Notes to the financial statements

For the year ended 31 March 2011 (Expressed in Hong Kong dollars)

1. Purpose, limitation and principal activity

The Securities and Futures Ordinance (SFO) provides for the establishment of the Investor Compensation Fund (the Fund) to compensate investors who suffer a loss due to the default of an intermediary in relation to trading of products on Hong Kong Exchanges and Clearing Limited. The defaulting intermediary must be licensed or registered with the Securities and Futures Commission (SFC) for dealing in securities, futures contracts or securities margin financing.

The SFC is primarily responsible for the administration and management of the Fund in accordance with Section 238 of the SFO, but has transferred some functions to the Investor Compensation Company Limited (ICC) under Section 80 of the SFO. ICC is thus responsible for receipt, determination and payment of valid claims against the Fund in respect of defaults of intermediaries occurring on or after 1 April 2003. Upon making payment to a claimant, the SFC is subrogated to the claimant's right against the defaulter.

Pursuant to Section 244 of the SFO, the Chief Executive in Council has by order set the maximum amount of compensation at $150,000 per claimant for a single default in relation to securities traded at The Stock Exchange of Hong Kong Ltd (SEHK) or futures contracts traded at Hong Kong Futures Exchange Ltd (HKFE).

If amounts owed to claimants against the Fund exceed the Fund's net assets, the SFC would apportion compensation payments to claimants as provided in the Securities & Futures (Investor Compensation-Claims) Rules. The SFC would pay unpaid claim amounts when funds become available in the Fund.

2. Money constituting the Fund

The Fund mainly consists of the amounts paid from the two compensation funds, the Unified Exchange Compensation Fund (UECF) and the Commodity Exchange Compensation Fund (CECF) (wound up on 26 May 2006). The SFC will also pay into the Fund any remaining balance in the Securities Dealers' Deposits Fund and the Commodities Dealers' Deposits Fund after repaying the dealers' deposits and any money due to the registered dealers in accordance with Section 76 (11) of Schedule 10 of the SFO though it is not likely that these payments will be made within the coming year.

Other sources of money for the Fund include the levies chargeable on securities traded on SEHK and futures contracts traded on HKFE, and returns earned on the investment of the Fund (see also note 5).

3. Significant accounting policies

(a) Statement of compliance

The Fund prepares its financial statements in accordance with International Financial Reporting Standards (IFRSs) (including applicable International Accounting Standards and Interpretations) issued by the International Accounting Standards Board (IASB). A summary of the significant accounting policies adopted by the Fund is set out below.

The IASB has issued certain new and revised IFRSs that are first effective or available for early adoption for the current accounting period of the Fund. However, none of these developments are relevant to the Fund's operations.

The Fund has not applied any new standard or interpretation that is not yet effective for the current accounting period (see note 15).

3. Significant accounting policies (Cont'd)

(b) Basis of preparation

We have prepared these financial statements using the historical cost basis as the measurement basis, except that we state financial instruments classified as designated at fair value through profit or loss at their fair value (see note 3(e)).

We prepare the financial statements in conformity with IFRSs which requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities, income and expenses. We make estimates and associated assumptions 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.

We review estimates and underlying assumptions on an ongoing basis. We recognise revisions to accounting estimates 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.

(c) Recognition of income

We recognise income in the statement of comprehensive income provided it is probable that the economic benefits will flow to the Fund and we can measure reliably the revenue and costs. We record interest income as it accrues using the effective interest method.

(d) Translation of foreign currencies

We translate foreign currency transactions during the year into Hong Kong dollars at the foreign exchange rates ruling at the transaction dates. We translate monetary assets and liabilities denominated in foreign currencies that are stated in fair value into Hong Kong dollars at the foreign exchange rates ruling at the end of the reporting period. We record exchange gains and losses on translation in the statement of comprehensive income.

(e) Financial instruments

(i) Initial recognition

We classify the financial instruments into different categories at inception, depending on the purpose for which the assets were acquired or the liabilities were incurred. The categories are: fair value through profit or loss, loans and receivables and other financial liabilities.

