

Notes on the Financial Statements

1 Background

Hang Seng H-Share 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 18 November 2003, as amended from time to time under the laws of Hong Kong, and registered on 19 November 2003 as an 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. 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.

The accounting policies have been applied consistently by the Fund and are consistent with those used in the previous year.

(c) Income and expenses

Interest income and expense are recognised as they accrue using the effective interest method. Distribution income is recognised when the underlying securities are quoted ex-distribution. Distribution income is presented gross of any non-recoverable withholding taxes, which are disclosed separately in the revenue statement. All other income and expenses are accounted for on an accruals basis.

(d) Translation of foreign currency

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

(e) Financial instruments

(i) Classification

All the investments including investments in the constituent stocks of Hang Seng China Enterprises Index are acquired principally for the purposes of selling in the short term and classified as held for trading. The Fund designates all the investments into financial assets at fair value through profit or loss category. Financial assets that are classified as receivables include amounts receivable on sale of investments and amounts receivable from subscription of units. Financial liabilities that are not at fair value through profit or loss include amounts payable on purchase of investments, amounts payable on redemption of units, distributions payables and other payables.

(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 or sale of financial assets and financial liabilities at fair value through profit or loss 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 at fair value through profit or loss are recorded.

Financial liabilities are not recognised unless one of the parties has performed its obligations under the contract 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 date of statement of assets and liabilities without any deduction of estimated future selling costs. Financial assets are priced at current bid prices while financial liabilities are priced at current ask prices.

Gains and losses on investments are included in the revenue statement. Realised gains and losses on investments and unrealised gains and losses on investments arising from a change in fair value are provided in note 7.

(v) Derecognition

A financial asset is derecognised when the contractual rights to receive the cash flows from the financial asset expire, or where the financial asset together with substantially all the risks and rewards of ownership, have been transferred.

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.

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

The Fund uses the weighted average method to determine realised gains and losses to be recognised in profit or loss on derecognition.

(f) Related parties

For the purposes of these financial statements, a party is considered to be related to the Fund if:

- (i) the party has the ability, directly or indirectly, through one or more intermediaries, to control the Fund or exercise significant influence over the Fund in making financial and operating policy decisions, or has joint control over the Fund;
- (ii) the Fund and the party are subject to common control;
- (iii) the party is a subsidiary, an associate of the Fund or a joint venture in which the Fund is a venturer;
- (iv) the party is a member of key management personnel of the Fund or the Fund's parent, or a close family member of such an individual, or is an entity under the control, joint control or significant influence of such individuals;
- (v) the party is a close family member of a party referred to in (i) or is an entity under the control, joint control or significant influence of such individuals; or
- (vi) the party is a post-employment benefit plan which is for the benefit of employees of the Fund or of any entity that is a related party of the Fund.

Close family members of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the Fund.

(g) 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 are included as a component of cash and cash equivalents for the purpose of the cash flow statement.

(h) Units in issue

All units issued by the Fund provide their respective unitholders with the right to require in-kind redemption through participation dealers for a basket of constituent stocks of the Hang Seng China Enterprises Index and a cash component, together equivalent to the value proportionate to the unitholder's share in the Fund's net assets at redemption. 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 accruals basis in revenue statement as part of finance costs.

3 Changes in accounting policies

The HKICPA has issued certain new and revised HKFRSs and Interpretations that are available for early adoption for the current accounting period of the Fund. The Fund has not applied any new or revised HKFRS or Interpretation that is not yet effective for the current accounting period (see note 13).

4 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.

Taxation for the year represents non-recoverable withholding tax on dividend income.

