

Notes to the Condensed Consolidated Accounts

(Financial figures are expressed in Hong Kong dollars)



1. BASIS OF PREPARATION AND ACCOUNTING POLICIES

These unaudited condensed consolidated interim accounts are prepared in accordance with Hong Kong Statement of Standard Accounting Practice (SSAP) 25: Interim Financial Reporting, issued by the Hong Kong Society of Accountants (HKSA).

These condensed consolidated interim accounts should be read in conjunction with the 2003 annual accounts.

The accounting policies and methods of computation used in the preparation of these accounts are consistent with those used in the annual accounts for the year ended 31 December 2003.

2. TURNOVER

Turnover comprises trading fees and trading tariff from securities and options traded on The Stock Exchange of Hong Kong Limited (the Stock Exchange) and derivatives contracts traded on Hong Kong Futures Exchange Limited (the Futures Exchange), Stock Exchange listing fees, clearing and settlement fees, depository, custody and nominee services fees, income from sale of information, investment income (including investment income net of interest expenses of Clearing House Funds) and other income, which are **disclosed as Income** in the condensed consolidated profit and loss account.



Notes to the Condensed Consolidated Accounts

3. SEGMENT INFORMATION

The Group's income is derived solely from business activities in Hong Kong. An analysis of the Group's income and results for the period by business segments is as follows:

	Unaudited Six months ended 30 Jun 2004				
	Cash Market \$'000	Derivatives Market \$'000	Clearing Business \$'000	Information Services \$'000	Group \$'000
Income	513,727	149,239	344,266	159,630	1,166,862
Costs	265,151	70,924	191,931	37,621	565,627
Segment results	248,576	78,315	152,335	122,009	601,235
Share of profits of associated companies	2	–	6,163	–	6,165
Segment profits before taxation	248,578	78,315	158,498	122,009	607,400
Taxation					(102,407)
Profit attributable to shareholders					<u>504,993</u>

	Unaudited Six months ended 30 Jun 2003				
	Cash Market \$'000	Derivatives Market \$'000	Clearing Business \$'000	Information Services \$'000	Group \$'000
Income	360,924	162,867	255,583	127,674	907,048
Costs	320,647	104,803	181,759	53,482	660,691
Segment results	40,277	58,064	73,824	74,192	246,357
Share of profits of associated companies	35	–	3,228	–	3,263
Segment profits before taxation	40,312	58,064	77,052	74,192	249,620
Taxation					(35,234)
Profit attributable to shareholders					<u>214,386</u>

Notes to the Condensed Consolidated Accounts

3. SEGMENT INFORMATION (CONTINUED)

The **Cash Market** business mainly refers to the operations of the Stock Exchange, which covers all products traded on the cash market platforms, such as equities, debt securities, unit trusts, warrants and rights. Currently, the Group operates two cash market platforms, the Main Board and the Growth Enterprise Market. The major sources of income of the business are trading fees, trading tariff and listing fees. Direct costs of Listing Function (which were previously included under the Others Segment) are treated as segment costs under the Cash Market Segment. Comparatives for 2003 have been reclassified retrospectively to conform to this practice. Costs of Listing Function are further explained in note 5.

The **Derivatives Market** business refers to the derivatives products traded on the Futures Exchange and stock options traded on the Stock Exchange, which includes the provision and maintenance of trading platforms for a range of derivatives products, such as equity and interest rate futures and options. Its income mainly comprises trading fees and net interest income on the margin funds received.

The **Clearing Business** refers to the operations of the three Clearing Houses, namely Hong Kong Securities Clearing Company Limited (HKSCC), The SEHK Options Clearing House Limited (SEOCH) and HKFE Clearing Corporation Limited (HKCC), which are responsible for clearing, settlement and custodian activities and the related risk management of the cash and derivatives markets operated by the Group. Its income is derived primarily from interest earned on the Clearing House Funds and fees from providing clearing, settlement, depository and nominee services.

The **Information Services Segment** is responsible for developing and promoting e-commerce products, compiling and developing index and statistical data, and sales and business development of market data. Its income comprises primarily income from sale of Cash Market and Derivatives Market information. Since Information Services activities share similar business risks as the Cash and Derivatives Market segments, results of Information Services activities were previously grouped under the two business segments based on the nature of their business risks (e.g., income from sales of Cash Market information under the Cash Market). As Information Services activities generate a significant amount of income for the Group, from year ended 31 December 2003 onwards, their results are disclosed under a separate Information Services Segment. Accordingly, comparatives for 2003 have been reclassified to conform to the new disclosure.

Notes to the Condensed Consolidated Accounts

3. SEGMENT INFORMATION (CONTINUED)

In addition to the above, central income (mainly investment income of Corporate Funds) and central costs (mainly costs of the support functions that centrally provide services to all of the business segments) are allocated to the business segments and included in the segment income and costs. Accordingly, comparatives for 2003 have been reclassified to conform to this practice.