We initially measure financial instruments at fair value, which normally will be equal to the transaction price, plus, in case of a financial asset or financial liability not held at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. We charge transaction costs on financial assets and financial liabilities at fair value through profit or loss to expense immediately.

We account for financial assets and financial liabilities on the date the Fund becomes a party to the contractual provisions of the instrument. We use settlement date accounting to record regular purchase or sale of financial assets. From this date, we record in our books any gains and losses arising from changes in fair value of the financial assets or financial liabilities.

The Fund's financial instruments mainly consist of debt and equity securities designated at fair value through profit or loss. We state financial assets and liabilities under this category at fair value and recognise changes in the fair value in the statement of comprehensive income in the period in which they arise. Upon disposal or repurchase, the difference between the net sale proceeds or the net payment and the carrying value is included in the statement of comprehensive income.

Notes to the financial statements (Cont'd)

For the year ended 31 March 2011

3. Significant accounting policies (Cont'd)

(e) Financial instruments (Cont'd)

(ii) Fair value measurement principles

We determine the fair value of financial instruments based on their quoted market prices on a recognised stock exchange or a price from a broker/dealer for non-exchange-traded financial instruments at the end of the reporting period 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. Unlisted equity investments are shares in pooled funds. The fair value is determined based on the Fund's share in the net assets of the pooled funds as determined by the custodian.

(iii) Derecognition

We derecognise a financial asset 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.

We derecognise a financial liability when the obligation specified in the contract is discharged, cancelled or expired.

(iv) Offsetting

We offset the financial assets and financial liabilities and report the net amount in the statement of financial position where 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.

(f) Impairment

(i) Recognition of impairment loss

We review the carrying amounts of the Fund's assets at the end of each reporting period to determine whether there is any objective evidence of impairment. If any such evidence exists, we estimate the asset's recoverable amount. We recognise in the statement of comprehensive income the difference between the asset's carrying amount and the recoverable amount as an impairment loss whenever the carrying amount of an asset exceeds its recoverable amount.

(ii) Calculation of impairment loss

We calculate the recoverable amount of the Fund's receivables by discounting their expected future cash flows to their present value at the original effective interest rate inherent in the asset. We do not discount receivables with a short duration in the calculation of their recoverable amount.

(iii) Reversals of impairment loss

We reverse an impairment loss in respect of an asset in a subsequent period if the circumstances and events that are objectively linked to the write down or write-off cease to exist and there is persuasive evidence that the new circumstances and events will persist for the foreseeable future. We reverse an impairment loss only to the extent that the asset's carrying amount does not exceed the carrying amount that we would have determined if we had not recognised any impairment loss.

(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.

(h) Other receivables

We state other receivables initially at fair value and thereafter at amortised cost less impairment losses (see note 3(f)), unless the effect of discounting would be immaterial, in which case we state them at cost less impairment losses.

3. Significant accounting policies (Cont'd)

(i) Provision for compensation

We make provision for liabilities arising from claims resulting from defaults for which it is probable that the Fund will require an outflow of economic benefits to settle the obligation and the amount can be estimated reliably, independent of whether a notice calling for claims pursuant to Section 3 of the Securities & Futures (Investor Compensation-Claims) Rules has been published. The provision covers all such claims received up to the date on which the financial statements are approved by the SFC. If the effect is material, we determine provisions by discounting the expected future cash flows that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

The maximum liability of the Fund to claims for each default case is set at $150,000 per claimant.

As the Fund is continually updating information in respect of claims received, it is possible that the recent claim experience is not indicative of future payments that will be required for claims received as at the end of the reporting period. Any increase or decrease in the provision would affect profit and loss in future years.

(j) Creditors and accrued charges

We state creditors and accrued charges initially at fair value and thereafter at amortised cost unless the effect of discounting would be immaterial, in which case we state them at cost.

(k) Contingent liabilities

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the obligation is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

(l) Related parties

For the purpose 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 decisions or has joint control over the Fund;

(ii) the Fund and the party are subject to common control;

(iii) the party is 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.

