

# Notes on the Financial Statements

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## 1 Background

Hang Seng FTSE/Xinhua China 25 Index ETF ("the Fund") is authorised by the Hong Kong Securities and Futures Commission under Section 104(1) of the Hong Kong Securities and Futures Ordinance, and is governed by the Hong Kong Code on Unit Trusts and Mutual Funds.

The Fund was constituted by a Trust Deed dated 1 June 2005, as amended from time to time under the laws of Hong Kong, and registered on the same date as a unit trust under the laws of Hong Kong.

## 2 Significant accounting policies

### (a) Statement of compliance

The financial statements of the Fund have been prepared in accordance with all applicable Hong Kong Financial Reporting Standards ("HKFRSs"), which collective term includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ("HKASs") and Interpretations issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), accounting principles generally accepted in Hong Kong, the relevant disclosure provisions of the Trust Deed, as amended, and the relevant disclosure provisions of the Hong Kong Code on Unit Trusts and Mutual Funds issued by the Hong Kong Securities and Futures Commission. These financial statements also comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited. A summary of the significant accounting policies adopted by the Fund is set out below.

### (b) Basis of preparation of the financial statements

The financial statements are presented in Hong Kong Dollars (dollars) and rounded to the nearest dollars.

The measurement basis used in the preparation of the financial statements is the historical cost basis except that investments are stated at their fair value as explained in the accounting policies set out below.

The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of HKFRSs that have significant effect on the financial statements and estimates with a significant risk of material adjustment in the next year are discussed in note 12.

### (c) Security transactions

Security transactions are accounted for on a trade date basis.

### (d) Revenue recognition

Interest income is recognised as it accrues using the effective interest rate method. Distribution income is recognised when the underlying securities are quoted ex-distribution. Interest and distribution income is stated after deduction of withholding tax where applicable.

### (e) Translation of foreign currency

Foreign currency transactions during the year are translated at the foreign exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated at the foreign exchange rates ruling at the balance sheet date. Exchange gains and losses are recognised in the revenue statement.

## *Notes on the Financial Statements (continued)*

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### **(f) Financial instruments**

#### **(i) Classification**

The Fund designated all its investments at fair value through profit or loss upon initial recognition and classified all its investments as trading instruments. Trading instruments are those that the Fund has acquired principally for the purpose of short-term profit-taking. These include investments in the constituent stocks of FTSE/Xinhua China 25 Index.

#### **(ii) Recognition**

The Fund recognises financial assets and financial liabilities on the date it becomes a party to the contractual provisions of the instruments.

A regular way purchase of financial assets is recognised using trade date accounting. From this date any gains and losses arising from changes in fair value of the financial assets or financial liabilities are recorded.

Financial liabilities are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of HKAS 39.

#### **(iii) Measurement**

Financial instruments are measured initially at fair value (transaction price). Transaction costs on financial assets and financial liabilities at fair value through profit or loss are expensed immediately.

Subsequent to initial recognition, all trading instruments are measured at fair value.

#### **(iv) Fair value measurement principles**

The fair value of financial instruments is generally based on their quoted market prices at the balance sheet date without any deduction for estimated future selling costs. Financial assets are priced at current bid prices while financial liabilities are priced at current asking prices.

Gains and losses on investments are included in the revenue statement. Realised and unrealised gains and losses on investments are provided in note 6. Realised gains or losses include net gains and losses on contracts which have been entered into.

#### **(v) Gains and loss on subsequent measurement**

Gains and losses arising from a change in fair value of trading instruments are recognised in the revenue statement.

#### **(vi) Derecognition**

The Fund derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire or they transfer the financial asset and the transfer qualifies for derecognition in accordance with HKAS 39.

Assets held for trading that are sold are derecognised and corresponding receivables from the brokers are recognised as of the date the Fund commits to sell the assets.

The Fund uses the weighted average method to determine realised gains and losses on derecognition.

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

### **(g) Related parties**

For the purposes of these financial statements, parties are considered to be related to the Fund if they have the ability, directly or indirectly, to control or exercise significant influence over the Fund in making financial and operating decisions, or vice versa, or where the Fund is subject to common control or common significant influence. Related parties may be individuals or other entities and include entities which are under the significant influence of related parties of the Fund where those parties are individuals.

### **(h) Formation costs**

Formation costs of the Fund are charged to the revenue statement as incurred.

## Notes on the Financial Statements (continued)

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### (i) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and on hand, demand deposits with banks and other financial institutions, and short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value, having been within three months of maturity at acquisition. Bank overdrafts that are repayable on demand and form an integral part of the Fund's cash management and are included as a component of cash and cash equivalents for the purpose of the cash flow statement.

### (j) Units in issue

All units issued by the Fund provide their respective unitholders with the right to require redemption for cash at the value proportionate to the unitholder's share in the Fund's net assets at the redemption date. In accordance with HKAS 32, such rights give rise to a financial liability to the Fund which is shown as "net assets attributable to unitholders" in the statement of assets and liabilities and distributions paid to unitholders thereon are recognised on an accrual basis in revenue statement as part of finance costs.

### (k) Finance costs (distributions to unitholders)

Distributions to unitholders are recognised in the revenue statement as finance costs.

## 3 Taxation

No provision for Hong Kong Profits Tax has been made in the financial statements as the income of the Fund is exempt from taxation under S26A(1A) of the Inland Revenue Ordinance.

