

# **THE CHINA FUND**

## **NOTES TO THE FINANCIAL STATEMENTS**

### **1. GENERAL**

The Company was incorporated on 20th January 1992 in the Cayman Islands as an exempted company. The shares of the Company are listed on The Stock Exchange of Hong Kong Limited (the “HKSE”).

The principal investment objective of the Company is the long term appreciation of its assets by investment, primarily in equity and equity linked securities in the PRC, and in companies with significant assets in, or significant earnings derived from the PRC, including Chinese companies, the securities of which either are or will be listed, either directly or indirectly, on any recognized stock exchange. In the opinion of the Directors, the Company operates in one business and one geographical segment.

The Company is an open-ended structure having the power to repurchase its shares from shareholders on a daily basis at 99.5% of their attributable net asset value and to issue shares daily at net asset value plus a dealing charge of 0.5%.

On 1st December 1994, the Securities and Futures Commission (the “SFC”) in Hong Kong approved the Company as an authorized mutual fund pursuant to Section 15(1) of the Securities Ordinance. The Company was granted a change of listing status from an investment company to an authorized mutual fund by the HKSE on 14th March 1995. Authorization or approval by the SFC does not imply official approval or recommendation.

### **2. DURATION**

The Company has been established for an unlimited duration. However, pursuant to the articles of association of the Company, in the event that at any time over a consecutive period of twelve weeks the net asset value of the Company falls below an average weekly amount of US\$10 million, the Board of Directors shall be entitled, at its discretion, to convene a meeting for the purpose of considering a resolution to the effect that the Company be wound up. In such event, the Company shall be wound up subject to the passing of an ordinary resolution of the shareholders in a general meeting voting to place the Company in voluntary liquidation.

# THE CHINA FUND

## NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

### 3. IMPACT OF A NEW INTERNATIONAL ACCOUNTING STANDARD

The following new International Accounting Standard (“IAS”) has been adopted for the first time in the preparation of the current year’s financial statements.

- **IAS 39: Financial Instruments: Recognition and Measurement**

IAS 39 prescribes the principles for recognizing, measuring and disclosing information on financial instruments. As further explained in the accounting policy note below, all investments of the Company are classified as available for sale and are stated at fair value, with changes in fair value recognized in the revenue account. Further, on derecognition of financial assets, the realized gains and losses on investments are recognized in the revenue account.

Prior to the adoption of IAS 39, realized and unrealized gains and losses on investments arising from changes in fair value, and foreign exchange gains and losses were recognized in the capital reserve. This accounting policy has been changed and the effect of adopting IAS 39 at 1st April 2001 has been reflected in the statement of movements in reserves as at that date, and represents a reclassification of previously reported unrealized gains on investments of US\$546,679 from the capital reserve to the revenue reserve.

### 4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### (a) Basis of preparation

These financial statements have been prepared in accordance with the International Accounting Standards issued by the International Accounting Standards Committee (“IASC”) and the Interpretations issued by the Standing Interpretations Committee of the IASC.

#### (b) Accounting convention

These financial statements have been prepared under the historical cost convention, modified to include the revaluation of investments.

## THE CHINA FUND

### NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

#### **4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (cont'd.)

##### **(c) Listed investments**

At 1st April 2001 the Company adopted IAS 39 and classified its investments as “available for sale”.

Investments classified as available for sale are not held principally for the purpose of generating a profit from short term fluctuations in price, but may be purchased or sold in response to changes in available cash resources arising from share issues and repurchases. The investment manager also buys and sells investments to balance the risks in the Company’s portfolio in response to changes in market conditions and to meet designated investment restrictions.

All investments are initially recognized at cost, which includes transaction costs. Investments are subsequently re-measured at fair value. Fair values are based on quoted market prices on the principal stock exchange on which the investments are traded, subject to permitted adjustments under IAS 39, which are made by the Directors. Adjustments may be made where overriding circumstances exist whereby another valuation basis gives a more accurate and reliable determination of fair value than the quoted market prices. Such adjustments may be made where there is infrequent activity in the market, the market is not well established (such as “over the counter” markets) or small volumes are traded relative to the number of units to be valued.