Notes to the financial statements (Cont'd)

For the year ended 31 March 2011

4. Taxation

The interest and profits on investments earned by the Fund are not subject to Hong Kong Profits Tax under Section 14 of the Inland Revenue Ordinance.

5. Net investment income

	2011 $'000	2010 $'000
Interest income from bank deposits	248	129
Interest income on financial assets designated at fair value through profit or loss	48,807	52,853
Realised (loss)/gain on disposal of equity securities	(10)	5
Realised (loss)/gain on redemption/disposal of debt securities	(2,443)	4,043
Gain on revaluation of equity securities	40,979	71,812
Gain on revaluation of debt securities	1,256	25,954
Net investment income	**88,837**	154,796

6. Levy from SEHK/HKFE

From 1 April 2003, the Fund received a levy chargeable on leviable SEHK transactions and leviable HKFE contracts pursuant to Part 2 and Part 3 of the Securities and Futures (Investor Compensation – Levy) Rules.

After the Securities and Futures (Investor Compensation – Levy) (Amendment) Rules 2005 came into effect on 28 October 2005, a levy suspension and re-instatement mechanism was established whereby the investor compensation levies can be suspended when the net asset value of the Fund exceeds $1.4 billion, and subsequently reinstated when the net asset value of the Fund falls below $1 billion. Pursuant to the Securities and Futures (Investor Compensation – Levy) (Amendment) Rules 2005 and the Gazette on 11 November 2005, no person is required to pay any levy to the Fund in respect of a sale and purchase of securities and futures contract with effect from 19 December 2005.

7. ICC expenses

The SFC formed the ICC in September 2002 to perform functions on behalf of the Fund in relation to the compensation to investors and other functions under Part III and Part XII of the SFO. The Fund is responsible for funding the establishment and operation of ICC. For the year ended 31 March 2011, ICC incurred costs of $4,157,000 for its operations (2010: $4,165,000).

8. Provision for compensation

	$'000
Balance as at 1 April 2009	8,032
Add: compensation expenses during the year ended 31 March 2010	363
Less: compensation paid during the year ended 31 March 2010	(2,739)
Balance as at 31 March 2010 and 1 April 2010	5,656
Less: compensation write-backs during the year ended 31 March 2011	(218)
Less: compensation paid during the year ended 31 March 2011	(5,288)
Balance as at 31 March 2011	**150**

We maintained provision for liabilities arising from claims received resulting from one default case for which ICC has published a notice calling for claims pursuant to Section 3 of the Securities & Futures (Investor Compensation-Claims) Rules. The maximum liability of the Fund to claims for this case is set at $150,000 per claimant. As at 31 March 2011 all provisions were expected to be paid within one year.

9. Financial assets designated at fair value through profit or loss

	2011 $'000	2010 $'000
(a) Debt securities		
(i) Listing status		
Listed – outside Hong Kong at quoted market prices	535,919	345,199
Listed – outside Hong Kong based on valuation techniques	109,436	63,001
Listed – in Hong Kong	143,605	51,608
Unlisted	819,623	1,057,995
	1,608,583	1,517,803
(ii) Maturity profile		
Within one year	552,995	317,118
After one year but within two years	443,101	406,937
After two years but within five years	484,958	629,833
After five years	127,529	163,915
	1,608,583	1,517,803
(iii) The weighted average effective interest rate of debt securities on 31 March 2011 was 1.7% (2010: 2.0%).		
(b) Pooled fund		
Unlisted	**224,824**	184,523

The pooled fund comprises mainly listed equity securities.

Notes to the financial statements (Cont'd)

For the year ended 31 March 2011

10. Deposits with banks and cash at bank

The effective interest rate on deposits with banks and cash at bank at 31 March 2011 ranged from 0.1% to 0.3% (2010: 0.04% to 0.2%). The balances mature within one year at both 31 March 2011 and 31 March 2010.

11. Contributions from UECF and CECF

Under Sections 74(2) and 75(2) of Schedule 10 of the SFO, the SFC may pay into the Fund such sum of money from the UECF and the CECF as it considers appropriate after 1 April 2003. Up to 31 March 2011, the SFC had $994,718,000 (2010: $994,718,000) and $108,923,000 (2010: $108,923,000) paid into the Fund from the UECF and the CECF respectively.

