

Report of the Director of Audit



Audit Commission

The Government of the Hong Kong Special Administrative Region

Independent Audit Report

To the Permanent Secretary for Education Incorporated

I certify that I have audited the financial statements of the Quality Education Fund set out on pages 3 to 17, which comprise the balance sheet as at 31 August 2007, and the income and expenditure account, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Permanent Secretary for Education Incorporated's responsibility for the financial statements

The Permanent Secretary for Education Incorporated is responsible for the preparation and the true and fair presentation of these financial statements in accordance with section 8(3) of the Permanent Secretary for Education Incorporation Ordinance (Cap. 1098) and Hong Kong Financial Reporting Standards. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with section 8(5) of the Permanent Secretary for Education Incorporation Ordinance and the Audit Commission auditing standards. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Permanent Secretary for Education Incorporated, as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

Opinion

In my opinion, the financial statements give a true and fair view of the financial position of the Quality Education Fund as at 31 August 2007 and of its financial performance and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with section 8(3) of the Permanent Secretary for Education Incorporation Ordinance.

(YING Kwok-wing)
Assistant Director of Audit
for Director of Audit

28 February 2008

Audit Commission
26th Floor
Immigration Tower
7 Gloucester Road
Wanchai, Hong Kong

**QUALITY EDUCATION FUND
INCOME AND EXPENDITURE ACCOUNT
FOR THE YEAR ENDED 31 AUGUST 2007**

	<u>Note</u>	2007 HK\$'000	2006 HK\$'000
INCOME			
Interest and dividends	3	197,075	148,145
Net realised and revaluation gains on financial instruments		773,486	478,457
Other income	4	<u>6,114</u>	<u>5,995</u>
		<u>976,675</u>	<u>632,597</u>
EXPENDITURE			
Grants	5	139,600	127,613
Incidental expenses	6	<u>41,211</u>	<u>31,116</u>
		<u>180,811</u>	<u>158,729</u>
SURPLUS FOR THE YEAR		<u><u>795,864</u></u>	<u><u>473,868</u></u>

The accompanying Notes 1 to 14 form part of these accounts.

QUALITY EDUCATION FUND
BALANCE SHEET
AS AT 31 AUGUST 2007

	<u>Note</u>	2007	2006
		HK\$'000	HK\$'000
ASSETS			
Cash at banks		1,443	14,920
Investments:			
Deposits with banks and other financial institutions	7	771,254	318,654
Securities	8	5,924,688	5,293,694
Trading financial instruments	9	7,160	630
Receivables and other assets	10	48,928	94,896
		<u>6,753,473</u>	<u>5,722,794</u>
LIABILITIES			
Trading financial instruments	9	(2,100)	(7,438)
Payables and other liabilities	11	(311,872)	(71,719)
NET ASSETS		<u>6,439,501</u>	<u>5,643,637</u>
 Representing:			
FUND BALANCE			
Accumulated surplus		<u>6,439,501</u>	<u>5,643,637</u>

The accompanying Notes 1 to 14 form part of these accounts.

(Raymond H C WONG)
Permanent Secretary for Education Incorporated
Trustee of the Quality Education Fund
28 February 2008

**QUALITY EDUCATION FUND
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 AUGUST 2007**

	2007	2006
	HK\$'000	HK\$'000
ACCUMULATED SURPLUS		
Balance at beginning of year	5,643,637	5,169,769
Surplus for the year	<u>795,864</u>	<u>473,868</u>
Balance at end of year	<u><u>6,439,501</u></u>	<u><u>5,643,637</u></u>

The accompanying Notes 1 to 14 form part of these accounts.

