HSBC Bank plc

Abridged unconsolidated interim financial statements

For the 6 months to 30 June 2006

HSBC Bank plc

Financial Statements (unaudited)

Income statement

for the half-year to 30 June 2006

		Half year to		
		30 June 2006	31 December 2005	30 June 2005
	Notes	**£m**	£m	£m
Interest income		**4,018**	3,928	3,557
Interest expense		**(2,697)**	(2,556)	(2,354)
Net interest income		**1,321**	1,372	1,203
Fee income		**1,157**	1,099	970
Fee expense		**(242)**	(203)	(192)
Net fee income		**915**	896	778
Trading income excluding net interest income		**427**	246	260
Net interest income on trading activities		**309**	304	252
Net trading income		**736**	550	512
Net income from financial instruments designated at fair value		**33**	(27)	17
Net investment income on assets backing policyholders' liabilities		**–**	–	–
Gains less losses from financial investments		**35**	23	27
Dividend income		**183**	431	397
Net earned insurance premiums		**–**	–	–
Other operating income		**38**	35	35
Total operating income		**3,261**	3,280	2,969
Net insurance claims incurred and movement in policyholders' liabilities		**–**	–	–
Net operating income before loan impairment charges		**3,261**	3,280	2,969
Loan impairment charges		**(352)**	(390)	(312)
Net operating income		**2,909**	2,890	2,657
Employee compensation and benefits		**(1,188)**	(1,123)	(1,018)
General and administrative expenses		**(585)**	(510)	(555)
Depreciation of property, plant and equipment		**(115)**	(114)	(113)
Amortisation of intangible assets and impairment of goodwill		**(73)**	(42)	(33)
Total operating expenses		**(1,961)**	(1,789)	(1,719)
Profit before tax		**948**	1,101	938
Tax expense		**(248)**	(180)	(181)
Profit for the period		**700**	921	757
Profit attributable to shareholders of the parent company		**700**	921	757
Profit attributable to minority interests		**–**	–	–

HSBC Bank plc

Financial Statements (unaudited) (continued)

Balance sheet
at 30 June 2006

	Notes	At 30 June 2006 £m	At 31 December 2005 £m	At 30 June 2005 £m
ASSETS				
Cash and balances at central banks		**3,069**	689	444
Items in the course of collection from other banks		**1,815**	2,125	1,609
Trading assets		**45,674**	34,733	36,425
Trading assets which may be repledged or resold by counterparties		**7,849**	3,950	2,964
Financial assets designated at fair value		**16**	16	22
Derivatives		**22,754**	17,570	19,158
Loans and advances to banks		**24,346**	19,196	29,957
Loans and advances to customers		**143,931**	134,819	129,388
Financial investments		**12,598**	15,383	16,525
Financial investments which may be repledged or resold by counterparties		**154**	2	1,838
Interests in associates and joint ventures		**255**	230	191
Investments in subsidiary undertakings		**14,471**	14,468	14,592
Goodwill and intangible assets		**538**	567	235
Property, plant and equipment		**1,439**	1,469	1,423
Other assets		**1,329**	1,469	1,655
Deferred taxation		**748**	1,007	966
Prepayments and accrued income		**1,822**	1,490	1,470
Total assets		**282,808**	249,183	258,862
LIABILITIES AND EQUITY				
Liabilities				
Deposits by banks		**26,549**	27,999	32,589
Customer accounts		**156,742**	141,761	134,608
Items in the course of transmission to other banks		**991**	805	922
Trading liabilities		**33,981**	21,303	24,179
Financial liabilities designated at fair value		**3,844**	4,321	3,586
Derivatives		**23,619**	17,251	18,767
Debt securities in issue		**8,190**	8,212	17,729
Retirement benefit liabilities		**1,315**	2,003	2,446
Other liabilities		**2,909**	2,846	2,584
Current taxation		**210**	95	243
Accruals and deferred income		**1,840**	1,851	1,404
Provisions:				
– deferred taxation		**7**	12	4
– other provisions		**126**	124	162
Subordinated liabilities		**5,164**	4,479	4,886
Total liabilities		**265,487**	233,062	244,109
Equity				
Called up share capital		**797**	797	797
Share premium account		**14,558**	13,883	12,383
Other reserves		**109**	82	69
Retained earnings	3	**1,857**	1,359	1,504
Total equity		**17,321**	16,121	14,753
Total equity and liabilities		**282,808**	249,183	258,862

S K Green, *Chairman*

M F Geoghegan, *Deputy Chairman*

D D John, *Chief Executive and Director*

J H McKenzie, *Secretary* 31 JULY 2006

HSBC Bank plc

Notes on the Financial Statements (unaudited)

1 **Basis of preparation**

HSBC Bank Plc ('the bank') has prepared these financial statements in accordance with International Financial Reporting Standards ('IFRSs') as endorsed by the EU and effective for its reporting for the period ended 30 June 2006. IFRSs comprise accounting standards issued by the International Accounting Standards Board ('IASB') and its predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') and its predecessor body.