Unrealized gains and losses arising from changes in the fair value of investments are recognized in the revenue account as they arise.

Realized gains and losses on investments are calculated on the average cost basis and are dealt with in the revenue account.

For investments purchased in currencies other than United States dollars, for disclosure purposes, the original costs are translated into United States dollars at the rates ruling at the balance sheet date.

# THE CHINA FUND

## NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

### **4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (cont'd.)

#### **(c) Listed investments (cont'd.)**

All purchases and sales of investments that require delivery within the time frame established by regulation or market convention (“regular way” purchases and sales) are recognized on the trade date, which is the date on which the Company commits to purchase or sell the asset.

#### **(d) Dividends receivable**

Dividends are recorded as being receivable on their ex-dividend dates. The ex-dividend dates for those dividends recognised as receivable in the balance sheets as at 31st March 2002 and 31st March 2001 had occurred within two weeks prior to the balance sheet date.

Dividends are generally paid one week after the ex-dividend date for equities quoted on the Shenzhen Stock Exchange and two to three days after the ex-dividend date for those quoted on the Shanghai Securities Exchange. There is no such general fixed period between the ex-dividend date and payment date for equities quoted on the HKSE. The dividends receivable included in the Company’s balance sheet as at 31st March 2002 will be settled within three months and those as at 31st March 2001 were settled within two months of the balance sheet date.

#### **(e) Amount due from brokers**

Amount due from brokers are carried at cost which is the fair value of the consideration to be received in the future for investments sold, net of charges to be paid for services received, whether or not they are billed to the Company.

Investments are settled according to the normal settlement period of the relevant stock exchange, which is usually within one week of the trade date. The amount due from brokers included in the Company’s balance sheet as at 31st March 2001 was settled in accordance with these trade terms.

# THE CHINA FUND

## NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

### **4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (cont'd.)

#### **(f) Accounts payable and accrued liabilities**

All of the accounts payable in the Company's balance sheet as at 31st March 2002 and 31st March 2001 were incurred within one month and two months, respectively, of the balance sheet date. Accrued liabilities represent estimates of liabilities for which accounts have not yet been received.

#### **(g) Amount due to brokers**

Amount due to brokers are carried at cost which is the fair value of the consideration to be paid in the future for investments purchased and services received, whether or not they are billed to the Company.

Investments are settled within normal settlement periods of the relevant stock exchanges, which are usually within one week after the trade date. The amount due to brokers included in the Company's balance sheet as at 31st March 2001 were settled in accordance with these trade terms.

#### **(h) Revenue recognition**

Bank interest income is recognized in the revenue account on a time proportion basis, taking into account the principal outstanding and the effective rate of interest applicable.

Dividend income is recognized in the revenue account when the Company's right to receive payment is established, which is the date on which equities are quoted as ex-dividend.

The Explanatory Memorandum states that any net loss in a particular year is written off against the Capital Reserve in that year and is not carried forward.

#### **(i) Foreign currency transactions**

The Company maintains its books and records in United States dollars. Foreign currency transactions are recorded at the applicable rates of exchange ruling at the transaction dates. All assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the applicable rates of exchange ruling at that date. Exchange differences are dealt with in the revenue account.

# THE CHINA FUND

## NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

### **4. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (cont'd.)

#### **(j) Equalization**

Equalization is the accrued income or loss included in the issue/repurchase price of shares and is dealt with in the revenue account following the issue/repurchase of shares.

#### **(k) Cash and cash equivalents**

Cash on hand and at banks and short term deposits which are held to maturity are carried at cost.

Cash and cash equivalents are defined as cash on hand, demand deposits and short term, highly liquid investments which are readily convertible into known amounts of cash and which are subject to insignificant risk of changes in value.

For the purpose of the cash flow statement, cash and cash equivalents consist of cash and deposits at banks.

#### **(l) Related parties**

Parties are considered to be related if one party has 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 or common significant influence. Related parties may be individuals or corporate entities.

