

## **Legislative Council Panel on Financial Affairs**

### **Securities and Futures Commission Budget for the Financial Year 2008-09**

#### **PURPOSE**

The purpose of this paper is to highlight the main features of the budget of the Securities and Futures Commission (“SFC”) for 2008-09.

#### **BACKGROUND**

2. Section 13(2) of the Securities and Futures Ordinance (Cap. 571) (“SFO”) requires the SFC to submit an estimates of its income and expenditure (“the budget”) for each financial year to the Chief Executive for approval. The Chief Executive has delegated the authority to the Financial Secretary. In accordance with section 13(3) of the SFO, the Financial Secretary shall cause the budget to be laid on the table of the Legislative Council. In line with past practice, the Administration has prepared this paper to invite Members to note the main features of the budget of the SFC. A copy of the budget is attached at Annex.

#### **FUNDING OF THE SFC**

3. Section 14 of the SFO provides that the Government shall provide funding to the SFC as appropriated by the Legislative Council. In practice, the SFC has not requested for appropriation from the Legislative Council since 1993-94. Its funding basically comes from the market in the form of levies, fees and charges.

4. Over the years, levies on securities and futures/options contracts trading have been the main source of income for the SFC. The current rate of levy on securities is 0.004% while the levy on futures and options contracts is \$0.8 or \$0.16 per leviabale transaction, depending on the type of contracts.

5. As regards fees and charges, the SFC adopts, to the extent possible, the principle of full cost recovery. The rates of SFC's fees and charges have not been revised since 1994.

### **BUDGET for 2008-09**

6. The SFC has projected a surplus budget of \$1,996.46 million for 2008-09. With the projected budget surplus and a reasonable size of reserves, for the sixteenth year in a row, the SFC does not request any appropriation from the Legislative Council for the 2008-09 budget. The main features of the 2008-09 budget are set out in paragraphs 7 to 14 below.

#### ***(a) Estimated Revenue***

7. The estimated revenue for 2008-09 is \$2,776.14 million, which is 12% above the revised estimates for 2007-08, taking into account the following factors –

- (a) levy income from securities and futures/options contracts is projected to increase by \$224.93 million (10.7%), on the basis that the transaction levy for securities will remain at 0.004% throughout 2008-09, and assuming the average daily turnover is \$114 billion for securities and 174,000 for futures/options contracts; and
- (b) income from fees and charges will be \$49 million (18.6%) lower than the 2007-08 revised estimates arising from a change in the charging policy in respect of waiver fees for derivative warrant from a per warrant basis to a per issuer basis.

#### ***(b) Estimated Operating Expenditure***

8. The estimated operating expenditure for 2008-09 is \$779.68 million, which is \$174.84 million (28.9%) above the 2007-08 revised estimates (\$604.84 million). The increase is mainly attributable to –

- (a) increase in Personnel Expenses by \$101.13 million (21.6%) arising mainly from –

- (i) creation of 29 new posts in various divisions to cope with increase in workload in priority projects and strengthening of its enforcement capabilities (\$44 million); and upgrading of 8 posts in various divisions to cope with increasing complexities of work and responsibilities (\$7.9 million);
  - (ii) a provision for an average of 6% pay increase (\$22.9 million) based on market pay trend surveys which suggest that the average pay increase projected for 2008 ranges from 5% to 7%;
  - (iii) an increase in provision for variable pay (\$8.3 million); and;
  - (iv) higher salary costs for new recruits to cope with the continual upward adjustment in pay package for professionals in the financial services sector (\$14 million).
- (b) increase in Premises Expenses by \$38.06 million (94.2%) in anticipation of an increase in rental of the existing office and the leasing of a second office from February 2008;
  - (c) increase in Professional and Other Expenses by \$5.77 million (20.7%) to meet the increase in legal fees and external professional services in anticipation of an increase in the number of judicial proceedings involving the SFC; and
  - (d) a provision of \$20 million for implementing new investor education initiatives.

**(c) Staff Establishment**

9. The SFC currently has 470 established posts. The SFC proposed to increase a total of 29 new posts in the proposed estimates of 2008-09 (paragraphs 8(a)(i) refers). The total establishment will become 499 by the end of 2008-09. The new posts are required mainly for the Enforcement Division (12 posts) and the Intermediaries and Investment Products Division (10 posts) to cope with increase in workload arising from –

- (a) increase in policy work concerning new products and regulatory policies and issues relating to Supplement IV to CEPA, the planned Through Train Scheme and other Mainland China related work; and regulation of commodity exchanges.
- (b) a decision-making panel to be set up in the Enforcement Division to ensure a proper segregation of the investigative and adjudicative functions; and
- (c) increase in complexity and size of investigation and surveillance work and increase in licensing applications; and stepping up of monitoring of brokers in the light of the increasingly volatile market.

