# Notes to the Consolidated Accounts

*(Financial figures are expressed in Hong Kong Dollar)*

## 1. General Information

Hong Kong Exchanges and Clearing Limited ("HKEx") and its subsidiaries (collectively, "Group") own and operate the only stock exchange and futures exchange in Hong Kong and their related clearing houses.

HKEx is a limited company incorporated and domiciled in Hong Kong. The address of its registered office is 12th Floor, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong.

These consolidated accounts were approved for issue by the Board of Directors on 8 March 2006.

## 2. Principal Accounting Policies

### (a) Statement of compliance

These consolidated accounts have been prepared in accordance with 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"), and have been aligned with the requirements of International Financial Reporting Standards in all material respects as at 31 December 2005, accounting principles generally accepted in Hong Kong, requirements of the Hong Kong Companies Ordinance and applicable disclosure requirements of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("Listing Rules").

### (b) Basis of preparation

These consolidated accounts have been prepared under the historical cost convention, as modified by the revaluation of leasehold buildings, investment properties, available-for-sale financial assets and financial assets and financial liabilities at fair value through profit or loss and the marking to market of shares borrowed and receivable by Hong Kong Securities Clearing Company Limited ("HKSCC") for the purpose of settlement under the Continuous Net Settlement ("CNS") basis.

The preparation of financial statements in conformity with HKFRSs requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. The areas involving higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated accounts are disclosed in note 3.

## 2. Principal Accounting Policies *(Continued)*

### (b) Basis of preparation *(Continued)*

*Adoption of new/revised HKFRSs that were effective during 2005*

In 2005, the Group adopted all new/revised HKFRSs that were relevant to its operations, details of which are set out below.

| | |
|---|---|
| HK(SIC)-INT 12 (Amendment) | Scope of HK(SIC)-INT 12 Consolidation – Special Purpose Entities |
| HK-INT 4 | Leases – Determination of the Length of Lease Term in respect of Hong Kong Land Leases |

The adoption of HK (SIC)-INT 12 (Amendment) does not have any financial impact to the Group in 2005 or prior years. In 2005, the Board of HKEx approved an Employees' Share Award Scheme ("Share Award Scheme"), under which shares of HKEx ("Awarded Shares") may be awarded to an Executive Director and employees of the Group. A trust, The HKEx Employees' Share Award Scheme ("HKEx Employee Share Trust"), has been set up and HKEx shares will be acquired by an independent trustee at the cost of HKEx and held in trust for the awardees until the Awarded Shares become vested. Prior to the amended interpretation, the HKEx Employee Share Trust did not need to be consolidated as equity compensation plans were not within the scope of HK(SIC)-INT 12. Following the adoption of the amended interpretation, equity compensation plans fall under the scope of HK(SIC)-INT 12, and the HKEx Employee Share Trust should be consolidated. In accordance with HKAS 27 – Consolidated and Separate Financial Statements, however, as HKEx is a Hong Kong incorporated company, and the HKEx Employee Share Trust was not considered as a subsidiary under the Hong Kong Companies Ordinance as at 31 December 2005, the HKEx Employee Share Trust should not be consolidated. Details of the effect on the consolidated accounts had the HKEx Employee Share Trust been consolidated are disclosed in note 29(d). With the enactment of the Companies (Amendment) Ordinance 2005, which is effective for accounting periods beginning on or after 1 January 2006, the HKEx Employee Share Trust will need to be consolidated into the Group's accounts in 2006. More details are set out under the section entitled "Effects of HKFRSs that had been issued as at 31 December 2005 but not yet effective".

The adoption of HK-INT 4 has no financial impact to the Group as the Group's accounting policies already comply with the interpretation.

## 2. Principal Accounting Policies *(Continued)*

### (b) Basis of preparation *(Continued)*

*Early adoption of HKFRSs*

In the fourth quarter of 2005, the Group early adopted all HKFRSs issued up to 31 December 2005 which were pertinent to its operations where early adoption was permitted. The applicable HKFRSs are set out below:

| | |
|---|---|
| HKFRS 7 | Financial Instruments: Disclosures |
| HKAS 1 (Amendment) | Capital Disclosures |
| HKAS 39 (Amendment) | The Fair Value Option |
| HKAS 39 and HKFRS 4 (Amendment) | Financial Guarantee Contracts |

The early adoption of HKAS 39 (Amendment) – The Fair Value Option does not have any financial impact as the Group's accounting policies already comply with the amendment. The early adoption of HKFRS 7 and HKAS 1 (Amendment) only affects the disclosures on financial instruments and capital.

Financial guarantee contracts were previously only disclosed as contingent liabilities as they did not fall within the scope of HKAS 39. Following the introduction of HKAS 39 and HKFRS 4 (Amendment), financial guarantee contracts should be treated as financial liabilities. Financial guarantee contracts should be measured initially at fair value and subsequently at the higher of (i) the amount determined in accordance with HKAS 37 – Provisions, Contingent Liabilities and Contingent Assets and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised over the life of the guarantee on a straight-line basis.

All relevant changes in accounting policies have been made in accordance with the provisions of the respective standards, which require retrospective application to prior year comparatives, except as follows:

HKAS 39 (Amendment):

- designate previously recognised financial assets or financial liabilities at fair value through profit or loss that qualified for such designation on 1 January 2005; and
- de-designate all financial assets or financial liabilities previously designated at fair value through profit or loss if they did not qualify for such designation on 1 January 2005.

HKAS 39 and HKFRS 4 (Amendment):

- the fair value of financial guarantee contracts is recognised in the balance sheet on the date when HKAS 39 was initially adopted by the Group (i.e. 1 January 2004) by adjusting the retained earnings.

## 2. Principal Accounting Policies *(Continued)*

### (b) Basis of preparation *(Continued)*

*Early adoption of HKFRSs (Continued)*

HKFRS 7:

- comparative information for the disclosures about the nature and extent of risks arising from financial instruments is not required if the standard is adopted for annual periods beginning before 1 January 2006.

*Effects of changes in accounting policies on consolidated balance sheet and HKEx's balance sheet*

The adoption of HKAS 39 and HKFRS 4 (Amendment) has the following impact on the consolidated balance sheet and HKEx's balance sheet as at 1 January 2004, 31 December 2004 and 31 December 2005:

| | Group<br>$'000 | HKEx<br>$'000 |
|---|---|---|
| **Increase in assets** | | |
| Increase in investments in subsidiaries | – | 11,390 |
| **(Increase)/decrease in liabilities/equity** | | |
| Increase in financial guarantee contract | (19,909) | (11,390) |
| Decrease in retained earnings | 19,909 | – |

*Effects of HKFRSs that had been issued as at 31 December 2005 but not yet effective*

The Group has not early adopted one HKFRS, HKAS 27 (Revised) – Consolidated and Separate Financial Statements, which is effective for accounting periods beginning on or after 1 January 2006 as early adoption is not permitted.

The adoption of the revised HKAS 27 will result in a change in accounting policy relating to the consolidation of special purpose entities (including trusts) of the Group. Prior to the revision, trusts could not be consolidated as they are not considered as subsidiaries under the Hong Kong Companies Ordinance. The Companies (Amendment) Ordinance 2005, effective for accounting periods beginning on or after 1 January 2006, removes the legal constraint that prevents a Hong Kong incorporated company from consolidating in its group accounts a subsidiary that does not meet the definition of a subsidiary under the current Hong Kong Companies Ordinance. The Group is, therefore, required to consolidate the HKEx Employee Share Trust, under HKAS 27 (Revised) from 2006 onwards.

Details of the effects on the consolidated accounts had the HKEx Employee Share Trust been consolidated as at 31 December 2005 are disclosed in note 29(d).

## 2. Principal Accounting Policies *(Continued)*

### (b) Basis of preparation *(Continued)*

*Effects of HKFRSs that were issued after 31 December 2005 and up to the date of approval of the consolidated accounts*

At the date of approval of these consolidated accounts, the following HKFRSs were issued after 31 December 2005 but were not applicable to the Group's operations:

| | |
|---|---|
| HK(IFRIC)-Int 7 | Applying the Restatement Approach under HKAS 29 Financial Reporting in Hyperinflationary Economies |
| HKAS 21 (Amendment) | The Effects of Changes in Foreign Exchange Rates – Net Investment in a Foreign Operation |
| HKAS 39 (Amendment) | Financial Instruments: Recognition and Measurement |

### (c) Consolidation

The Group has adopted merger accounting in the preparation of the consolidated accounts at the time of the merger of the Group in 2000. The consolidated accounts include the accounts of HKEx and all of its subsidiaries made up to 31 December.

(i) Subsidiaries

A subsidiary is an entity in which HKEx, directly or indirectly, controls the composition of the board of directors, controls more than half of the voting power or holds more than half of the issued share capital. Where HKEx, directly or indirectly, otherwise controls any special purpose entity as described in HK(SIC)-INT 12 by way of having the power to govern its financial and operating policies so that the Group obtains benefits from its activities, such special purpose entity is not considered as a subsidiary and is not included in the consolidated accounts except by way of note disclosure to show the effects on the consolidated accounts had the special purpose entity been consolidated.

The accounts of subsidiaries are included in the consolidated accounts from the date on which control commences until the date that control ceases. All material intra-group transactions and balances have been eliminated on consolidation.

In HKEx's balance sheet, investments in subsidiaries are stated at cost less provision for any impairment, if necessary. The results of subsidiaries are accounted for by HKEx on the basis of dividends received and receivable.

## 2. Principal Accounting Policies *(Continued)*

### (c) Consolidation *(Continued)*

(ii) Associates

An associate is a company, not being a subsidiary nor an interest in a joint venture, in which the Group has significant influence generally accompanying a shareholding of between 20 per cent and 50 per cent of the voting rights.

Investments in associates are accounted for in the consolidated accounts under the equity method. The consolidated profit and loss account includes the Group's share of the post-acquisition results of associates for the year, and the consolidated balance sheet includes the Group's share of the net assets of associates and goodwill (net of accumulated impairment losses).

### (d) Turnover

Turnover comprises trading fees and trading tariff from securities and options traded on The Stock Exchange of Hong Kong Limited ("Stock Exchange") and derivatives contracts traded on Hong Kong Futures Exchange Limited ("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 consolidated profit and loss account.

### (e) Revenue recognition

Income is recognised in the profit and loss account on the following basis:

(i) Trading fees and trading tariff on securities and options traded on the Stock Exchange and trading fees on derivatives contracts traded on the Futures Exchange are recognised on a trade date basis.

(ii) Settlement fees on derivatives contracts traded on the Futures Exchange are recognised on outstanding contracts at the official final settlement day.

(iii) Fees for clearing and settlement of broker-to-broker trades in eligible securities transacted on the Stock Exchange are recognised in full on T+1, i.e., on the day following the trade day, upon acceptance of the trades. Fees for other settlement transactions are recognised upon completion of the settlement.

(iv) Custody fees for securities held in the Central Clearing and Settlement System ("CCASS") depository are calculated and accrued on a monthly basis. Income on registration and transfer fees on nominee services are calculated and accrued on the book close dates of the relevant stocks during the financial year.

## 2. Principal Accounting Policies *(Continued)*

### (e) Revenue recognition *(Continued)*

(v) Initial listing fees for initial public offering ("IPO") are recognised upon the listing of an applicant, cancellation of the application or six months after submission of the application, whichever is earlier. Income from annual listing fees is recognised on a straight-line basis over the period covered by the respective fees received in advance.

(vi) Income from sale of information and other fees are recognised when the related services are rendered.

(vii) Interest income represents gross interest income from bank deposits and investments and is recognised on a time apportionment basis using the effective interest method.

(viii) Dividend income is recognised when the right to receive payment is established.

(ix) Rental income is recognised on an accrual basis.

### (f) Interest expenses

Interest expenses are recognised on a time apportionment basis, taking into account the principal outstanding and the applicable interest rates. All interest expenses are charged to the profit and loss account in the year in which they are incurred.

### (g) Employee benefit costs

(i) Employee leave entitlements

The cost of accumulating compensated absences is recognised as an expense and measured based on the additional amount that the Group expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

(ii) Equity compensation benefits

For share options granted under the Post-Listing Share Option Scheme ("Post-Listing Scheme") and the Awarded Shares granted under the Share Award Scheme, the fair value of the employee services received in exchange for the grant of the options and the Awarded Shares is recognised as an expense and credited to an employee share-based compensation reserve under equity. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options and Awarded Shares granted at grant date.

At each balance sheet date, the Group revises its estimates of the number of options and Awarded Shares that are expected to ultimately vest. The impact of the revision of the original estimates, if any, is recognised in the profit and loss account over the remaining vesting period, with a corresponding adjustment to the employee share-based compensation reserve.

## 2. Principal Accounting Policies *(Continued)*

### (g) Employee benefit costs *(Continued)*

(ii) Equity compensation benefits *(Continued)*

Share options granted under the Pre-Listing Share Option Scheme ("Pre-Listing Scheme") are not expensed as the options were granted before 7 November 2002 and not subject to requirements of HKFRS 2.

When the options are exercised, the proceeds received are credited to share capital (nominal value) and share premium, and the associated amount in the employee share-based compensation reserve, if any, is transferred to share premium.

(iii) Retirement benefit costs

Contributions to the defined contribution provident fund regulated under the Occupational Retirement Schemes Ordinance ("ORSO") and operated by the Group and the AIA-JF Premium MPF Scheme are expensed as incurred. Forfeited contributions of the provident fund in respect of employees who leave before the contributions are fully vested are not used to offset existing contributions but are credited to a reserve account of that provident fund. Reserves of the provident fund representing forfeited employer's contributions are available for distribution to the provident fund members at the discretion of the trustees. Assets of the provident fund and the AIA-JF Premium MPF Scheme are held separately from those of the Group and are independently administered.

### (h) Operating leases

Leases where substantially all the rewards and risks of ownership of assets remain with the leasing company are accounted for as operating leases. Rentals applicable to such operating leases net of any incentives received from the leasing company are charged to the profit and loss account on a straight-line basis over the lease term.

### (i) Fixed assets

The building component of owner-occupied leasehold properties are stated at valuation less accumulated depreciation. Fair value is determined by the Directors based on independent valuations which are performed periodically. The valuations are on the basis of depreciated replacement cost. Depreciated replacement cost is used as open market value cannot be reliably allocated to the building component. The Directors review the carrying value of the leasehold buildings and adjustment is made where they consider that there has been a material change. Increases in valuation are credited to the leasehold buildings revaluation reserve. Decreases in valuation are first offset against increases on earlier valuations in respect of the same property and are thereafter charged to the profit and loss account. Any subsequent increases are credited to the profit and loss account up to the amount previously charged and thereafter to leasehold buildings revaluation reserve.

## 2. Principal Accounting Policies *(Continued)*

### (i) Fixed assets *(Continued)*

Other tangible fixed assets are stated at historical cost less accumulated depreciation and impairment losses. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Tangible fixed assets are depreciated at rates sufficient to write off their cost net of expected residual value over their estimated useful lives on a straight-line basis. The useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

The useful lives of major categories of fixed assets are as follows:

| | |
|---|---|
| Leasehold buildings | 25 years |
| Leasehold improvements | over the remaining life of the leases but not exceeding 5 years |
| Computer trading and clearing systems | |
| – hardware and software | 5 years |
| Other computer hardware and software | 3 years |
| Furniture and equipment | Up to 5 years |
| Motor vehicles | 3 years |

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance costs are charged to the profit and loss account during the year in which they are incurred.

An asset is written down immediately to its recoverable amount if its carrying amount is higher than the asset's estimated recoverable amount (note 2(m)).

Qualifying software system development expenditures are capitalised and recognised as a fixed asset in the balance sheet as the software forms an integral part of the hardware on which it operates. The expenditures comprise all qualifying direct and allocated expenses attributable to the development of distinct major computer systems.

Qualifying development expenditures incurred after the roll-out of a system are added to the carrying amount of the related assets when it is probable that future economic benefits that are attributable to the assets will flow to the Group. All other subsequent expenditures are recognised as non-qualifying expenditures.

All non-qualifying expenditures and expenses incurred on other non-qualifying development activities are charged as expenses to the profit and loss account in the period in which such expenses are incurred.

## 2. Principal Accounting Policies *(Continued)*

### (i) Fixed assets *(Continued)*

Amortisation of the cost of capitalised software system development expenditures is provided from the dates when the systems are available for use.

Upon the disposal of leasehold buildings, the relevant portion of the revaluation reserve realised in respect of previous valuations is released from the leasehold buildings revaluation reserve to retained earnings.

The gain or loss on disposal of a fixed asset is the difference between the net sale proceeds and the carrying amount of the relevant asset, and is recognised in the profit and loss account.

### (j) Investment properties

Investment properties are properties held for long-term rental yields and not occupied by the Group. Investment properties comprise land held under operating leases and buildings held under finance leases. Investment properties are carried at fair value, representing open-market value determined by independent qualified valuers in accordance with the "HKIS Valuation Standards on Properties" issued by the Hong Kong Institute of Surveyors ("HKIS Valuation Standards"), "The RICS Appraisal and Valuation Standards" published by the Royal Institution of Chartered Surveyors ("RICS") and the "International Valuation Standards" published by the International Valuation Standards Committee where the HKIS Valuation Standards are silent on subjects requiring guidance. Changes in fair value are recognised in the profit and loss account.

Subsequent costs are included in the asset's carrying amount only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance costs are expensed in the profit and loss account during the year in which such expenses are incurred.

### (k) Lease premiums for land

Leasehold land premiums are up-front payments to acquire long-term interests in lessee-occupied properties. The premiums are stated at cost and are amortised over the period of the lease on a straight-line basis to the profit and loss account.

### (l) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net assets of the acquired company at the date of acquisition. Goodwill on acquisition of associates is included in investments in associates.

Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses.

## 2. Principal Accounting Policies *(Continued)*

### (m) Impairment of assets other than investments

Assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment and are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount may not be recoverable. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount (i.e., the higher of an asset's fair value less costs to sell and value in use). Such impairment losses are recognised in the profit and loss account except where the asset is carried at valuation and the impairment loss does not exceed the revaluation surplus for that same asset, in which case it is treated as a decline in revaluation.