## THE CHINA FUND

### NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

#### 5. LISTED INVESTMENTS

	<b>2002</b> <i>US\$</i>	<b>2001</b> <i>US\$</i>
Listed investments, at cost	21,919,524	22,602,185
Unrealized gains	<u>1,328,094</u>	<u>546,679</u>
Market value at 31st March	<u><u>23,247,618</u></u>	<u><u>23,148,864</u></u>

A detailed portfolio listing is set out on page 17.

#### 6. CASH AND CASH EQUIVALENTS

	<b>2002</b> <i>US\$</i>	<b>2001</b> <i>US\$</i>
Cash at bank	486	153,028
Call deposit	<u>977,943</u>	<u>907,146</u>
	<u><u>978,429</u></u>	<u><u>1,060,174</u></u>

The call deposit has an effective interest rate of 1.1875% per annum.

#### 7. SHARE CAPITAL

	<b>2002</b> <i>US\$</i>	<b>2001</b> <i>US\$</i>
Authorized:		
90,000,000 ordinary shares of US\$0.01 each	<u><u>900,000</u></u>	<u><u>900,000</u></u>
Issued and fully paid:		
1,231,914 (2001: 1,272,504) ordinary shares of US\$0.01 each	<u><u>12,319</u></u>	<u><u>12,725</u></u>

## THE CHINA FUND

### NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

#### 7. SHARE CAPITAL (cont'd.)

The Company repurchased 129,671 (2001: 105,212) and issued 89,081 (2001: 186,094) of its listed ordinary shares during the year, priced at the Net Asset Value of the shares on the respective repurchase and issue dates, adjusted for a dealing charge of 0.5%. The Company paid US\$2,280,995 (2001: US\$2,136,826) in aggregate for the shares repurchased and received US\$1,606,958 (2001: US\$3,585,750) in aggregate for the shares issued during the year. Details of repurchases and issues of shares on a monthly basis were as follows:

Month	Number of shares repurchased	Repurchase price range US\$	Number of shares issued	Issue price range US\$
April 2001	(7,000)	18.95	—	—
May 2001	(4,600)	21.78 – 22.03	—	—
June 2001	(16,371)	21.85 – 23.19	—	—
July 2001	(8,400)	20.50	—	—
August 2001	(500)	18.72	3,198	18.76
September 2001	(65,000)	14.95	—	—
October 2001	—	—	—	—
November 2001	(15,900)	17.66 – 18.40	7,211	17.56 – 18.17
December 2001	—	—	—	—
January 2002	—	—	77,424	18.07 – 18.63
February 2002	(11,000)	18.72	—	—
March 2002	(900)	19.04	1,248	20.03
	<u>(129,671)</u>		<u>89,081</u>	

The Company did not buy back any of its listed ordinary shares on the HKSE during the year.



# THE CHINA FUND

## NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

### 8. NET ASSET VALUE PER SHARE

The calculation of net asset value per share is based on net assets as at 31st March 2002 of US\$24,265,954 (2001: US\$23,964,396) and 1,231,914 (2001: 1,272,504) ordinary shares in issue at that date.

### 9. FEES

#### *Investment management fee*

Deutsche Asset Management (Asia) Limited is entitled to receive a fee calculated on the basis of the average daily Net Asset Value (before deduction of the fees of the Investment Manager, the Custodian and the Administrator) of the Company at an annual rate of 0.75%, subject to a minimum annual fee of US\$100,000.

#### *Administration fee*

The Administrator is entitled to receive a fee calculated on the Net Asset Value of the Company, subject to a minimum monthly fee of US\$4,000, at the following annual rates:

- 0.25% from nil to US\$50 million
- 0.20% from US\$50 million to US\$75 million
- 0.15% from US\$75 million to US\$100 million
- 0.10% above US\$100 million

With effect from 20th July 2001, the Directors approved that the role of Administrator be assigned from Fortis Bank (Cayman) Limited to Fortis Fund Services (Cayman) Limited ("FFSCL"). Both companies are 100% owned subsidiaries of the same ultimate parent company. FFSCL is a Licensed Mutual Fund Administrator under The Mutual Funds Law (2001 Revision) of the Cayman Islands.

Fortis Fund Services (Asia) Limited, the Sub-Administrator, is entitled to a fee payable out of the Administration Fee.