The detailed justifications are described in paragraphs 4.1 to 4.10 of the budget at Annex.

10. The 8 posts to be upgraded include 5 Assistant Manager and Manager posts, 1 Counsel post and 2 non-executive posts in various divisions. The SFC explained that the upgrading is required to reflect the expansion of the scope and complexities of these posts. The SFC also pointed out that there was significant growth in the volume and complexity of work over the past few years. It is necessary to strengthen its manpower to ensure that their capacity meets market expectations in the regulatory and market development aspects.

***(d) Surplus and Reserves***

11. As at end-December 2007, the reserves of the SFC reached \$3,510.05 million, which is 5.9 times of its approved operating expenditure for the current financial year (\$596.76 million). The SFC estimated that by 31 March 2008, the reserves will reach \$3,852.89 million, which is 6.5 times of the operating expenditure of the 2007-08 approved estimates.

12. According to section 396 of the SFO, the SFC may consult the Financial Secretary with a view to recommending to the Chief Executive in Council that the rate or amount of levy be reduced if the reserves of the SFC is more than twice its estimated operating expenses for that financial year. The SFC has carried out a review on this. In view of the uncertainties in market performance, it is considered that a reduction in levy should not be pursued for the time being. The SFC

will continue to consider new initiatives to make better use of the reserves. In this connection, the SFC has engaged consultancy service to embark on a process review project to identify areas of possible improvement and to design and implement more modern and efficient processes to meet the rising expectation and needs of the market.

*(e) Estimated Capital Expenditure*

13. The total capital expenditure budget proposed for 2008-09 is \$52.47 million representing an increase of 98.3% (\$26 million) above the revised estimates for 2007-08. The increase is required to cater for -

- (a) re-configuration of the existing office (\$15 million) and new equipment for the second office (\$2.5 million);
- (b) implementation of the recommendations of a process review project in relation to process improvement and change management initiatives for the licensing process (\$15 million); and
- (c) enhancement in technological support to information process (\$8.2 million) and replacement of obsolete computer equipment (\$6.5 million) and a Commission car (\$0.5 million).

14. Projected income and expenditure statement for 2008-09 are on page 18 of the budget at Annex.

**COMPARISON OF THE APPROVED BUDGET WITH THE REVISED ESTIMATES FOR 2007-08**

15. The table on page 9 of the budget at Annex provides a comparison of the approved budget and the revised estimates for 2007-08. The main features are set out in paragraphs 16 to 18 below.

*(a) Revenue*

16. The SFC's revenue in 2007-08 has grown significantly, as a result of a substantial increase in levy income due to robust market activities. The revised estimated revenue for 2007-08 is

\$2,477.77 million, which represents a 130.4% increase above the approved estimates<sup>1</sup>. Income from securities levy is estimated to increase by 170.3%. The surplus for the year is now estimated to be \$1,872.94 million, which is about 3.9 times of the approved estimates of \$478.52 million.

***(b) Operating expenditure***

17. The revised estimated operating expenditure is \$604.83 million, which is slightly above the approved estimates (\$596.76 million) by \$8.07 million (1.3%). The increase is mainly attributable to -

- (a) increase in Premises Expenses arising from the leasing of a second office from February 2008 (\$2.1 million);
- (b) creation of 7 new posts mainly in the Intermediaries and Investment Products Division to cope with the increase in workload (\$1.8 million);
- (c) engagement of consultancy service to conduct a process review project to review the efficiency of the SFC's current operating model and its operational objectives (\$1.5 million); and
- (d) set-up costs to support investor education initiative (\$5 million) and contribution to the International Accounting Standards Committee Foundation (\$0.39 million).

***(c) Capital expenditure***

18. The total capital expenditure estimate is increased from \$17.6 million to \$26.46 million (50.4%) to provide for fitting out of the second office as mentioned in paragraphs 8(b) and 17(a) above.

**ADMINISTRATION'S VIEWS**

19. The Administration has examined the SFC budget for 2008-09 and is pleased to note that the SFC has projected a rich surplus in the budget, and that the SFC, as in the past years, has not requested for appropriation from the Legislative Council.

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<sup>1</sup> In the approved estimates for 2007-08, the average daily turnover of securities was assumed to be \$38 billion. The daily turnover of futures and options contracts was assumed to be 90,000.

20. Having regard to the volatile changes in the securities market, we concur with the SFC that the levy rate should not be revised for the time being. That said, we note that the SFC has introduced new initiatives to streamline its operation and is considering possible new initiatives to make better use of the reserves.

21. On personnel expenses, we note that the rapid growth of the market and increase in policy work relating to the regulation of new products have put pressure on the SFC's resources. The SFC has assured us that the increase in staff establishment is necessary to cope with the increase in workload and responsibilities and to address staff retention problem. The SFC is mindful of the need to continue to exercise vigilant control on staff resources.