In respects of assets other than goodwill, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount and the circumstances and events leading to the impairment cease to exist. A reversal of impairment loss is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversal of impairment losses is credited to the profit and loss account except when the asset is carried at valuation, in which case the reversal of impairment loss is credited to the profit and loss account up to the amount previously charged to the profit and loss account and thereafter treated as a revaluation movement.

### (n) Clearing House Funds/Cash and Derivatives Market Development Fund ("CDMD Fund")

Income arising from bank deposits and investments comprising these funds and expenses incurred for these funds are dealt with in the profit and loss account. Investment income net of expenses of the Clearing House Funds is appropriated from retained earnings to the respective designated reserves of these funds and allocated to amounts attributable to Clearing Participants' contributions and to clearing houses' contributions based on the ratio of their respective average initial contributions and accumulated allocated investment income net of expenses. Investment income net of expenses of the CDMD Fund may be appropriated to the designated reserve of this fund at the discretion of the Board of Directors of HKFE Clearing Corporation Limited ("HKCC"). Changes in valuation of the available-for-sale financial assets comprising these funds are dealt with in the investment revaluation reserve.

Net assets of the Clearing House Funds, which are derived from contributions from CCASS Participants (other than investor participants), HKCC Participants and The SEHK Options Clearing House Limited ("SEOCH") Participants ("Clearing Participants") and the respective clearing houses, and the accumulated investment income net of expenses of these funds appropriated from retained earnings, are included in the balance sheet as non-current assets. Clearing Participants' contributions are treated as non-current liabilities in the balance sheet. Non-cash collateral of the Clearing House funds (i.e. contributions receivable from Clearing Participants fully secured by bank guarantees) and the corresponding liabilities are not reflected as assets and liabilities in the balance sheet in accordance with HKAS 39 but are disclosed in note 42 to the consolidated accounts. Contributions from the respective clearing houses, the accumulated investment income net of expenses of these funds appropriated from retained earnings and forfeiture of defaulted Clearing Participants' contributions are included in the balance sheet as designated reserves.

## 2. Principal Accounting Policies *(Continued)*

### (n) Clearing House Funds/Cash and Derivatives Market Development Fund ("CDMD Fund") *(Continued)*

The CDMD Fund was fully utilised in 2004 for funding initiatives that were for the development and betterment of the Cash and Derivatives Markets in Hong Kong.

### (o) Margin Funds on derivatives contracts/margin deposits and securities received from Clearing Participants on derivatives contracts

Margin Funds are established by cash received or receivable from SEOCH and HKCC Clearing Participants for their open positions in derivatives contracts. The funds are refundable to the Clearing Participants of SEOCH and HKCC when they close their positions in derivatives contracts. These funds are held for the SEOCH and HKCC Clearing Participants' liabilities to the respective clearing houses and are held in segregated accounts of the respective clearing houses. Cash margin deposits received are disclosed as Margin Funds on derivatives contracts under current assets and the obligation to refund such deposits as Margin deposits from Clearing Participants on derivatives contracts under current liabilities. Non-cash collateral (i.e. securities and bank guarantees) received from Clearing Participants for satisfying margin requirements and the corresponding liabilities are not recorded as assets and liabilities of the Margin Funds in accordance with HKAS 39 but are disclosed in note 42 to the consolidated accounts.

Income arising from bank deposits and investments comprising these Margin Funds and expenses incurred for these funds are dealt with in the profit and loss account. Changes in fair value of available-for-sale financial assets comprising these Margin Funds are dealt with in the investment revaluation reserve. Changes in fair value of investments designated as financial assets at fair value through profit or loss are included in the profit and loss account. The Clearing Participants of SEOCH and HKCC are entitled to interest at a rate determined by SEOCH and HKCC on the margin deposits they place with SEOCH and HKCC respectively.

### (p) Cash marks received from Participants

Cash marks received from HKSCC Participants for their open positions are recorded as assets in the balance sheet. As these funds are refundable to the Participants when they close their positions, the marks received are reflected as liabilities to the Participants in the balance sheet.

Income arising from bank deposits comprising these funds is dealt with in the profit and loss account. HKSCC Participants are entitled to interest at a rate determined by HKSCC on the marks they place with HKSCC.

## 2. Principal Accounting Policies *(Continued)*

### (q) Derivative financial instruments

Derivatives, which include forward foreign exchange contracts, are initially recognised at fair value on the date on which a derivative contract is entered into and subsequently remeasured at their fair values. Fair values are based on quoted market prices in active markets or recent market transactions or valuation techniques such as discounted cash flow models and options pricing models, as appropriate. Changes in fair value of the derivatives are recognised in the profit and loss account except where derivatives are designated as a qualifying cash flow hedge in which case recognition of any resultant fair value gain or loss depends on the nature of the item being hedged (note 2 (r)). All derivatives except those designated as qualifying cash flow hedges are classified as financial assets at fair value through profit or loss when the fair value is positive and as financial liabilities at fair value through profit or loss when the fair value is negative.

### (r) Hedge accounting

The Group documents at the inception of the transactions the relationship between the hedging instruments and the hedged items, as well as the risk management objectives and strategies for undertaking various hedge transactions. The Group also documents its assessment, both at the inception of the hedges and on an ongoing basis, of whether the hedging instruments are highly effective in offsetting changes in fair values or cash flows of the hedged items.

(i) Fair value hedges

Changes in the fair value of hedging instruments that are designated and qualify as fair value hedges are recognised in the profit and loss account, together with any changes in the fair value of the hedged assets, liabilities or firm commitments that are attributable to the hedged risk.

(ii) Cash flow hedges

For hedging instruments that are designated as cash flow hedges, the changes in the fair value relating to the effective portion of the hedges are recognised in equity. The gains or losses relating to the ineffective portion of the hedges are recognised immediately in the profit and loss account.

Amounts accumulated in equity are recycled to the profit and loss account in the periods when the hedged items affect profit or loss. However, when the forecast transactions that are hedged result in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously deferred in equity are transferred from equity and included in the initial measurement of the cost of the non-financial asset or non-financial liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss retained in equity at that time remains in equity and is recognised in accordance with the above policy when the forecast transaction occurs. When a forecast transaction is no longer expected to occur, the cumulative gain or loss retained in equity is immediately transferred to the profit and loss account.

## 2. Principal Accounting Policies *(Continued)*

### (s) Investments

(i) Classification

Investments of the Group are classified under the following categories:

*Financial assets at fair value through profit or loss*

This category comprises financial assets held for trading (i.e., those acquired for the purpose of selling in short-term or derivatives which are not designated as hedging instruments) and those designated as fair value through profit and loss at inception if the designation:

- eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring financial assets or financial liabilities or recognising the gains and losses on them on different bases; or
- applies to a group of financial assets, financial liabilities or both that is managed and its performance evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and where information about that group of financial instruments is provided internally on that basis to key management personnel; or
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments.

*Available-for-sale financial assets*

This category comprises financial assets which are non-derivatives and are designated as available-for-sale financial assets or not classified under other investment categories.

*Loans and receivables*

Loans and receivables which comprise bank deposits, trade and accounts receivable, deposits and other assets, are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and the Group has no intention of trading the loans or receivables. Bank deposits are disclosed as time deposits and cash equivalents.

(ii) Recognition and initial measurement

Loans and receivables arise when the Group provides money, goods or services directly to a debtor.

Purchases and sales of investments are recognised on trade-date – the date on which the Group commits to purchase or sell the asset. Investments at fair value through profit or loss are initially recognised at fair value with transaction costs recognised as expenses in the profit and loss account. Investments not designated as fair value through profit or loss are initially recognised at fair value plus transaction costs.

## 2. Principal Accounting Policies *(Continued)*

### (s) Investments *(Continued)*

(iii) Derecognition

Investments are derecognised when the rights to receive cash flows from the investments have expired or have been transferred and the Group has transferred substantially all the risks and rewards of ownership of the investments.

(iv) Gains or losses on subsequent measurement and interest income

*Financial assets at fair value through profit or loss*

- Investments under this category are carried at fair value. Unrealised gains and losses arising from changes in the fair value are included in the profit and loss account in the period in which they arise. Upon disposal, the difference between the net sale proceeds and the carrying value is included in the profit and loss account.

- Interest income is recognised using the effective interest method and included as net realised and unrealised gains/(losses) and interest income from these investments.

*Available-for-sale financial assets*

- Available-for-sale financial assets are carried at fair value. Unrealised gains and losses (including transaction costs on acquisition) arising from changes in the fair value are recognised in investment revaluation reserve in accordance with HKAS 39, except for impairment losses in excess of previous revaluation surpluses and exchange differences of monetary securities resulting from changes in amortised costs are recognised in profit and loss account. For the purpose of recognising foreign exchange gains and losses under HKAS 21, monetary available-for-sale financial assets are treated as if they were carried at amortised cost in the foreign currency and, accordingly, exchange differences resulting from changes in amortised cost are recognised in profit or loss and other changes in carrying amount are recognised in reserve in accordance with HKAS 39. When the securities are sold, the difference between the net sale proceeds and the carrying value, and the accumulated fair value adjustments in the investment revaluation reserve are treated as gains or losses on disposal.

- Interest income is recognised using the effective interest method and disclosed as interest income.

*Loans and receivables*

- Loans and receivables are carried at amortised cost using the effective interest method less provision for impairment.

- Interest income is recognised using the effective interest method and disclosed as interest income.

## 2. Principal Accounting Policies *(Continued)*

### (s) Investments *(Continued)*

(v) Fair value measurement principles

Fair values of quoted investments are based on bid prices. For unlisted securities or financial assets without an active market, the Group establishes the fair value by using valuation techniques including the use of recent arm's length transactions, reference to other instruments that are substantially the same, discounted cash flow analysis, and option pricing models.

(vi) Impairment

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred, if and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a "loss event") and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the Group about the following loss events:

- significant financial difficulty of the debtor or obligor;
- fees receivable that have been outstanding for over 180 days;
- the Group granting to the debtor or obligor, for economic or legal reasons relating to the debtor's or obligor's financial difficulty, a concession that the Group would not otherwise consider;
- it is becoming probable that the debtor or obligor will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties;
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the Group, including:
    - adverse changes in the payment status of debtors or obligors in the Group;
    - economic conditions that correlate with defaults on the assets in the Group.

## 2. Principal Accounting Policies *(Continued)*

### (s) Investments *(Continued)*

#### (vi) Impairment *(Continued)*

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If the Group determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assessed them for impairment. Assets that are individually assessed for impairment and which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics relevant to the estimation of future cash flows. These financial assets are collectively assessed based on historical loss experience on each type of assets and management judgement of the current economic and credit environment.

*Loans and receivables*

If there is objective evidence that an impairment loss on loans and receivables carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the assets' carrying amounts and the present values of estimated future cash flows discounted at the financial assets' original effective interest rates. The carrying amount of the asset is reduced through the use of a doubtful debt allowance account and the amount of the loss is recognised in the profit and loss account.

When there is no realistic prospect of recovery of a loan or receivable, it is written off against the related provision for impairment loss. Subsequent recovery of the amount previously written off reduces the amount of the provision for impairment loss in the profit and loss account.

As soon as a loan or receivable becomes impaired, the Group may continue to provide services or facilities to the debtor or obligor but no further accounts receivable is recognised on balance sheet as economic benefits may not flow to the Group. The revenue concerned is not recognised but tracked as doubtful deferred revenue and will only be recognised as income when received.

If, in a subsequent period, the amount of impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed by adjusting the doubtful debt allowance account. The amount of reversal is recognised in the profit and loss account.

## 2. Principal Accounting Policies *(Continued)*

### (s) Investments *(Continued)*

(vi) Impairment *(Continued)*

*Available-for-sale financial assets*

If there is objective evidence that an impairment loss on available-for-sale financial assets has been incurred, the cumulative loss (measured as the difference between the acquisition cost and the current fair value, less any impairment loss on the financial asset previously recognised in the profit or loss account) is removed from investment revaluation reserve and recognised in the profit and loss account.

In the case of equity securities classified as available-for-sale financial assets, a significant or prolonged decline in the fair value of the securities below their cost is considered in determining whether the securities are impaired. Impairment losses recognised in the profit and loss account on equity instruments are not reversed through the profit and loss account.

If, in a subsequent period, the fair value of a debt instrument increases and the increase can be related objectively to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through the profit and loss account up to the amount previously charged to the profit and loss account and any further increase in fair value thereafter is treated as a revaluation movement.

### (t) Financial liabilities

(i) Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss are financial liabilities held for trading (i.e. principally held for the short-term and derivatives which are not designated as hedging instruments) and those designated at fair value through profit or loss at inception if the designation satisfies the same criteria as set out in note 2(s)(i) under the caption of "Financial assets at fair value through profit or loss".

Liabilities under this category are initially recognised at fair value on the date on which a contract is entered into and subsequently remeasured at their fair value. Changes in fair value of the liabilities are recognised in the profit and loss account.

(ii) Financial guarantee contracts

A financial guarantee contract is a contract that requires the Group to make specified payments to reimburse the holder for a loss it incurs because a specified entity or person fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Financial guarantee contracts are accounted for as financial instruments under HKAS 39 and are initially recognised at fair value. Subsequently, such contracts are measured at the higher of the amount determined in accordance with HKAS 37 – Provisions, Contingent Liabilities and Contingent Assets and the amount initially recognised less, where appropriate, cumulative amortisation recognised over the life of the guarantee on a straight-line basis.

## 2. Principal Accounting Policies *(Continued)*

### (t) Financial liabilities *(Continued)*

(iii) Other financial liabilities

Financial liabilities, other than financial liabilities at fair value through profit and loss and financial guarantee contracts, are carried at amortised cost.

### (u) Repurchase transactions

When securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and the consideration received is recorded as a liability.

### (v) Recognition of receivables and payables from/to HKSCC Clearing Participants on Stock Exchange trades settled on the CNS basis

Upon acceptance of Stock Exchange trades for settlement in CCASS under the CNS basis, HKSCC interposes itself between the HKSCC Clearing Participants as the settlement counterparty to the trades through novation. Final acceptance of Stock Exchange trades is confirmed on T+1 by details contained in the final clearing statement transmitted to every HKSCC Clearing Participant.

The CNS money obligations due by/to HKSCC Clearing Participants on the Stock Exchange trades are recognised as receivables and payables when they are confirmed and accepted on T+1.

For all other trades and transactions, HKSCC merely provides a facility for settlement within CCASS and does not interpose itself between the HKSCC Clearing Participants as the settlement counterparty to the trades. The settlement of these trades does not constitute money obligations and is excluded from the consolidated accounts of the Group.

### (w) Deferred taxation

Deferred taxation is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the accounts. Deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences or the income tax losses can be utilised. Tax rates enacted or substantively enacted by the balance sheet date are used to determine deferred tax assets and liabilities. Movements in deferred tax provision are recognised in the profit and loss account with the exception of deferred tax related to fair value re-measurement of fixed assets, available-for-sale financial assets and cash flow hedges, which are charged or credited directly to equity, is also credited or charged directly to equity.

## 2. Principal Accounting Policies *(Continued)*

### (x) Deferred revenue

Deferred revenue comprises annual listing fees received in advance, payments received in advance for services in relation to the sales of stock market information and telecommunication line rentals for trading facilities located at brokers' offices.

### (y) Provisions, contingent liabilities and contingent assets

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made. Where the Group expects a provision to be reimbursed, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group. It can also be a present obligation arising from past events that is not recognised because it is not probable that outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognised but is disclosed in the notes to the consolidated accounts. When a change in the probability of an outflow occurs so that outflow is probable, it will then be recognised as a provision.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the Group.

Contingent assets are not recognised but are disclosed in the notes to the consolidated accounts when an inflow of economic benefits is probable. When inflow is virtually certain, an asset is recognised.

### (z) Foreign currency translation

(i) Functional and presentation currency

Items included in the accounts of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency). The consolidated accounts are presented in Hong Kong Dollar ("HKD"), which is HKEx's and the Group's functional and presentation currency.

## 2. Principal Accounting Policies *(Continued)*

### (z) Foreign currency translation *(Continued)*

(ii) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets (accounting treatment for available-for-sale financial assets is included in note 2(s)(iv)) and liabilities denominated in foreign currencies are recognised in the profit and loss account, except when the foreign exchange gains/losses are related to a qualifying cash flow hedge in which case the amount will be deferred in hedging reserve.

Translation differences on non-monetary items, such as equity investments held that are classified as financial assets at fair value through profit or loss, are reported as part of the fair value gain or loss. Translation differences on non-monetary items such as equity instruments classified as available-for-sale financial assets are included in the investment revaluation reserve in equity.

### (aa) Cash and cash equivalents

Cash and cash equivalents comprise cash on hand, bank balances and other short-term highly liquid investments (mainly time deposits) with original maturities of three months or less.

### (ab) Segment reporting

Business segment assets consist primarily of fixed assets, assets of the Clearing House Funds, Compensation Fund Reserve Account, Margin Funds, financial assets and other assets. Business segment liabilities comprise primarily of liabilities to Participants, financial and other liabilities. Non-business segment assets and liabilities include taxation recoverable and payable, deferred tax assets and liabilities and dividends declared by HKEx but not yet claimed by its shareholders. Capital expenditures comprise additions to fixed assets. Business segments have been used as the primary reporting format and no geographical segment analysis is presented as all business activities are conducted in Hong Kong.

### (ac) Dividends

Dividends disclosed in the consolidated profit and loss account represent interim dividend paid and final and special dividends proposed/declared (based on the issued share capital as at the balance sheet date) for the year.

Dividends declared are recognised as liabilities in the Group's accounts in the year the dividends are approved by the shareholders.

## 2. Principal Accounting Policies *(Continued)*

**(ad) Related parties**

Parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel, significant shareholders and/or their close family members) or entities and include entities which are controlled or under the significant influence of related parties of the Group where those parties are individuals, and post-employment benefit plans which are for the benefit of employees of the Group or of any entity that is a related party of the Group.