# THE CHINA FUND

## NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

### 9. FEES (cont'd.)

#### *Custodian fee*

Fortis Bank (Nederland) N.V. does not receive any fees in its capacity as a custodian.

Citibank N.A., Hong Kong, a sub-custodian, is entitled to receive fees based on the month-end market value of the Company's investment holdings, at the annual rate of 0.06% for investments listed on the Shanghai Securities Exchange and the Shenzhen Stock Exchange, and 0.03% for the investments listed on the HKSE.

In addition, the sub-custodian is entitled to receive transaction fees amounting to US\$60 for each transaction involving shares listed on the Shanghai Securities Exchange and the Shenzhen Stock Exchange, and US\$40 for shares listed on the HKSE.

### 10. DIRECTORS' REMUNERATION

The Directors are entitled to be compensated for their services on the Board of Directors of the Company in the amount of US\$7,500 each (2001: US\$7,500) per year, plus expenses. During the year, an arrangement continued whereby the Executive Directors waived the right to their remuneration and the Non-Executive Directors agreed to reduce their remuneration to US\$5,000 each. The Directors are the only employees of the Company.

### 11. TAX

Under the current laws of the Cayman Islands, the Company is not required to pay any taxes in the Cayman Islands on either income or capital gains. The Company has received an undertaking from the Governor in Council of the Cayman Islands, pursuant to the provisions of Section 6 of the Tax Concessions Law (Revised), which exempts the Company from any such tax at least until the year 2012.

# **THE CHINA FUND**

## **NOTES TO THE FINANCIAL STATEMENTS (cont'd.)**

### **11. TAX (cont'd.)**

No provision has been made for tax in the People's Republic of China as dividends and gains realized from the sale of "B" shares are not taxable.

No provision for Hong Kong profits tax has been made as the Company is exempted from tax under Section 26A(1A) of the Inland Revenue Ordinance.

### **12. EARNINGS PER SHARE**

The calculation of basic earnings per share is based on the net income for the year of US\$1,237,607 (2001: US\$324,523) and the weighted average of 1,221,284 (2001: 1,232,563) ordinary shares in issue during the year.

Diluted earnings per share amounts have not been presented as there were no diluting events.

### **13. DIVIDEND**

The Board of Directors recommend the payment of a dividend in the amount of US\$0.33 (2001: US\$0.24) per ordinary share totalling US\$406,532 (2001: US\$305,401), payable on 28th June 2002 to all shareholders appearing on the share register of the Company on 14th June 2002. The proposed dividend has not been reflected in the financial statements as at 31st March 2002.

## THE CHINA FUND

### NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

#### **14. FINANCIAL ASSETS AND LIABILITIES AND RISK MANAGEMENT POLICY OF THE COMPANY**

In pursuing its objectives, as set out in the Investment Manager's report, the Company holds a number of financial instruments:

1. Equities and equity related securities which are held in accordance with the Company's objectives; and
2. Cash, liquid resources and short term debtors and creditors that arise directly from the Company's operations.

Details of the investment strategy of the Investment Manager during the year are contained within its report to the Company.

The investments held by the Company are set out in the portfolio of investments. The Company has no financial liabilities other than short term creditors. The main risks relating to investments are set out below.

##### **(a) Market price risk**

Market price risk arises mainly from uncertainty about future prices of the financial instruments held. It represents the potential loss the Company might suffer through holding market positions in the face of price movements.

The Company is exposed to market price risk on all of its investments.

The Company employs efficient portfolio management techniques to provide a degree of protection against market price falls. The Investment Manager's Investment Policy Committee meets on a formal basis monthly and frequently intra-monthly to discuss market developments. It also meets in response to unexpected external developments. The role of the committee is to analyze markets, to form opinions on the relative attractions of each asset class and to set asset mix targets.

## THE CHINA FUND

### NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

#### **14. FINANCIAL ASSETS AND LIABILITIES AND RISK MANAGEMENT POLICY OF THE COMPANY (cont'd.)**

##### **(a) Market price risk (cont'd.)**

The fund management team is responsible for monitoring the portfolio in accordance with the overall asset allocation parameters. It also seeks to ensure that individual stocks meet acceptable risk/reward profiles.