### **ADVICE SOUGHT**

22. Members are invited to note the proposed budget of the SFC for 2008-09.

Financial Services Branch  
Financial Services and the Treasury Bureau  
February 2008

**SECURITIES & FUTURES COMMISSION  
BUDGET OF INCOME & EXPENDITURE  
FOR THE FINANCIAL YEAR 2008/2009**



## CONTENT

<u>Section</u>	<u>Description</u>	<u>Page</u>
1.	Approach and Background to 2008/09 Budget	1
2.	Executive Summary	2
3.	Assumptions	5
4.	Manpower Plan – Summary	7
5.	Proposed Budget of Income & Expenditure	9
	5.1 Income	10
	5.2 Operating Expenditure	11
	5.3 Funding to External Parties	16
	5.4 Capital Expenditure	16
6.	Projected Income and Expenditure Statement	18

## **1. APPROACH AND BACKGROUND TO 2008/09 BUDGET**

- 1.1 Each year the budget is prepared based on a policy of tightly controlling all expenditure, as befits a publicly funded organization. Prior year expenditure levels are utilized as a benchmark except in areas where additional resources have clearly been identified as necessary to meet our regulatory obligations or to support initiatives to modify and strengthen the regulatory environment. During the year strict controls are exercised to ensure that costs stay within budget commitments.
- 1.2 This disciplined approach to budgetary preparation and cost control over many years has been successful in containing growth in overall costs below rates of growth in underlying activity thereby enhancing efficiency. However, the approach has been largely based on an historic look-back view of what has happened in the markets and has not been able to anticipate the unprecedented market growth in recent years. It has also not allowed the organisation to recover from certain cost control measures put in place during the 2001 to 2004 recessionary period. These measures reduced capacity in some areas and eroded the SFC's competitiveness in some segments of the labour market. As the economy and in particular the securities market, has taken off in the last two years the increased workload and pressure on resources has highlighted the need to address a number of these issues.
- 1.3 While we have made proposals to address areas where additional resources are required we are also conscious of the need to constantly challenge how we execute our duties, to improve processes and to meet the ever increasing expectations of stakeholders. A number of key processes have been in place for many years and regulatory requirements have changed and new technologies emerged since they were designed. Expectations have also moved on, as Hong Kong develops as an International Financial Centre and aspires to ever higher standards. We have therefore included in our 2007/08 forecast and 2008/09 budget, provision to engage consultants to assist in an organization-wide project, to identify areas of possible improvement and to design and implement more modern and efficient processes to meet today's needs of both the market and us as its regulator. Further details are given in para. 5.2.11.
- 1.4 A number of budget headings are different from the prior year and certain detailed expenditure categories have been grouped under more appropriate sub-headings this year. These changes have been made to reflect how the organization is managed, what the expenditure more appropriately relates to and to reflect the merger of two departments. To facilitate comparison with this year's budget the prior year approved budget has been re-presented in the same format as this year. However, the overall budget for the prior year has not been changed and a full reconciliation of the presentation last year, to the more appropriate presentation this year, is attached as Appendix.

## 2. EXECUTIVE SUMMARY

2.1 Set out below is a summary of the Commission's proposed budget for 2008/09. This summary is intended to give an overview of the key factors influencing the Commission's budget for 2008/09. For more detailed explanations reference should be made to sections 4 and 5 of this budget book.

	2008/09	2007/08		Variance	
	<b>Proposed Budget (a) HK\$m</b>	Forecast (b) HK\$m	Approved Budget HK\$m	c = (a-b) HK\$m	(c/b) %
<b>Income</b>	<b>2,776.14</b>	2,477.77	1,075.28	298.37	12.0%
<b>Expenditure</b>					
- Operating expenditure	756.79	596.94	594.26	159.85	26.8%
- Funding to external parties	22.89	7.89	2.50	15.00	190.1%
Total Operating Expenditure	<b>779.68</b>	604.83	596.76	174.85	28.9%
<b>Surplus for the year</b>	<b>1,996.46</b>	1,872.94	478.52	123.52	6.6%
Reserves brought forward	<b>3,852.89</b>	1,979.95	1,812.84	1,872.94	94.6%
<b>Reserves carried forward</b>	<b>5,849.35</b>	3,852.89	2,291.36	1,996.46	51.8%
<b>Capital Expenditure</b>	<b>52.47</b>	26.46	17.60	26.01	98.3%
<b>Headcount</b>	<b>499</b>	477	470	22	4.6%

### Income

2.2 As can be seen from the above summary, 2007/08 income is forecast to far exceed budget and operating expenditure to be approximately on budget. This will result in a very significant increase in reserves with a forecast balance of approximately \$3.85 billion at the end of this financial year.