QUALITY EDUCATION FUND
CASH FLOW STATEMENT
FOR THE YEAR ENDED 31 AUGUST 2007

	2007	2006
	HK\$'000	HK\$'000
CASH FLOWS FROM OPERATING ACTIVITIES		
Surplus for the year	795,864	473,868
Adjustments for:		
Interest income	(131,345)	(83,745)
Dividend income	(65,730)	(64,400)
Increase in investments in securities	(630,994)	(377,067)
Change in trading financial instruments	(11,868)	5,710
Decrease in receivables and other assets	54,733	31,566
Increase/(Decrease) in payables and other liabilities	240,153	(17,059)
Elimination of foreign exchange differences in revaluation of cash and cash equivalents	(575)	(497)
Interest received	123,103	77,338
Dividends received	<u>65,207</u>	<u>65,694</u>
NET CASH FROM OPERATING ACTIVITIES	438,548	111,408
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	333,574	221,669
Effects of exchange rate changes on cash and cash equivalents	575	497
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u><u>772,697</u></u>	<u><u>333,574</u></u>

ANALYSIS OF THE BALANCES OF CASH AND CASH EQUIVALENTS

	2007	2006
	HK\$'000	HK\$'000
Fixed deposits with original maturity within three months	752,025	316,625
Cash at banks and call deposits and balances with custodians	20,672	16,949
	<u><u>772,697</u></u>	<u><u>333,574</u></u>

The accompanying Notes 1 to 14 form part of these accounts.

QUALITY EDUCATION FUND

Notes to the Accounts

1. General

The Quality Education Fund was established by a declaration of trust made on 2 January 1998 by the Permanent Secretary for Education Incorporated (the Trustee). The Fund provides grants to fund projects that aim to raise the quality of school education, and to promote quality school education in Hong Kong.

2. Significant accounting policies

(a) Statement of compliance

The accounts have been prepared in accordance with section 8(3) of the Permanent Secretary for Education Incorporation Ordinance (Cap. 1098), accounting principles generally accepted in Hong Kong, and all applicable Hong Kong Financial Reporting Standards (HKFRSs), which is a collective term that 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). A summary of the significant accounting policies is set out below.

(b) Basis of preparation of the accounts

The measurement basis used in the preparation of the accounts is historical cost except that investments in securities and trading financial instruments are stated at their fair value as explained in the accounting policies set out below.

The preparation of accounts requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgements about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

There are no critical accounting judgements involved in the application of the Fund's accounting policies. There are also no key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities in the next year.

(c) Financial assets and financial liabilities

(i) Initial recognition

The Fund classifies its financial assets and financial liabilities into different categories at inception, depending on the purpose for which the assets were acquired or the liabilities were incurred. The categories are: trading financial instruments, securities, loans and receivables, and other financial liabilities.

Financial assets and financial liabilities are measured initially at fair value, which normally will be equal to the transaction prices, plus transaction costs for loans and receivables and other financial liabilities that are directly attributable to the acquisition of the financial asset or issue of the financial liability. Transaction costs on trading financial instruments and securities are expensed immediately.

The Fund recognises financial assets and financial liabilities on the date it becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of financial assets are accounted for at trade date.

(ii) Categorisation

Trading financial instruments

These comprise forward currency contracts used by the Fund to manage its risks associated with foreign currency fluctuations. Such derivative financial instruments do not qualify for hedge accounting and are categorised as “trading” under HKAS 39, “Financial instruments: Recognition and measurement”.

Trading financial instruments are carried at fair value, and presented as assets when the fair value is positive and as liabilities when the fair value is negative. Changes in the fair value are included in the income and expenditure account in the period in which they arise.

Securities

Securities primarily consist of equity and debt securities. Under HKAS 39, these investments are designated upon initial recognition as financial assets at fair value through profit or loss, based on the fact that they are managed and their performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy.

Securities are carried at fair value under HKAS 39. Changes in the fair value are included in the income and expenditure account in the period in which they arise.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and which the Fund has no intention of trading, other than those that the Fund, upon initial recognition, designates as at fair value through profit or loss. This category includes cash at banks, deposits with banks and other financial institutions, and other financial assets.

Loans and receivables are carried at amortised cost using the effective interest method less impairment losses, if any (note 2(c)(vi)).

Other financial liabilities

These are financial liabilities other than trading financial instruments. They are carried at amortised cost using the effective interest method.