## 3. Critical Accounting Estimates and Judgements

The Group makes estimates and assumptions concerning the future. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below:

**(a) Estimated impairment of investments in associates**

The Group assesses annually if investments in associates have suffered any impairment in accordance with the accounting policy stated in note 2(m). The recoverable amount of the investment in one of the associates, Computershare Hong Kong Investor Services Limited ("CHIS"), is determined using discounted cash flows which require the use of estimated dividends, proceeds on disposal and an appropriate discount rate as stated in note 20(b)(ii).

If the discount rate moves above 16 per cent, or annual dividends received fall by more than 46 per cent, an impairment loss may be considered necessary.

**(b) Impairment of available-for-sale financial assets**

The Group follows the guidance of HKAS 39 when determining whether an investment in available-for-sale financial assets is other-than-temporarily impaired. This determination requires significant judgement. In making this judgement, the Group evaluates, among other factors, the duration and extent to which the fair value of an investment is less than its cost, and the expected time span the Group will hold on to this investment.

The Group's available-for-sale financial assets are expected to be held till maturity and therefore any revaluation deficit arising from revaluation is not expected to have any impact to the Group's profit and loss account (note 32(b)). If the assumptions regarding the Group's intention to continue to hold on to such investments are proved to be not correct, the Group would suffer an additional $39,332,000 loss (excluding share of associate's revaluation surplus of $21,000) in its 2006 financial statements, being the transfer of the related investment revaluation reserve to the profit and loss account.

## 4. Segment Information

The Group's income is derived solely from business activities in Hong Kong. An analysis of the Group's income, results, assets, liabilities, capital expenditures and non-cash expenses for the year by business segment is as follows:

| | 2005 | | | | | |
|---|---|---|---|---|---|---|
| | Cash Market $'000 | Derivatives Market $'000 | Clearing Business $'000 | Information Services $'000 | Others $'000 | Group $'000 |
| **Income** | 1,172,850 | 441,755 | 753,695 | 325,757 | – | 2,694,057 |
| **Operating expenses** | | | | | | |
| Direct costs | 429,042 | 111,812 | 305,821 | 46,703 | – | 893,378 |
| Indirect costs | 115,914 | 36,149 | 79,089 | 20,952 | – | 252,104 |
| | 544,956 | 147,961 | 384,910 | 67,655 | – | 1,145,482 |
| **Segment results** | 627,894 | 293,794 | 368,785 | 258,102 | – | 1,548,575 |
| Share of profits less losses of associates | (3) | – | 18,436 | – | – | 18,433 |
| Segment profits before taxation | 627,891 | 293,794 | 387,221 | 258,102 | – | 1,567,008 |
| Taxation | | | | | | (227,460) |
| Profit attributable to shareholders | | | | | | 1,339,548 |
| Segment assets | 2,171,939 | 14,619,810 | 6,039,165 | 62,270 | 3,168 | 22,896,352 |
| Investments in associates | 1,305 | – | 63,276 | – | – | 64,581 |
| | 2,173,244 | 14,619,810 | 6,102,441 | 62,270 | 3,168 | 22,960,933 |
| Segment liabilities | 608,182 | 13,697,352 | 4,106,773 | 35,451 | 145,686 | 18,593,444 |
| Segment capital expenditures | 68,364 | 2,875 | 12,416 | 2,148 | – | 85,803 |
| Segment depreciation and amortisation | 64,263 | 13,192 | 65,870 | 8,218 | – | 151,543 |
| Segment provision for impairment losses | 73 | 102 | 261 | 7 | – | 443 |
| Segment other non-cash expenses | 12,619 | 3,141 | 8,281 | 1,315 | – | 25,356 |

## 4. Segment Information *(Continued)*

| | 2004 (As restated) | | | | | |
|---|---|---|---|---|---|---|
| | Cash Market $'000 | Derivatives Market $'000 | Clearing Business $'000 | Information Services $'000 | Others $'000 | Group $'000 |
| **Income** | 1,058,306 | 327,430 | 698,052 | 310,149 | – | 2,393,937 |
| **Operating expenses** | | | | | | |
| Direct costs | 434,876 | 114,185 | 313,492 | 56,043 | – | 918,596 |
| Indirect costs | 109,096 | 30,943 | 75,796 | 21,865 | – | 237,700 |
| | 543,972 | 145,128 | 389,288 | 77,908 | – | 1,156,296 |
| **Segment results** | 514,334 | 182,302 | 308,764 | 232,241 | – | 1,237,641 |
| Share of profits less losses of associates | (12) | – | 12,896 | – | – | 12,884 |
| Segment profits before taxation | 514,322 | 182,302 | 321,660 | 232,241 | – | 1,250,525 |
| Taxation | | | | | | (193,641) |
| Profit attributable to shareholders | | | | | | 1,056,884 |
| Segment assets | 2,131,971 | 11,402,930 | 7,802,747 | 65,707 | 1,318 | 21,404,673 |
| Investments in associates | 1,309 | – | 37,422 | – | – | 38,731 |
| | 2,133,280 | 11,402,930 | 7,840,169 | 65,707 | 1,318 | 21,443,404 |
| Segment liabilities | 600,319 | 10,571,605 | 5,949,260 | 33,617 | 256,369 | 17,411,170 |
| Segment capital expenditures | 5,445 | 2,221 | 14,225 | 3,028 | – | 24,919 |
| Segment depreciation and amortisation | 90,326 | 15,594 | 68,202 | 9,826 | – | 183,948 |
| Segment provision for/ (reversal of provision for) impairment losses | 156 | 30 | 39 | (1,000) | – | (775) |
| Segment other non-cash expenses | 6,724 | 1,383 | 4,889 | 792 | – | 13,788 |

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 ("GEM"). The major sources of income of the business are trading fees, trading tariff and listing fees. Costs of the Listing Function are treated as segment costs under the Cash Market. Costs of the Listing Function are further explained in note 6.

## 4. Segment Information *(Continued)*

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 investment income on the Margin Funds invested.

The **Clearing Business** refers to the operations of the three Clearing Houses, namely HKSCC, SEOCH and 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 investment income earned on the Clearing House Funds and fees from providing clearing, settlement, depository, custody and nominee services.

The **Information Services** business is responsible for developing, promoting, compiling and sales of real-time, historical as well as statistical market data and issuer information. Its income comprises primarily income from sale of Cash Market and Derivatives Market data.

In addition to the above, central income (mainly investment income of the 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.

Assets and liabilities under the **Others Segment** represent mainly taxation recoverable and payable, deferred tax assets and liabilities and unclaimed dividends declared by HKEx.

## 5. Trading Fees and Trading Tariff

| | **2005 $'000** | 2004 $'000 |
|---|---|---|
| Trading fees and trading tariff were derived from: | | |
| Securities traded on the Cash Market | **528,954** | 459,524 |
| Derivatives contracts traded on the Derivatives Market | **264,293** | 222,769 |
| | **793,247** | 682,293 |

## 6. Stock Exchange Listing Fees

Stock Exchange listing fees and costs of Listing Function comprised the following:

| | 2005 | | | | 2004 | | | |
|---|---|---|---|---|---|---|---|---|
| | Equity | | | | Equity | | | |
| | **Main Board $'000** | **GEM $'000** | **Debt & Derivatives $'000** | **Total $'000** | Main Board $'000 | GEM $'000 | Debt & Derivatives $'000 | Total $'000 |
| **Income** | | | | | | | | |
| Annual listing fees | 236,125 | 25,946 | 1,874 | 263,945 | 224,875 | 25,435 | 2,048 | 252,358 |
| Initial and subsequent issue listing fees | 53,175 | 5,880 | 83,020 | 142,075 | 43,932 | 12,654 | 62,882 | 119,468 |
| Prospectus vetting fees | 2,775 | 375 | 140 | 3,290 | 2,690 | 300 | 205 | 3,195 |
| Other listing fees | 2,706 | 984 | – | 3,690 | 2,116 | 1,290 | – | 3,406 |
| Total income | 294,781 | 33,185 | 85,034 | 413,000 | 273,613 | 39,679 | 65,135 | 378,427 |
| **Costs of Listing Function** | | | | | | | | |
| *Direct costs* | | | | | | | | |
| Staff costs and related expenses | 98,408 | 28,749 | 5,645 | 132,802 | 80,806 | 30,223 | 5,464 | 116,493 |
| Information technology and computer maintenance expenses | 1,608 | 441 | 2 | 2,051 | 2,217 | 584 | 3 | 2,804 |
| Premises expenses | 6,336 | 1,846 | 363 | 8,545 | 5,706 | 2,113 | 381 | 8,200 |
| Legal and professional fees | 4,907 | 1,202 | 1 | 6,110 | 2,471 | 1,446 | – | 3,917 |
| Depreciation | 6,234 | 1,918 | 206 | 8,358 | 10,417 | 3,769 | 544 | 14,730 |
| Payment to SFC under dual filing regime | 16,369 | 3,631 | – | 20,000 | 16,353 | 3,647 | – | 20,000 |
| Other operating expenses | 4,408 | 1,706 | 164 | 6,278 | 5,702 | 1,889 | 181 | 7,772 |
| *Total direct costs* | 138,270 | 39,493 | 6,381 | 184,144 | 123,672 | 43,671 | 6,573 | 173,916 |
| *Indirect costs* | 27,822 | 5,602 | 4,571 | 37,995 | 19,810 | 4,917 | 2,899 | 27,626 |
| **Contribution** | 128,689 | (11,910) | 74,082 | 190,861 | 130,131 | (8,909) | 55,663 | 176,885 |

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.

The direct costs listed above are regulatory in nature, which comprise costs of the Listing Function on vetting IPOs and enforcing the Listing Rules and the Rules Governing the Listing of Securities on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited, disseminating information relating to listed companies, and payments to the Securities and Futures Commission ("SFC") under the dual filing regime. Indirect costs comprise costs of support services and other central overheads attributable to the Listing Function.

## 7. Investment Income

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Interest income | | |
| – bank deposits | **246,729** | 26,481 |
| – listed available-for-sale financial assets | **11,852** | 4,401 |
| – unlisted available-for-sale financial assets | **78,064** | 52,292 |
| | **336,645** | 83,174 |
| Interest expenses | **(126,260)** | (1,309) |
| Net interest income | **210,385** | 81,865 |
| Net realised and unrealised gains/(losses) and interest income on financial assets and financial liabilities at fair value through profit or loss | | |
| On designation | | |
| – bank deposits with embedded derivatives | **266** | 3,529 |
| – unlisted debt securities with embedded derivatives | **–** | 2,032 |
| | **266** | 5,561 |
| Held for trading | | |
| – listed securities | **84,644** | 76,834 |
| – unlisted securities | **15,513** | 31,433 |
| – exchange differences | **(17,928)** | 530 |
| | **82,229** | 108,797 |
| | **82,495** | 114,358 |
| Gains/(losses) on disposal and maturity of available-for-sale financial assets | | |
| – listed securities (note a) | **–** | 24,841 |
| – unlisted securities | **–** | 101 |
| – exchange differences | **–** | (192) |
| | **–** | 24,750 |
| Dividend income | | |
| – listed available-for-sale financial assets | **–** | 1,070 |
| – listed financial assets at fair value through profit or loss | **7,630** | 6,378 |
| | **7,630** | 7,448 |
| Other exchange differences on loans and receivables | **(401)** | 166 |
| Total investment income | **300,109** | 228,587 |
| Total investment income was derived from: | | |
| Corporate Funds (note b) | **119,187** | 148,781 |
| Margin Funds | **150,209** | 69,313 |
| Clearing House Funds | **30,713** | 10,493 |
| | **300,109** | 228,587 |

(a) Amount in 2004 represented profit on sale of investment in Singapore Exchange Limited in July 2004.

(b) Investment income derived from the Corporate Funds included investment income of the Compensation Fund Reserve Account of $1,286,000 (2004: $576,000) and CDMD Fund of $Nil (2004: $20,000). The CDMD Fund was fully utilised in 2004.

## 8. Other Income

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Network, terminal user, dataline and software sub-license fees | **129,733** | 120,261 |
| Participants' subscription and application fees | **34,351** | 34,341 |
| Brokerage on direct IPO applications | **34,123** | 17,586 |
| Fair value gain of an investment property (note 18) | **4,400** | 3,300 |
| 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 | **2,154** | 5,133 |
| Miscellaneous income | **16,256** | 8,380 |
| | **221,017** | 189,001 |

## 9. Staff Costs and Related Expenses

(a) Staff costs and related expenses comprised the following:

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Salaries and other short-term employee benefits | **512,548** | 479,352 |
| Employee share-based compensation benefits (note 31) | **22,955** | 14,290 |
| Termination benefits | **237** | 4,418 |
| Retirement benefit costs (note b): | | |
| – ORSO Plan | **50,011** | 47,270 |
| – MPF Scheme | **282** | 324 |
| | **586,033** | 545,654 |

(b) Retirement Benefit Costs

The Group has sponsored a defined contribution provident fund scheme, namely the Hong Kong Exchanges and Clearing Provident Fund Scheme ("ORSO Plan"), which is registered under ORSO and has obtained Mandatory Provident Fund ("MPF") exemption. The ORSO Plan is for all full-time permanent employees. Contributions to the ORSO Plan by the Group and employees are calculated as a percentage of employees' basic salaries. In compliance with the MPF Ordinance, HKEx has participated in a master trust MPF scheme, the AIA-JF Premium MPF Scheme ("MPF Scheme"), to provide retirement benefits to full-time permanent employees who elect to join the MPF Scheme and all temporary or part-time employees who are not eligible for joining the ORSO Plan. Contributions to the MPF Scheme are in accordance with the statutory limits prescribed by the MPF Ordinance.

## 9. Staff Costs and Related Expenses *(Continued)*

(b) Retirement Benefit Costs *(Continued)*

The retirement benefit costs charged to the consolidated profit and loss account represent contributions paid and payable by the Group to the ORSO Plan and the MPF Scheme and related fees. No contribution payable was outstanding as at 31 December 2004 and 2005.

For the ORSO Plan, contributions during the year are not offset by contributions forfeited in respect of employees who left the ORSO Plan before the contributions were fully vested. Instead, forfeited contributions are credited to a reserve account of the ORSO Plan for the benefit of its members.

| | **2005**<br>**$'000** | 2004<br>$'000 |
|---|---|---|
| Forfeited contributions during the year and retained in the ORSO Plan | **3,143** | 5,847 |

## 10. Information Technology and Computer Maintenance Expenses

| | **2005**<br>**$'000** | 2004<br>$'000 |
|---|---|---|
| Costs of services and goods: | | |
| – consumed by the Group | **146,568** | 161,142 |
| – directly consumed by Participants | **55,157** | 60,482 |
| | **201,725** | 221,624 |

## 11. Other Operating Expenses

| | **2005**<br>**$'000** | 2004<br>$'000 |
|---|---|---|
| Reversal of provision for impairment losses of trade receivables (note 23(b)) | **(389)** | (850) |
| Impairment losses of leasehold buildings – revaluation deficit (note 17(a)(iii)) | **837** | – |
| Insurance | **16,187** | 16,401 |
| Financial data subscription fees | **4,954** | 7,414 |
| Custodian and fund management fees | **7,887** | 7,772 |
| Bank charges | **4,420** | 7,889 |
| Repair and maintenance expenses | **8,476** | 6,984 |
| License fees | **6,279** | 5,181 |
| Communication expenses | **4,659** | 5,018 |
| Other miscellaneous expenses | **29,034** | 28,630 |
| | **82,344** | 84,439 |

## 12. Profit before Taxation

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Profit before taxation is stated after crediting/(charging): | | |
| Amortisation of lease premiums for land | **(548)** | (548) |
| Auditors' remuneration | | |
| – audit fees | **(2,000)** | (1,862) |
| – secondment fee | **(300)** | (1,800) |
| – non-audit fees | **(1,034)** | (1,403) |
| Interest on bank loans and overdrafts repayable within five years | **(9)** | (95) |
| Operating lease rentals | | |
| – land and buildings | **(44,976)** | (43,797) |
| – computer systems and equipment | **(6,514)** | (9,292) |
| Rental income from investment property | **501** | 465 |
| Direct operating expenses of the investment property that generates rental income | **(166)** | (165) |
| Depreciation | **(150,995)** | (183,400) |
| Impairment losses of leasehold buildings under other operating expenses – revaluation deficit | **(837)** | – |
| Reversal of provision for/(provision for) impairment loss of club debenture under other income/ (other operating expenses) | **5** | (75) |
| Gain/(loss) on disposal or write-off of fixed assets | **38** | (24) |
| Exchange (losses)/gains on: | | |
| – financial assets (excluding financial assets at fair value through profit or loss) | **(401)** | (26) |
| – Others | **1,604** | (185) |

## 13. Directors' Emoluments

All Directors, including one Executive Director, received emoluments during the years ended 31 December 2005 and 31 December 2004. The aggregate emoluments paid and payable to the Directors during the year were as follows:

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Executive Director: | | |
| Salaries and other short-term employee benefits | **7,262** | 7,275 |
| Performance bonus | **1,200** | 900 |
| Retirement benefit costs | **900** | 900 |
| | **9,362** | 9,075 |
| Employee share-based compensation benefits (note a) | **1,791** | 2,204 |
| | **11,153** | 11,279 |
| Non-executive Directors: | | |
| Fees | **2,460** | 1,200 |
| | **13,613** | 12,479 |

(a) Employee share-based compensation benefits represent fair value at grant date of share options issued under the Post-Listing Scheme amortised to the profit and loss account during the year disregarding whether the options have been vested/exercised or not.