4. TRADING FEES AND TRADING TARIFF

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Trading fees and trading tariff are derived from:		
Securities traded on the Cash Market	236,807	98,578
Derivatives contracts traded on the Derivatives Market	110,365	85,931
	347,172	184,509

5. STOCK EXCHANGE LISTING FEES

Stock Exchange listing fees comprise the following:

	Unaudited Six months ended 30 Jun 2004			Unaudited Six months ended 30 Jun 2003		
	Equity \$'000	Debt & derivatives \$'000	Total \$'000	Equity \$'000	Debt & derivatives \$'000	Total \$'000
Income						
Annual listing fees	122,596	1,068	123,664	117,042	1,764	118,806
Initial listing fees	21,750	28,148	49,898	25,375	11,560	36,935
Prospectus vetting fees	1,855	–	1,855	1,150	–	1,150
Other listing fees	4,473	3,080	7,553	3,168	–	3,168
	150,674	32,296	182,970	146,735	13,324	160,059

Notes to the Condensed Consolidated Accounts

5. STOCK EXCHANGE LISTING FEES (CONTINUED)

Listing fee income is fees paid by issuers to enable them to gain access to the Stock Exchange and enjoy the privileges and facilities by being admitted, listed and traded on the Stock Exchange.

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Costs of Listing Function		
Staff costs and related expenses	51,119	49,224
Information technology and computer maintenance expenses	1,474	1,177
Premises expenses	3,857	4,398
Legal and professional fees	1,977	10,135
Depreciation and amortisation	8,405	6,906
Payment to SFC under dual filing regime	10,000	5,000
Other operating expenses	4,290	3,056
	81,122	79,896

The costs listed above are regulatory in nature, which comprise direct costs of the Listing Function on vetting IPOs and enforcing the Listing Rules, disseminating information relating to listed companies, and payments to the Securities and Futures Commission (the SFC) under dual filing regime. Other indirect costs, comprising costs incurred by other units on building the reputation of the Stock Exchange (e.g., marketing and promotion, brand-building, and providing an efficient market infrastructure and market access facilities) to attract issuers to list on the Stock Exchange, which contribute to the Stock Exchange listing fee income above, are not included as they are part and parcel of the activities of the Group and cannot be separately quantified. Moreover, the costs do not cover costs of support services and other central overheads attributable to the Listing Function.

Notes to the Condensed Consolidated Accounts

6. INVESTMENT INCOME

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Interest income		
– bank deposits	9,028	33,116
– listed securities	18,625	21,933
– unlisted securities	45,028	56,566
	72,681	111,615
Interest expenses	(119)	(969)
Net interest income	72,562	110,646
Accommodation income on cash margin deposits in non-contract settlement currencies and securities deposited by Participants as alternatives to cash deposits of the margin funds	3,789	8,669
Non-interest investment income		
Net realised and unrealised gain/(loss) on investments (note a)		
– listed trading and non-trading securities	10,490	23,230
– unlisted trading and non-trading securities	(5,814)	13,547
– exchange difference	(5,078)	19,210
	(402)	55,987
Dividend income		
– non-trading securities	1,070	1,049
– trading securities	3,352	1,939
	4,422	2,988
Total non-interest investment income	4,020	58,975
Total investment income	80,371	178,290
Total investment income is derived from:		
Corporate Funds (note b)	44,226	124,312
Margin funds	31,416	43,088
Clearing House Funds	4,729	10,890
	80,371	178,290

Notes to the Condensed Consolidated Accounts

6. INVESTMENT INCOME (CONTINUED)

- (a) Includes net realised gain on disposal of non-trading securities of \$101,000 (2003: \$6,586,000), of which \$101,000 (2003: \$3,763,000) has been previously recognised in investment revaluation reserve.
- (b) Corporate Funds include investment income of Compensation Fund Reserve Account of \$263,000 (2003: \$391,000) and Cash and Derivatives Market Development Fund (CDMD Fund) of \$12,000 (2003: \$44,000).

7. OTHER INCOME

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Exchange network, terminal user, dataline and software sub-license fees	55,574	48,617
Participants' subscription and application fees	17,230	18,543
Share registration services fees	1,030	727
Brokerage on direct IPO applications	8,382	133
Miscellaneous income	4,686	3,012
	86,902	71,032

8. OTHER OPERATING EXPENSES

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Write-down of strategic investments (note a)	–	32,667
Retirement of redundant IT systems	157	9,846
Impairment of other property – revaluation deficit	–	4,411
Provision for doubtful debts	130	3,574
Insurance	8,245	5,984
Financial data subscription fees	3,933	4,504
Custodian and fund management fees	3,963	4,238
Bank charges	3,959	3,098
Repair and maintenance expenses	3,389	3,250
Other miscellaneous expenses	19,912	19,614
	43,688	91,186

- (a) Write-down of strategic investments for 2003 includes a 100 per cent write-down (\$32,303,000) of the Group's investment in BondsInAsia Limited under non-trading securities following a review of the Group's business strategy and operations.