(iii) Fair value measurement principles

The fair value of financial instruments is based on their quoted market prices at the balance sheet date without any deduction for estimated future selling costs. Financial assets are priced at current bid prices, while financial liabilities are priced at current asking prices.

If there is no publicly available latest traded price nor a quoted market price on a recognised stock exchange or a price from a broker/dealer for non-exchange-traded financial instruments, or if the market for it is not active, the fair value of the financial asset or financial liability is estimated using valuation techniques that provide a reliable estimate of prices which could be obtained in actual market transactions.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate used is a market rate at the balance sheet date applicable for an instrument with similar terms and conditions. Where other pricing models are used, inputs are based on market data at the balance sheet date.

(iv) Derecognition

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

The Fund uses the weighted average method to determine realised gains and losses to be recognised in the income and expenditure account on derecognition.

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

(v) Offsetting

Financial assets and financial liabilities are offset and the net amount is reported in the balance sheet where there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(vi) Impairment of financial assets

The carrying amounts of loans and receivables are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, an impairment loss is recognised in the income and expenditure account as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. If in a subsequent period the amount of such impairment loss decreases and the decrease can be linked objectively to an event occurring after the impairment loss was recognised, the impairment loss is reversed through the income and expenditure account.

(d) Cash and cash equivalents

For the purpose of the cash flow statement, cash and cash equivalents include cash at banks and deposits with banks and other financial institutions with a maturity of three months or less from the date of placement.

(e) Revenue recognition

(i) Interest income

Interest income is recognised in the income and expenditure account on an accrual basis, using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Fund estimates cash flows considering all contractual terms of the financial instrument but does not consider future credit losses. The calculation includes all fees received or paid between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

(ii) Dividend and other income

Dividend income from listed equity securities is recognised in the income and expenditure account when the share price goes ex-dividend. Dividend income from unlisted equity securities is recognised in the income and

expenditure account when the shareholder's right to receive payment is established.

Other income is recognised in the income and expenditure account on an accrual basis.

(f) Grants recognition

Grants are recognised as expenditure when they are approved by the Trustee except in those cases where the release of grant is subject to certain conditions, such grants being recognised as expenditure when the grantees comply with the conditions.

(g) Income tax

The Fund is exempt from income tax.

(h) Foreign currency translation

Foreign currency transactions during the year are translated into Hong Kong dollars at the exchange rates ruling at the transaction dates. Assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at exchange rates ruling at the balance sheet date. All exchange differences are dealt with in the income and expenditure account.

3. Interest and dividends

	2007 HK\$'000	2006 HK\$'000
Interest income from Hong Kong dollar deposits	9,559	7,164
Interest income from foreign currency deposits	19,737	4,996
Dividend income from Hong Kong listed equities	36,178	36,772
Dividend income from overseas listed equities	29,552	27,628
Interest income from Hong Kong debt securities	38,851	26,412
Interest income from overseas debt securities	63,198	45,173
	<u>197,075</u>	<u>148,145</u>

4. Other income

	2007 HK\$'000	2006 HK\$'000
Commission recapture income	1,603	1,106
Securities lending income	4,345	4,666
Others	166	223
	<u>6,114</u>	<u>5,995</u>

5. Grants

	2007 HK\$'000	2006 HK\$'000
Grants to schools/educational bodies/ institutions/individuals	147,521	134,458
Refund of unused grants	(7,921)	(6,845)
	<u>139,600</u>	<u>127,613</u>

6. Incidental expenses

	2007 HK\$'000	2006 HK\$'000
Publicity costs	4,766	667
Teaching excellence scheme	5,800	2,800
Honoraria	48	41
Fees for investment managers	16,479	15,646
Fees for custodians	2,011	1,795
Investment transaction costs	12,099	10,116
Others	8	51
	<u>41,211</u>	<u>31,116</u>

7. Deposits with banks and other financial institutions

	2007 HK\$'000	2006 HK\$'000
Hong Kong dollar fixed deposits	100,481	154,661
Foreign currency fixed deposits	651,544	161,964
Foreign currency call deposits and balances with custodians	19,229	2,029
	<u>771,254</u>	<u>318,654</u>