(b) The emoluments, including employee share-based compensation benefits for options issued under the Post-Listing Scheme, of the Directors were within the following bands:

| | 2005 Number of Directors | 2004 Number of Directors |
|---|---|---|
| $1 – $500,000 | **13** | 12 |
| $11,000,001 – $11,500,000 | **1** | 1 |
| | **14** | 13 |

## 13. Directors' Emoluments *(Continued)*

The emoluments of all Directors, including the Chief Executive who is an ex-officio member, for the years ended 31 December 2005 and 2004 are set out below:

| 2005 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Name of Director | Fees $'000 | Salary $'000 | Other benefits (note 1) $'000 | Performance bonus $'000 | Retirement benefit costs (note 2) $'000 | Sub-total $'000 | Employee share-based compensation benefits $'000 | Total $'000 |
| Charles Y K Lee | 205 | – | – | – | – | 205 | – | 205 |
| Paul M Y Chow | – | 7,200 | 62 | 1,200 | 900 | 9,362 | 1,791 | 11,153 |
| Marvin K T Cheung (note 3) | 180 | – | – | – | – | 180 | – | 180 |
| Henry H L Fan | 205 | – | – | – | – | 205 | – | 205 |
| Fong Hup | 205 | – | – | – | – | 205 | – | 205 |
| Tim Freshwater | 205 | – | – | – | – | 205 | – | 205 |
| Bill C P Kwok | 205 | – | – | – | – | 205 | – | 205 |
| Dannis J H Lee | 205 | – | – | – | – | 205 | – | 205 |
| Vincent K H Lee | 205 | – | – | – | – | 205 | – | 205 |
| Leong Ka Chai (note 4) | 25 | – | – | – | – | 25 | – | 25 |
| Lo Ka Shui | 205 | – | – | – | – | 205 | – | 205 |
| John E Strickland | 205 | – | – | – | – | 205 | – | 205 |
| David M Webb | 205 | – | – | – | – | 205 | – | 205 |
| Oscar S H Wong | 205 | – | – | – | – | 205 | – | 205 |

| 2004 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Name of Director | Fees $'000 | Salary $'000 | Other benefits (note 1) $'000 | Performance bonus $'000 | Retirement benefit costs (note 2) $'000 | Sub-total $'000 | Employee share-based compensation benefits $'000 | Total $'000 |
| Charles Y K Lee | 100 | – | – | – | – | 100 | – | 100 |
| Paul M Y Chow | – | 7,200 | 75 | 900 | 900 | 9,075 | 2,204 | 11,279 |
| Marvin K T Cheung (note 3) | – | – | – | – | – | – | – | – |
| Henry H L Fan | 100 | – | – | – | – | 100 | – | 100 |
| Fong Hup | 100 | – | – | – | – | 100 | – | 100 |
| Tim Freshwater | 100 | – | – | – | – | 100 | – | 100 |
| Bill C P Kwok | 100 | – | – | – | – | 100 | – | 100 |
| Dannis J H Lee | 100 | – | – | – | – | 100 | – | 100 |
| Vincent K H Lee | 100 | – | – | – | – | 100 | – | 100 |
| Leong Ka Chai (note 4) | 100 | – | – | – | – | 100 | – | 100 |
| Lo Ka Shui | 100 | – | – | – | – | 100 | – | 100 |
| John E Strickland | 100 | – | – | – | – | 100 | – | 100 |
| David M Webb | 100 | – | – | – | – | 100 | – | 100 |
| Oscar S H Wong | 100 | – | – | – | – | 100 | – | 100 |

*Notes:*

1. *Other benefits include insurance premium and club membership.*
2. *Employees who retire before normal retirement age are eligible for 18% of the employer's contribution to the provident fund after completion of two years of service. The rate of vested benefit increases at an annual increment of 18% thereafter reaching 100% after completion of seven years of service.*
3. *Appointment effective on 12 April 2005.*
4. *Retired on 12 April 2005.*

## 14. Five Top-paid Employees

One (2004: one) of the five top-paid employees was a Director, whose emoluments were disclosed in note 13. Details of the emoluments of the other four (2004: four) top-paid employees were as follows:

| | 2005<br>$'000 | 2004<br>$'000 |
|---|---|---|
| Salaries and other short-term employee benefits (note a) | **17,569** | 17,287 |
| Performance bonus | **2,790** | 2,470 |
| Retirement benefit costs | **2,151** | 2,135 |
| | **22,510** | 21,892 |
| Employee share-based compensation benefits (note b) | **5,374** | 5,375 |
| | **27,884** | 27,267 |

(a) The 2004 emoluments disclosed above excluded individual income tax paid or incurred by an employee of $410,000 in respect of his services as the Chief Representative of the Group's representative office in the Mainland. No such cost was incurred in 2005.

(b) Employee share-based compensation benefits represent fair value at grant date of share options issued under the Post-Listing Scheme and Awarded Shares issued under the Share Award Scheme amortised to the profit and loss account during the year disregarding whether the options and the Awarded Shares have been vested/exercised or not.

(c) The emoluments of these four (2004: four) employees, including employee share-based compensation benefits for options issued under the Post-Listing Scheme and Awarded Shares issued under the Share Award Scheme, were within the following bands:

| | 2005<br>Number of employees | 2004<br>Number of employees |
|---|---|---|
| $5,500,001 – $6,000,000 | **1** | 1 |
| $6,000,001 – $6,500,000 | **1** | 2 |
| $6,500,001 – $7,000,000 | **1** | – |
| $9,000,001 – $9,500,000 | **1** | 1 |
| | **4** | 4 |

The employees, whose emoluments are disclosed above, included senior executives who were also Directors of the subsidiaries during the years. No Directors of the subsidiaries waived any emoluments.

## 15. Taxation

(a) Taxation charge/(credit) in the consolidated profit and loss account represented:

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Provision for Hong Kong Profits Tax for the year (note i) | **245,043** | 219,086 |
| Over provision in respect of prior years | **(8,845)** | (79) |
| | **236,198** | 219,007 |
| Deferred taxation (note 36(a)) | **(8,738)** | (25,366) |
| | **227,460** | 193,641 |

(i) Hong Kong Profits Tax has been provided for at 17.5 per cent (2004: 17.5 per cent) on the estimated assessable profit for the year.

(b) The taxation on the Group's profit before taxation differs from the theoretical amount that would arise using the taxation rate of 17.5 per cent (2004: 17.5 per cent) as follows:

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Profit before taxation (excluding share of profit less losses of associates) | **1,548,575** | 1,237,641 |
| Calculated at a taxation rate of 17.5 per cent (2004: 17.5 per cent) | **271,001** | 216,587 |
| Income not subject to taxation | **(53,959)** | (32,906) |
| Expenses not deductible for taxation purposes | **7,735** | 6,485 |
| Change in deferred tax arising from unrecognised tax losses | **11,390** | 3,411 |
| Adjustment of deferred tax | **138** | 143 |
| Over provision in respect of prior years | **(8,845)** | (79) |
| Taxation charge | **227,460** | 193,641 |

## 16. Earnings Per Share

The calculation of basic earnings per share is based on the profit attributable to shareholders of $1,339,548,000 (2004: $1,056,884,000) and the weighted average of 1,060,349,075 shares (2004: 1,054,985,321 shares) in issue during the year.

The employee share options outstanding as set out in note 31 did not have a material dilutive effect on the basic earnings per share.

# 17. Fixed Assets

(a) Group

| | Leasehold buildings $'000 | Computer trading and clearing systems $'000 | Other computer hardware and software $'000 | Leasehold improvements, furniture, equipment and motor vehicles $'000 | Total $'000 |
|---|---|---|---|---|---|
| Net book value at 1 Jan 2004 (note i) | 18,300 | 344,679 | 75,717 | 44,231 | 482,927 |
| Additions | – | 12,739 | 10,275 | 1,905 | 24,919 |
| Disposals (note ii) | – | (159) | (9) | (14) | (182) |
| Depreciation | (736) | (116,882) | (38,487) | (27,295) | (183,400) |
| Revaluation (note iii) | 36 | – | – | – | 36 |
| Net book value at 31 Dec 2004 | 17,600 | 240,377 | 47,496 | 18,827 | 324,300 |
| At 31 Dec 2004 | | | | | |
| At cost | – | 1,223,047 | 352,106 | 229,674 | 1,804,827 |
| At valuation | 17,600 | – | – | – | 17,600 |
| Accumulated depreciation | – | (982,670) | (304,610) | (210,847) | (1,498,127) |
| Net book value | 17,600 | 240,377 | 47,496 | 18,827 | 324,300 |
| Net book value at 1 Jan 2005 | **17,600** | **240,377** | **47,496** | **18,827** | **324,300** |
| Additions | **–** | **48,137** | **10,004** | **27,662** | **85,803** |
| Disposals (note ii) | **–** | **(17)** | **(1)** | **–** | **(18)** |
| Depreciation | **(686)** | **(103,393)** | **(30,410)** | **(16,506)** | **(150,995)** |
| Revaluation (note iii) | **(1,214)** | **–** | **–** | **–** | **(1,214)** |
| Net book value at 31 Dec 2005 | **15,700** | **185,104** | **27,089** | **29,983** | **257,876** |
| At 31 Dec 2005 | | | | | |
| At cost | **–** | **1,271,146** | **350,659** | **253,746** | **1,875,551** |
| At valuation | **15,700** | **–** | **–** | **–** | **15,700** |
| Accumulated depreciation | **–** | **(1,086,042)** | **(323,570)** | **(223,763)** | **(1,633,375)** |
| Net book value | **15,700** | **185,104** | **27,089** | **29,983** | **257,876** |

(i) The analysis of net book value as at 1 January 2004 was as follows:

| | | | | | |
|---|---|---|---|---|---|
| At cost | – | 1,345,403 | 347,385 | 231,519 | 1,924,307 |
| At valuation | 18,300 | – | – | – | 18,300 |
| Accumulated depreciation | – | (1,000,724) | (271,668) | (187,288) | (1,459,680) |
| Net book value | 18,300 | 344,679 | 75,717 | 44,231 | 482,927 |

(ii) The total cost of fixed assets disposed of or written off during 2005 was $15,079,000 (2004: $144,400,000).

## 17. Fixed Assets *(Continued)*

(a) Group *(Continued)*

(iii) Leasehold buildings were revalued as at 31 December 2005 on the basis of their depreciated replacement costs calculated by Jones Lang LaSalle, an independent firm of qualified property valuers. The total revaluation deficit of the leasehold buildings for the year ended 31 December 2005 amounted to $1,214,000, of which $377,000 has been taken to leasehold buildings revaluation reserve to set off against previous valuation surpluses (note 32), whereas the remaining $837,000 has been charged to the profit and loss account as impairment losses of leasehold buildings under other operating expenses (note 11). The revaluation gain of $36,000 for the year ended 31 December 2004 was credited to leasehold buildings revaluation reserve (note 32).

(iv) The cost of leasehold buildings of the Group was $26,900,000 (2004: $26,900,000). The carrying value of these leasehold buildings as at 31 December 2005 would have been $12,077,000 (2004: $13,153,000) had they been carried at cost less accumulated depreciation.

(b) HKEx

| | Other computer hardware and software $'000 | Leasehold improvements, furniture, equipment and motor vehicles $'000 | Total $'000 |
|---|---|---|---|
| Net book value at 1 Jan 2004 (note i) | 29,612 | 7,246 | 36,858 |
| Additions | 5,178 | 343 | 5,521 |
| Depreciation | (12,728) | (4,487) | (17,215) |
| Net book value at 31 Dec 2004 | 22,062 | 3,102 | 25,164 |
| At 31 Dec 2004 | | | |
| Cost | 46,695 | 16,565 | 63,260 |
| Accumulated depreciation | (24,633) | (13,463) | (38,096) |
| Net book value | 22,062 | 3,102 | 25,164 |
| Net book value at 1 Jan 2005 | **22,062** | **3,102** | **25,164** |
| Additions | **5,828** | **1,771** | **7,599** |
| Disposals (note ii) | **(1)** | **–** | **(1)** |
| Depreciation | **(12,532)** | **(2,507)** | **(15,039)** |
| Net book value at 31 Dec 2005 | **15,357** | **2,366** | **17,723** |
| At 31 Dec 2005 | | | |
| Cost | **52,673** | **19,128** | **71,801** |
| Accumulated depreciation | **(37,316)** | **(16,762)** | **(54,078)** |
| Net book value | **15,357** | **2,366** | **17,723** |

## 17. Fixed Assets *(Continued)*

(b) HKEx *(Continued)*

(i) The analysis of net book value as at 1 January 2004 was as follows:

| | Other computer hardware and software $'000 | Leasehold improvements, furniture, equipment and motor vehicles $'000 | Total $'000 |
|---|---|---|---|
| At cost | 43,278 | 16,226 | 59,504 |
| Accumulated depreciation | (13,666) | (8,980) | (22,646) |
| Net book value | 29,612 | 7,246 | 36,858 |

(ii) The total cost of fixed assets disposed of or written off during 2005 was $3,000 (2004: $1,765,000).

## 18. Investment Property

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| At 1 Jan | **13,300** | 10,000 |
| Fair value gain | **4,400** | 3,300 |
| At 31 Dec | **17,700** | 13,300 |

The investment property is held under long-term lease and situated in Hong Kong. The cost of investment property was $8,229,000 (2004: $8,229,000). The investment property was revalued as at 31 December 2005 on the basis of its open market value by Jones Lang LaSalle, an independent firm of qualified property valuers. The fair value gain during the year amounted to $4,400,000 (2004: $3,300,000) and was credited to the profit and loss account under other income (note 8).

## 19. Lease Premiums for Land

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| Net book value at 1 Jan | **95,218** | 95,766 |
| Amortisation | **(548)** | (548) |
| Net book value at 31 Dec | **94,670** | 95,218 |
| Current portion of non-current assets | **(547)** | (548) |
| Non-current portion | **94,123** | 94,670 |

The leasehold land is held under long-term lease and situated in Hong Kong. The cost of the leasehold land was $102,770,000 (2004: $102,770,000).

## 20. Investments in Associates

| | Group | |
|---|---|---|
| | **2005** **$'000** | 2004 $'000 |
| Share of net assets of associates (note a) | **14,374** | 13,790 |
| Goodwill (note b) | **50,207** | 24,941 |
| | **64,581** | 38,731 |

(a) Share of net assets of associates

| | **2005** **$'000** | 2004 $'000 |
|---|---|---|
| At 1 Jan | **13,790** | 11,707 |
| Further acquisition of 6% interest in CHIS on 3 May 2005 | **10** | – |
| Share of profits less losses of associates: | | |
| – share of profits less losses before taxation | **22,110** | 15,770 |
| – share of taxation | **(3,677)** | (2,886) |
| | **18,433** | 12,884 |
| Share of reserves of an associate | **93** | – |
| Dividends received and receivable from an associate | **(17,952)** | (10,801) |
| At 31 Dec | **14,374** | 13,790 |

(b) Goodwill

| | **2005** **$'000** | 2004 $'000 |
|---|---|---|
| At 1 Jan (note i) | **24,941** | 24,941 |
| Further acquisition of 6% interest in CHIS on 3 May 2005 | **25,266** | – |
| At 31 Dec | **50,207** | 24,941 |
| Represented by: | | |
| Opening value upon adoption of HKFRS 3 | **25,321** | 25,321 |
| Addition at cost | **25,266** | – |
| Accumulated impairment | **(380)** | (380) |
| | **50,207** | 24,941 |

(i) Goodwill as at 1 January 2004 represented the opening value upon adoption of HKFRS 3 of $25,321,000 less accumulated impairment of $380,000.

## 20. Investments in Associates *(Continued)*

(b) Goodwill *(Continued)*

(ii) Impairment tests for investments in associates

The recoverable amount of the investment in CHIS is determined using discounted cash flows which represents the present value of estimated future cash flows expected to arise from dividends to be received from CHIS and its ultimate disposal. The discount rate used is the ten-year Hong Kong Government bond rate as at 31 December 2005 of 4.18 per cent (2004: 3.55 per cent).

The recoverable amount of the investment in ADP Wilco Processing Services Limited ("AWPS") is based on the share of the net assets of the associate, which comprise predominantly cash and bank balances.

(c) Details of the unlisted associates as at 31 December 2005 were 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 | 7,317 Class A ordinary shares | 30% |
| ADP Wilco Processing Services Limited | Hong Kong | Provision of transaction processing services to Stock Exchange Participants | 6 Class B ordinary shares | 30% |

AWPS has an accounting year end of 30 June, which is not coterminous with the Group's accounting year end. Voluntary liquidation of AWPS commenced in April 2005.

(d) The summarised financial information based on the unaudited management accounts of the associates as at 31 December was as follows:

| | **2005 $'000** | 2004 $'000 |
|---|---|---|
| Assets | **90,387** | 82,540 |
| Liabilities | **42,537** | 26,172 |
| Income | **232,098** | 209,953 |
| Profit | **66,071** | 53,708 |

## 21. Clearing House Funds

| | Group 2005 $'000 | Group 2004 $'000 |
|---|---|---|
| Net assets of the Clearing House Funds were as follows: | | |
| HKSCC Guarantee Fund | **342,679** | 339,598 |
| SEOCH Reserve Fund | **376,758** | 160,119 |
| HKCC Reserve Fund | **620,973** | 1,361,770 |
| | **1,340,410** | 1,861,487 |
| Net assets of the Clearing House Funds were composed of: | | |
| Available-for-sale financial assets, at fair value | | |
| – listed debt securities | **98,896** | – |
| – unlisted debt securities | **125,241** | 127,569 |
| Time deposits with original maturities over three months | **30,290** | 144,610 |
| Cash and cash equivalents | **1,091,233** | 1,604,089 |
| | **1,345,660** | 1,876,268 |
| Less: Other liabilities | **(5,250)** | (14,781) |
| | **1,340,410** | 1,861,487 |
| The Clearing House Funds were funded by: | | |
| Clearing Participants' cash contributions (note a) | **751,751** | 1,298,752 |
| Designated reserves (note 34): | | |
| – Clearing houses' contributions | **320,200** | 320,200 |
| – Forfeiture of a defaulted Clearing Participant's contributions | **1,928** | 1,928 |
| – Accumulated investment income net of expenses attributable to: | | |
| – Clearing Participants' contributions | **204,213** | 182,839 |
| – Clearing houses' contributions | **63,635** | 55,659 |
| | **589,976** | 560,626 |
| Revaluation reserve (Note 32(b)) | **(1,317)** | 2,109 |
| | **1,340,410** | 1,861,487 |
| The maturity profile of the net assets of the Clearing House Funds was as follows: | | |
| Amounts maturing after more than twelve months | **98,896** | 157,858 |
| Amounts maturing within twelve months | **1,241,514** | 1,703,629 |
| | **1,340,410** | 1,861,487 |

(a) Amount included Participants' additional deposits of $393,701,000 (2004: $961,502,000).