The Fund defines "capital" as including contributions from the UECF and the CECF and the accumulated surplus.

12. Material related party transactions

We have related party relationships with the SFC, the ICC and the UECF. During the year, there were no significant related party transactions other than those disclosed in the financial statements (refer to notes 7 & 11).

13. Financial risk management and fair values

The financial assets of the Fund mainly comprise debt securities and units in a pooled fund. The underlying investments of the pooled fund mainly comprise equity securities.

The main financial risks of the Fund arise from its investments in debt securities and units in the pooled fund. The SFC appoints external investment managers to manage the Fund's investments and to ensure that the portfolio's investments comply with the Fund's investment policy approved by the SFC which sets control limits on credit risk, market risk, interest rate risk, liquidity risk and foreign currency risk. The external investment managers report thereon to the SFC on a regular basis.

The Fund's exposure to these risks and the financial risk management policies and practices used by the Fund to manage these risks are described below.

(a) Credit risk

The Fund's Investment Policy and Administrative Guidelines (the Policy) only allows the Fund to invest in pooled funds, fixed rate dated securities rated A or above or in bank deposits. The Policy further limits the Fund's exposure to each issuer and each country, except for holdings of US Treasuries, any issuances by Hong Kong Government and specified multilateral agencies rated AAA by Moody's or S&P's and approved pooled funds. The Fund's investment managers are responsible for managing the portfolio and ensuring the portfolio's investments meet the Policy and restrictions and reports thereon on a monthly basis. During the year, the Fund complied with the above Policy and, as a result, was not exposed to significant credit risk. The maximum exposure to credit risk is the carrying value of the assets in the statement of financial position.

(b) Liquidity risk

The Fund's policy is to regularly monitor its liquidity requirement to ensure that it maintains sufficient reserves of cash and readily realisable marketable securities to meet its liquidity requirements in the short and longer term.

13. Financial risk management and fair values (Cont'd)

(c) Interest rate risk

The Fund's interest bearing assets mainly comprise fixed interest rate bearing debt securities and bank deposits. The Fund's bank deposits are exposed to short term bank deposit interest re-pricing risk.

The Fund is subject to the risk that future cash flows of a debt security will fluctuate because of changes in market interest rates. In order to manage the re-pricing risk, the Fund adopts a policy of maintaining duration at no more than 2.5 years within its debt securities portfolio. As at 31 March 2011 the duration was 1.82 years (31 March 2010: 2.11 years).

At 31 March 2011, it is estimated that a general increase/decrease of 100 basis points in interest rates, with all other variables held constant, would decrease/increase the Fund's gains on revaluation of debt securities and the accumulated surplus by approximately $32,492,000 (2010: $35,039,000). Further, at 31 March 2011, it is estimated that a general increase of 100 basis points in interest rates, with all other variables held constant, would increase the Fund's interest income and the accumulated surplus by approximately $4,398,000 (2010: $3,217,000). The extent of any decrease in interest rate is expected to be minimal which would decrease the Fund's surplus by an insignificant amount. Other components of the accumulated surplus would not be affected (2010: Nil) by the changes in interest rates.

The sensitivity analysis above indicates the instantaneous change in the Fund's accumulated surplus that would arise assuming that the change in interest rates had occurred at the end of the reporting period and had been applied to re-measure those financial instruments held by the Fund which expose the Fund to fair value interest rate risk at the end of the reporting period. The analysis is performed on the same basis for the year ended 31 March 2010.

(d) Foreign currency risk

The Fund's investment policy allows the Fund to have US dollar foreign exchange exposure. As the HK dollar is pegged with the US dollar, the Fund was not exposed to significant foreign exchange risk.

(e) Market risk

The investment activities of the Fund expose it to various types of market risks which are associated with the markets in which it invests, to the extent of the amount invested in debt and equity securities. Such risk will be reflected in the price and the carrying value of the financial assets concerned.