5 Financial instruments and associated risks

The Fund maintains investment portfolio in the constituent stocks of Hang Seng China Enterprises Index as dictated by its investment management strategy, but is not limited to equity instruments. The Fund's investment objective is to match, before expenses, as closely as practicable, the performance of Hang Seng China Enterprises Index ("the Index") against which the Fund is benchmarked. The Manager primarily adopts a replication strategy to achieve the investment objective of the Fund. When there is a change in the constituent stock(s) of the Index or the weighting of the constituent stocks in the Index, the Manager will be responsible for implementing any adjustment to the Fund's portfolio of stocks to ensure that the Fund's investment portfolio closely correspond to the composition of the Index and the weighting of each constituent stock. Details of such investments held as at 31 December 2008 are shown in the investment portfolio.

The nature and extent of the financial instruments outstanding at the balance sheet date and the risk management policies employed by the Fund are discussed below.

(a) Market risk

Market risk arises when the fair value and future cash flows of a financial instrument will fluctuate because of changes in market prices and includes currency risk, interest rate risk and price risk.

(i) Currency risk

Currency risk arises from change in foreign rate of financial assets and financial liabilities denominated in currencies other than the Fund's functional currency.

As all the financial assets and liabilities of the Fund are denominated in Hong Kong Dollars, the functional currency, the Fund has limited exposure to currency risk.

(ii) Interest rate risk

Interest rate risk arises from change in interest rates which may inversely affect the value of debt instruments and therefore result in potential gain or loss to the Fund. Except for bank deposits, all the financial assets and liabilities of the Fund are non-interest bearing. As a result, the Fund has limited exposure to interest rate risk.

(iii) Price risk

Price risk is the risk that value of the instrument will fluctuate as a result of changes in market prices (other than those arising from interest rate risk or currency risk), whether caused by factors specific to an individual investment, its issuer or all factors affecting all instruments traded in market.

The Manager constructed the portfolio through adopting replication strategy. The Fund is not actively managed and the Manager does not have the discretion to select stocks or to take defensive position in declining market. Hence, any fall in the underlying index will result in a corresponding fall in the value of the Fund.

All investments of the Fund are constituent stocks of Hang Seng China Enterprises Index listed on The Stock Exchange of Hong Kong Limited. A 20% (2007:5%) increase in Hang Seng China Enterprises Index at 31 December 2008, other variables held constant, it is estimated that the net assets attributable to unitholders would increase by HKD 1,605,408,133 (2007: HKD 652,078,049); an equal change in the opposite direction, the net assets attributable to unitholders would decrease by an equal but opposite amount.

(b) Credit risk

Credit risk arising on transactions with brokers relates to transactions awaiting settlement. Risk relating to unsettled transactions is considered small due to the short settlement period involved and the high quality of the brokers used. The Manager monitors the credit rating and financial positions of the brokers used to further mitigate this risk.

All of the assets of the Fund are safe-kept by HSBC Provident Fund Trustee (Hong Kong) Limited (the "Trustee"). Bankruptcy or insolvency of the Trustee may cause the Fund's rights with respect to the assets safe-kept by the Trustee to be delayed or limited. Fund manager monitors the credit quality of the Trustee by performing due diligence annually.

All of the investments of the Fund are held by Hang Seng Bank Limited (the "Custodian"). Bankruptcy or insolvency of the Custodian may cause the Fund's rights with respect to investments held by the Custodian to be delayed or limited. The Manager monitors this risk by monitoring the credit rating of the Custodian on an on-going basis.

Majority of the cash held by the Fund is deposited with Hang Seng Bank Limited, and The Hongkong and Shanghai Banking Corporation Limited (the "banks"). Bankruptcy or insolvency of the banks may cause the Fund's rights with respect to the cash held by the banks to be delayed or limited. The Manager monitors this risk by monitoring the credit rating of these banks on an on-going basis.

Other than outlined above, there were no significant concentrations of credit risk to counterparties at 31 December 2008 and 31 December 2007.

(c) Liquidity risk

Liquidity risk arises when the Fund are not able to convert investments into cash to meet liquidity needs in a timely manner.