(b) The HKSCC Guarantee Fund provides resources to enable HKSCC to discharge the liabilities and obligations of defaulting Broker Participants in CCASS arising from their Stock Exchange trades accepted for settlement on the 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.

## 22. Compensation Fund Reserve Account

| | Group 2005 $'000 | Group 2004 $'000 |
|---|---|---|
| Net assets of the Compensation Fund Reserve Account were composed of: | | |
| Available-for-sale financial assets, at fair value | | |
| – unlisted debt securities | **18,488** | 18,831 |
| Cash and cash equivalents | **30,240** | 29,137 |
| Other receivable | **–** | 100 |
| | **48,728** | 48,068 |
| Less: Other liabilities | **(10,318)** | (10,617) |
| | **38,410** | 37,451 |
| The Fund represented: | | |
| Accumulated investment income net of expenses included in designated reserves (note 34) | **38,420** | 37,117 |
| Revaluation reserve (note 32(b)) | **(10)** | 334 |
| | **38,410** | 37,451 |
| The maturity profile of the net assets of the Compensation Fund Reserve Account was as follows: | | |
| Amounts maturing after more than twelve months | **–** | 18,831 |
| Amounts maturing within twelve months | **38,410** | 18,620 |
| | **38,410** | 37,451 |

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:

(i) 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;

(ii) Amounts received or paid out in relation to each of the Stock Exchange Trading Rights granted or revoked by the Stock Exchange respectively; and

(iii) Amounts reserved for the replenishment to the Compensation Fund.

The Compensation Fund is further explained in note 40(a)(i).

## 23. Accounts Receivable, Prepayments and Deposits

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Receivable from Exchange and Clearing Participants: | | | | |
| – CNS money obligations | **2,889,804** | 4,261,202 | **–** | – |
| – transaction levy, stamp duty and fees receivable | **193,849** | 217,270 | **–** | – |
| – others | **10,084** | 13,103 | **–** | – |
| Other fees receivable | **137,848** | 161,638 | **–** | – |
| Prepayments | **36,638** | 39,275 | **26,114** | 20,315 |
| Other receivables and deposits | **22,941** | 4,525 | **160** | 323 |
| Less: Provision for impairment losses of trade receivables (note b) | **(4,329)** | (5,167) | **–** | – |
| | **3,286,835** | 4,691,846 | **26,274** | 20,638 |

(a) The carrying amounts of accounts receivable and deposits approximated their fair values.

(b) The movements in provision for impairment losses of trade receivables were as follows:

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| At 1 Jan | **5,167** | 6,112 |
| Reversal of provision for impairment losses of trade receivables (note 11) | **(389)** | (850) |
| Trade receivables written off during the year as uncollectible | **(449)** | (95) |
| At 31 Dec | **4,329** | 5,167 |

(c) CNS money obligations receivable accounted for 88 per cent (2004: 91 per cent) of the total accounts receivable, prepayments and deposits. CNS money obligations receivable mature within two days after the trade date. Fees receivable are due immediately or up to 30 days depending on the type of services rendered. The majority of the remaining accounts receivable, prepayments and deposits would mature within three months.

## 24. Margin Funds on Derivatives Contracts

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| The Margin Funds comprised: | | |
| SEOCH Clearing Participants' Margin Funds | **1,506,962** | 915,250 |
| HKCC Clearing Participants' Margin Funds | **12,141,619** | 9,614,442 |
| | **13,648,581** | 10,529,692 |
| The assets of the Margin Funds comprised: | | |
| Financial assets at fair value through profit or loss, on designation | | |
| – bank deposits with embedded derivatives, at fair value (note a) | **–** | 130,871 |
| Available-for-sale financial assets, at fair value | | |
| – listed debt securities | **438,542** | 339,158 |
| – unlisted debt securities | **3,390,291** | 3,280,786 |
| Time deposits with original maturities over three months | **100,018** | 300,784 |
| Cash and cash equivalents | **9,686,026** | 6,443,406 |
| Margin receivable from Clearing Participants | **33,704** | 34,687 |
| | **13,648,581** | 10,529,692 |
| The Group's liabilities in respect of the Margin Funds were as follows: | | |
| Margin deposits from SEOCH and HKCC Participants on derivatives contracts | **13,648,581** | 10,529,692 |
| The maturity profile of the assets of Margin Funds was as follows: | | |
| Amounts maturing after more than twelve months | **1,114,326** | 2,138,362 |
| Amounts maturing within twelve months | **12,534,255** | 8,391,330 |
| | **13,648,581** | 10,529,692 |

(a) The maximum exposure to credit risk of the bank deposits as at 31 December 2004 was $130,871,000. No related credit derivatives or similar instruments were used to mitigate the maximum exposure to credit risk. There was no fair value change of the bank deposits attributable to changes in credit risk since its acquisition, during 2004 and up to its maturity in 2005, which was determined as the amount of change in its fair value that was not attributable to changes in market conditions that gave rise to market risk.

## 25. Financial Assets/Liabilities at Fair Value through Profit or Loss

| | Group 2005 $'000 | Group 2004 $'000 |
|---|---|---|
| **Analysis of financial assets at fair value through profit or loss:** | | |
| *Held for trading* | | |
| Equity securities, at fair value | | |
| – listed in Hong Kong | **139,220** | 93,154 |
| – listed outside Hong Kong | **173,349** | 151,954 |
| | **312,569** | 245,108 |
| *Held for trading* | | |
| Debt securities, at fair value | | |
| – listed in Hong Kong | **86,509** | – |
| – listed outside Hong Kong | **1,070,100** | 1,278,858 |
| – unlisted | **1,172,015** | 1,200,195 |
| | **2,328,624** | 2,479,053 |
| *Held for trading* | | |
| Derivative financial instruments, at fair value | | |
| – forward foreign exchange contracts | **2,595** | 247 |
| *Designated as financial assets at fair value through profit or loss* | | |
| Bank deposits with embedded derivatives, at fair value (note a) | **–** | 37,185 |
| | **2,643,788** | 2,761,593 |
| **Analysis of financial liabilities at fair value through profit or loss:** | | |
| *Held for trading* | | |
| Derivative financial instruments, at fair value | | |
| – forward foreign exchange contracts | **1,443** | 10,749 |

(a) The maximum exposure to credit risk of the bank deposits as at 31 December 2004 was $37,185,000. No related credit derivatives or similar instruments were used to mitigate the maximum exposure to credit risk. There was no fair value change of the bank deposits attributable to changes in credit risk since its acquisition, during 2004 and up to its maturity in 2005, which was determined as the amount of change in its fair value that was not attributable to changes in market conditions that gave rise to market risk.

## 26. Accounts Payable, Accruals and Other Liabilities

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Payable to Exchange and Clearing Participants: | | | | |
| – CNS money obligations | **2,889,524** | 4,261,382 | **–** | – |
| – cash collateral and marks | **144,144** | 95,677 | **–** | – |
| – others | **46,450** | 54,368 | **–** | – |
| Transaction levy payable to the SFC | **55,027** | 63,736 | **–** | – |
| Unclaimed dividends (note b) | **180,327** | 143,177 | **32,288** | 25,815 |
| Stamp duty payable | **75,899** | 70,854 | **–** | – |
| Deposits received | **22,156** | 29,376 | **–** | – |
| Other payables and accruals | **227,543** | 183,780 | **129,730** | 84,786 |
| | **3,641,070** | 4,902,350 | **162,018** | 110,601 |

(a) The carrying amounts of accounts payable and other liabilities approximated their fair values.

(b) Unclaimed dividends for the Group represent dividends declared by listed companies which were held by HKSCC Nominees Limited but not yet claimed by shareholders of the companies concerned, and dividends declared by HKEx but not yet claimed by its shareholders.

(c) CNS money obligations payable accounted for 79 per cent (2004: 87 per cent) of the total accounts payable, accruals and other liabilities. CNS money obligations payable mature within two days after the trade date. The majority of the remaining accounts payable, accruals and other liabilities would mature within three months.

## 27. Participants' Admission Fees Received

The admission fees are non-interest bearing and may be repayable upon the expiry of seven years from the date of admission of a Participant or upon the termination of a Participant's participation in CCASS, whichever is later. HKSCC may, at its discretion, grant early refunds of admission fees to terminated Participants after six months from the date of termination of their participation in CCASS and to Broker Participants after six months from the date of sale of their Stock Exchange Trading Right.

## 28. Provisions

(a) Group

| | Reinstatement costs $'000 | Employee benefit costs $'000 | Total $'000 |
|---|---|---|---|
| At 1 Jan 2005 | 24,104 | 23,212 | 47,316 |
| Provision for the year | 1,492 | 34,403 | 35,895 |
| Amount used during the year | (1,468) | (29,560) | (31,028) |
| Amount paid during the year | – | (2,442) | (2,442) |
| At 31 Dec 2005 | 24,128 | 25,613 | 49,741 |

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Analysis of provisions: | | |
| Current | 27,145 | 23,212 |
| Non-current | 22,596 | 24,104 |
| | 49,741 | 47,316 |

(b) HKEx

| | Reinstatement costs $'000 | Employee benefit costs $'000 | Total $'000 |
|---|---|---|---|
| At 1 Jan 2005 | 555 | 23,212 | 23,767 |
| Provision for the year | 20 | 34,403 | 34,423 |
| Amount used during the year | – | (29,560) | (29,560) |
| Amount paid during the year | – | (2,442) | (2,442) |
| At 31 Dec 2005 | 575 | 25,613 | 26,188 |

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Analysis of provisions: | | |
| Current | 25,613 | 23,212 |
| Non-current | 575 | 555 |
| | 26,188 | 23,767 |

## 29. Investments in and Amounts Due from/(to) Subsidiaries

(a) Investments in subsidiaries

| | HKEx | |
|---|---|---|
| | 2005<br>$'000 | As restated<br>2004<br>$'000 |
| Investments in unlisted shares, at cost | **4,145,198** | 4,145,198 |
| Financial guarantee granted to a subsidiary (note 40(b)(i)) | **11,390** | 11,390 |
| | **4,156,588** | 4,156,588 |

(b) Amounts due from/(to) subsidiaries

The amounts due from/(to) subsidiaries are interest-free and repayable on demand.

(c) Particulars of subsidiaries

HKEx had direct or indirect interests in the following subsidiaries as at 31 December 2005, all of which are wholly-owned private companies incorporated and operating in Hong Kong except for HKEx (China) Limited, which operates mainly in the Mainland. Details of these companies were as follows:

| Company | Issued and fully paid up share capital | Principal activities | Interest held |
|---|---|---|---|
| **Direct subsidiaries:** | | | |
| The Stock Exchange of Hong Kong Limited | A shares $929 | Operates the single, unified stock exchange in Hong Kong for the purposes of the Securities and Futures Ordinance | 100% |
| Hong Kong Futures Exchange Limited | Ordinary $19,600,000<br>Standard $850,000 | Operates a futures and options exchange | 100% |
| Hong Kong Securities Clearing Company Limited | Ordinary $2 | Operates CCASS and the central securities depository and provides custody and nominee services for eligible securities listed in Hong Kong | 100% |
| HKEC Nominees Limited | Ordinary $2 | Nominee services | 100% |
| Hong Kong Financial Markets Development Limited | Ordinary $2 | Promotes the securities, futures and financial industry | 100% |

## 29. Investments in and Amounts Due from/(to) Subsidiaries *(Continued)*

(c) Particulars of subsidiaries *(Continued)*

| Company | Issued and fully paid up share capital | Principal activities | Interest held |
|---|---|---|---|
| HKEx (China) Limited | Ordinary $2 | Promotes HKEx products and services in the Mainland | 100% |
| HKEx (Singapore) Limited | Ordinary $2 | Dormant | 100% |
| **Indirect subsidiaries:** | | | |
| The SEHK Options Clearing House Limited | Ordinary $1,000,000 | Operates a clearing house for options contracts traded on the Stock Exchange | 100% |
| HKEx Information Services Limited | Ordinary $100 | Sale of stock market information | 100% |
| Prime View Company Limited | Ordinary $20 | Property holding | 100% |
| The Stock Exchange Club Limited | Ordinary $8 | Property holding | 100% |
| The Stock Exchange Nominee Limited | Ordinary $2 | Nominee services | 100% |
| HKFE Clearing Corporation Limited | Ordinary $1,000,000 | Operates a clearing house for derivatives contracts traded on the Futures Exchange | 100% |
| HKFE Clearing Linkage Limited | Ordinary $2 | Dormant | 100% |
| HKSCC Nominees Limited | Ordinary $20 | Acting as common nominee in respect of securities held in the CCASS depository | 100% |
| Many Profit Limited | Ordinary $2 | Investment holding | 100% |
| Freestar Corporation Limited | Ordinary $2 | Investment holding | 100% |
| Star Prime Limited | Ordinary $2 | Investment holding | 100% |
| HK Conversion Agency Services Limited | Ordinary $2 | Conversion agency services | 100% |

## 29. Investments in and Amounts Due from/(to) Subsidiaries *(Continued)*

(d) Effects on the consolidated accounts of consolidating the HKEx Employee Share Trust

The HKEx Employee Share Trust is a trust set up for the purpose of administering and holding HKEx shares for the Share Award Scheme, details of which are set out in note 31(c). As HKEx has the power to govern its financial and operating policies and can derive benefits from the contributions of the employees who have been awarded the Awarded Shares through their continued employment with the Group, the Group is required to consolidate the HKEx Employee Share Trust under HK(SIC)-INT 12 (Amendment). As at 31 December 2005, however, the HKEx Employee Share Trust was not consolidated as it was not a subsidiary under the Hong Kong Companies Ordinance.

The effects on the consolidated accounts had the HKEx Employee Share Trust been consolidated as at 31 December 2005 were as follows:

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| *Consolidated profit and loss account* | | |
| Increase in investment income | **11** | – |
| Increase in other operating expenses | **(1)** | – |
| Total increase in profit | **10** | – |

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| *Consolidated balance sheet* | | |
| **Increase/(decrease) in assets** | | |
| Contributions to The HKEx Employees' Share Award Scheme | **(30,037)** | – |
| Cash and cash equivalents | **20** | – |
| **Increase/(decrease) in liabilities/equity** | | |
| Accounts payable, accruals and other liabilities | **1** | – |
| Treasury shares* | **(30,028)** | – |
| Retained earnings | **10** | – |

* The HKEx shares held by the HKEx Employee Share Trust are classified as "Treasury shares" and presented as a deduction of total equity. The amount represented the consideration paid and directly attributable incremental costs in acquiring the shares.

## 30. Share Capital and Share Premium

| | Group and HKEx 2005 $'000 | 2004 $'000 |
|---|---|---|
| Authorised: | | |
| 2,000,000,000 shares of $1 each | **2,000,000** | 2,000,000 |

Issued and fully paid:

| | Number of shares of $1 each | Share capital $'000 | Share premium $'000 | Total $'000 |
|---|---|---|---|---|
| At 1 Jan 2004 | 1,048,998,846 | 1,048,999 | 54,338 | 1,103,337 |
| Shares issued under employee share option schemes | 7,640,000 | 7,640 | 49,696 | 57,336 |
| At 31 Dec 2004 | 1,056,638,846 | 1,056,639 | 104,034 | 1,160,673 |
| At 1 Jan 2005 | **1,056,638,846** | **1,056,639** | **104,034** | **1,160,673** |
| Shares issued under employee share option schemes | **6,116,000** | **6,116** | **41,263** | **47,379** |
| Transfer from employee share-based compensation reserve | **–** | **–** | **5,108** | **5,108** |
| At 31 Dec 2005 | **1,062,754,846** | **1,062,755** | **150,405** | **1,213,160** |

During the year, employee share options granted under the Pre-Listing Scheme and the Post-Listing Scheme were exercised to subscribe for 6,116,000 shares (2004: 7,640,000 shares) in HKEx at an average consideration of $7.75 per share (2004: $7.50 per share), of which $1.00 per share was credited to share capital and the balance was credited to the share premium account.

## 31. Employee Share-based Compensation Reserve

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| At 1 Jan | **17,061** | 2,771 | **17,061** | 2,771 |
| Employee share-based compensation benefits (note (a) and note 9(a)) | **22,955** | 14,290 | **22,955** | 14,290 |
| Transfer to share premium upon exercise of employee share options | **(5,108)** | – | **(5,108)** | – |
| Share of reserve of an associate | **72** | – | **–** | – |
| At 31 Dec | **34,980** | 17,061 | **34,908** | 17,061 |

## 31. Employee Share-based Compensation Reserve *(Continued)*

(a) Employee share-based compensation benefits represent the fair value of employee services estimated to be received in exchange for the grant of the relevant options and Awarded Shares over the relevant vesting periods, the total of which is based on the fair value of the options and Awarded Shares at grant date. The amount for each period is determined by spreading the fair value of the options and Awarded Shares over the relevant vesting periods and is recognised as staff costs and related expenses (note 9(a)) with a corresponding increase in the employee share-based compensation reserve.

(b) Share options

(i) Share options are granted to an Executive Director and employees of the Group to subscribe for shares in HKEx in accordance with the terms and conditions of the Share Option Schemes approved by the shareholders of HKEx at an extraordinary general meeting held on 31 May 2000. Share options granted are subject to a vesting scale in tranches of 25 per cent each per annum starting from the second anniversary and fully vested in the fifth anniversary of the date of grant, providing that the grantees remain under the employ of the Group. The vested share options are exercisable within ten years of the grant date.

During the year, options for the subscription of 5,884,000 shares were granted under the Post-Listing Scheme to a number of employees on 26 January 2005 which are exercisable between 26 January 2007 and 25 January 2015 at an exercise price of $19.25 per share.