Notes to the Condensed Consolidated Accounts

9. TAXATION

Taxation in the condensed consolidated profit and loss account represents:

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Provision for Hong Kong Profits Tax (note a)	109,535	37,352
Deferred taxation (note b)	(8,473)	(2,871)
	101,062	34,481
Share of taxation of associated companies	1,345	753
	102,407	35,234

- (a) Hong Kong Profits Tax has been provided for at 17.5 per cent (2003: 17.5 per cent) on the estimated assessable profit for the period.
- (b) Deferred taxation for 2003 includes a one-off deferred tax charge of \$6,040,000, which arose from recomputing outstanding deferred tax liabilities carried forward from 2002 using the higher tax rate of 17.5 per cent and the adoption of SSAP12: Income Taxes in 2003.

10. EARNINGS PER SHARE

The calculation of basic earnings per share is based on the profit attributable to shareholders of \$504,993,000 (2003: \$214,386,000) and the weighted average of 1,053,391,703 shares (2003: 1,044,626,393) in issue during the six-month period.

The employee share options outstanding did not have a material dilutive effect on the basic earnings per share.

Notes to the Condensed Consolidated Accounts

11. FIXED ASSETS

The Group is heavily reliant on the capability and reliability of its computer systems for its business operations, including those required for its electronic trading platforms and for post-trading clearing and settlement services. The total cost of additions to fixed assets of the Group during the six months to 30 June 2004 was \$12,439,000 (2003: \$17,811,000) of which \$11,035,000 (2003: \$15,858,000) or 89 per cent (2003: 89 per cent) was on computer systems, hardware and software. The total cost and net book value of disposals and write-offs of fixed assets during the six months to 30 June 2004 were \$140,159,000 and \$305,000 respectively (2003: \$164,823,000 and \$10,048,000 respectively). During the period, the estimated useful life of hardware of trading and clearing systems was revised from 3 years to 5 years to better reflect the useful life of the equipment.

The Group's investment property and land and buildings were revalued as at 30 June 2004 on the basis of their open market value by Jones Lang LaSalle, an independent firm of qualified property valuers.

The value of the investment property remained unchanged during the six months ended 30 June 2004 (2003: deficit of \$200,000 was charged to the investment properties revaluation reserve).

A revaluation surplus of \$18,237,000 (\$22,107,000 net of applicable deferred taxes of \$3,870,000) for the land and buildings was credited to the other properties revaluation reserve during the six months ended 30 June 2004 (note 20). For the six months ended 30 June 2003, a revaluation deficit of \$7,508,000 (\$8,271,000 net of applicable deferred taxes of \$763,000) was taken to other properties revaluation reserve and \$4,411,000 was charged to the profit and loss account.

Notes to the Condensed Consolidated Accounts

12. INVESTMENTS IN ASSOCIATED COMPANIES

	Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000
Share of net assets of associated companies	11,851	11,707
Goodwill on acquisition of shares in associated companies less amortisation and impairment (note a)	20,971	22,295
	32,822	34,002

(a) Goodwill

	\$'000
Cost	
At 1 Jan 2004 and 30 Jun 2004	<u>26,889</u>
Accumulated amortisation and impairment	
At 1 Jan 2004	4,594
Charge for the period	<u>1,324</u>
At 30 Jun 2004	<u>5,918</u>
Net book value	
At 30 Jun 2004	<u>20,971</u>
At 31 Dec 2003	<u>22,295</u>

(b) Goodwill is amortised on a straight-line basis over 10 years.

Notes to the Condensed Consolidated Accounts

12. INVESTMENTS IN ASSOCIATED COMPANIES (CONTINUED)

(c) Details of the unlisted associated companies as at 30 June 2004 are as follows:

Name	Place of incorporation	Principal activities	Particulars of shares held	Interest held
Computershare Hong Kong Investor Services Limited	Hong Kong	Provision of share registration services	5,854 Class A ordinary shares	24%
ADP Wilco Processing Services Limited	Hong Kong	Provision of transaction processing services to Stock Exchange Participants	6 Class B ordinary shares	30%

ADP Wilco Processing Services Limited has an accounting year end of 30 June, which is not coterminous with the Group's accounting year end.

Notes to the Condensed Consolidated Accounts

13. CLEARING HOUSE FUNDS

	Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000
Net asset values of the Clearing House Funds are as follows:		
HKSCC Guarantee Fund	371,406	371,289
SEOCH Reserve Fund	128,121	131,274
HKCC Reserve Fund	642,487	1,048,767
	1,142,014	1,551,330
Net assets of the Clearing House Funds are composed of:		
Unlisted non-trading securities, at fair value		
– debt securities	124,574	125,643
Contributions receivable from Clearing Participants fully secured by bank guarantees	55,310	92,234
Bank balances and time deposits	975,281	1,349,644
	1,155,165	1,567,521
Less: Other liabilities	(13,151)	(16,191)
	1,142,014	1,551,330
The Clearing House Funds are funded by:		
Clearing Participants' contributions		
– cash	519,586	891,811
– bank guarantees	55,310	92,234
Clearing houses' contributions	320,200	320,200
Forfeiture of defaulted Clearing Participants' contributions	1,928	1,928
Accumulated investment income net of expenses included in designated reserves attributable to		
– Clearing Participants' contributions	184,297	183,305
– Clearing houses' contributions	60,399	60,233
Revaluation reserve (note 20(b))	294	1,619
	1,142,014	1,551,330