2.3 For 2008/09 we are budgeting a significant increase in operating expenditure (\$159.85 million) and also an increase in expected income (\$298.37 million). Our budget indicates that a surplus of approximately \$2 billion will be generated in 2008/09 leaving our overall reserves at \$5.8 billion by the end of that financial year.

2.4 While income is principally derived from stock market levies and therefore subject to variances in market activity, the level of surplus projected and the substantial reserves that have been accumulated mean that there is no appreciable risk to the SFC's funding sources. Projections based on various 'worst possible' scenarios indicate that the SFC will receive sufficient income from levies to fully cover its operating costs even in a significant market downturn and will not have to fall back on its substantial reserves.

2.5 The forecast income includes a \$50 million reduction in Fees for Part XV waivers given to issues of listed warrants (already approved by the Commission). Please refer to section 5.1.6 for details.

## Expenditure

2.6 Changes in budgeted expenditure levels are explained in detail within the body of this budget book. However, the following table summarises the key issues which contribute to the increase in expenditure being budgeted for 2008/09.

	<u>2008/09</u>	2007/08		Variance	
	<u>Proposed Budget (a) HK\$'m</u>	<u>Forecast (b) HK\$'m</u>	<u>Approved Budget HK\$'m</u>	<u>c = (a-b) HK\$'m</u>	<u>(c/b) %</u>
<b>Personnel expenses</b>	<b>569.9</b>	468.8	468.6	101.1	21.6%
<b>Premises</b>	<b>78.5</b>	40.4	36.9	38.1	94.3%
<b>Professional &amp; others</b>	<b>33.6</b>	27.9	23.9	5.7	20.4%
<b>Depreciation</b>	<b>28.0</b>	18.0	20.0	10.0	55.6%
<b>Other operating costs</b>	<b>46.8</b>	41.8	44.9	5.0	12.0%
<b>Total Operating Expenditure</b>	<b>756.8</b>	<b>596.9</b>	<b>594.3</b>	<b>159.9</b>	<b>26.8%</b>

## Personnel expenses

2.7 As more fully explained in section 4 we have proposed increases in headcount of 29 full time positions, 7 of which are included in our forecast for this year. This represents an increase in total headcount of approximately 6%. Explanations for these increases are set out within the body of this report (para. 4.1 to 4.10) but may be summarized as being due to three main factors:

- overall market growth, which is reflected in the work that we perform e.g. licenses issued and products approved;
- a very significant increase in issues related to Mainland China e.g. QDII and the planned 'Through Train Scheme'; and
- an increase in complexity of our enforcement activities both in terms of action taken through the courts and in market surveillance where volumes and volatility have created additional challenges.

2.8 A provision has been included in the 2008/09 Budget for an average pay rise for Commission staff of 6%. This provision is based on information available to us at this time regarding comparable staff in comparable organizations. However, final decisions regarding the level of award to each grade of staff will not be made until early 2008 when our regular pay survey data is available. The Executive will then determine the specific awards and a summary will be presented to the Remuneration Committee for discussion and to the Commission for approval. Please see para. 5.2.7(ii) for further details.

### **Premises**

- 2.9 Our Chater House office is subject to rent review in July 2008. Whilst our rent will be capped at a very advantageous level, compared to current market rates, it will still increase by 160% from current levels. The additional rental expense as a result of this rent review amounts to \$25.2 million.
- 2.10 The Commission has previously been briefed on the need for more space and has approved the signing of a lease for additional office space in a separate building. The assumption is that we will start paying rent in February 2008 and this has resulted in an additional \$2.3 million in the 2007/08 forecast and \$11.6 million in the 2008/09 budget. Further details are set out in para. 5.2.4.

### **Professional and others**

- 2.11 Over the past year we have seen a significant increase in legal costs. This has arisen from two main factors; a change in enforcement focus to concentrate resources on bigger and more important cases and an increased level of challenges to our actions. This has resulted in the number of high court cases (where external counsel is required) increasing significantly. The forecast for 2007/08 includes an additional \$2m of legal fees over the original budget and the budget for 2008/09 includes a further \$4.6 million over the 2007/08 forecast level. Further details are given in para. 5.2.11 and 5.2.12. Also included in the forecast fees for 2007/08 are some unbudgeted consulting fees for a special review of operations as a precursor to changing some of our front office systems and processes during 2008/09. See para. 5.2.11 for further details.

### **Depreciation**

- 2.12 This is driven by both levels and timing of capital expenditure which are more fully explained in para. 5.2.19 and has also been increased by the fit out costs of our new and existing premises.