Shares are issued when options are exercised. The Group has no legal or constructive obligations to repurchase or settle the options in cash.

## 31. Employee Share-based Compensation Reserve *(Continued)*

(b) Share options *(Continued)*

(ii) Movements in the number of shares issuable under options granted and their related weighted average exercise prices were as follows:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | **Average exercise price per share $** | **Number of shares issuable under options granted** | Average exercise price per share $ | Number of shares issuable under options granted |
| **Pre-Listing Scheme** | | | | |
| Outstanding at 1 Jan | **6.88** | **6,680,000** | 7.52 | 14,171,626 |
| Exercised | **6.88** | **(4,554,000)** | 7.50 | (7,640,000) |
| Forfeited | – | – | 7.00 | (524,829) |
| Adjusted* | – | – | N/A | 673,203 |
| Outstanding at 31 Dec | **6.88** | **2,126,000** | 6.88 | 6,680,000 |
| **Post-Listing Scheme** | | | | |
| Outstanding at 1 Jan | **13.78** | **13,218,000** | 11.26 | 5,800,000 |
| Granted | **19.25** | **5,884,000** | 17.21 | 6,888,000 |
| Exercised | **10.27** | **(1,562,000)** | – | – |
| Forfeited | **18.05** | **(966,000)** | 16.96 | (106,000) |
| Adjusted* | – | – | N/A | 636,000 |
| Outstanding at 31 Dec | **15.80** | **16,574,000** | 13.78 | 13,218,000 |
| Total | **14.79** | **18,700,000** | 11.46 | 19,898,000 |

* Adjustments approved by shareholders at the 2004 annual general meeting held on 31 March 2004

At 31 December 2005, out of the 18,700,000 outstanding options (2004: 19,898,000), 2,148,000 options (2004: 2,093,000 options) were exercisable at a weighted average exercise price of $6.94 (2004: $6.88) per share.

During the year, employee share options granted under the Pre-Listing Scheme and the Post-Listing Scheme were exercised to subscribe for 6,116,000 shares (2004: 7,640,000 shares) in HKEx at a weighted average exercise price of $7.75 per share (2004: $7.50 per share). The weighted average closing share price on the dates on which the options were exercised was $21.06 (2004: $18.45) per share.

## 31. Employee Share-based Compensation Reserve *(Continued)*

(b) Share options *(Continued)*

(iii) Share options outstanding as at 31 December had the following remaining contractual lives and exercise prices:

| | **2005** | | 2004 | |
|---|---|---|---|---|
| | **Remaining contractual life** | **Number of shares issuable under options granted** | Remaining contractual life | Number of shares issuable under options granted |
| Exercise price | | | | |
| $6.88 | **4.41 years** | **2,126,000** | 5.41 years | 6,680,000 |
| $8.28 | **7.33 years** | **2,460,000** | 8.33 years | 3,280,000 |
| $12.45 | **7.62 years** | **844,000** | 8.62 years | 1,094,000 |
| $12.49 | **7.63 years** | **1,476,000** | 8.63 years | 1,968,000 |
| $17.30 | **8.04 years** | **1,094,000** | 9.04 years | 1,094,000 |
| $16.96 | **8.24 years** | **5,074,000** | 9.24 years | 5,582,000 |
| $15.91 | **8.37 years** | **200,000** | 9.37 years | 200,000 |
| $19.25 | **9.07 years** | **5,426,000** | – | – |
| | **7.84 years** | **18,700,000** | 7.70 years | 19,898,000 |

## 31. Employee Share-based Compensation Reserve *(Continued)*

(b) Share options *(Continued)*

(iv) According to the Binomial Option Pricing Model, the value and adjusted value of the options granted during the year and 2004 were as follows:

| | Date of grant | | | |
|---|---|---|---|---|
| | 2005 | 2004 | | |
| | 26 Jan 2005 | 15 Jan 2004 | 31 Mar 2004 | 17 May 2004 |
| **Option value** Ω | | | | |
| Before adjustment | **$26,183,800** | $6,550,000 | $32,250,960 | $1,156,000 |
| After adjustment* | **Not subject to adjustment** | $6,564,000 | Not subject to adjustment | Not subject to adjustment |
| **Variables** | | | | |
| Closing share price at date of grant | **$19.25** | $18.90 | $16.70 | $14.65 |
| Risk Free Rate (being the yield of 10-year Exchange Fund Notes) | **3.67% as at 26 Jan 2005** | 3.96% as at 15 Jan 2004 | 3.78% as at 31 Mar 2004 | 4.55% as at 17 May 2004 |
| Expected Volatility# | **26%** | 34% | 35% | 37% |
| Expiration of the options | **10 years from 26 Jan 2005** | 10 years from 15 Jan 2004 | 10 years from 31 Mar 2004 | 10 years from 17 May 2004 |
| Expected ordinary dividend | **4.42% (2005 prospective dividend yield of the shares as at 26 Jan 2005)** | 3.23% (2004 prospective dividend yield of the shares as at 15 Jan 2004) | 3.59% (2004 prospective dividend yield of the shares as at 31 Mar 2004) | 3.77% (2004 prospective dividend yield of the shares as at 17 May 2004) |

* Adjustments approved by the shareholders at the 2004 annual general meeting held on 31 March 2004

\# The volatility measured at the standard deviation of expected share price returns is based on statistical analysis of daily share prices annualised for one year immediately preceding the grant date.

Ω The above calculation is based on the assumption that there is no material difference between the expected volatility over the whole life of the options and the historical volatility of the shares in HKEx set out above.

## 31. Employee Share-based Compensation Reserve *(Continued)*

(b) Share options *(Continued)*

(v) Had all the outstanding employee share options been fully exercised on 31 December 2005, the Group would have received $276,552,460 in proceeds. The market value of the shares issued based on the closing price of $32.15 per share on that date would have been $601,205,000. The theoretical gains made by the employees or Executive Director concerned would have been as follows:

| | Number of shares issuable under options granted as at 31 Dec 2005 | Exercise price $ | Gain per share $ | Aggregate gain $'000 |
|---|---|---|---|---|
| **Pre-Listing Scheme** | | | | |
| – granted to employees on 20 Jun 2000 | 2,126,000 | 6.88 | 25.27 | 53,724 |
| **Post-Listing Scheme** | | | | |
| – granted to an Executive Director on 2 May 2003 | 2,460,000 | 8.28 | 23.87 | 58,720 |
| – granted to an employee on 14 Aug 2003 | 844,000 | 12.45 | 19.70 | 16,627 |
| – granted to an employee on 18 Aug 2003 | 1,476,000 | 12.49 | 19.66 | 29,018 |
| – granted to an employee on 15 Jan 2004 | 1,094,000 | 17.30 | 14.85 | 16,246 |
| – granted to employees on 31 Mar 2004 | 5,074,000 | 16.96 | 15.19 | 77,074 |
| – granted to an employee on 17 May 2004 | 200,000 | 15.91 | 16.24 | 3,248 |
| – granted to employees on 26 Jan 2005 | 5,426,000 | 19.25 | 12.90 | 69,996 |
| Total | 18,700,000 | | | 324,653 |

(c) Awarded Shares

(i) On 14 September 2005, the Board of HKEx approved the Share Award Scheme under which Awarded Shares may be awarded to an Executive Director and employees of the Group in accordance with the terms and conditions of the Share Award Scheme. Awarded Shares awarded are subject to a vesting scale in tranches of 25 per cent each per annum starting from the second anniversary and fully vested in the fifth anniversary of the date of award, providing that the awardees remain under the employ of the Group.

Pursuant to the rules of the Share Award Scheme, upon awarding of the Awarded Shares, the number of HKEx shares awarded will be acquired from the market at the cost of HKEx by the trustee of the HKEx Employee Share Trust, which has been set up for the purpose of administering the Share Award Scheme. The Awarded Shares will be held by the trustee until the end of each vesting period.

On 19 December 2005, 960,000 Awarded Shares were awarded to a number of employees, which will be transferred to the employees at nil consideration upon vesting between 19 December 2007 and 19 December 2010. As at 31 December 2005, the Group had advanced $30,037,000 to the HKEx Employee Share Trust and the amount was recorded as "Contributions to The HKEx Employees' Share Award Scheme" in the consolidated balance sheet. The trustee acquired 958,000 HKEx shares in December 2005 and the remaining 2,000 shares in January 2006.

## 31. Employee Share-based Compensation Reserve *(Continued)*

(c) Awarded Shares *(Continued)*

(ii) Movements in the number of Awarded Shares awarded and their related average fair value were as follows:

| | **2005** | | 2004 | |
|---|---|---|---|---|
| | **Average fair value per share $** | **Number of Awarded Shares awarded** | Average fair value per share $ | Number of Awarded Shares awarded |
| Outstanding at 1 Jan | **–** | **–** | – | – |
| Awarded | **31.20** | **960,000** | – | – |
| Outstanding at 31 Dec | **31.20** | **960,000** | – | – |

The fair value of the Awarded Shares awarded under the Share Award Scheme was based on the fair value (i.e. market value) of HKEx shares at award date, taking into account the expected dividends during the vesting periods.

(iii) The remaining vesting periods of the Awarded Shares outstanding as at 31 December 2005 ranged from 1.97 years to 4.97 years.

(iv) Had all the outstanding Awarded Shares been fully vested on 31 December 2005, the theoretical benefits of the employees based on the closing price of $32.15 per share on that date would have been $30,864,000.

## 32. Revaluation Reserves

| | Group | | |
|---|---|---|---|
| | Leasehold buildings revaluation reserve $'000 | Investment revaluation reserve $'000 | Total $'000 |
| At 1 Jan 2004 | 2,507 | 33,992 | 36,499 |
| Change in valuation of leasehold buildings (note 17(a)(iii)) | 36 | – | 36 |
| Change in fair value of available-for-sale financial assets | – | 10,535 | 10,535 |
| Realisation of change in fair value of financial assets on maturity and disposal | – | (26,741) | (26,741) |
| Deferred tax arising from change in valuation of leasehold buildings (note 36(b)) | (6) | – | (6) |
| Deferred tax arising from change in fair value of available-for-sale financial assets (note 36(b)) | – | (1,494) | (1,494) |
| At 31 Dec 2004 | 2,537 | 16,292 | 18,829 |
| At 1 Jan 2005 | **2,537** | **16,292** | **18,829** |
| Change in valuation of leasehold buildings (note 17(a)(iii)) | **(377)** | – | **(377)** |
| Change in fair value of available-for-sale financial assets | – | **(52,985)** | **(52,985)** |
| Realisation of change in fair value of available-for-sale financial assets on maturity and disposal | – | **(5,775)** | **(5,775)** |
| Deferred tax arising from change in valuation of leasehold buildings (note 36(b)) | **65** | – | **65** |
| Deferred tax arising from change in fair value of available-for-sale financial assets (note 36(b)) | – | **3,136** | **3,136** |
| Share of reserve of an associate | – | **21** | **21** |
| At 31 Dec 2005 | **2,225** | **(39,311)** | **(37,086)** |

(a) The revaluation reserves are segregated for their respective specific purposes and are stated net of applicable deferred taxes.

(b) Included gross investment revaluation deficits of $1,317,000 and $10,000 which were attributable to investments of the Clearing House Funds and the Compensation Fund Reserve Account respectively (2004: gross surpluses of $2,109,000 and $334,000 respectively). The significant decrease in investment revaluation reserve was primarily due to the decrease in fair value of available-for-sale financial assets of the Margin Funds arising mainly from increases in interest rates during the year. The revaluation deficit is not expected to have any impact to the Group's profit and loss account as the available-for-sale financial assets are expected to be held till maturity and the deficit will gradually reduce to zero (note 3(b)).

## 33. Hedging Reserve

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| At 1 Jan | **–** | – | **–** | – |
| Cash flow hedges: | | | | |
| – fair value loss of hedging instrument | **(129)** | – | **(332)** | – |
| – transfer to profit and loss account as information technology and computer maintenance expenses | **129** | – | **332** | – |
| At 31 Dec | **–** | – | **–** | – |
| Fair value of hedging instrument at 31 Dec | **8,281** | – | **8,281** | – |
| Ineffectiveness of cash flow hedge credited to profit and loss account | **1** | – | **3** | – |

During the year, one of the subsidiaries designated a bank deposit of 8,500,000 Swedish Krona ("SEK") as a cash flow hedge for hedging the foreign exchange risk of forecast information technology and computer maintenance expenses payable of SEK 8,500,000 from 1 August 2005 to 31 December 2005. On 29 August 2005, the said bank deposit was transferred to HKEx without changing the terms of the cash flow hedge.

## 34. Designated Reserves

These reserves are segregated for their respective purposes. Details of the movements on the reserves during the year were as follows:

| | Group | | | | |
|---|---|---|---|---|---|
| | Clearing House Funds reserves (note a) $'000 | Compensation Fund Reserve Account reserve $'000 | CDMD Fund reserve $'000 | Development reserve (note b) $'000 | Total $'000 |
| At 1 Jan 2004 | 565,666 | 36,541 | 914 | 86,536 | 689,657 |
| (Deficit)/surplus of investment income net of expenses transferred from retained earnings | (5,040) | 576 | – | – | (4,464) |
| Transfer to retained earnings | – | – | (914) | (3,283) | (4,197) |
| Transfer (to)/from retained earnings | (5,040) | 576 | (914) | (3,283) | (8,661) |
| At 31 Dec 2004 | 560,626 | 37,117 | – | 83,253 | 680,996 |
| At 1 Jan 2005 | **560,626** | **37,117** | **–** | **83,253** | **680,996** |
| Surplus of investment and other income net of expenses transferred from retained earnings | **29,350** | **1,303** | **–** | **–** | **30,653** |
| Transfer to retained earnings | **–** | **–** | **–** | **(11,008)** | **(11,008)** |
| Transfer from/(to) retained earnings | **29,350** | **1,303** | **–** | **(11,008)** | **19,645** |
| At 31 Dec 2005 | **589,976** | **38,420** | **–** | **72,245** | **700,641** |

## 34. Designated Reserves *(Continued)*

(a) Clearing House Funds reserves

| | HKSCC Guarantee Fund reserve $'000 | SEOCH Reserve Fund reserve $'000 | HKCC Reserve Fund reserve $'000 | Total $'000 |
|---|---|---|---|---|
| At 1 Jan 2004 | 255,912 | 48,571 | 261,183 | 565,666 |
| (Deficit)/surplus of investment income net of expenses of Clearing House Funds transferred from retained earnings | (8,059) | 203 | 2,816 | (5,040) |
| At 31 Dec 2004 | 247,853 | 48,774 | 263,999 | 560,626 |
| At 1 Jan 2005 | **247,853** | **48,774** | **263,999** | **560,626** |
| Surplus of investment income net of expenses of Clearing House Funds transferred from retained earnings | **2,591** | **7,572** | **19,187** | **29,350** |
| At 31 Dec 2005 | **250,444** | **56,346** | **283,186** | **589,976** |

(b) Development reserve

The reserve was set aside for systems development for the Stock Exchange. During 2005, $11,008,000 (2004: $3,283,000) of the reserve was utilised and transferred to the Group's retained earnings (note 37) for funding systems development projects related to the securities market.

## 35. Merger Reserve

The Group has taken advantage of the merger relief available under section 48C of the Hong Kong Companies Ordinance and treated the premium created by the issuance of shares on 6 March 2000, the date HKEx became the holding company of the Stock Exchange and the Futures Exchange and their subsidiaries, as a merger reserve. In the consolidated balance sheet, the full amount of the merger reserve has been used to offset against the reserve arising on consolidation as explained in note 37(c).

## 36. Deferred Taxation

Deferred taxation is calculated in full on temporary differences under the liability method using a principal taxation rate of 17.5 per cent (2004: 17.5 per cent).

(a) The movements on the deferred tax liabilities/(assets) account were as follows:

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| At 1 Jan | **29,649** | 53,515 | **(1,227)** | 150 |
| Transfer to the profit and loss account (note 15(a)) | **(8,738)** | (25,366) | **(1,740)** | (1,377) |
| Transfer (to)/from shareholders' equity (note b) | **(3,201)** | 1,500 | **–** | – |
| At 31 Dec (note e) | **17,710** | 29,649 | **(2,967)** | (1,227) |

(b) The deferred taxation transfer (to)/from shareholders' equity during the year was as follows:

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| Reserves in shareholders' equity: | | |
| – leasehold buildings revaluation reserve (note 32) | **(65)** | 6 |
| – investment revaluation reserve (note 32) | **(3,136)** | 1,494 |
| | **(3,201)** | 1,500 |

(c) Deferred tax assets are recognised for tax losses carried forward to the extent that realisation of the related tax benefit through future taxable profits is probable. The Group had unrecognised tax losses of $276,331,000 as at 31 December 2005 (2004: $208,207,000) carried forward for offsetting against future taxable income.

