

## NOTES TO THE FINANCIAL STATEMENTS

### 1 General information

Tracker Fund of Hong Kong (the "Fund") is a unit trust which is governed by its Trust Deed dated on 23rd October 1999 (the "Trust Deed"). The Fund is authorized by the Securities & Futures Commission of Hong Kong under Section 104(1) of the Hong Kong Securities and Futures Ordinance. The Fund is also listed on the Stock Exchange of Hong Kong Limited (a subsidiary of The Hong Kong Exchanges and Clearing Limited).

The Fund's objective is to provide investment results that closely correspond to the performance of the Hang Seng Index (the "Index").

### 2 Principal accounting policies

The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

#### (a) Basis of preparation

The financial statements have been prepared in accordance with accounting principles generally accepted in Hong Kong and comply with accounting standards issued by the Hong Kong Institute of Certified Public Accountants. The financial statements are prepared under the historical cost convention as modified by the revaluation of investments.

The preparation of financial statements in conformity with Hong Kong Financial Reporting Standards ("HKFRS") requires the use of certain critical accounting estimates. It also requires the Manager (the "Management") to exercise its judgment in the process of applying the Fund's accounting policies.

##### (i) Amendment to published standards effective in 2006

HKAS 39 (Amendment), The Fair Value Option is mandatory for the Fund's accounting period beginning on 1st January 2006. It allows entities to designate financial assets and financial liabilities at fair value through profit or loss when not held for trading if doing so eliminates or significantly reduce a measurement or recognition inconsistency ('an accounting mismatch') or if a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis.

Adoption of this amendment only impacts the format and extent of disclosures presented in the financial statements.

##### (ii) Standards, amendments and interpretations effective in 2006 but not relevant

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

- HKAS 19 (Amendment), Employee Benefits;
- HKAS 21 (Amendment), Net Investment in a Foreign Operation;
- HKAS 39 (Amendment), Cash Flow Hedge Accounting of Forecast Intragroup Transactions;
- HKAS 39 and HKFRS 4 (Amendment), Financial Guarantee Contracts;
- HKFRS 6, Exploration for and Evaluation of Mineral Resources;
- HKFRS 1 (Amendment), First-time Adoption of Hong Kong Financial Reporting Standards, and HKFRS 6 (Amendment), Exploration for and Evaluation of Mineral Resources;

## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 2 Principal accounting policies (Continued)

#### (a) Basis of preparation (Continued)

(ii) *Standards, amendments and interpretations effective in 2006 but not relevant (Continued)*

- HK(IFRIC) - Int 4, Determining whether an Arrangement contains a Lease;
- HK(IFRIC) - Int 5, Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds; and
- HK(IFRIC) - Int 6, Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment.

(iii) *Interpretations to existing standards that are not yet effective and not relevant for the Fund's operations*

The following interpretations are mandatory for the Fund's accounting periods beginning on or after 1st March 2006 or later periods but are not relevant for the Fund's operations:

- HK(IFRIC) - Int 7, Applying the Restatement Approach under HKAS 29, Financial Reporting in Hyperinflationary Economies (effective from 1st March 2006);
- HK(IFRIC) - Int 8, Scope of HKFRS 2 (effective from 1st May 2006);
- HK(IFRIC) - Int 9, Reassessment of Embedded Derivatives (effective from 1st June 2006);
- HK(IFRIC) - Int 10, Interim Financial Reporting and Impairment (effective from 1st November 2006);
- HK(IFRIC) - Int 11, HKFRS 2 - Group and Treasury Share Transactions (effective from 1st March 2007); and
- HK(IFRIC) - Int 12, Service Concession Agreements (effective from 1st January 2008).

#### (b) Investments

The Fund classifies its investments in equity securities as financial assets or financial liabilities at fair value through profit or loss. In accordance with HKAS39 financial instruments with prices quoted, listed or normally dealt in on the Stock Exchange of Hong Kong Limited (the "Stock Exchange") are stated at the Stock Exchange's bid prices, excluding transaction costs which are expensed as incurred.

Purchases and sales of investments are accounted for on a trade date basis.

Realized gains and losses on sale of investments and unrealized gains and losses on revaluation of investments are recognized in the statement of operations as they arise.

Transaction costs on purchase and sale of investments are accounted for in the Statement of Operations.

#### (c) Income

Dividend income on equity securities is recorded on the ex-dividend date. Dividend income on equity securities where no ex-dividend date is quoted are accounted for when the Fund's right to receive payment is established.

Bank interest and other income are recognized on an accruals basis.

## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 2 Principal accounting policies (Continued)

#### (d) Expenses

All expenses are accounted for on an accruals basis.