### 3. ASSUMPTIONS

#### 3.1 Investor Levy Rates

The levy rate will remain unchanged for the year 2008/09, i.e.

- Investor Levy Rate - Securities, at 0.004% and
- Investor Levy Rate - Future/Options contracts, at \$0.8/\$0.16 per contract.

#### 3.2 Market Turnover

*Equity market:* Based on Research department's latest forecast, the average securities market turnover is assumed to be \$120 billion/day for the rest of 2007/08 and \$114 billion/day for 2008/09.

*Futures and Options market:* Based on the transaction volume for the past three months (Jul - Sep 2007), futures/options market turnover is assumed to be an average 183,000 contracts per day for the rest of 2007/08. We assume that the transaction volume will drop by 5% to 174,000 contracts per day in 2008/09 in line with the assumptions made for turnover on the equity market.

#### 3.3 Fees and Charges

We have assumed that the change to the basis used to grant waivers from Part XV of the SFO to issuers of derivative warrants will be implemented in December 2007. This will result in an estimated reduction of \$50 million in Corporate Finance fees income for 2008/09. The rates of other fees and charges are assumed to remain unchanged for 2008/09.

#### 3.4 Interest Rate

The average return on investment of our reserve funds is assumed to be 5% p.a. for the year 2008/09.

#### 3.5 Remuneration Adjustment

Provision for a 6% average general salary increase is included in the 2008/09 budget based on the best available information to date. The actual rate of increase will be reviewed by the Remuneration Committee and approved by the Commission with the benefit of market research reports which are only available after the submission of the budget to the Commission and the FSTB.

#### 3.6 Inflation

A 5% provision is included for general price level increases, except for travelling costs and professional charges (such as legal fees), where underlying costs are expected to increase by 10% in 2008/09, and certain specific items expenditure where higher rates of increase are anticipated.

### 3.7 Capital Expenditure

It is assumed that the approved estimates of capital expenditure for different capital projects will, as previously, be carried forward until the completion of the projects.

#### 4. MANPOWER PLAN – SUMMARY

4.1 The preparation of the manpower plan for 2008/09 is based on our assessment of the staff strength required to discharge the Commission's existing regulatory functions. In a number of areas we have identified the need for additional resources to meet increased demands being placed on the Commission. These demands arise from changes in nature of the market we regulate and in particular market growth, increased sophistication of products and the increasing influence of activities in Mainland markets. The effect of tightening measures in prior years have also been felt during the current year and it has been felt necessary to relieve pressure in certain areas in order to maintain an acceptable level of capability.

Our proposed manpower plan is outlined below:

Division	Function	Headcount				
		Approved 2007/08	Proposed 2008/09	Position upgrades	Net Change	Para /ref
CEO's Office	Division Management & Commission Secretariat	15	18		+3	4.2
Corporate Finance	Corporate Finance	60	60	1	-	
Intermediaries & Investment Products	Division Management	20	22		+2	4.3-4.4
	Licensing	43	46		+3	4.3-4.4
	Intermediaries Supervision	75	77		+2	4.3-4.4
	Investment Products	33	36		+3	4.3-4.4
Enforcement	Enforcement	100	112	2	+12	4.5-4.6
Supervision of Markets	Supervision of Markets	20	20	1	-	
	Research	5	6	1	+1	4.7
Legal Services	Legal Services	17	19	1	+2	4.8
Corporate Affairs	External Relations	28	28	1	-	
	Information Technology	18	18		-	
	Finance & Administration	22	23		+1	4.9
	Human Resources, Training & Development	14	14	1	-	
<b>TOTAL</b>		<b>470</b>	<b>499</b>	<b>8</b>	<b>29</b>	

*Note 1: Headcount consists of previous staff categories of permanent established posts, temporary established posts (special advisers and manager trainees), regular temporary posts and executive trainees.*

4.2 Three new posts are proposed for the China Affairs department in the CEO's office to cope with the increasing and complex policy work related to Mainland China and to bring coordination to the various Mainland related activities conducted by different divisions. One of these new posts is proposed for 2007/08 and the remaining two for 2008/09.

4.3 For 2007/08 six new posts are proposed for IIP. Two executives will be added to the Licensing team to cope with increases in the number of applications, especially from Mainland Chinese intermediaries that want to operate in Hong Kong. Two positions will be added in Investment Products to handle increased levels of work created by the high number of product issuances by fund houses and demand for authorization of Mainland China related products e.g. QDII. Two positions will be added in Intermediary Supervision to



monitor risky brokers. These are areas where the level of work required has increased and where problems have been discovered over the past two years.