## 36. Deferred Taxation *(Continued)*

(d) The movements on the deferred tax liabilities/(assets) account were as follows:

| | Group | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Accelerated tax depreciation | | Revaluation of properties | | Tax losses | | Revaluation of available-for-sale financial assets | | Employee benefits | | Total | |
| | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 |
| At 1 Jan | 38,085 | 63,853 | 1,663 | 1,021 | (9,158) | (8,856) | 3,121 | 1,627 | (4,062) | (4,130) | 29,649 | 53,515 |
| Charged/(credited) to profit and loss account | (13,033) | (25,768) | 693 | 636 | 4,022 | (302) | – | – | (420) | 68 | (8,738) | (25,366) |
| Charged/(credited) to equity | – | – | (65) | 6 | – | – | (3,136) | 1,494 | – | – | (3,201) | 1,500 |
| At 31 Dec | 25,052 | 38,085 | 2,291 | 1,663 | (5,136) | (9,158) | (15) | 3,121 | (4,482) | (4,062) | 17,710 | 29,649 |

| | HKEx | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Accelerated tax depreciation | | Tax losses | | Employee benefits | | Total | |
| | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 |
| At 1 Jan | 2,835 | 4,825 | – | (545) | (4,062) | (4,130) | (1,227) | 150 |
| Charged/(credited) to profit and loss account | (1,320) | (1,990) | – | 545 | (420) | 68 | (1,740) | (1,377) |
| At 31 Dec | 1,515 | 2,835 | – | – | (4,482) | (4,062) | (2,967) | (1,227) |

(e) Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when the deferred taxes relate to the same fiscal authority. The following amounts, determined after appropriate offsetting, are shown in the balance sheet:

| | Group | | HKEx | |
|---|---|---|---|---|
| | 2005 $'000 | 2004 $'000 | 2005 $'000 | 2004 $'000 |
| Net deferred tax assets recognised on the balance sheet | (3,060) | (1,227) | (2,967) | (1,227) |
| Net deferred tax liabilities recognised on the balance sheet | 20,770 | 30,876 | – | – |
| | 17,710 | 29,649 | (2,967) | (1,227) |

## 37. Retained Earnings (Including Proposed/Declared Dividends)

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | As restated 2004 $'000 | **2005 $'000** | 2004 $'000 |
| At 1 Jan, as previously reported | | | | |
| Retained earnings/ (accumulated losses) | **1,677,964** | 1,578,991 | **(272,421)** | (1,825,358) |
| Proposed/declared dividends | **496,620** | 2,202,898 | **496,620** | 2,202,898 |
| | **2,174,584** | 3,781,889 | **224,199** | 377,540 |
| Effect of initial adoption of HKAS 39 and HKFRS 4 (Amendment) | **(19,909)** | (19,909) | **–** | – |
| At 1 Jan, as restated | **2,154,675** | 3,761,980 | **224,199** | 377,540 |
| Profit for the year | **1,339,548** | 1,056,884 | **1,032,260** | 2,519,509 |
| (Surplus)/deficit of investment income net of expenses of Clearing House Funds transferred to Clearing House Funds reserves | **(29,350)** | 5,040 | **–** | – |
| Investment and other income net of expenses of Compensation Fund Reserve Account transferred to Compensation Fund Reserve Account reserve | **(1,303)** | (576) | **–** | – |
| Transfer from CDMD Fund reserve | **–** | 914 | **–** | – |
| Transfer from Development reserve | **11,008** | 3,283 | **–** | – |
| Dividends paid: | | | | |
| 2004 final dividend/2003 special and final dividends | **(496,620)** | (2,202,898) | **(496,620)** | (2,202,898) |
| Dividend on shares issued for employee share options exercised after 31 Dec 2004/2003 | **(1,597)** | (15,661) | **(1,597)** | (15,661) |
| | **(498,217)** | (2,218,559) | **(498,217)** | (2,218,559) |
| 2005/2004 interim dividend | **(519,988)** | (454,283) | **(519,988)** | (454,283) |
| Dividend on shares issued for employee share options exercised after 30 Jun 2005/2004 | **(579)** | (8) | **(579)** | (8) |
| | **(520,567)** | (454,291) | **(520,567)** | (454,291) |
| At 31 Dec | **2,455,794** | 2,154,675 | **237,675** | 224,199 |
| Representing: | | | | |
| Retained earnings/ (accumulated losses) | **1,775,631** | 1,658,055 | **(442,488)** | (272,421) |
| Proposed/declared dividends | **680,163** | 496,620 | **680,163** | 496,620 |
| At 31 Dec | **2,455,794** | 2,154,675 | **237,675** | 224,199 |

## 37. Retained Earnings (Including Proposed/Declared Dividends)

*(Continued)*

(a) Profit attributable to shareholders included a profit of $1,032,260,000, of which $1,020,000,000 was dividends from subsidiaries (2004: $2,519,509,000, of which $2,505,957,000 was dividends from subsidiaries), which has been dealt with in the accounts of HKEx, the holding company of the Group.

(b) The Group's profit after taxation included a net profit attributable to the investment and other income net of expenses after taxation of the Clearing House Funds, Compensation Fund Reserve Account and CDMD Fund for an aggregate amount of $30,653,000 (2004: deficit of $2,182,000).

(c) The negative reserve arising on consolidation of $4,116,436,000, representing the difference between the cost of acquiring the subsidiaries at the time of the merger and their respective issued share capital, was offset against merger reserve of $2,997,115,000 (note 35) and retained earnings of $1,119,321,000.

## 38. Notes to the Consolidated Cash Flow Statement

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

| | 2005 $'000 | 2004 $'000 |
|---|---|---|
| Profit before taxation | **1,567,008** | 1,250,525 |
| Adjustments for: | | |
| Net interest income | **(210,385)** | (81,865) |
| Dividends from available-for-sale financial assets | **–** | (1,070) |
| Net realised and unrealised gains and interest income on financial assets and financial liabilities at fair value through profit or loss | **(82,495)** | (114,358) |
| Gain on disposal of available-for-sale financial assets | **–** | (24,841) |
| Amortisation of lease premiums for land | **548** | 548 |
| Fair value gain of an investment property | **(4,400)** | (3,300) |
| Depreciation | **150,995** | 183,400 |
| Employee share-based compensation benefits | **22,955** | 14,290 |
| (Reversal of provision for)/provision for impairment loss of club debenture | **(5)** | 75 |
| Impairment losses of leasehold buildings | **837** | – |
| Reversal of provision for impairment losses of trade receivables | **(389)** | (850) |
| Changes in provisions | **933** | (526) |
| Share of profits less losses of associates | **(18,433)** | (12,884) |
| (Gain)/loss on disposal of fixed assets | **(38)** | 24 |
| Operating profit before working capital changes | **1,427,131** | 1,209,168 |
| Net decrease in financial assets and financial liabilities at fair value through profit or loss | **80,699** | 548,516 |
| Settlement of amount transferred (from)/to retained earnings for Clearing House Funds and Compensation Fund Reserve Account | **(21,842)** | 4,464 |
| Settlement of amount transferred from CDMD Fund reserve to retained earnings | **–** | 914 |
| Contributions to The HKEx Employees' Share Award Scheme | **(30,037)** | – |
| Decrease/(increase) in accounts receivable, prepayments and deposits | **1,357,096** | (108,478) |
| (Decrease)/increase in other current liabilities | **(1,261,361)** | 135,824 |
| Net cash inflow from operations | **1,551,686** | 1,790,408 |
| Interest received | **246,729** | 26,481 |
| Cash received on financial assets at fair value through profit or loss | **79,456** | 75,877 |
| Interest paid | **(125,897)** | (1,181) |
| Hong Kong Profits Tax paid | **(352,076)** | (75,232) |
| Net cash inflow from operating activities | **1,399,898** | 1,816,353 |

(b) The net assets of the 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 year therefore did not constitute any cash or cash equivalent transactions to the Group.

## 39. Commitments

(a) Commitments in respect of capital expenditures:

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Contracted but not provided for | **18,130** | 4,484 | **3** | – |
| Authorised but not contracted for | **118,838** | 73,554 | **22,647** | 12,898 |
| | **136,968** | 78,038 | **22,650** | 12,898 |

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

(b) Commitments for total future minimum lease payments under operating leases and computer maintenance contracts

(i) Land and buildings

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Payable | | | | |
| – within one year | **82,483** | 45,844 | **1,590** | 1,307 |
| – in the second to fifth years | **157,989** | 10,060 | **476** | 1,278 |
| | **240,472** | 55,904 | **2,066** | 2,585 |

## 39. Commitments *(Continued)*

(b) Commitments for total future minimum lease payments under operating leases and computer maintenance contracts *(Continued)*

(ii) Computer systems and equipment

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 post-trading clearing and settlement services. In order to maintain the high standard of performance of the systems, the Group has entered into various maintenance and operating lease contracts with its vendors. The future minimum payments under maintenance contracts and operating leases (including licenses) in respect of computer systems and equipment were as follows:

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Operating leases in respect of computer systems and equipment, payable | | | | |
| – within one year | **9,570** | 17,626 | **8,642** | 9,326 |
| – in the second to fifth years | **754** | 2,827 | **754** | 2,667 |
| | **10,324** | 20,453 | **9,396** | 11,993 |
| Maintenance contracts in respect of computer systems and equipment, payable | | | | |
| – within one year | **25,981** | 47,212 | **14,384** | 33,723 |
| – in the second to fifth years | **12,324** | 36,194 | **4,930** | 14,472 |
| | **38,305** | 83,406 | **19,314** | 48,195 |
| | **48,629** | 103,859 | **28,710** | 60,188 |

As at 31 December 2005, in respect of computer systems and equipment, the majority of the leases would mature within one year (2004: two years) and the Group did not have any purchase options.

## 40. Contingent Liabilities

(a) Group

(i) The Compensation Fund is a fund set up under the repealed SO for the purpose of compensating any person (other than a Stock Exchange Participant) dealing with a Stock Exchange Participant for any pecuniary losses suffered as a result of a default by 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, and with the approval of the SFC, allow an additional payment to successful claimants before apportionment. Under section 107(1) of the SO, the Stock Exchange has contingent liabilities to the Compensation Fund as it is obligated to replenish the Compensation Fund upon the SFC's request. 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 31 December 2005, there were outstanding claims received in respect of 5 Stock Exchange Participants (2004: 10).

Pursuant to the SFO, the Stock Exchange issued a notice on 3 April 2003 inviting 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 were received in response to that notice. Claims made after the claims period are, unless the Stock Exchange otherwise determines, barred. As at 31 December 2005, no such claims had been received in response to the said notice.

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 were 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 the SFO pending completion of any determination of outstanding claims and replenishment to the Compensation Fund.

(ii) 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 the default of any one Participant. In the unlikely event that all of its 429 trading Participants as at 31 December 2005 (2004: 434) defaulted, the maximum contingent liability of the Stock Exchange under the indemnity would amount to $86 million (2004: $87 million).

The carrying amount of the financial guarantee contract recognised in the consolidated balance sheet in accordance with HKAS 39 and HKFRS 4 (Amendment) was $19,909,000 (2004: $19,909,000).

## 40. Contingent Liabilities *(Continued)*

(a) Group *(Continued)*

(iii) In May 2005, the Court of Appeal issued its judgement in the New World Development Company Limited and others ("New World") judicial review appeal case. The Court allowed the appeal and quashed the direction of the Chairman of the Listing (Disciplinary) Committee in the New World disciplinary proceedings that legal advisers not be permitted to address the Listing (Disciplinary) Committee. New World was awarded costs which are presently unknown but estimated to be in the region of $4 million. The Stock Exchange has been granted leave to appeal to the Court of Final Appeal. The appeal is set down to be heard by the Court of Final Appeal on 21 and 22 March 2006. In the opinion of external legal counsel, the Stock Exchange has valid grounds for an appeal, a reasonable prospect of success and consequently it is not probable that the Stock Exchange will be required to bear the costs incurred by New World in the legal proceedings. Accordingly, no provision for such costs has been made in the accounts.

(b) Group and HKEx

(i) 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.

The carrying amount of the financial guarantee contract recognised in HKEx's balance sheet in accordance with HKAS 39 and HKFRS 4 (Amendment) was $11,390,000 (2004: $11,390,000). The financial guarantee contract was eliminated on consolidation.

## 41. Future Operating Lease Arrangements

As at 31 December, the Group had the following future aggregate minimum lease receipts under non-cancellable operating leases:

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| Land and buildings | | |
| – within one year | **444** | 501 |
| – in the second to fifth years | **–** | 439 |
| | **444** | 940 |
| Trading booths and related facilities | | |
| – within one year | **9,061** | – |
| – in the second to fifth years | **19,264** | – |
| | **28,325** | – |
| Total | **28,769** | 940 |

## 42. Non-cash Collateral Received from Participants

Under existing rules of the clearing houses, Participants may lodge cash or approved non-cash collateral to satisfy their Clearing House contributions and Margin Fund obligations. In accordance with HKAS 39, only cash collateral is recognised as assets and liabilities on the consolidated balance sheet.

As at 31 December, the amount of non-cash collateral received from Participants and the amount utilised for covering part of their Clearing House Fund contributions and Margin Fund obligations were as follows:

| | Group | | | |
|---|---|---|---|---|
| | 2005 | | 2004 | |
| | **Amount received $'000** | **Amount utilised $'000** | Amount received $'000 | Amount utilised $'000 |
| **Clearing House Funds** | | | | |
| Bank guarantees | **333,900** | **58,603** | 392,910 | 322,724 |
| **Margin Funds** | | | | |
| Equity securities, listed in Hong Kong | **439,591** | **–** | 610,318 | 3,736 |
| US Treasury Bills | **191,965** | **141,086** | 504,287 | 456,996 |
| Bank guarantees | **100,000** | **–** | 100,000 | – |
| | **731,556** | **141,086** | 1,214,605 | 460,732 |
| | **1,065,456** | **199,689** | 1,607,515 | 783,456 |

## 43. Connected Transactions and Material Related Party Transactions

(a) Connected transactions and material related party transactions

(i) Certain Directors of HKEx are investor participants of HKSCC ("Investor Participants") or directors and/or shareholders of (i) Stock Exchange Participants and Futures Exchange Participants ("Exchange Participants"), Clearing Participants and Investor 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, Clearing Participants and Investor 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, Clearing Participants, Investor Participants, listed companies and Exchange Participants for buying shares on behalf of HKSCC.

Certain transactions undertaken during the year were regarded as related party transactions in accordance with HKAS 24 but the amounts were immaterial. Certain transactions fell under the definition of continuing connected transactions under the Listing Rules are disclosed in the Corporate Governance Report.

## 43. Connected Transactions and Material Related Party Transactions *(Continued)*

(a) Connected transactions and material related party transactions *(Continued)*

(ii) During the year, the Group also entered into the following material transactions with entities that were both related parties and connected persons as one of their directors was a director of HKEx:

| | Group | |
|---|---|---|
| | **2005 $'000** | 2004 $'000 |
| Rental payments (including air conditioning and cleaning service charges) to Shine Hill Development Limited ("Shine Hill") | **5,327** | 4,698 |

On 5 February 2003, the Futures Exchange as the tenant entered into a tenancy agreement ("Lease") with Shine Hill as the landlord. The Lease expired on 31 December 2004 and was subsequently renewed for a further term of two years commencing 1 January 2005 ("New Lease"). 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 deputy chairman, managing director and substantial shareholder of Great Eagle. The Lease and the New Lease were arm's length transactions entered into on normal commercial terms. The transaction was a related party transaction in accordance with HKAS 24 and a continuing connected transaction as defined under the Listing Rules.

(b) Material related party transactions

In addition to the above, the Group or HKEx entered into certain material related party transactions which were not regarded as connected transactions as defined under the Listing Rules. Details of such transactions are set out below.

(i) Transactions with an associate and subsidiaries

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Income received and receivable from/(expenses paid and payable to) an associate, CHIS: | | | | |
| – Dividend income | **17,952** | 10,801 | **–** | – |
| – Share registration service fees | **(439)** | (354) | **(439)** | (354) |
| Transactions with subsidiaries: | | | | |
| – Management fee and equipment rental fee charged to subsidiaries | **–** | – | **250,352** | 246,172 |
| – Expenses recharged to subsidiaries | **–** | – | **657,734** | 633,545 |

## 43. Connected Transactions and Material Related Party Transactions *(Continued)*

(b) Material related party transactions *(Continued)*

(ii) Key management personnel compensation

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Salaries and other short-term employee benefits | **55,649** | 51,884 | **49,124** | 43,136 |
| Employee share-based compensation benefits | **9,199** | 8,439 | **8,664** | 8,137 |
| Termination benefits | **–** | 1,569 | **–** | 750 |
| Retirement benefit costs | **5,475** | 5,425 | **4,786** | 4,491 |
| | **70,323** | 67,317 | **62,574** | 56,514 |

(iii) Amounts due from/(to) related parties

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Amounts due from: | | | | |
| – An associate | **5,284** | – | **–** | – |
| – Subsidiaries | **–** | – | **583,102** | 497,463 |
| – Related companies with common directors | **867** | 867 | **–** | – |
| Amounts due to: | | | | |
| – An associate | **(14)** | (55) | **(14)** | (55) |
| – Subsidiaries | **–** | – | **(183,116)** | (180,603) |
| – Related companies with common directors | **(113)** | (144) | **–** | – |

(iv) Post-retirement benefit plans

Details of transactions with the Group's post-retirement benefit plans are included in note 9(b).

(v) Save as aforesaid, the Group and HKEx have entered into other transactions in the ordinary course of business with companies where there are common directors but the amounts were immaterial.

## 44. Banking Facilities with Assets Pledged

The Group did not have any assets pledged as at 31 December 2004 and 31 December 2005.

## 45. Capital Management

The Group's objectives when managing capital are:

- To safeguard the Group's ability to continue as a going concern, so that it continues to provide returns for shareholders and benefits for other stakeholders;
- To support the Group's stability and growth; and
- To provide capital for the purpose of strengthening the Group's risk management capability.

The Group actively and regularly reviews and manages its capital structure to ensure optimal capital structure and shareholder returns, taking into consideration the future capital requirements of the Group and capital efficiency, prevailing and projected profitability, projected operating cash flows, projected capital expenditures and projected strategic investment opportunities. The Group adopts a dividend policy of providing shareholders with regular dividends with a target payout ratio of 90 per cent of the profit of the year, while retaining 10 per cent of the profit as capital of the Group for future use. The Group has set aside $1,500 million of retained earnings for the purpose of strengthening the risk management regime of the clearing houses and supporting their roles as central counterparties.

As in prior years, the Group monitors capital by reviewing the level of capital that is at the disposal of the Group ("adjusted capital"). Adjusted capital comprises all components of shareholders' equity other than the hedging reserve relating to cash flow hedges, designated reserves and investment revaluation reserve of the Clearing House Funds and Compensation Fund Reserve Account net of applicable deferred taxes. The adjusted capital of the Group at 31 December 2005 and at 31 December 2004 was $3,668,160,000 and $3,349,209,000 respectively.

## 46. Financial Risk Management

The Group's activities expose it to a variety of financial risks: market risk (including foreign exchange risk, equity price risk and interest rate risk), liquidity risk and credit risk. The Group's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the Group's performance.