Notes to the Condensed Consolidated Accounts

13. CLEARING HOUSE FUNDS (CONTINUED)

The HKSCC Guarantee Fund provides resources to enable HKSCC to discharge the liabilities and obligations of defaulting Broker Participants in Central Clearing and Settlement System (CCASS) arising from their Stock Exchange trades accepted for settlement on the Continuous Net Settlement (CNS) basis and defective securities deposited into CCASS. The SEOCH Reserve Fund and the HKCC Reserve Fund were established for the exclusive purpose of supporting SEOCH and HKCC to fulfil their counterparty obligations in the event that one or more of their Clearing Participants fail to meet their obligations to SEOCH and HKCC respectively.

For the HKSCC Guarantee Fund, investment income was insufficient to cover the fund's expenses during the six months ended 30 June 2004 and a loss of \$3,064,000 (2003: \$451,000) arose. Accumulated losses of \$5,326,000 were included in the Group's retained earnings as at 30 June 2004 (31 December 2003: \$2,262,000). Future surplus investment income net of expenses of the fund will be offset against such accumulated losses before appropriation from the Group's retained earnings to the fund.

14. COMPENSATION FUND RESERVE ACCOUNT

The SFC is responsible for maintaining the Unified Exchange Compensation Fund (Compensation Fund). By virtue of Schedule 10 of the Securities and Futures Ordinance (SFO), the Stock Exchange's obligation under the repealed Securities Ordinance (SO) to deposit with the SFC and keep deposited \$50,000 in respect of each Stock Exchange Trading Right in the Compensation Fund remains. The Stock Exchange maintains an account known as the Compensation Fund Reserve Account for all receipts and payments in relation to the Compensation Fund under the Rules of the Exchange, in particular the following:

- (a) The interest received from the SFC on the statutory deposits paid in respect of each Stock Exchange Trading Right into the Compensation Fund maintained by the SFC;
- (b) Amounts received or paid out in relation to each of the Stock Exchange Trading Rights granted or revoked by the Stock Exchange respectively; and
- (c) Amounts reserved for the replenishment of the Compensation Fund.

The Compensation Fund is further explained in note 26(a).

Notes to the Condensed Consolidated Accounts

15. CASH AND DERIVATIVES MARKET DEVELOPMENT FUND

The CDMD Fund was established by the cash received from The Hong Kong Futures Guarantee Corporation Limited (the former clearing house of the Futures Exchange) for the purpose of providing funding for the development and betterment of the cash and derivatives markets in Hong Kong.

During the period ended 30 June 2004, \$243,000 (2003: \$Nil) of the CDMD Fund was utilised and transferred from the CDMD Fund reserve to the Group's retained earnings (note 22) for marketing expenses of certain derivatives products. The remaining sum of \$672,000 is expected to be utilised in the next twelve months.

16. MARGIN FUNDS ON DERIVATIVES CONTRACTS

	Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000
The margin funds comprise:		
SEOCH Clearing Participants' margin funds	1,184,570	1,083,679
HKCC Clearing Participants' margin funds	7,704,364	6,790,831
	8,888,934	7,874,510
The assets of the margin funds comprise:		
Bank balances and time deposits	4,685,092	4,900,011
Listed securities deposited as alternatives to cash deposits, at market value	932,388	805,430
Listed non-trading securities, at fair value – debt securities	260,246	102,780
Unlisted non-trading securities, at fair value – debt securities	3,011,208	2,066,289
	8,888,934	7,874,510
The Group's liabilities in respect of the margin funds are as follows:		
Margin deposits and securities received from SEOCH and HKCC Participants on derivatives contracts	8,888,934	7,874,510

Notes to the Condensed Consolidated Accounts

17. ACCOUNTS RECEIVABLE, PREPAYMENTS AND DEPOSITS/ACCOUNTS PAYABLE, ACCRUALS AND OTHER LIABILITIES

The Group's accounts receivable, prepayments and deposits and accounts payable, accruals and other liabilities amounted to \$2,173,389,000 (31 December 2003: \$4,644,680,000) and \$2,409,698,000 (31 December 2003: \$4,779,904,000) respectively. These mainly represent the Group's CNS money obligations under the T+2 settlement cycle. The Group's CNS money obligations receivable represents 86 per cent (31 December 2003: 87 per cent) of the total accounts receivable, prepayments and deposits. CNS money obligations payable represents 78 per cent (31 December 2003: 84 per cent) of the total accounts payable, accruals and other liabilities. CNS money obligations mature within two days as they are due for settlement two days after the trade date. The majority of the remaining accounts receivable, prepayments, deposits, accounts payable, accruals and other liabilities will mature within three months.