- 4.4 For the 2008/09 budget, four new executive posts are proposed for IIP. Two posts will be in Divisional Management and focused on policy work concerning new products as well as regulatory policies, amendments to the SFO and issues relating to CEPA IV, the Through Train Scheme and other Mainland China related work. One executive post will be added in Licensing to deal with increased workload and to allow more attention to be focused on identifying steps to facilitate industry growth and market development. One post will be added in Investment Products to focus on authorization of unit trust and market issues related to QDII.
- 4.5 To discharge our Enforcement functions, apart from resources required for conducting investigations, four new executive posts are proposed to supplement Enforcement's daily market surveillance resources. The daily work of this area has increased substantially with the higher volume of transactions in the market triggering a greater number of surveillance assessment inquiries and activities. One new non-executive position is required to supplement the administrative resources in Enforcement.
- 4.6 It is proposed to create four executive posts and one non-executive post to create a Decision-making panel for licensing discipline. These are new posts to replace functions undertaken currently by the Executive Director, Enforcement and Senior Director, Discipline. A separate decision-making panel reporting to CEO would not only handle disciplinary decision-making, it would also supplement the SFC's commitment to fairer process because it would introduce, for the first time, a proper separation between investigative and disciplinary decision-making functions. It is envisaged this panel would also be able to take on disciplinary decision-making in other areas, like enforcement of the Takeovers Code.
- 4.7 One executive post is proposed for Supervision of Markets to handle new challenging work in relation to the regulation of commodity exchanges.
- 4.8 For Legal Services, one executive is proposed to assist in advisory work and deal with the increasing workload in civil litigation. One non-executive is proposed to assist in preparation for cases and filing documents in court.
- 4.9 One non-executive is proposed for Finance & Administration to cope with the increasing workload following a head count reduction some years ago. This will allow the department to produce Management Information reports which are presently not available in part due to head count constraints.
- 4.10 To reflect the increasingly complex work nature and additional responsibilities arising from new initiatives, upgrading of six executive posts and two non-executive posts are proposed. These adjustments will align our headcount complement more accurately with the skill sets required to execute our regulatory functions.

**5 PROPOSED BUDGET OF INCOME AND EXPENDITURE**

Following is a summary of major budget items :-

		(A)	(B)	(C)	(A)-(B) (B)	(B)-(C) (C)
	Para. Ref.	Proposed Budget For Year 2008/09 HK\$'000	Forecast For Year 2007/08 HK\$'000	Approved Budget For Year 2007/08 <sup>(Note)</sup> HK\$'000	Proposed Budget Over/(under) Forecast %	Forecast Over/(Under) Approved Budget %
<b><u>INCOME</u></b>						
Investor Levy	5.1.2-5.1.4					
Securities		2,261,760	2,038,150	753,920	10.9	170.3
Futures/Options Contracts		69,043	67,724	35,712	1.9	89.6
Fees & Charges	5.1.5-5.1.6	215,000	264,000	193,700	(18.6)	36.3
Investment Income	5.1.7-5.1.8	227,120	104,896	89,950	116.5	16.6
Other Income	5.1.9	3,220	3,000	2,000	7.3	50.0
<b>Total</b>		<b>2,776,143</b>	<b>2,477,770</b>	<b>1,075,282</b>	<b>12.0</b>	<b>130.4</b>
<b><u>OPERATING EXPENDITURE</u></b>						
Premises	5.2.1-5.2.4	78,480	40,420	36,867	94.2	9.6
Personnel Expenses	5.2.5-5.2.7	569,927	468,795	468,550	21.6	0.1
Info. & Sys. Services	5.2.8	23,958	20,511	20,964	16.8	(2.2)
General Office & Insurance	5.2.9	6,682	6,415	7,230	4.2	(11.3)
Training & Development	5.2.10	5,624	5,035	5,035	11.7	--
Professional & Others	5.2.11-5.2.12	33,631	27,858	23,948	20.7	16.3
External Relations	5.2.13-5.2.15	8,863	8,370	8,670	5.9	(3.5)
FinNet	5.2.16-5.2.17	120	540	1,500	(77.8)	(64.0)
Contingency	5.2.18	1,500	1,000	1,500	50.0	(33.3)
Depreciation	5.2.19	28,000	18,000	20,000	55.6	(10.0)
<b>Total (1)</b>		<b>756,785</b>	<b>596,944</b>	<b>594,264</b>	<b>26.8</b>	<b>0.5</b>
<b><u>FUNDING TO EXTERNAL PARTIES</u></b>						
Funding to IEC	5.3.1	20,000	5,000	-	300.0	N/A
Funding to FRC	5.3.2	2,500	2,500	2,500	--	--
Funding to IASC Foundation	5.3.3	390	390	-	--	N/A
<b>Total (2)</b>		<b>22,890</b>	<b>7,890</b>	<b>2,500</b>	<b>190.1</b>	<b>215.6</b>
<b>TOTAL EXPENDITURE (1)+(2)</b>		<b>779,675</b>	<b>604,834</b>	<b>596,764</b>	<b>28.9</b>	<b>1.3</b>
<b><u>CAPITAL EXPENDITURE</u></b>						
Furniture & Fixtures		15,000	10,000	500	50.0	1,900.0
Office Equipment		9,000	4,500	5,000	100.0	(10.0)
Vehicles		500	--	--	N/A	--
Process Review Project		15,000	--	--	N/A	--
Computer Sys. Development		8,200	10,500	10,500	(21.9)	--
Sub-total		47,700	25,000	16,000	90.8	56.3
Contingency		4,770	1,464	1,600	225.8	(8.5)
<b>Total</b>	5.4.1-5.4.2	<b>52,470</b>	<b>26,464</b>	<b>17,600</b>	<b>98.3</b>	<b>50.4</b>