8. Securities

	2007 HK\$'000	2006 HK\$'000
Equity securities		
Hong Kong listed equities	1,072,110	1,155,871
Overseas listed equities	1,791,986	1,908,579
	<u>2,864,096</u>	<u>3,064,450</u>
Debt securities		
Hong Kong debt securities		
— Listed	443,989	388,334
— Unlisted	617,800	468,351
Overseas debt securities		
— Listed	1,702,924	1,203,650
— Unlisted	295,879	168,909
	<u>3,060,592</u>	<u>2,229,244</u>
	<u>5,924,688</u>	<u>5,293,694</u>

9. Trading financial instruments

	2007		2006	
	Assets HK\$'000	Liabilities HK\$'000	Assets HK\$'000	Liabilities HK\$'000
Forward currency contracts, at fair value	7,160	2,100	630	7,438

All these forward currency contracts will mature within one year. They have a total notional amount of HK\$1,831 million (2006: HK\$1,419 million). The notional amounts of these contracts indicate the volume of outstanding transactions and do not represent amounts at risk.

10. Receivables and other assets

	2007 HK\$'000	2006 HK\$'000
Interest and dividends receivable	41,370	32,605
Proceeds from securities sold	6,063	61,305
Other debtors	1,495	986
	<u>48,928</u>	<u>94,896</u>

11. Payables and other liabilities

	2007 HK\$'000	2006 HK\$'000
Cost of securities bought	304,107	64,430
Other creditors and accruals	7,765	7,289
	<u>311,872</u>	<u>71,719</u>

12. Commitments

As at 31 August 2007, approved grants to be released by the Fund when the grantees comply with the conditions and not provided for in the accounts amounted to HK\$115 million (2006: HK\$168 million). Since inception up to 31 August 2007, grants totalling HK\$3,436 million for 6,776 projects (2006: HK\$3,338 million for 6,315 projects) were approved by the Trustee.

13. Financial risk management

(a) Investment management and control

The Permanent Secretary for Education Incorporated, as the Trustee of the Fund, may invest monies of the Fund in accordance with section 5(1) of the Permanent Secretary for Education Incorporation Ordinance. He has appointed the Director of Accounting Services to handle the investment of the Fund monies.

The Steering Committee may advise the Trustee on policies and procedures governing the operation of the Fund and on the assessment of applications for the funding from the Fund. Members of the Steering Committee are appointed by the Secretary for Education.

The Fund's investment objective is to generate a reasonable growth in the value of the funds whilst producing recurrent income to meet regular funding requests in order to support the development of quality education in Hong Kong and to fund activities that aim to raise the quality of school education, and to promote quality school education in Hong Kong.

The investment performance of the Fund is monitored through the Investment Committee which usually meets on quarterly basis to review investment reports prepared by the Director of Accounting Services and to interview the Fund's external investment managers. The Investment Committee also formulates guidelines on asset allocation in order to meet the investment objective. Members of the Investment Committee are appointed by the Secretary for Education.

The investment management and control of the Fund are set out in a documented risk management or investment strategy and are reviewed on a regular basis by the Investment Committee.

(b) Market risk

Market risk is the risk that changes in market variables such as security prices, interest rates and currency exchange rates may affect the fair value or cash flows of a financial instrument.

(i) Price risk

The Fund's securities are subject to the price risk inherent in all securities i.e. the value of holdings may fall as well as rise. At 31 August 2007, the securities are included in investments as shown in note 8. The risk is primarily addressed through diversification of investment portfolio in accordance with a documented risk management or investment strategy, and the Fund monitors the price risk on a continuous basis.

(ii) Interest rate risk

Interest rate risk refers to the risk of loss arising from changes in market interest rates. This can be further classified into fair value interest rate risk and cash flow interest rate risk.

Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate because of changes in market interest rates. Since a substantial portion of the Fund's debt securities and all of its deposits with banks and other financial institutions bear interest at fixed rates, their fair values will fall when market interest rates increase. Investments in debt securities are made in accordance with a documented risk management or investment strategy, and the Fund monitors the fair value interest rate risk on a continuous basis. As regards deposits with banks and other financial institutions, since they are all stated at amortised cost, their carrying amounts will not be affected by changes in market interest rates.

Cash flow interest rate risk is the risk that future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Fund does not have a significant exposure to cash flow interest rate risk because only a small portion of its debt securities bear interest at rates determined by reference to market interest rates.

The table below sets out the Fund's exposure to interest rate risk, based on the major interest bearing assets stated at carrying amounts and categorised by the

earlier of contractual re-pricing dates or maturity dates and stating the effective interest rate for each group of assets.

	Weighted average effective interest rate	Up to 3 months HK\$'000	More than 3 months but not more than 1 year HK\$'000	More than 1 year but not more than 5 years HK\$'000	Over 5 years HK\$'000	Total HK\$'000
2007						
Deposits with banks and other financial institutions	5.14%	771,254	—	—	—	771,254
Debt securities	4.56%	277,505	174,663	1,128,536	1,479,888	3,060,592
		1,048,759	174,663	1,128,536	1,479,888	3,831,846
2006						
Deposits with banks and other financial institutions	4.48%	318,654	—	—	—	318,654
Debt securities	4.11%	89,338	150,707	916,519	1,072,680	2,229,244
		407,992	150,707	916,519	1,072,680	2,547,898

(iii) Currency risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to the changes in currency exchange rates. The Fund's non-Hong Kong investments are exposed to currency risk. The Fund only makes investments denominated in Hong Kong dollar, US dollar and currency of a country whose foreign currency long-term debt has a high credit rating. Assets denominated in foreign currencies and the exposure to non-Hong Kong dollar are handled in accordance with a documented risk management or investment strategy, and the Fund monitors the currency risk on a continuous basis.

The following table indicates the concentration of currency risk for the net assets at the balance sheet date.

	2007	2006
Net Currency Exposure	HK\$'000	HK\$'000
Hong Kong dollar	2,385,047	2,117,316
US dollar	1,921,124	1,722,363
Euro	957,752	848,959
Great British Pound	439,435	367,458
Japanese Yen	384,448	269,074
Others	351,695	318,467
Net assets	6,439,501	5,643,637

(c) Credit risk

Credit risk is the risk that an issuer or counterparty will be unable or unwilling to pay amounts in full when due. Investments in debt securities, trading financial instruments, and loans and receivables are potentially subject to credit risk. The maximum exposure to credit risk for these assets is represented by their carrying amounts in the balance sheet. The Fund selects issuer or counterparty with good credit standing, strong financial strength and sizable capital. The Fund also limits the individual exposure, in accordance with a documented risk management or investment strategy. Hence the Fund does not have significant exposures to credit risk and monitoring is done on a continuous basis.

(d) Liquidity risk

Liquidity risk is the risk that the Fund may not have sufficient funds available to meet its obligations as they fall due. The Fund monitors the liquidity requirements on a continuous basis and maintains a level of short term deposits and cash to pay grants as necessary. Hence the Fund does not have significant exposures to liquidity risk.

(e) Fair values

The fair values of financial instruments quoted in active markets are their quoted prices at the balance sheet date. In the absence of such quoted market prices, fair values are estimated using present value or other valuation techniques, using inputs based on market conditions existing at the balance sheet date.

All financial instruments are stated in the balance sheet at amounts equal to or not materially different from their fair values.

14. Possible impact of amendments, new standards and interpretations issued but not yet effective for the year ended 31 August 2007

Up to the date of issue of the accounts, the HKICPA has issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 August 2007 and which have not been early adopted in the accounts.

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

The following new standards may result in new or amended disclosures in future accounts:

<u>Not yet adopted in the accounts</u>		<u>Effective for accounting periods beginning on or after</u>
HKFRS 7	Financial instruments: Disclosures	1 January 2007
HKAS 1 (Revised)	Presentation of financial statements	1 January 2009