18. PROVISIONS

	Reinstatement costs \$'000	Employee benefit costs \$'000	Total \$'000
At 1 Jan 2004	24,578	23,525	48,103
Provision for the period	–	16,698	16,698
Amount used during the period	–	(14,254)	(14,254)
Amount paid during the period	(190)	(2,095)	(2,285)
At 30 Jun 2004	24,388	23,874	48,262
		Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000
Analysis of provisions:			
Current		24,178	25,011
Non-current		24,084	23,092
		48,262	48,103

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19. SHARE CAPITAL AND SHARE PREMIUM

		Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000	
Authorised:				
2,000,000,000 shares of \$1 each		2,000,000	2,000,000	
Issued and fully paid:				
	No. of shares of \$1 each	Share capital \$'000	Share premium \$'000	Total \$'000
At 1 Jan 2003	1,043,580,846	1,043,581	19,012	1,062,593
Shares issued under employee share option schemes	5,418,000	5,418	35,326	40,744
At 31 Dec 2003	1,048,998,846	1,048,999	54,338	1,103,337
Shares issued under employee share option schemes	7,474,000	7,474	48,720	56,194
At 30 Jun 2004	1,056,472,846	1,056,473	103,058	1,159,531

Under the Pre-Listing Share Option Scheme (Pre-Listing Scheme) of HKEx, share options were granted to employees on 20 June 2000 which are exercisable between 6 March 2002 and 30 May 2010 at an exercise price of \$7.52 per share. Following the declaration of a special dividend and final dividend for 2003, at the annual general meeting (AGM) held on 31 March 2004, shareholders of HKEx approved the adjustments to the subscription price and the contract size of the outstanding options granted under the Pre-Listing Scheme. The subscription price of the shares issuable under the options granted was adjusted from \$7.52 per share to \$6.88 per share and the aggregate contract size of the options granted but not yet exercised as at 31 March 2004 was adjusted from 6,615,465 shares to 7,288,668 shares.

Under the Post-Listing Share Option Scheme (Post-Listing Scheme) of HKEx, share options were granted to:

- (a) an executive director on 2 May 2003 which are exercisable between 2 May 2005 and 1 May 2013 at an exercise price of \$9.05 per share;

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19. SHARE CAPITAL AND SHARE PREMIUM (CONTINUED)

- (b) an employee on 14 August 2003 which are exercisable between 14 August 2005 and 13 August 2013 at an exercise price of \$13.60 per share;
- (c) an employee on 18 August 2003 which are exercisable between 18 August 2005 and 17 August 2013 at an exercise price of \$13.65 per share;
- (d) an employee on 15 January 2004 which are exercisable between 15 January 2006 and 14 January 2014 at an exercise price of \$18.90 per share;
- (e) a number of employees on 31 March 2004 which are exercisable between 31 March 2006 and 30 March 2014 at an exercise price of \$16.96 per share; and
- (f) an employee on 17 May 2004 which are exercisable between 17 May 2006 and 16 May 2014 at an exercise price of \$15.91 per share.

At the AGM held on 31 March 2004, shareholders of HKEx approved the adjustments to the subscription price and the contract size of the options granted under the Post-Listing Scheme in (a) to (d) above that were not yet exercised prior to the AGM. The adjustments made to the first four option grants under the Post-Listing Scheme are as follows:

Date of grant	Exercise price after adjustment	Number of shares issuable under the options granted before adjustment	Number of shares issuable under the options granted after adjustment
2 May 2003	\$8.28	3,000,000	3,280,000
14 August 2003	\$12.45	1,000,000	1,094,000
18 August 2003	\$12.49	1,800,000	1,968,000
15 January 2004	\$17.30	1,000,000	1,094,000

During the period, Pre-Listing employee share options were exercised to subscribe for 7,474,000 shares (year ended 31 December 2003: 5,418,000) in HKEx at a consideration of \$7.52 per share on or before 31 March 2004 and \$6.88 per share after 31 March 2004, of which \$1.00 per share was credited to share capital and the balance was credited to the share premium account.

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19. SHARE CAPITAL AND SHARE PREMIUM (CONTINUED)

Movements of the employee share options during the period were as follows:

	Number of shares issuable under the employee share options outstanding as at 1 Jan 2004	Number of shares issuable under the new employee share options granted during the period	Number of shares issuable under the employee share options granted pursuant to the adjustment approved at the AGM	Number of shares issuable under the employee share options lapsed during the period	Number of shares issued under the employee share options exercised during the period	Number of shares issuable under the employee share options outstanding as at 30 Jun 2004
Pre-Listing Scheme	14,171,626	–	673,203	(362,829)	(7,474,000)	7,008,000
Post-Listing Scheme	5,800,000	6,888,000	636,000	(14,000)	–	13,310,000
	19,971,626	6,888,000	1,309,203	(376,829)	(7,474,000)	20,318,000

Currently, when the employee share options are exercised and new shares are issued, the share capital is increased by the nominal value of the new shares issued and the share premium account is increased by the remainder of the proceeds. HKEx has not expensed the employee share options to the profit and loss account. Had all the outstanding employee share options been fully exercised on 30 June 2004, the Group would have received \$231,913,300 in proceeds. The market value of the shares issued based on the closing price of \$16.00 per share on that date would have been \$325,088,000. The employees concerned under the Pre-Listing Scheme would have made a gain of \$9.12 per share, or, in aggregate, \$63,912,960. The executive director concerned under the Post-Listing Scheme would have made a gain of \$7.72 per share, or, in aggregate, \$25,321,600. The three employees concerned under the Post-Listing Scheme granted on 14 August 2003, 18 August 2003 and 17 May 2004 would have made a gain of \$3.55 per share, or, in aggregate, \$3,883,700, \$3.51 per share, or, in aggregate, \$6,907,680 and \$0.09 per share, or, in aggregate, \$18,000 respectively.