The primary financial statements in this document are presented in accordance with IAS 1 'Presentation of Financial Statements'.

2 **Principal accounting policies**

(a) Interest income and expense

Interest income and expense for all interest-bearing financial instruments except for those classified as held-for-trading or designated at fair value (other than debt issued by the bank and related derivatives) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest rates of the financial assets or financial liabilities to which they relate.

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments earned or paid on a financial asset or financial liability through its expected life or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the bank estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the bank that are an integral part of the effective interest rate, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

(b) Non interest income

Fee income

The bank earns fee income from a diverse range of services provided to its customers. Fee income is accounted for as follows:

- income earned on the execution of a discrete act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

Dividend income

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

Net income from financial instruments designated at fair value

'Net income from financial instruments designated at fair value' includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on those financial instruments are also included, except for debt securities in issue and derivatives managed in conjunction with debt securities in issue. Interest on these instruments is shown in 'Net interest income'.

Net trading income

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends.

(c) Determination of fair value

All financial instruments are recognised initially at fair value. The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the initial fair value may be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held or liabilities to be issued and offer prices for assets to be acquired or liabilities held at the time. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

For certain derivatives, fair values may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data.

A number of factors such as bid-offer spread, credit profile, servicing costs of portfolios and model uncertainty are taken into account, as appropriate, when values are calculated using valuation techniques.

If the fair value of a financial asset measured at fair value becomes negative, it is recorded as a financial liability until its fair value becomes positive, at which time it is recorded as a financial asset, or it is extinguished.

(d) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the bank which are not intended to be sold in the short term and have not been classified either as held for trading or designated at fair value through profit and loss. Loans and advances are recognised when cash is advanced to borrowers and are derecognised when either borrowers repay their obligations, or the loans are sold or written off. 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 impairment losses.

(e) Loan impairment

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment losses are calculated on individual loans and on loans assessed collectively. Losses expected from future events, no matter how likely, are not recognised.

Individually assessed loans

At each balance sheet date, the bank assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining impairment losses on these loans, the following factors are considered:

- the bank's aggregate exposure to the customer;
- the viability of the customer's business model and its capability to trade successfully out of financial difficulties and generate sufficient cash flow to service its debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, the bank and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not local currency; and
- when available, the secondary market price of the debt.

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying value. Any loss is charged in the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of an allowance account.

Collectively assessed loans

Impairment is assessed on a collective basis in two different scenarios:

- for loans subject to individual assessment, to cover losses which have been incurred but have not yet been identified; and
- for homogeneous groups of loans that are not considered individually significant, where there is objective evidence of impairment.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of loss has been identified are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This arises from impairment at the balance sheet date which will only be individually identified in the future.

The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio.

Homogeneous groups of loans

For homogeneous groups of loans that are not considered individually significant, two alternative methods are used to calculate allowances on a portfolio basis:

- When appropriate empirical information is available, the bank utilises roll rate methodology. This methodology employs a statistical analysis of historical trends of the probability of default and the amount of consequential loss, assessed at each time period for which the customer's contractual payments are overdue. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying value of the portfolio. Other historical data and current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.

- In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, the bank adopts a formulaic approach which allocates progressively higher percentage loss rates in line with the period of time for which a customer's loan is overdue. Loss rates are calculated from the discounted expected future cash flows from a portfolio.

  Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from realising the security have been received.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The reversal is recognised in the income statement.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. The asset acquired is recorded at the lower of its fair value (less costs to sell) and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the income statement.

Renegotiated loans

Personal loans, which are generally subject to collective impairment assessment, whose terms have been renegotiated, are no longer considered to be past due or impaired but are treated as new loans only after the minimum required number of payments under the new arrangements have been received.

Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

(f) Trading assets and trading liabilities

Treasury bills, debt securities, equity shares and short positions in securities are classified as held-for-trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These financial assets or financial liabilities are recognised on trade date when the bank enters into contractural arrangements with counterparties to purchase or sell securities, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, their fair values are remeasured, and all gains and losses from changes therein, are recognised in the income statement in 'Net trading income' as they arise.

(g) Financial instruments designated at fair value

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated by management. The bank may designate financial instruments at fair value when the designation:

- eliminates or significantly reduces valuation or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases.
- applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised on trade date, when the bank enters into contractual arrangements with counterparties to purchase or sell securities, and are normally derecognised when sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured and, except for interest payable on debt securities in issue designated at fair value, gains and losses from changes therein are recognised in 'Net income from financial instruments designated at fair value'.

Gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with designated financial assets or financial liabilities are also included in 'Net income from financial instruments designated at fair value'. Interest on these derivatives is also included in this line, except for interest on derivatives managed with debt securities in issue designated at fair value, which is included in net interest income. The amount of change during the period, and cumulatively, in the fair value of designated financial liabilities and loans and receivables that is attributable to changes in their credit risk, is determined as the amount of change in fair value that is not attributable to changes in market conditions.

(h) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value (Note 2(g)), are classified as 'available-for-sale' or 'held-to-maturity'. Financial investments are recognised on trade date, when the bank enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the transactions are sold or the borrowers repay their obligations.

(i) Available-for-sale securities are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in equity in the 'Available-for-sale reserve' until the securities are either sold or impaired. When available-for-sale securities are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale securities using the effective interest rate method, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established. Financial investments are recognised using trade date accounting.

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset or group of assets. This usually arises when circumstances are such that an adverse effect on future cash flows from the asset or group of assets can be reliably estimated. If an available-for-sale security is impaired, the cumulative loss (measured as the difference between the asset's acquisition cost and its current fair value, less any impairment loss on that asset previously recognised in the income statement) is removed from equity and recognised in the income statement. Reversals of impairment losses are subject to contrasting treatments depending on the nature of the instrument concerned:

- if the fair value of a debt instrument classified as available-for-sale increases in a subsequent period, 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;

- impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the bank positively intends, and is able, to hold until maturity. Held-to-maturity investments 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 any impairment losses.

(i) Sale and repurchase agreements (including stock lending and borrowing)

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to sell ('reverse repos') are not recognised on the balance sheet and the consideration paid is recorded in 'Loans and advances to banks' or 'Loans and advances to customers' as appropriate. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

Securities borrowed are not recognised on the balance sheet, unless they are sold to third parties, in which case the obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in 'Net trading income'.

For repos and security lending, if the counterparty has the right to sell or repledge the securities transferred, the securities are presented separately on the balance sheet from assets that may not be repledged or resold by a counterparty.

(j) Derivatives and hedge accounting

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter ('OTC') derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

In the normal course of business, the fair value of a derivative on initial recognition is the transaction price (i.e. the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the bank recognises a trading profit or loss on inception of the derivative. When unobservable market data have a significant impact on the valuation of derivatives, the entire initial charge in fair value indicated by the valuation model is not recognised immediately in the income statement. It is instead recognised over the life of the transaction on an appropriate basis, or is recognised in the income statement when the inputs become observable, or when the transaction matures or is closed out.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative are the same as those of a stand-alone derivative; and the combined contract is not held for trading or designated at fair value through profit and loss. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivatives are classed as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are only offset if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains or losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, the bank classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) hedges of net investments in a foreign operation ('net investment hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

Hedge accounting

At the inception of a hedging relationship, the bank documents the relationship between the hedging instruments and hedged items, its risk management objective and its strategy for undertaking the hedge. The bank also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the derivatives that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in 'Net interest income'.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the assets, liabilities or group thereof, that are attributable to the hedged risk.

If a hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedge item has been derecognised whereby it is released to the income statement immediately.

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised in equity within the cash flow hedging reserve. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously deferred in equity are transferred from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Hedge effectiveness testing

To qualify for hedge accounting, IAS 39 requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness). Actual effectiveness (retrospective effectiveness) must also be demonstrated on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent for the hedge to be deemed effective.

Hedge effectiveness is recognised in the income statement in 'Net trading income'.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of any derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives related to debt issued by the bank), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'.

(k) Derecognition of financial assets and liabilities

Financial assets are derecognised when the right to receive cash flows from the assets has expired; or when the bank has transferred its contractual right to receive the cash flows of the financial assets, and substantially all the risks and rewards of ownership; or where control is not retained. Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged, cancelled or expires.