The Group's investment policy is to prudently invest all funds managed by the Group in a manner which will satisfy liquidity requirements, safeguard financial assets and manage risks while optimising return on investments.

Investment and fund management is governed by investment policies and risk management guidelines approved by the Board. Investment restrictions and guidelines form an integral part of risk control. Fund-specific restrictions and guidelines are set according to the investment objectives of each fund. In addition, specific limits are set for each fund to control risks (e.g. permissible asset type, asset allocation, liquidity, credit, counterparty concentration, maturity, foreign exchange and interest rate risks) of the investments.

## 46. Financial Risk Management *(Continued)*

(a) Market risk

Market risk is the risk of loss arising from movements in observable market variables such as foreign exchange rates, equity and commodity prices and interest rates. The Group is exposed to market risk primarily through its investments held.

Funds available for investment comprise three main categories: Corporate Funds (mainly share capital and retained earnings of the Group), Clearing House Funds and Margin Funds received (which exclude non-cash collateral and contributions receivable from Participants).

An Investment Advisory Committee, comprised of Non-executive Directors of HKEx and an external member from the financial community, advises the Board on portfolio management and monitors the risk and performance of HKEx's investments. A Treasury team in the Finance Department is dedicated to the day-to-day management and investment of the funds. Three external fund managers have also been appointed to manage part of the Corporate Funds since July 2001. The external fund managers are stable and financially strong financial institutions and each has a worldwide aggregate fund size of a minimum of US$10 billion under management.

(i) Foreign exchange risk

Foreign exchange risk is the risk of loss due to adverse movements in foreign exchange rates relating to investments and transactions denominated in foreign currencies. When seeking to optimise the returns on its funds available for investment, the Group may invest in non-HKD securities from time to time. Forward foreign exchange contracts and foreign currency deposits have been used to hedge the currency exposure of the Group's non-HKD investments, highly probable forecast transactions and liabilities to mitigate risks arising from fluctuations in exchange rates. Details of the exposure of foreign exchange risk and outstanding forward foreign exchange contracts of the Group and HKEx as at 31 December were as follows:

| | Group | | HKEx | |
|---|---|---|---|---|
| | **2005<br>$ million** | 2004<br>$ million | **2005<br>$ million** | 2004<br>$ million |
| Aggregate net open foreign currency positions (total) | **2,031** | 1,996 | **1** | 4 |
| Aggregate net open foreign currency positions (non-USD exposures) | **160** | 170 | **1** | 4 |
| Total nominal value of outstanding forward foreign exchange contracts | **275** | 358 | **–** | – |
| Maximum contractual maturity of forward foreign exchange contracts | **One month** | One month | **N/A** | N/A |

## 46. Financial Risk Management *(Continued)*

(a) Market risk *(Continued)*

(i) Foreign exchange risk *(Continued)*

Foreign currency margin deposits received by the Group are hedged by investments in the same currencies.

During the year, one of the subsidiaries designated a bank deposit of SEK 8,500,000 as a cash flow hedge for hedging the foreign exchange risk of SEK 8,500,000 of forecast information technology and computer maintenance expenses payable from 1 August 2005 to 31 December 2005. On 29 August 2005, the said bank deposit was transferred to HKEx without changing the terms of the cash flow hedge.

During the year, the Group and HKEx designated another bank deposit of SEK 11,000,000 as a fair value hedge to hedge against the foreign exchange risk of a financial liability of the Group and HKEx of SEK 11,000,000. The fair value loss on the bank deposit designated as hedging instrument was $569,000 (2004: $Nil) whereas the fair value gain on the financial liability being hedged was $569,000 (2004: $Nil) during the year. The fair value of the deposit as at 31 December 2005 was $10,717,000 (2004: $Nil).

(ii) Equity and commodity price risk

The Group is exposed to equity price risk as equities are held as part of the Corporate Fund's investments. Equity price risk is capped by an asset allocation limit. The Group is not exposed to commodity price risk as investment in commodities is not permitted under the Group's Investment Policy.

(iii) Interest rate risks

There are two types of interest rate risk:

- Fair value interest rate risk – the risk that the value of a financial instrument will fluctuate because of changes in market interest rates; and

- Cash flow interest rate risk – the risk that the future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

The Group is exposed to both fair value and cash flow interest rate risks as the Group has significant assets and liabilities which are interest-bearing.

## 46. Financial Risk Management *(Continued)*

(a) Market risk *(Continued)*

(iv) Risk management

Risk management techniques, such as Value-at-Risk ("VaR") based on historical simulation and portfolio stress testing, are used to identify, measure and control foreign exchange risk, equity price risk and interest rate risks of the Group's investments. VaR measures the expected maximum loss over a given time interval (a holding period of 10 trading days is used by the Group) at a given confidence level (95 per cent confidence interval is adopted by the Group) based on historical data (one year is used by the Group). The Board sets a limit on total VaR of the Group and VaR is monitored on a weekly basis.

VaR is a statistical measure of risks and has limitations associated with the assumptions employed. Historical simulation assumes that actual observed historical changes in market indices, such as interest rates, foreign exchange rates and equity prices reflect possible future changes. This implies that the approach is vulnerable to sudden changes in market behaviour. The use of a 10-day holding period assumes that the positions can be unwound in 10 trading days and the holding period may be insufficient at times of severe illiquidity. Also, VaR does not necessarily reflect all aspects of risks that affect the price of financial instruments and may underestimate real market risk exposure. In addition, VaR does not factor in the possibility of catastrophic risk but the use of stress testing for abnormal market conditions can mitigate this limitation.

The VaR for each risk factor and the total VaR of the investments of the Group and HKEx during the year were as follows:

| | Group | | | HKEx | | |
|---|---|---|---|---|---|---|
| | 2005 | | | 2005 | | |
| | Average $million | Highest $million | Lowest $million | Average $million | Highest $million | Lowest $million |
| Foreign exchange risk | 5.0 | 6.1 | 3.6 | 0.2 | 0.7 | – |
| Equity price risk | 8.5 | 11.2 | 6.6 | – | – | – |
| Interest rate risk | 20.5 | 24.0 | 14.4 | – | – | – |
| Total VaR | 23.5 | 26.9 | 20.4 | 0.2 | 0.7 | – |

VaR for each risk factor is the independently derived largest potential loss due to fluctuations solely in that risk factor. The individual VaRs did not add up to the total VaR as there was diversification effect due to correlation amongst the risk factors. Moreover, in respect of the highest and lowest VaRs during the year, the highest and lowest VaRs in each market did not necessarily occur on the same day.

## 46. Financial Risk Management *(Continued)*

(b) Liquidity risk

Liquidity risk is the risk that funds will not be available to meet liabilities as they fall due, and it results from amount and maturity mismatches of assets and liabilities. Investments of the Group are kept sufficiently liquid to meet the operating needs and possible liquid requirements of the Clearing House Funds and Margin Funds. The Group also sets a limit on the minimum level of cash or bank deposits held for the Corporate Funds, and the minimum level of investments to be held that would mature the same day and the next day for the Clearing House Funds and Margin Funds.

The financial liabilities of the Group and HKEx as at 31 December 2005 are analysed into relevant maturity buckets based on their contractual maturity dates in the table below:

| | Group | | | | |
|---|---|---|---|---|---|
| | 2005 | | | | |
| | Up to 1 month $'000 | >1 month to 3 months $'000 | >3 months to 1 year $'000 | Not determinable $'000 | Total $'000 |
| **Current liabilities** | | | | | |
| Margin deposits from Clearing Participants | 13,648,581 | – | – | – | 13,648,581 |
| Accounts payable, accruals and other liabilities | 3,596,564 | 30,405 | 191 | 13,910 | 3,641,070 |
| Financial liabilities at fair value through profit or loss (note i) | 153,973 | – | – | – | 153,973 |
| Participants' admission fees received | 900 | 150 | 1,300 | 200 | 2,550 |
| | 17,400,018 | 30,555 | 1,491 | 14,110 | 17,446,174 |
| **Non-current liabilities** | | | | | |
| Participants' admission fees received | – | – | – | 80,150 | 80,150 |
| Participants' contributions to Clearing House Funds | – | – | – | 751,751 | 751,751 |
| Financial guarantee contract (note ii) | – | – | – | 85,800 | 85,800 |
| | – | – | – | 917,701 | 917,701 |
| Total | 17,400,018 | 30,555 | 1,491 | 931,811 | 18,363,875 |

## 46. Financial Risk Management *(Continued)*

(b) Liquidity risk *(Continued)*

| | HKEx | | | | |
|---|---|---|---|---|---|
| | 2005 | | | | |
| | Up to 1 month $'000 | >1 month to 3 months $'000 | >3 months to 1 year $'000 | Not determinable $'000 | Total $'000 |
| **Current liabilities** | | | | | |
| Accounts payable, accruals and other liabilities | 162,018 | – | – | – | 162,018 |
| Amounts due to subsidiaries | 183,116 | – | – | – | 183,116 |
| | 345,134 | – | – | – | 345,134 |
| **Non-current liabilities** | | | | | |
| Financial guarantee contract (note ii) | – | – | – | 50,000 | 50,000 |
| | – | – | – | 50,000 | 50,000 |
| Total | 345,134 | – | – | 50,000 | 395,134 |

(i) The amount disclosed is based on the gross contractual amounts to be exchanged under the forward foreign exchange contracts under financial liabilities at fair value through profit or loss, which is different from the carrying amount (i.e. fair value) in the consolidated balance sheet. The corresponding gross contractual amounts receivable under these forward foreign exchange contracts were $152,530,000.

(ii) The amount disclosed for financial guarantee contracts represented the amount of contingent liabilities at the balance sheet date.

The Group employs projected cash flow analysis to manage liquidity risk by forecasting the amount of cash required and monitoring the working capital of the Group to ensure that all liabilities due and known funding requirements could be met. In addition, banking facilities have been put in place for contingency purposes. As at 31 December 2005, the Group's total available banking facilities amounted to $1,608 million (2004: $1,608 million), of which $1,500 million (2004: $1,500 million) were repurchase facilities to augment the liquidity of the Margin Funds.

## 46. Financial Risk Management *(Continued)*

(c) Credit risk

(i) Investment and accounts receivable-related risk

The Group is exposed to credit risk, which is the risk that a counterparty will be unable to pay amounts in full when due. It arises primarily from the Group's investments and trade receivables. Impairment provisions are made for losses that have been incurred at the balance sheet date. The Group limits its exposure to credit risk by rigorously selecting the counterparties (i.e. deposit-takers, bond issuers and debtors) and by diversification. As at 31 December 2005, the bonds held were of investment grade and had a weighted average credit rating of Aa2 (2004: Aa2), and there were no financial assets whose terms were renegotiated. Deposits are placed only with the note-issuing banks in Hong Kong, investment grade licensed banks and restricted licence banks approved by the Board from time to time. All investments are subject to a maximum concentration limit approved by the Board and there was no significant concentration risk to a single counterparty. The Group mitigates its exposure to risks relating to accounts receivable from its Participants by requiring the Participants to meet the Group's established financial requirements and criteria for admission as Participants.

(ii) Clearing and settlement-related risk

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 accounts.

The Group mitigates its exposure to 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.

Position limits are imposed by HKCC to regulate or limit the maximum number or value of gross and net positions which can be held or controlled by the Participants based on their liquid capital. Bank guarantees may also be accepted to extend Participants' position limits. As of 31 December 2005, bank guarantees of $915,400,000 (2004: $902,500,000) were accepted for such purpose.

In addition to the above, the Group has set aside $1,500 million of retained earnings for the purpose of strengthening the risk management regime of the clearing houses and supporting their roles as central counterparties.

## 46. Financial Risk Management *(Continued)*

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

#### (iii) Exposure to credit risk

As at 31 December 2005, the financial assets and financial liabilities of the Group and HKEx that were exposed to credit risk and their maximum exposure were as follows:

| | Group | | HKEx | |
|---|---|---|---|---|
| | 2005 | | 2005 | |
| | Carrying amount in balance sheet $'000 | Maximum exposure to credit risk $'000 | Carrying amount in balance sheet $'000 | Maximum exposure to credit risk $'000 |
| **Financial assets** | | | | |
| Clearing House Funds: | | | | |
| Available-for-sale financial assets | 224,137 | 224,137 | – | – |
| Time deposits with original maturities over three months | 30,290 | 30,290 | – | – |
| Cash and cash equivalents | 1,091,233 | 1,091,233 | – | – |
| Compensation Fund Reserve Account: | | | | |
| Available-for-sale financial assets | 18,488 | 18,488 | – | – |
| Cash and cash equivalents | 30,240 | 30,240 | – | – |
| Time deposit with maturity over one year | 38,768 | 38,768 | – | – |
| Other assets | 17,162 | 17,162 | 480 | 480 |
| Accounts receivable and deposits# | 3,250,197 | 3,250,197 | 160 | 160 |
| Amounts due from subsidiaries | – | – | 583,102 | 583,102 |
| Margin Funds on derivatives contracts: | | | | |
| Available-for-sale financial assets | 3,828,833 | 3,828,833 | – | – |
| Time deposits with original maturities over three months | 100,018 | 100,018 | – | – |
| Cash and cash equivalents | 9,686,026 | 9,686,026 | – | – |
| Margin receivable from Clearing Participants | 33,704 | 33,704 | – | – |
| Financial assets at fair value through profit or loss | 2,643,788 | 2,643,788 | – | – |
| Time deposits with original maturities over three months | 116,622 | 116,622 | 10,184 | 10,184 |
| Cash and cash equivalents | 1,359,113 | 1,359,113 | 43,383 | 43,383 |
| **Financial liabilities** | | | | |
| Undertaking to indemnify the Collector of Stamp Revenue | (19,909) | 85,800 | – | – |
| Financial guarantee granted to HKSCC | – | – | (11,390) | 50,000 |

# Certain debtors were required to place cash deposits with the Group to mitigate the maximum exposure to credit risk.

## 46. Financial Risk Management *(Continued)*

(c) Credit risk *(Continued)*

(iv) Financial assets that were past due but not impaired

As at 31 December 2005, trade receivables of the Group amounting to $149,940,000 were past due but not determined to be impaired. The age analysis of the balances according to the period past due is as follows:

| | Group | | | | |
|---|---|---|---|---|---|
| | 2005 | | | | |
| | Up to 6 months $'000 | >6 months to 1 year $'000 | >1 year to 3 years $'000 | >3 years $'000 | Total $'000 |
| Trade receivables past due but not determined to be impaired | **141,277** | **–** | **8,521** | **142** | **149,940** |

The fair value of cash deposits placed by the related trade debtors with the Group was $3,600,000. No provision for impairment losses has been made against trade receivables amounting to $8,521,000 as the balances can be recovered from the Clearing House Funds.

No financial assets of HKEx were past due as at 31 December 2005.

(v) Financial assets that were impaired at balance sheet date

As at 31 December 2005, trade receivables of the Group amounting to $4,329,000 were determined to be impaired and full provision had been made. These receivables were outstanding for over 180 days as at the balance sheet date. The factors the Group considered in determining whether the financial assets were impaired are disclosed in note 2(s)(vi). No cash deposits had been placed by the related trade debtors with the Group.

No financial assets of HKEx were impaired as at 31 December 2005.

(vi) Outstanding balances from debtors which were not recognised as Income

As soon as a loan or receivable becomes impaired, the Group may continue to provide services or facilities to the debtors concerned but no further accounts receivable will be recognised on balance sheet as economic benefits may not flow to the Group. The revenue concerned is not recognised but tracked as doubtful deferred revenue and will only be recognised as income when received. As at 31 December 2005, the amount of doubtful deferred revenue amounted to $37,643,000 (2004: $30,240,000).

## 46. Financial Risk Management *(Continued)*

(d) Fair values of financial assets and financial liabilities not reported at fair values

Summarised in the following table are the carrying amounts and fair values of financial assets and financial liabilities not presented in the Group's and HKEx's balance sheets at their fair values. The carrying amounts of short-term receivables (i.e. accounts receivable, deposits and cash and cash equivalents) and short-term payables (i.e. accounts payable and other liabilities) approximated their fair values, and accordingly no disclosure of the fair values of these items is presented.

| | Carrying amount in balance sheet | | Fair value | |
|---|---|---|---|---|
| | **2005 $'000** | 2004 $'000 | **2005 $'000** | 2004 $'000 |
| Group | | | | |
| **Financial assets** | | | | |
| Time deposit with maturity over one year | **38,768** | 38,941 | **36,659** | 37,808 |
| Other financial assets included in other non-current assets (note i) | **17,162** | 9,935 | **15,550** | 9,833 |
| **Financial liabilities** | | | | |
| Participants' admission fees received included in non-current liabilities (note i) | **80,150** | 82,850 | **76,732** | 82,306 |
| Participants' contributions to Clearing House Funds: | | | | |
| – Minimum contributions (note i) | **358,050** | 337,250 | **342,779** | 335,035 |
| – Participants' additional deposits | **393,701** | 961,502 | **393,701** | 961,502 |
| Financial guarantee contract (note ii) | **19,909** | 19,909 | **20,526** | 24,451 |
| HKEx | | | | |
| **Financial assets** | | | | |
| Other financial assets included in other non-current assets (note i) | **480** | 457 | **460** | 448 |
| **Financial liabilities** | | | | |
| Financial guarantee contract (note ii) | **11,390** | 11,390 | **11,962** | 14,085 |

(i) The fair values are based on cash flows discounted using Hong Kong Government bond rates of a tenor similar to the contractual maturity of the respective assets/liabilities, adjusted by an estimated credit spread. Assets/liabilities without a contractual maturity are assumed to mature exactly one year after the balance sheet date. The discount rates used range from 4.46 per cent to 4.64 per cent as at 31 December 2005 (2004: 0.66 per cent to 1.30 per cent).

(ii) The fair values are based on the fees charged by financial institutions for granting such guarantees discounted using a ten-year Hong Kong Government bond rate to perpetuity.

## 47. Comparative Figures

Certain comparative figures have been adjusted to conform with changes in presentation in the current year.