In April 2004, the HKSA issued a Hong Kong Financial Reporting Standard, HKFRS2: Share-based Payment, which covers the accounting treatment for employee share options. The new HKFRS2 is effective for accounting periods beginning on or after 1 January 2005.

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20. REVALUATION RESERVES

	Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000
Investment properties revaluation reserve	1,771	1,771
Other properties revaluation reserve (note 11)	28,905	10,668
Investment revaluation reserve (note b)	1,569	33,992
	32,245	46,431

- (a) The revaluation reserves are segregated for their respective specific purposes and are stated net of applicable deferred taxes.
- (b) Includes \$294,000, \$1,000 and \$95,000 (31 December 2003: \$1,619,000, \$11,000 and \$318,000 respectively) of gross revaluation surplus which are attributable to investments of the Clearing House Funds, the CDMD Fund and the Compensation Fund Reserve Account respectively. The significant decrease in investment revaluation reserve is mainly due to the decrease in fair value of non-trading securities of the margin funds.

21. DESIGNATED RESERVES

	Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000
Clearing House Funds reserves		
– HKSCC Guarantee Fund reserve	255,912	255,912
– SEOCH Reserve Fund reserve	48,589	48,571
– HKCC Reserve Fund reserve	262,323	261,183
	566,824	565,666
Compensation Fund Reserve Account reserve	36,804	36,541
CDMD Fund reserve	671	914
Development reserve (note b)	83,377	86,536
	687,676	689,657

- (a) These reserves are segregated for their respective purposes.
- (b) Development reserve was set aside for systems development for the Stock Exchange. During the period ended 30 June 2004, \$3,159,000 (2003: \$39,364,000) of the reserve was utilised and transferred to the Group's retained earnings (note 22) for funding systems development projects relating to the securities market.

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22. RETAINED EARNINGS

	Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000
At 1 Jan		
Retained earnings	1,560,940	3,221,321
Proposed and declared dividends	2,202,898	448,740
Profit for the period/year (note a)	504,993	691,765
Investment income net of expenses of Clearing House Funds for the period/year transferred to Clearing House Funds reserves	(1,158)	(8,430)
Investment income net of expenses of Compensation Fund Reserve Account for the period/year transferred to Compensation Fund Reserve Account reserve	(263)	(714)
Transfer from CDMD Fund reserve (note 15)	243	–
Transfer from Development reserve (note 21)	3,159	49,226
Dividends paid:		
2003 interim dividend	–	(188,452)
2003 special and final dividends/2002 final dividends	(2,202,898)	(448,740)
Dividend on shares issued for employee share options exercised after declaration of 2003 special and final dividends/2002 final dividends	(15,661)	(647)
Dividend on shares issued for employee share options exercised after declaration of 2003 interim dividend	–	(231)
At 30 Jun/31 Dec	<u>2,052,253</u>	<u>3,763,838</u>
Representing:		
Retained earnings	1,597,970	1,560,940
Proposed and declared dividends	454,283	2,202,898
At 30 Jun/31 Dec	<u>2,052,253</u>	<u>3,763,838</u>

- (a) The Group's profit for the period/year includes a net deficit attributable to investment income net of expenses of the Clearing House Funds, Compensation Fund Reserve Account and CDMD Fund for an aggregate amount of \$1,631,000 (year ended 31 December 2003: surplus of \$6,938,000).

Notes to the Condensed Consolidated Accounts

23. NOTES TO THE CONDENSED CONSOLIDATED CASH FLOW STATEMENT

(a) Reconciliation of profit before taxation to net cash inflow from operating activities

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Profit before taxation	607,400	249,620
Adjustments for:		
Net interest income	(72,562)	(110,646)
Accommodation income on cash margin deposits in non-contract settlement currencies and securities deposited by Participants as alternatives to cash deposits of the margin funds	(3,789)	(8,669)
Dividends received from non-trading securities	(1,070)	(1,049)
Loss/(gain) on trading securities and exchange differences on investments	286	(33,530)
Depreciation and amortisation	92,520	93,025
Impairment of non-trading securities	–	32,303
Impairment of investments in associated companies	–	364
Impairment of other property	–	4,411
Changes in provisions	159	(3,815)
Provision for doubtful debts	130	3,574
Share of profits of associated companies	(6,165)	(3,263)
Loss on retirement of redundant IT systems	157	9,846
(Gain)/loss on disposal of other fixed assets	(7)	126
Operating profit before working capital changes	617,059	232,297
Net decrease in trading securities	623,931	300,709
Settlement of amount transferred from retained earnings to Clearing House Funds and Compensation Fund Reserve Account	(1,421)	(6,007)
Settlement of amount transferred from CDMD Fund reserve to retained earnings	243	–
Decrease in accounts receivable, prepayments and deposits	2,432,610	1,363,350
Decrease in other current liabilities	(2,478,468)	(1,266,083)
Net cash inflow from operations	1,193,954	624,266