##### **(b) Liquidity risk**

Liquidity risk is the risk that the Company will encounter difficulty in raising funds to meet commitments associated with financial assets. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value.

The Company's exposure to liquidity risk is considered to be relatively minimal as all of the investments of the Company are publicly listed.

The Investment Manager will normally keep an allocation of cash to meet pending liabilities that may arise from time to time.

##### **(c) Credit risk**

Credit risk is the risk that one party to a financial asset will fail to discharge its obligation and cause the other party to incur a financial loss. Substantially all of the Company's cash and cash equivalents are deposited with a single reputable financial institution and as a result, it is exposed to a concentration of credit risk.

## THE CHINA FUND

### NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

#### **14. FINANCIAL ASSETS AND LIABILITIES AND RISK MANAGEMENT POLICY OF THE COMPANY (cont'd.)**

##### **(c) Credit risk (con'd)**

The Investment Manager buys and sells investments only through brokers which have been approved by the Deutsche Asset Management (Asia) Limited Risk Committee. These approved brokers are monitored to determine that they remain acceptable counterparties. In addition, the maximum exposure to any one broker is limited and these limits are reviewed on an ongoing basis.

##### **(d) Foreign currency risk**

Foreign currency risk is the risk that the value of financial assets or liabilities will fluctuate due to changes in foreign exchange rates. The Company is exposed to foreign currency risk from investments which are denominated in currencies other than United States dollars.

Financial assets and liabilities, other than listed investments described above, are subject to foreign currency risk and credit risk.

##### **(e) Interest rate risk**

Interest rate risk is the risk that the values of interest bearing financial instruments will fluctuate as a result of changes in interest rates.

Other than the call deposit held as at the balance sheet date which has an effective interest rate of 1.1875% per annum, the Fund mainly invests in equity securities and as such, its exposure to interest rate risk is considered to be relatively minimal.

## THE CHINA FUND

### NOTES TO THE FINANCIAL STATEMENTS (cont'd.)

#### 15. TRANSACTIONS WITH CONNECTED PERSONS

In addition to those transactions with Connected Persons disclosed in notes 9 and 10, the following is a summary of transactions entered into during the year between the Company and the Investment Manager and its Connected Persons. Connected Persons are those as defined in the Listing Rules of The Stock Exchange of Hong Kong Limited and in the Code on Unit Trusts and Mutual Funds established by the Securities and Futures Commission of Hong Kong. All such transactions were entered into in the ordinary course of business and on normal commercial terms.

Execution of investment transactions by a Connected Person of the Investment Manager:

	<b>Total purchases and sales of securities US\$</b>	<b>% of the Company's total transactions during the year</b>
Deutsche Securities (Asia) Limited		
2002	1,144,428	3.22
2001	1,952,413	4.99
	<b>Total commission paid on the above transactions US\$</b>	<b>Average commission rate %</b>
Deutsche Securities (Asia) Limited		
2002	2,864	0.25
2001	4,881	0.25

## **THE CHINA FUND**

### **NOTES TO THE FINANCIAL STATEMENTS (cont'd.)**

#### **16. SOFT COMMISSION ARRANGEMENTS**

The Investment Manager, Deutsche Asset Management (Asia) Limited, is responsible for the selection of brokers to be used by the Company. In some instances, the Investment Manager has entered into soft commission arrangements with the brokers. Under these soft commission arrangements, the Investment Manager obtains services or benefits from third parties which are paid for by the brokers out of the commission they receive. Such services or benefits are related primarily to performance measurement, valuation and research services. The Investment Manager is satisfied that the investment transactions generating soft commissions comply with requirements for best execution both as to price and settlement.

#### **17. RELATED PARTY TRANSACTIONS**

The Company's transactions with related parties are detailed in notes 9, 10, 15 and 16 to the financial statements.

#### **18. CONSIDERATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN HONG KONG ("HK GAAP")**

There are no material differences that would require the financial statements of the Company for the year, which have been prepared in accordance with the IAS, to be adjusted to conform with HK GAAP.