The Fund invests in units of a pooled fund, which mainly comprises listed equity securities, the performance of which is measured against the benchmark index MSCI AC Pacific ex Japan. It is estimated that a general increase/decrease of 24.9% in the benchmark index would increase/decrease the Fund's surplus and the accumulated surplus by approximately $48,337,000 (2010: a general increase/decrease of 24.2% in the benchmark index would increase/decrease the Fund's surplus and the accumulated surplus by approximately $35,982,000).

The sensitivity analysis above indicates the instantaneous change in the Fund's accumulated surplus that would arise assuming that the changes in the benchmark index had occurred at the end of the reporting period and had been applied to re-measure those financial instruments held by the Fund which expose the Fund to equity price risk at the end of the reporting period. It is also assumed that the fair values of the Fund's investment in pooled fund would change in accordance with the historical correlation with the relevant benchmark index since the portfolio is diversified in terms of industry distribution and that all other variables remain constant. The analysis is performed on the same basis for 2010.

Notes to the financial statements (Cont'd)

For the year ended 31 March 2011

13. Financial risk management and fair values (Cont'd)

(f) Fair values of financial instruments

The following table presents the carrying value of financial instruments measured at fair value at the end of the reporting period across the three levels of the fair value hierarchy defined in IFRS 7, *Financial Instruments: Disclosures*, with the fair value of each financial instrument categorised in its entirety based on the lowest level of input that is significant to that fair value measurement. The levels are defined as follows:

- Level 1 (highest level): fair values measured using quoted prices (unadjusted) in active markets for identical financial instruments
- Level 2: fair values measured using quoted prices in active markets for similar financial instruments, or using valuation techniques in which all significant inputs are directly or indirectly based on observable market data
- Level 3: (lowest level): fair values measured using valuation techniques in which any significant input is not based on observable market data

All financial instruments are carried at amounts not materially different from their fair values as at 31 March 2011 and 2010.

Where available, the fair value of the debt securities is the quoted market price. The fair value of unlisted debt securities is determined based on quotes from bond market-makers.

The fair value of the investment in the unlisted pooled fund is determined based on the Fund's share in the net assets of the pooled fund as determined by the custodian. The majority of the underlying assets of the pooled fund are listed securities.

Changes in the market conditions could materially affect fair value estimates. Any increase or decrease in the fair values of financial instruments would affect profit or loss in future years.

	2011			
	Level 1 $'000	Level 2 $'000	Level 3 $'000	Total $'000
Assets				
Trading securities				
– Listed	663,537	125,423	–	788,960
– Unlisted	72,133	747,490	–	819,623
Pooled fund				
– Unlisted	224,824	–	–	224,824
	960,494	872,913	–	**1,833,407**

13. Financial risk management and fair values (Cont'd)

(f) Fair values of financial instruments (Cont'd)

	2010			
	Level 1 $'000	Level 2 $'000	Level 3 $'000	Total $'000
Assets				
Trading securities				
– Listed	396,807	63,001	–	459,808
– Unlisted	277,500	780,495	–	1,057,995
Pooled fund				
– Unlisted	184,523	–	–	184,523
	858,830	843,496	–	1,702,326

During the year there were no significant transfers between financial instruments in Level 1 and Level 2.

14. Contingent liabilities

As at the date of this report, in addition to the provision made, as described in note 8, there are other claims received for which currently there is insufficient information to determine the likely level of payment. The maximum liability in respect of these claims is $600,000 (2010: $450,000). This is determined based on the lower of the maximum compensation limit of $150,000 per claimant or the amount claimed.

15. Possible impact of amendments, new standards and interpretations issued but not yet effective for the year ended 31 March 2011

Up to the date of issue of these financial statements, the IASB has issued a number of amendments and Interpretations and one new standard which are not yet effective for the year ended 31 March 2011 and which have not been adopted in these financial statements.

	Effective for accounting periods beginning on or after
Revised IAS 24, *Related party disclosures*	1 January 2011
IFRS 9, *Financial instruments*	1 January 2013

The Fund is in the process of making an assessment of what the impact of these amendments 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.