#### (e) Distributions payable to holders of redeemable units

Proposed distributions to holders of redeemable units are recognized in the Statement of Operations when they are approved by the Trustee. The distribution on these redeemable units is recognized in the Statement of Operations as finance cost.

#### (f) Further cash amount

Further cash amount represents the amount included in the issue price or redemption proceeds (as the case may be) of the units issued or redeemed, representing the difference between the net asset value per Creation Unit as calculated by the Manager as of that date, and the value of the Index Basket (based on the nominal closing prices as of that date) and the dividend equivalent amount per Creation Unit.

#### (g) Cash and cash equivalents

Cash and cash equivalents includes cash in hand, demand deposits, other short-term highly liquid investments with original maturities of three months or less and bank overdrafts.

#### (h) Translation of foreign currencies

##### *Functional and presentation currency*

Items included in the financial statements are measured using the currency of the primary economic environment in which the Fund operates (the "functional currency"). The performance of the Fund is measured and reported to the holders of redeemable units in Hong Kong dollar. The Management considers the Hong Kong dollars as the currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. The financial statements are presented in Hong Kong dollars, which is the Fund's functional and presentation currency.

##### *Transactions and balances*

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognized in the Statement of Operations. Translation differences on non-monetary financial assets and liabilities such as equities at fair value through profit or loss are recognized in the Statement of Operations within the fair value net gain or loss.

## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 2 Principal accounting policies (Continued)

#### (i) Proceeds and payments on allotment and redemption of units

The net asset value per unit is computed for each dealing day. The price at which units are allotted or redeemed is calculated by reference to the net asset value per unit as at the close of business on the relevant dealing day. Units in the Fund are classified as a financial liability in the Statement of Assets and Liabilities and are stated at fair value representing the last traded market prices at which holders of the redeemable units can redeem the units from the Fund.

#### (j) Redeemable units

The Fund issues redeemable units, which are redeemable at the holder's option. Redeemable units can only redeem in-kind equal to a proportionate share of the Fund's net asset value. The redeemable unit is carried at the redemption amount that is payable at the balance sheet date if the holder exercises the right to put the unit back to the Fund. In accordance with the Fund's Trust Deed, the minimum redemption unit is 1,000,000 units.

Redeemable units are issued and redeemed at the holder's option at prices based on the Fund's net assets value per unit at the time of issue or redemption. The Fund's net asset value per unit is calculated by dividing the net assets attributable to the holders of redeemable units with the total number of outstanding redeemable units. In accordance with the provisions of the Fund's Trust Deed, investment positions are valued based on the last traded market price for the purpose of determining the net asset value per unit for creations and redemptions.

#### (k) Segmental information

In the opinion of the Manager, all activities of the Fund are in the single business of investment activities conducted mainly in Hong Kong. Geographical information is provided in the investment portfolio.

#### (l) Use of estimates

The preparation of financial statements in conformity with Hong Kong Financial Reporting Standards requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

### 3 Net gain on investments

	2006 HK\$	2005 HK\$
Change in unrealized gain/loss on investments	3,759,828,811	(191,297,274)
Realized gain on sale of investments	4,059,040,661	1,374,735,685
	<u>7,818,869,472</u>	<u>1,183,438,411</u>

## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 4 Income

#### (a) Transaction fee

For each application for the creation of units or for the redemption of units, the Fund was entitled to receive a transaction fee of HK\$30,000 per application. With effect from 1st June 2006, the transaction fee with respect to the creation and redemption application has been reduced from HK\$30,000 per application to HK\$15,000 per total aggregate creation and redemption application per day per Participating Dealer.

#### (b) Other income

Other income represents registrar charges levied on unitholders (other than HKSCC Nominees) who hold units registered in their own names as at each Record Date for the relevant distribution. Currently, these charges amount to HK\$80 per year per unitholder. Such charges are deducted on a half-yearly basis from the half-yearly distributions payable to the relevant unitholders.

### 5 Number of units in issue and net assets attributable to holders of redeemable units

In accordance with the provisions of the Fund's Trust Deed, listed investments and investments with prices quoted in over the counter markets or by market makers are stated at the last traded price on the valuation day for the purpose of determining net asset value per unit for creation and redemptions and for various fee calculation. However, as stated in note 2(a) the accounting policy of the Fund for the purpose of compliance with HKAS 39 and for reporting purpose is to value its investments at the relevant bid market prices on the Statement of Assets and Liabilities date. The difference between the valuation stated in the financial statement of investments and the valuation methodology indicated in the Fund's Trust Deed, results in a decrease in value of investment by HK\$8,630,309 (2005: HK\$58,590,272). The amount of the adjustment recognized in the Statement of Operations is HK\$49,959,963 (2005: HK\$58,590,272).

Net assets attributable to holders of redeemable units at last traded market prices represent a liability in the balance sheet, carried at the redemption amount that would be payable at the balance sheet date if the unitholder exercised the right to redeem the unit to the Fund.

