Interest income	–	–

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	11	–
Outstanding balance at end of the year	29	11

53. Significant related party transactions (continued)

(h) Transactions with Central SAFE and other companies controlled by Central SAFE (continued)

(ii) Investment securities

	2006 HK$'m	2005 HK$'m
Interest income	**66**	59

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**2,043**	1,743
Outstanding balance at end of the year	**1,270**	2,043

(iii) Trading securities and other financial instruments at fair value through profit or loss

	2006 HK$'m	2005 HK$'m
Interest income	**–**	–

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**19**	–
Outstanding balance at end of the year	**25**	19

(iv) Due from banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Interest income	**35**	29

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**1,034**	2,115
Outstanding balance at end of the year	**854**	1,034

53. Significant related party transactions (continued)

(h) Transactions with Central SAFE and other companies controlled by Central SAFE (continued)

(v) Due to banks and other financial institutions

	2006 **HK$'m**	2005 HK$'m
Interest expense	**(1)**	(1)

	2006 **HK$'m**	2005 HK$'m
Outstanding balance at beginning of the year	**15**	14
Outstanding balance at end of the year	**77**	15

(i) Transactions with other state-controlled entities

The state-controlled entities are those, other than BOC (the intermediate holding company and its subsidiaries) and Central SAFE and its controlled companies over which the PRC government directly or indirectly holds over 50% of the outstanding shares or voting rights, and has the ability to control or the power to govern their financial or operational policies through its government authorities, agencies and affiliates. The Group has extensive transactions with other state controlled entities. These transactions, conducted in the ordinary course of business, may include, but are not limited to, the following:

- lending, provision of credits and guarantees and deposit taking;
- inter-bank balance taking and placing;
- sale, purchase, underwriting and redemption of bonds issued by other state-controlled entities;
- rendering of foreign exchange, remittance, investment related services;
- provision of fiduciary activities; and
- purchase of utilities, transport, telecommunication and postal services.

Utilities, transport, telecommunication and postal services are charged by service providers at market rates. Management believes that, based on their assessment, the amounts of such related party transactions are insignificant for the year and therefore are not disclosed. Details of other transactions are set forth below:

53. Significant related party transactions (continued)

(i) Transactions with other state-controlled entities (continued)

The Group enters into banking transactions with other state-controlled entities in the ordinary course of business. These include loans, deposits, investment securities, money market transactions and off-balance sheet exposures. The outstanding balances and related provisions at the year end, and the related income and expenses for the year are as follows:

(i) Advances to customers/banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Interest income	**1,697**	1,341
Reversal of/(charge for) individually assessed loan impairment allowances	**334**	(2)

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**41,543**	31,870
Outstanding balance at end of the year	**32,248**	41,543
Less: individually assessed loan impairment allowances	**(88)**	(469)
	32,160	41,074

(ii) Investment securities

	2006 HK$'m	2005 HK$'m
Interest income	**349**	343

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**6,977**	6,086
Outstanding balance at end of the year	**7,640**	6,977

Investment securities include held-to-maturity securities and available-for-sale securities.

53. Significant related party transactions (continued)

(i) Transactions with other state-controlled entities (continued)

(iii) Trading securities and other financial instruments at fair value through profit or loss

	2006 HK$'m	2005 HK$'m
Interest income	**14**	29

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**738**	117
Outstanding balance at end of the year	**377**	738

(iv) Due from banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Interest income	**270**	129

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**4,839**	4,418
Outstanding balance at end of the year	**4,746**	4,839

(v) Due to banks and other financial institutions

	2006 HK$'m	2005 HK$'m
Interest expense	**(195)**	(112)

	2006 HK$'m	2005 HK$'m
Outstanding balance at beginning of the year	**6,434**	7,463
Outstanding balance at end of the year	**10,949**	6,434

53. Significant related party transactions (continued)

(i) Transactions with other state-controlled entities (continued)

(vi) Deposits from customers

	2006 **HK$'m**	2005 HK$'m
Interest expense	**(1,406)**	(1,013)

	2006 **HK$'m**	2005 HK$'m
Outstanding balance at beginning of the year	**44,652**	39,161
Outstanding balance at end of the year	**26,613**	44,652

(vii) Contingent liabilities and commitments (including guarantees)

	2006 **HK$'m**	2005 HK$'m
Contingent liabilities and commitments (including guarantees)	**26,273**	26,852

(viii) Outstanding derivative transactions (notional amount)

	2006 **HK$'m**	2005 HK$'m
Outstanding derivative transactions (notional amount)	**618**	4,020

54. Ultimate holding company

Central SAFE, acting on behalf of the State is the ultimate holding company of the Company whilst BOC is the Company's intermediate holding company.

55. Comparative amounts

In June 2006, the Group acquired a 51% shareholding of an entity under common control, BOC Life. The financial statements have been prepared in accordance with the principles of merger accounting as set out in Accounting Guideline 5 "Merger accounting for common control combinations" issued by the HKICPA. The comparative amounts for the year ended 31 December 2005 have been restated in accordance with the principles for merger accounting to present the result and assets of the Group as if BOC Life had been combined with the Group during the year.

For the purpose of presentation of income statement, certain items are now reclassified and included as part of the operating profit of the Group as management believes that this better reflects the Group's operations. Certain comparative amounts have been reclassified to conform with the current year's presentation.

56. Approval of financial statements

The financial statements were approved and authorised for issue by the Board of Directors on 22 March 2007.