Note : Comparative figures have been restated to comply with the current year's presentation as was fully explained in para. 1.4.

## 5.1 INCOME

### Annual Grant from Government

5.1.1. S.14 of the Securities and Futures Ordinance provides that: “For each financial year of the Commission, the Government shall pay to the Commission out of the general revenue the moneys appropriated by the Legislative Council for that purpose.” As in previous years, the Commission proposes that the Government do not request any appropriation from the Legislative Council for the financial year 2008/09. The Commission’s decision is made without prejudice to the funding principles established when the SFC was formed, and has no implications for requests for appropriations in future years.

### Investor Levy

5.1.2. A summary of the turnover and levy rate assumptions for the 2007/08 Approved Budget and Forecast and the 2008/09 Proposed Budget is given below.

	2007/08			2008/09
	Approved Budget	First 7 months (actual)	Last 5 months (assumption)	Proposed Budget (assumption)
<b>Securities</b>				
Daily turnover (billion/day)	\$38.0	\$100.0	\$120.0	\$114.0
Levy rate	0.004%	0.004%	0.004%	0.004%
<b>Futures/Options Contracts</b>				
Daily turnover (contracts)	90,000	165,000	183,000	174,000
Levy Rate	\$0.8	\$0.8	\$0.8	\$0.8

5.1.3. The 2007/08 Forecast of Investor Levy – Securities is higher than the Approved Budget by 170.3% (\$1,284.23 million) and for Investor levy – Futures and Options by 89.6% (\$32.01 million). These increases are attributable to the robust market activities in recent months which have exceeded the assumptions underlying the Approved Budget.

5.1.4. The assumed turnover underlying the 2008/09 Proposed Budget is based on estimates prepared by our Research Department on a basis consistent with prior years.

### Fees and Charges

5.1.5. The Forecast aggregate fees and charges income for 2007/08 is 36.3% (\$70.30 million) higher than the Approved Budget. This increase arises from higher than expected fee income from Part XV waivers for derivative warrants and increased numbers of licensing applications.

5.1.6. The 2008/09 Budget shows fee income down by 18.6% against Forecast for 2007/08. This decline is due to a change, expected in December 2007, in the way in which waivers from Part XV of the Securities and Futures Ordinance are granted to issuers of derivative warrants. This change is expected to result in an estimated reduction in

fees of \$50 million as compared to 2007/08. No changes to other fees are proposed for 2008/09 and volumes are assumed to be similar to 2007/08.

### **Investment Income**

- 5.1.7. Investment income for 2007/08 is forecast to be \$104.90 million, 16.6% higher than the Approved Budget due to increased funds available for investment arising from greater than forecast increases in reserves. For the remainder of the year, the average return on dated securities and fixed deposits has been assumed to be 5% p.a..
- 5.1.8. Investment income in the 2008/09 Budget is \$227.12 million, 116.5% (\$122.22 million) higher than the 2007/08 Forecast. This increase is attributable to expected increases in the funds available for investment as a result of continued growth in the reserves balance. The average rate of return is assumed to be 5% p.a..

### **Other Income**

- 5.1.9. In previous years, income generated from FinNet (network support and connection fees) was included as other income in our budget. From this year onward, we will offset FinNet income against FinNet expenses to reflect the true net cost to the Commission. Other income represents recoveries from investigation cases and sale of SFC publications.