Notes to the Condensed Consolidated Accounts

23. NOTES TO THE CONDENSED CONSOLIDATED CASH FLOW STATEMENT (CONTINUED)

- (a) Reconciliation of profit before taxation to net cash inflow from operating activities
(continued)

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Interest received	57,851	100,617
Accommodation income on cash margin deposits in non-contract settlement currencies and securities deposited by Participants as alternatives to cash deposits of the margin funds	3,789	8,669
Interest paid	(25)	(1,118)
Hong Kong Profits Tax paid	(36)	(18,335)
Net cash inflow from operating activities	1,255,533	714,099

- (b) Analysis of cash and cash equivalents

	Unaudited Six months ended 30 Jun 2004 \$'000	Unaudited Six months ended 30 Jun 2003 \$'000
Time deposits with original maturity within three months	597,587	975,468
Cash at bank and in hand	119,780	48,152
Cash and cash equivalents at 30 Jun	717,367	1,023,620

- (c) The net assets in Clearing House Funds, Compensation Fund Reserve Account and margin funds are held in segregated accounts for specific purposes. Movements in individual items of the net assets of the funds during the period therefore do not constitute any cash or cash equivalent transactions to the Group.

Notes to the Condensed Consolidated Accounts

24. COMMITMENTS

	Unaudited at 30 Jun 2004 \$'000	Audited at 31 Dec 2003 \$'000
Commitments in respect of capital expenditures:		
Contracted but not provided for	4,786	18,359
Authorised but not contracted for	44,411	72,275
	49,197	90,634

The commitments in respect of capital expenditures were mainly for the development and purchases of computer systems.

25. FINANCIAL RISK MANAGEMENT

When seeking to optimise returns on its funds available for investment, the Group may invest in non-HKD securities from time to time. Forward foreign exchange contracts are used to hedge the currency exposures of the Group's non-HKD investments and liabilities to mitigate risks arising from fluctuations in exchange rates. As at 30 June 2004, the total nominal value of outstanding forward foreign exchange contracts amounted to HK\$319 million (31 December 2003: HK\$322 million). All contracts will mature within four months.

26. CONTINGENT LIABILITIES

- (a) The Compensation Fund is a fund set up under the repealed SO for the purpose of compensating any person dealing with a Stock Exchange Participant (other than another Stock Exchange Participant) for any pecuniary losses suffered as a result of a default of the Stock Exchange Participant. According to section 109(3) of the SO, the maximum compensation amount is \$8 million for each Stock Exchange Participant's default. Under section 113(5A) of the SO, the Stock Exchange may, upon satisfying certain conditions, with the approval of the SFC, allow an additional payment to the successful claimants before apportionment. Under section 107(1) of the SO, the Stock Exchange has contingent liabilities to the Compensation Fund as it shall replenish the Compensation Fund upon the SFC's request to do so. The amounts to be replenished should be equal to the amount paid in connection with the satisfaction of the claims, including any legal and other expenses paid or incurred in relation to the claims but capped at \$8 million per default. As at 30 June 2004, there were outstanding claims received in respect of 12 defaulted Stock Exchange Participants (31 December 2003: 13).

Notes to the Condensed Consolidated Accounts

26. CONTINGENT LIABILITIES (CONTINUED)

Pursuant to the SFO, the Stock Exchange issued a notice on 3 April 2003 inviting for claims against the Compensation Fund in relation to any default of a Stock Exchange Participant occurring before 1 April 2003. The claims period expired on 3 October 2003 and no claims had been received in response to that notice. Claims made after the claims period shall, unless the Stock Exchange otherwise determines, be barred. Until 30 June 2004, no such claims had been received.

Following the implementation of the new compensation arrangements under the SFO, an Investor Compensation Fund has been established to replace the existing Compensation Fund, the Commodity Exchange Compensation Fund and the Dealers' Deposit Schemes for non-exchange participant dealers. Pursuant to the SFO, Exchange Participants are no longer required to make deposits to the Investor Compensation Fund and the Stock Exchange is not required to replenish the Investor Compensation Fund. Hence, deposits to the Commodity Exchange Compensation Fund had been returned to the Futures Exchange by the SFC in January 2004. The Futures Exchange had in turn reimbursed holders of Futures Exchange Trading Rights their contributions to the Commodity Exchange Compensation Fund. Similarly, deposits to the Compensation Fund would be returned to the Stock Exchange in accordance with SFO pending completion of the determination of the outstanding claims and replenishment to the Compensation Fund.