The Fund is exposed to daily redemption. While the redemption made through participation dealers could be settled largely by a basket of constituent stocks of the Hang Seng China Enterprises Index with the difference being settled by cash, redemption made by Hang Seng China H-Share Index Fund has to be settled by cash upon request in accordance with the Offering Document. Also, all the financial liabilities are repayable on demand or have contractual maturities less than three months. Therefore the Fund invests the majority of the assets in investments that are traded in an active market and can be readily disposed of. The Fund's investments are considered to be readily realisable as equities are listed on the Stock Exchange of Hong Kong Limited.

6 Interest income

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

7 Gains and losses on investments

During the year, the Fund disposed of equities and earned or incurred realised and unrealised gains and losses as shown in the table on page 15.

8 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 under 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 4,020,445 (2007: HKD 6,247,778).
- (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 fee to which it was entitled from the Fund during the year and waived its right to the difference. Trustee's fee is calculated as at each dealing date and payable monthly. Trustee fee payable at the year end is HKD 375,505 (2007: HKD 621,705). The Trustee also earned 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. Details of such transactions executed and fees paid during the year are shown in the table (c) on page 16.

Also, the Fund utilises the services of HSB and pays securities expenses and safe custody charges for depository of securities and commitment fee on unused portion of bank overdraft facility to HSB. Details of such fees paid during the year are shown in the table (c) on page 16.
- (d) The Fund has been licensed by HSI Services Limited ("HSI") and Hang Seng Data Services Limited ("HSDS"), wholly-owned subsidiaries of HSB, to use the Hang Seng H-Share Index to create, offer, market and sell the Hang Seng H-Share Index ETF during the year. License fees and issue share data services fees paid to HSI and HSDS are shown on page 16.
- (e) Certain bank accounts are maintained with The Hongkong and Shanghai Banking Corporation Limited ("HSBC") and HSB. The respective bank balances at 31 December 2008 are HKD 1,063,328 (2007: HKD 685,886) and HKD 65,738,745 (2007: HKD 85,684,223). The interest income earned from HSB's bank accounts during the year is HKD 62,904 (2007: HKD 555,071).
- (f) The Fund paid bank overdraft interest of HKD 14,430 (2007: HKD 38,642) to HSB during the year.
- (g) During the year, HSB charged service fees for handling distribution income amounted to HKD 183,594 (2007: HKD 74,741) for the Fund.
- (h) Sub-funds under Hang Seng Investment Series managed by HSIM invested in the Fund and earn the Fund's distributions to unitholders. At the year end date, these sub-funds held 6,917,545 units (2007: 7,820,300 units) of the Fund. During the year, distributions to unitholders earned by these sub-funds were HKD 17,064,290 (2007: HKD 7,262,069) and distributions payable to these sub-funds at the year end date was HKD 3,534,273 (2007: HKD 5,319,280).
- (i) Hang Seng China H-Share Index Fund, a fund managed by HSIM, subscribed 1,178,972 units (2007: 50,558,748 units) and redeemed 305,727 units (2007: 2,262,000 units) of the Fund, at amounts of HKD 149,107,881 (2007: HKD 7,361,756,411) and HKD 18,818,070 (2007: HKD 196,034,678) respectively during the year.

9 Units in issue

For movements of units in issue, please refer to page 16.

10 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 Hong Kong Offering Document 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 17.

11 Soft dollar commission

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

12 Fair value information

The Fund's financial instruments are measured at fair value on the date of statement of assets and liabilities. Fair value estimates are made at a specified point in time, based on market conditions and information about the financial instruments. Usually, fair value can be reliably determined within a reasonable range of estimates. For certain other financial instruments, including amounts receivable from sale of investments, amounts receivable on subscription of units, cash and cash equivalents, amounts payable on purchase of investments, 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.

13 Possible impact of amendments, new standards and interpretations issued but not yet effective for the year ended 31 December 2008

Up to the date of issue of these financial statements, the HKICPA has issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2008 and which have not been adopted in these financial statements.

The Fund is in the process of making an assessment of what the impact of these amendments, new standards and interpretations is expected to be in the period of initial application. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Fund's results of operations and financial position.