(l) Offsetting financial assets and financial liabilities

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

(m) Subsidiaries, associates and joint ventures

The bank's investments in subsidiaries and associates and interests in joint ventures are stated at cost less impairment losses. Reversals of impairment losses are recognised in the income statement if there has been a change in the estimates used to determine the recoverable amount of the investment.

(n) Goodwill and intangible assets

(i) Goodwill arises on business combinations when the cost of acquisition exceeds the fair value of the bank's share of the identifiable assets, liabilities and contingent liabilities acquired. By contrast, if the bank's interest in the fair value of the identifiable assets, liabilities and contingent liabilities of an acquired business is greater than the cost to acquire, the excess is recognised immediately in the income statement.

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed annually by comparing the present value of the expected future cash flows from a business with the carrying value of its net assets, including attributable goodwill. Goodwill is stated at cost less accumulated impairment losses which are charged to the income statement.

At the date of disposal of a business, attributable goodwill is included in the banks's share of net assets in the calculation of the gain or loss on disposal.

(ii) Intangible assets include computer software and merchant relationships. Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

- Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually. This impairment test may be performed at any time during the year, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current year.

- Intangible assets that have a finite useful life are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected economic life.

Intangible assets are amortised over their finite useful lives as follows:

Internally generated software	over 5 years
Customer/merchant relationships	between 3 and 10 years
Other	over 10 years

(o) Property, plant and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs ('deemed cost'), less any impairment losses and depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated; and
- buildings are depreciated at the greater of two per cent per annum on a straight-line basis or, if leasehold, over the unexpired terms of the leases, or over their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where the bank is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their accumulated useful lives, which run to a maximum of 35 years but are generally between five years and 20 years.

The bank holds certain properties as investments to earn rentals or for capital appreciation, or both. Investment properties are included in the balance sheet at fair value with changes therein recognised in the income statement in the period of change. Fair values are determined by independent professional valuers who apply recognised valuation techniques.

Property, plant and equipment is subject to an impairment review if there are events or changes in circumstance which indicate that the carrying amount may not be recoverable.

(p) Income tax

Income tax on the profit or loss for the year comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in shareholders' equity, in which case it is recognised in shareholders' equity.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantially enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the bank intends to settle on a net basis and the legal right to set-off exists.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to set off exists in the entity.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in equity. Deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedges which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

(q) Pension and other post-employment benefits

The bank operates a number of pension and other post-employment benefit plans. These plans include both defined benefit and defined contribution plans and various other post-employment benefits such as post-employment health-care.

Payments to defined contribution plans and state-managed retirement benefit plans, when the bank's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The costs recognised for funding defined benefit plans are determined using the Projected Unit Credit Method, with annual actuarial valuations performed on each plan. Actuarial differences that arise are recognised in shareholders' equity and presented in the 'Statement of recognised income and expense' in the period in which they arise. All cumulative actuarial gains and losses on defined benefit plans as at 1 January 2004 were recognised in equity at the date of transition to IFRSs. Past service costs are recognised immediately to the extent that the benefits have vested, and are otherwise recognised on a straight-line basis over the average period until the benefits vest. Current service costs and any past service costs, together unwinding of the discount on plan liabilities less the expected return on plan assets, are charged to operating expenses.

The defined benefit liability recognised in the balance sheet represents the present value of defined benefit obligations adjusted for unrecognised past service costs and reduced by the fair value of plan assets. Any net defined benefit surplus limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The costs of providing other post-employment benefits such as post-employment health-care are accounted for on the same basis as defined benefit plans.

(r) Equity compensation plans

Shares in HSBC Holdings plc awarded to an employee on joining the bank that are made available immediately, with no vesting period attached to the award, are expensed immediately. When an inducement is awarded to an employee on commencement of employment with the bank, and the employee must complete a specified period of service before the inducement vests, the expense is spread over the period to vesting. As these awards are made by the bank a liability for the shares is recognised on balance sheet over the vesting period, at fair value.

Share option awards are granted by HSBC Holdings to bank employees and are satisfied by HSBC Holdings transferring shares to the employees.

The compensation expense of share options charged to the income statement is credited to the share-based payment reserve over the vesting period. Compensation expense is determined by reference to the fair value of the options on grant date, and the effect of any non-market vesting conditions such as option lapses. An option may lapse if, for example, an employee ceases to be employed by the bank before the end of the vesting period. Estimates of future such employee departures are taken into account when accruing the cost during the service period.