- (b) The Stock Exchange has undertaken to indemnify the Collector of Stamp Revenue against any loss of revenue resulting from any underpayment or default or delay in payment of stamp duty by its Participants, up to \$200,000 in respect of default of any one Participant. In the unlikely event that all of its 436 trading Participants as at 30 June 2004 (31 December 2003: 437) default, the maximum contingent liability of the Stock Exchange under the indemnity will amount to \$87 million (31 December 2003: \$87 million).
- (c) HKEx gave an undertaking on 6 March 2000 in favour of HKSCC to contribute an amount not exceeding \$50 million in the event of HKSCC being wound up while it is a wholly-owned subsidiary of HKEx or within one year after HKSCC ceases to be a wholly-owned subsidiary of HKEx, for payment of the debts and liabilities of HKSCC contracted before HKSCC ceases to be a wholly-owned subsidiary of HKEx, and for the costs, charges and expenses of winding up.

Notes to the Condensed Consolidated Accounts

27. MATERIAL RELATED PARTY TRANSACTIONS

Certain Directors of HKEx are directors and/or shareholders of (i) Stock Exchange Participants and Futures Exchange Participants (Exchange Participants) and Clearing Participants; (ii) companies listed on the Stock Exchange; and (iii) Exchange Participants for buying shares on behalf of HKSCC. Securities and derivatives contracts traded by, and fees levied on, these Exchange Participants and Clearing Participants, fees levied on these listed companies and fees paid to these Exchange Participants for buying shares on behalf of HKSCC are all undertaken in the ordinary course of business of the Group on the standard terms and conditions applicable to all other Exchange Participants and Clearing Participants, listed companies and Exchange Participants for buying shares on behalf of HKSCC.

In addition to the above, on 5 February 2003, the Futures Exchange as the tenant entered into a tenancy agreement (the Lease) with Shine Hill Development Limited (Shine Hill) as the landlord. The Futures Exchange is a wholly-owned subsidiary of HKEx. Shine Hill is a subsidiary of Great Eagle Holdings Limited (Great Eagle). Dr LO Ka Shui is an independent non-executive director of HKEx and the managing director of Great Eagle. The Lease was an arm's length transaction entered into on normal commercial terms. The rental payments, including air conditioning and cleaning service charges for the six-month period ended 30 June 2004 amounted to \$1,980,100 (2003: \$1,929,427).

During the period, share registration service fees amounted to \$171,996 (2003: \$345,186) were paid to and dividends and loan interest amounted to \$6,000,350 and \$Nil respectively (2003: \$2,400,140 and \$20,652 respectively) were received from an associated company, Computershare Hong Kong Investor Services Limited.

During the six months ended 30 June 2004, bank charges of \$2,597,091 (2003: \$1,420,780) were paid to The Hongkong & Shanghai Banking Corporation Limited where Dr LO Ka Shui was a non-executive director.

During the corresponding period in 2003, consultancy fee of \$862,285 was paid to Goldman Sachs (Asia) LLC where Mr FRESHWATER, Timothy George, an independent non-executive director of HKEx, is a director. The transaction was carried out in the ordinary course of business on normal commercial terms.

Save as aforesaid, HKEx had entered into other transactions with companies where there are common directors but the amount was immaterial.

Notes to the Condensed Consolidated Accounts

28. OFF-BALANCE SHEET RISKS

In the normal course of business, the clearing houses of the Group, HKSCC, SEOCH and HKCC, act as the counterparties to eligible trades concluded on the Stock Exchange and the Futures Exchange through the novation of the obligations of the buyers and sellers. HKSCC is also responsible for the good title to the securities deposited and accepted in the CCASS depository. As a result, the Group has considerable market risk and credit risk since the Participants' ability to honour their obligations in respect of their trades and securities deposited may be adversely impacted by economic conditions affecting the cash and derivatives markets. If the Participants default on their obligations on settlement or there are defects in the title of securities deposited and accepted in the CCASS depository, the Group could be exposed to potential risks not otherwise accounted for in these condensed consolidated interim accounts.

The Group mitigates its exposure to the risks described above by requiring the Participants to meet the Group's established financial requirements and criteria for admission as Participants, monitoring compliance with risk management measures such as position limits established by the Group and requiring Clearing Participants to contribute to the Clearing House Funds set up by HKSCC, SEOCH and HKCC. HKSCC also retains recourse against those Participants whose securities are deposited and accepted in the CCASS depository. Moreover, insurance has been taken out by the Group to cover the risks.

29. EVENTS AFTER BALANCE SHEET DATE

Subsequent to 30 June 2004, the Group has disposed of its entire investment in Singapore Exchange Limited included under non-trading securities for a consideration of approximately \$76 million and realised a profit over cost of \$24.8 million.

30. COMPARATIVE FIGURES

- (a) The comparative figure of time deposits with maturity over one year has been reclassified to non-current assets in order to conform with the current period's presentation.
- (b) For non-trading securities sold or matured, changes in fair value during the period up to disposal or maturity are no longer recognised as "change in fair value of non-trading securities" during the period and accordingly not reversed in the "realisation of change in fair value of non-trading securities on maturity or disposal" (there is no impact on the profit and loss account). The 2003 comparatives for "change in fair value of non-trading securities" and "realisation of change in fair value of non-trading securities on maturity or disposal" in the Condensed Consolidated Statement of Changes in Equity have been amended to conform to the current period's presentation.