## 4 Financial instruments and associated risks

The Fund maintains investment portfolio in equity instruments consist of constituent stocks of FTSE/Xinhua China 25 Index as dictated by its investment management strategy, which is not limited to equity instruments. Details of such investments held as at 31 December 2006 are shown in the investment portfolio.

The Fund's investing activities expose it to various types of risks that are associated with the financial instruments and markets in which it invests. To comply with HKAS 32, the Manager and the Trustee have set out below the most important types of financial risks inherent in equity instruments. The Manager and the Trustee would like to highlight that the following list of associated risks only set out some of the risks but does not purport to constitute an exhaustive list of all the risks inherent in an investment of the Fund. Investors should note that additional information in respect of risks associated with investment in the Fund can be found in the offering document of the Fund.

During the year, the Manager invested for the fund in financial instruments which the Manager considered are commensurate with the risk level of the fund according to its investment objective.

### Equity instruments

The Fund invests in equity instruments and therefore is exposed to price risk and currency risk.

- (i) Price risk arises from value of equity instruments which may be subject to both normal market fluctuations and other specific risks affecting the value of an individual equity instrument.
- (ii) Currency risk arises where the fund invests in equity instruments denominated in currencies different from the fund's reporting currencies. As the fund only invests in the constituent stocks of FTSE/Xinhua China 25 Index which are denominated in Hong Kong Dollars, the exposure on the currency risk is minimal.

## 5 Interest income

During the year, the Fund earned all its interest income from cash and cash equivalents.

## *Notes on the Financial Statements (continued)*

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### **6 Gains and losses on investments**

During the year, the Fund disposed of equities and earned and incurred realised and unrealised gains and losses as shown in the table on page 16.

### **7 Transactions with related parties**

The following is a summary of transactions with related parties during the year which were entered into in the ordinary course of business and on normal commercial terms:

- (a) Hang Seng Investment Management Limited ("HSIM"), a wholly-owned subsidiary of Hang Seng Bank Limited ("HSB"), which is a member of the HSBC Group, is the Manager of the Fund. HSIM earns management fees at a maximum rate of 1% of net asset value per annum. HSIM received less than the full management fees to which it was entitled from the Fund during the year and waived its right to the difference. Management fees are calculated as at each dealing date and payable monthly. Management fees payable to the Manager at the year end date is HKD 74,601 (2005: HKD 54,648).
- (b) HSBC Provident Fund Trustee (Hong Kong) Limited, a member of the HSBC Group, is the Trustee of the Fund and earns trustee's fee at a maximum rate of 0.15% of net asset value per annum. The Trustee received less than the full trustee's fee to which it was entitled from the Fund during the year and waived its right to the difference. Trustee fee is calculated as at each dealing date and payable monthly. Trustee's fee payable at the year end is HKD 18,601 (2005: HKD 20,630). The Trustee also earns fees for providing various other services to the Fund during the year as shown in the table on page 16.
- (c) The Fund utilises the services of Hang Seng Securities Limited ("HSSL"), a wholly-owned subsidiary of HSB, in its purchase and sale of investments and depository of securities. In addition, commitment fee is paid to HSB for the unused portion of bank overdraft facility. Details of such transactions executed during the year are shown in the table on page 17.
- (d) Certain bank accounts are maintained with The Hongkong and Shanghai Banking Corporation Limited and HSB. The respective bank balances at 31 December 2006 were HKD 11,829 (2005: HKD 8,079) and HKD 10,337 (2005: 216,208). The interest income earned from the HSB bank account during the year is HKD 10,418 (2005: HKD 3,608).

### **8 Units in issue**

For movements of units in issue, please refer to page 17.

### **9 Reconciliation of Net Asset Values**

The Trustee and the Manager would like to highlight that the principles for calculating the published unit price as set out in the Explanatory Memorandum of the Fund are different from that required for calculating the net assets attributable to unitholders and hence the corresponding net asset value per unit for financial reporting purposes under HKFRSs. The net assets attributable to unitholders as reported in the financial statements are therefore different from the adjusted total net assets for valuation purposes at the reporting dates. The reconciliation between the net assets attributable to unitholders as reported in the financial statements and the adjusted total net assets for valuation purposes is shown in the table on page 18.

### **10 Soft dollar commission**

As regards the Fund, the Manager has not entered into any soft dollar commission arrangements with brokers.

## Notes on the Financial Statements (continued)

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### 11 Fair value information

The Fund's financial instruments are measured at fair value on the balance sheet. Fair value estimates are made at a specified point in time, based on market conditions and information about the financial instruments. Usually, fair values can be reliably determined within a reasonable range of estimates. For certain other financial instruments, including amounts receivable from sale of investments, cash and cash equivalents, amounts payable on redemption of units, accrued expenses and other payables and distributions payable, the carrying amounts approximate fair value due to the immediate or short-term nature of these financial instruments.

### 12 Possible impact of amendments, new standards and interpretations issued but not yet effective for the annual accounting ended 31 December 2006

Up to the date of issue of these financial statements, the HKICPA has issued the following amendments, new standards and interpretations which are not yet effective for the accounting ending 31 December 2006 and which have not been adopted in these financial statements:

	<b>Effective for accounting periods beginning on or after</b>
HKFRS 7, Financial instruments: disclosures	1 January 2007
Amendment to HKAS 1, Presentation of financial statements: capital disclosures	1 January 2007

The Fund has not early adopted these amendments, new standards and interpretations in the financial statements for the year ended 31 December 2006.

The Fund has already commenced an assessment of the impacts of these amendments, new standards and interpretations but is not yet in a position to whether these amendments, new standards and interpretations would have a significant impact on their results of operations and financial positions.