The cost of bonuses awarded in respect of past service, by which an employee is required to complete a specified period of future service to be entitled to the award, is spread over the period of service rendered to the vesting date.

(s) Foreign currencies

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction, except for goodwill and fair value adjustments arising on consolidation, which are translated into the functional currency using the rate of exchange ruling at the balance sheet date. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined.

(t) Provisions

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

(u) Debt securities in issue and subordinated liabilities

Debt securities in issue are initially measured at fair value, which is normally the consideration received net of directly attributable transaction costs incurred. Subsequent measurement is at amortised cost, using the effective interest rate method to amortise the difference between proceeds net of directly attributable transaction costs and the redemption amount over the expected life of the debt, unless the securities are designated at fair value (Note 2(g)).

(v) Share capital

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

Notes on the Financial Statements (unaudited)

3 Reconciliation of movements in equity

	2006								
				Other reserves					
	Called up share capital £m	Share premium £m	Retained earnings £m	Available-for-sale fair value reserve £m	Cash flow hedging reserve £m	Foreign exchange reserve £m	Share-based payment reserve £m	Associates and Joint Ventures £m	Total equity £m
At 1 January	797	13,883	1,359	36	(22)	(1)	69		16,121
New share capital subscribed, net of costs		675							675
Profit for the year attributable to shareholders			700						697
Dividends to shareholders of the parent company			(700)						(700)
Actuarial gains/(losses) on defined benefit plans			694						694
Fair value gains/(losses) taken to equity				9	(17)				(8)
Reallocation of share options			19						19
Amounts transferred to the income statement									
Exchange differences			(6)		2				(4)
Charge to the income statement in respect of equity settled share-based payment transactions							42		42
Tax on items taken directly to or transferred from equity			(190)	9	5		(23)		(199)
Other movements			(19)						(16)
At 30 June	797	14,558	1,857	54	(32)	(1)	88		17,321

Notes on the Financial Statements (unaudited)

	2005								
				Other reserves					
	Called up share capital £m	Share premium £m	Retained earnings £m	Available-for-sale fair value reserve £m	Cash flow hedging reserve £m	Foreign exchange reserve £m	Share-based payment reserve £m	Associates and Joint Ventures £m	Total equity £m
At 30 June	797	12,383	1,504	34	(2)	–	37	–	14,753
New share capital subscribed, net of costs	–	1,500	–	–	–	–	–	–	1,500
Profit for the year attributable to shareholders	–	–	921	–	–	–	–	–	921
Dividends to shareholders of the parent company	–	–	(700)	–	–	–	–	–	(700)
Actuarial gains/(losses) on defined benefit plans	–	–	(510)	–	–	–	–	–	(510)
Fair value gains/(losses) taken to equity	–	–	–	(6)	(29)	–	–	–	(35)
Exchange differences	–	–	8	–	–	(1)	–	–	7
Amounts transferred to the income statement	–	–	–	(1)	–	–	–	–	(1)
Charge to the income statement in respect of equity settled share-based payment transactions	–	–	–	–	–	–	32	–	32
Tax on items *taken directly to or transferred* from equity	–	–	136	9	9	–	–	–	154
At 31 December	797	13,883	1,359	36	(22)	(1)	69	–	16,121

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	2005								
				Other reserves					
	Called up share capital £m	Share premium £m	Retained earnings £m	Available-for-sale fair value reserve £m	Cash flow hedging reserve £m	Foreign exchange reserve £m	Share-based payment reserve £m	Associates and Joint Ventures £m	Total equity £m
At 1 January	797	12,820	1,494	–	–	(8)	37	–	15,140
IFRSs transition adjustment at 1 January 2005	–	(437)	(234)	34	–	–	–	–	(637)
Profit for the year attributable to shareholders	–	–	757	–	–	–	–	–	757
Dividends to shareholders of the parent company	–	–	(700)	–	–	–	–	–	(700)
Actuarial gains/(losses) on defined benefit plans	–	–	270	–	–	–	–	–	270
Fair value gains/(losses) taken to equity	–	–	–	6	(2)	–	–	–	4
Exchange differences	–	–	(8)	–	–	8	–	–	-
Charge to the income statement in respect of equity settled share-based payment transactions	–	–	–	–	–	–	–	–	
Tax on items taken directly to or transferred from equity	–	–	(75)	(6)	–	–	–	–	(81)
At 30 June	797	12,383	1,504	34	(2)	–	37	–	14,753