	Number of units	
	2006	2005
Units in issue at the beginning of the year	1,801,992,500	2,140,992,500
Redemption of units in-kind	(480,000,000)	(339,000,000)
Units in issue at the end of the year	<u>1,321,992,500</u>	<u>1,801,992,500</u>
	<i>HK\$</i>	<i>HK\$</i>
Net assets attributable to holders of redeemable units	<u>26,602,946,195</u>	<u>27,048,038,344</u>
Net assets attributable to holders of redeemable units (per unit)	<u>20.12</u>	<u>15.01</u>
Net asset value per Creation Unit (1 Creation Unit is equivalent to 1,000,000 units)	<u>20,123,371</u>	<u>15,010,073</u>

## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 6 Taxation

No provision for Hong Kong profits tax has been made as the interest, dividend income and realized gains on disposal of investments of the Fund are excluded from the charge to profits tax under Section 14, Section 26 or Section 26A of the Hong Kong Inland Revenue Ordinance.

### 7 Transactions with the Manager and its Connected Persons

Connected Persons of the Manager are those as defined in the Code on Unit Trusts and Mutual Funds established by the Securities and Futures Commission of Hong Kong (the "SFC Code"). All transactions entered into during the year between the Fund and the Manager and its Connected Persons were carried out in the normal course of business and on normal commercial terms. To the best of the Manager's knowledge, the Fund does not have any other transactions with Connected Persons except for what is disclosed below.

The directors and officers of the Manager may transact in the units of the Fund as principal provided that prior written notice is obtained from the Trustee. As of 31st December 2006, the directors and officers of the Manager together held 27,820 units in the Fund (2005: 27,820 units).

#### (a) Management fee

The fee payable to the Manager is calculated at the following annual rates of the net asset value of the Fund on the last dealing day in the relevant quarter:

For first HK\$15 billion of the net asset value	0.050%
For next HK\$15 billion of the net asset value	0.045%
For next HK\$15 billion of the net asset value	0.030%
Any amount by which the net asset value exceeds HK\$45 billion	0.025%

The management fee is accrued daily and is payable quarterly in arrears.

#### (b) Trustee fee

The fee payable to the Trustee is calculated at the following annual rates of the net asset value of the Fund of the last dealing day in the relevant quarter:

For first HK\$15 billion of the net asset value	0.050%
For next HK\$15 billion of the net asset value	0.045%
For next HK\$15 billion of the net asset value	0.030%
Any amount by which the net asset value exceeds HK\$45 billion	0.025%

The trustee fee is accrued daily and payable quarterly in arrears.

#### (c) Bank balances

Bank balances are maintained with the Trustee. Bank balances held with the Trustee as at 31st December 2006 was HK\$76,646,478 (2005: HK\$68,329,644). During the year, interest earned on the above bank balances was HK\$8,422,898 (2005: HK\$7,032,291).

## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 8 Other fees

#### (a) Registrar fee

The fee payable to the Registrar is calculated based on the number of unitholders on the register on the first business day of the relevant month at the following fee scale, subject to a monthly maximum aggregate registrar fee of HK\$1,000,000. With effect from 1st May 2005, the registrar fee has been revised at the following rates:

	With effect from 1st May 2005 <i>HK\$</i> <i>(per month)</i>	Prior to 1st May 2005 <i>HK\$</i> <i>(per month)</i>
For first 2,000 Unitholders	9,500	9,500
For every additional 1,000 Unitholders up to 70,000 Unitholders	2,000	–
For every additional 1,000 Unitholders up to 100,000 Unitholders	1,700	2,000
For every additional 1,000 Unitholders up to 200,000 Unitholders	1,800	1,800
For every additional 1,000 Unitholders up to 300,000 Unitholders	1,500	1,500
For every additional 1,000 Unitholders above 300,000 Unitholders	1,200	1,200

In addition, the Registrar is reimbursed for all of its out-of-pocket expenses incurred in connection with performing its services.

The registrar fee is accrued daily and is payable monthly in advance.

#### (b) Conversion agent fee

The Conversion Agent received the higher of a monthly retainer fee of HK\$16,000 plus a transaction fee of HK\$12,000 for each creation or redemption application, and a minimum monthly fee of HK\$36,000 before 1st June 2006. With effect from 1st June 2006, no minimum monthly fee would be applied.

The conversion agent fee is accrued daily and payable monthly in arrears.

#### (c) Index license fee

The index license fee is calculated at the rate of 0.015% per annum on the daily average net asset value of the Fund, subject to a minimum of US\$10,000 per annum.

The index license fee is accrued daily and is payable quarterly in arrears.

## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 9 Major non-cash transactions

In accordance with the Fund's Trust Deed and since the termination of the Tap agreement, units can only be issued through an in-kind creation of an Index Basket and not through a cash subscription. For each Creation Unit (of 1,000,000 units), the Fund receives an Index Basket consisting of constituent shares as determined by the Manager on a daily basis. During the year, the Fund did not issue any units (2005: nil) in exchange for Index Baskets by the Manager.

In accordance with the Fund's Trust Deed, units can only be redeemed in-kind and are not redeemable for cash. During the year, the Fund redeemed 480,000,000 units (2005: 339,000,000 units) in exchange for Index Baskets consisting of investments valued at HK\$8,253,275,589 (2005: HK\$4,861,452,507) by the Manager.

### 10 Soft dollar practices

The Manager may effect transactions, provided that any such transaction is consistent with standards of "best execution", by or through the agency of another person for the account of the Fund with whom the Manager or any of its Connected Persons have an arrangement under which that party will from time to time provide to or procure for the Manager or any of its Connected Persons goods, services or other benefits (such as research and advisory services, computer hardware associated with specialized software or research services and performance measures) the nature of which is such that their provision can reasonably be expected to benefit the Fund as a whole and may contribute to an improvement in the performance of the Fund. For the avoidance of doubt, such goods and services may not include travel, accommodation, entertainment, general administrative goods or services, general office equipment or premises, membership fees, employees' salaries or direct money payments.

Since the inception of the Fund, the Manager had not participated in any soft dollar arrangements in respect of any transactions for the account of the Fund.

### 11 Investment limitation and prohibitions under the SFC Code

The SFC Code allows the Fund to invest in constituent securities issued by a single issuer for more than 10% of the Fund's net asset value provided that the investment is limited to any constituent securities that each accounts for more than 10% of the weighting of the Index and the Fund's holding of any such constituent securities may not exceed their respective weightings in the Index (except as a result of changes in the composition of the Index and the excess is transitional and temporary in nature).

Constituent stocks that account for more than 10% of the net asset value of the Fund as at year end were as follows:

	Respective weighting in the Index (%)		% of net asset value	
	2006	2005	2006	2005
HSBC Holdings plc	23.2	30.1	23.0	29.9
China Mobile (Hong Kong) Ltd.	19.6	15.5	19.6	15.4



## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 12 Financial risk management

The objective of the Fund is to provide investment results that closely correspond to the performance of the index. The risk exposures inherent in the Fund as at year end are summarized below.

#### (a) Market price risk

The Fund's investments are subject to the securities price risk inherent in all securities i.e. the value of holdings may fall as well as rise. The Fund's market risk is managed through diversification of investment portfolio.

As at year end, the overall market exposure were as follows:

	At 31 December		2005	
	2006	% of	Fair value	% of
	Fair value	net assets	Fair value	net assets
	HK\$		HK\$	
Listed investments Equities				
– Hong Kong	<u>26,609,946,195</u>	<u>99.49</u>	<u>26,842,037,452</u>	<u>99.24</u>
Total investments, at cost	<u>14,111,538,164</u>		<u>18,243,716,574</u>	

#### (b) Credit risk

Credit risk is the risk that an issuer or counterparty will be unable or unwilling to pay amounts in full when due.

The Fund's financial assets which are potentially subject to concentrations of credit risk consist principally of securities and bank balances.

The Fund limits its exposure to credit risk by transacting the majority of its securities and contractual commitment activity with well established broker-dealers, banks with high credit ratings and regulated exchanges that the Fund considers to be well established.

All transactions in securities are settled/paid for upon delivery using approved and reputable brokers. The risk of default is considered minimal since delivery of securities sold is only made once the broker has received payment. On a purchase, payment is made once the securities have been received by the broker. If either party fails to meet its obligation, the trade will fail.

Accordingly, the Fund has no significant concentration of credit risk.

#### (c) Interest rate risk

The Fund is exposed to a minimal interest rate risk as the Fund invests mainly in equity securities and only the bank balances are exposed to interest rate risk which is considered to be minimal.

## NOTES TO THE FINANCIAL STATEMENTS (Continued)

### 12 Financial risk management (Continued)

#### (d) Currency risk

Currency risk is the risk that the value of financial instruments will fluctuate due to the changes in foreign exchange rates.

The Fund has no significant currency risk because substantially all assets and liabilities are denominated in Hong Kong dollars, the Fund's reporting currency.

#### (e) Fair values of financial instruments

The Fund's carrying amounts of securities, other assets and liabilities approximate to their fair values. Other assets and liabilities include bank balances, accruals and other payables which are realized or settled within a short period of time.

### 13 Events after the balance sheet date

There was no post balance-sheet event.

### 14 Approval of financial statements

The financial statements were approved by the Trustee and the Manager on 31st March 2007.