## **5.2 OPERATING EXPENDITURE**

### **Premises**

- 5.2.1. Premises expenses for 2007/08 have been revised upward by 9.6% (\$3.55 million) to cover the actual rates increase levied by Government on our existing office (\$1.3 million) and the rent and management fees for the lease of a second office (\$2.1 million), which is expected to commence in February 2008 (see also para. 5.2.4 below).
- 5.2.2. Premises expenses for 2008/09 are budgeted to be \$38.06 million (94.2%) higher than forecast expenses for 2007/08. This increase arises both from an increase in the rental of our existing premises and also from the planned lease of additional space in a second building.
- 5.2.3. In July 2008 the rent on our existing premises in Chater House comes up for renewal. Under the terms of our lease the new rent is capped at a very favourable rate compared to the current market but it is nevertheless 160% higher than the rate we are currently paying. This results in an increase in our premises costs of \$25.17 million compared to 2007/08 forecast.
- 5.2.4. In November 2007 the Commission approved a proposal to take additional space in a separate building to accommodate the increased accommodation needs which have arisen since moving to our current premises in 2003. Negotiations are still ongoing to try and acquire the space we need but it is currently proposed that we will lease an additional 16,000 square feet (net) of space and sublet approximately 4,000 square feet (net) of existing space to provide 12,000 square feet of additional usable space. While detailed plans have yet to be finalised it is likely that the additional space will

be utilized primarily to house support functions. The forecast has assumed that this additional space will be available from February 2008 and \$2.25 million has been included in the Forecast for costs related to this new space. The 2008/09 budget includes \$11.58 million, net of sublet income, in respect of this new space. Additional amounts are also included in the capital budget for refurbishment costs related to this new space.

### **Personnel Expenses**

5.2.5. Certain personnel related expenses that were previously included in other budget headings (as shown in the table below) have been reclassified under personnel expenses. This more accurately reflects the nature of these expenses and all comparative figures for prior periods have been restated on this new basis.

	<b>Formerly included under</b>
Staff Functions	Training and Development
Recruitment	Professional & Others
Registration and Membership Fees	Professional & Others

5.2.6. The projected staff complement for 2007/08 is 477, an increase of 7 over the approved establishment for 2007/08. However, overall personnel expenses for 2007/08 are forecast to be on budget. The explanation for the additional headcount in 2007/08 is included in section 4.

5.2.7. The projected headcount at 31 March 2009 is 499, an increase of 29 (6.2%) over the headcount included in the 2007/08 approved budget. In addition, we have proposed 8 position upgrades. Please see para. 4.2-4.10 for an explanation of this increase in headcount. The projected personnel expenses for 2008/09 are 21.6% (\$101.13 million) higher than the 2007/08 Forecast. A breakdown of the underlying sources of this overall increase is set out below:

<b><u>Source of increase in personnel costs</u></b>	<i>HK\$m</i>	<i>% impact</i>	<i>Note</i>
Additional headcount	44.0	43.5	<i>i</i>
Position upgrades	7.9	7.8	<i>i</i>
General pay increase	22.9	22.7	<i>ii</i>
Full year effect of 2007/08 new joiners	14.0	13.8	<i>iii</i>
Provision for variable pay	8.3	8.2	<i>iv</i>
Insurance premium increase	1.8	1.8	<i>v</i>
Internship programme	1.3	1.3	<i>vi</i>
Recruitment	0.7	0.7	<i>vii</i>
Staff functions	0.2	0.2	<i>viii</i>
<b>Total</b>	<b>101.1</b>	<b>100%</b>	

*Notes*

- i.* 24 executive posts and 5 non-executive posts are proposed to cope with the increasing workload as well as priority projects. In addition, 8 upgradings are proposed to cope with the increased job complexity in respective areas (Details of the manpower plan are discussed in section 4 of this paper).
- ii.* The budget includes provision for an average 6% pay increase for Commission staff. This is based on an analysis of current pay scales against market information from external parties including pay consultants and professional associations. Detailed proposals for the allocation of this average pay increase between grades will be formulated in Q1 2008. These proposals will be presented to the Remuneration Committee for endorsement and subsequently to the Commission for final approval. The allocations between grades will be determined based on an analysis of external data and in particular pay level surveys by two external consultants (Hay and McLangan), which are only received after approval of this budget by the Commission. The allocation between grades will also take into account the commercial pressure being experienced at each grade as reflected in current turnover rates.
- iii.* This is the full year impact since a full year charge was not budgeted for additional headcount requested in 2007/08.
- iv.* The difference is due to a full provision equivalent to 17.1% of staff wage bill being made for 2008/09 variable pay, instead of using provision plus savings in the remuneration budget to fund the variable pay as in last year.
- v.* The estimates for 2008/09 are based on actual (competitive) quotes obtained from our suppliers representing increases in premium rates due to inflation and claims history.
- vi.* Additional funding has been provided to provide opportunities for interns from the Mainland to work in the China Policy area.
- vii.* Recruitment expenses have increased in view of the proposed increases in headcount and the prevailing turnover rates.
- viii.* As part of our overall HR initiatives and to roll back costs control measures put in place during the recession, two staff gatherings will be held at outside venues in 2008/09, as opposed to one in 2007/08. However, this will be offset by reducing the total number of events from four to three.

**Information and Systems Services**

5.2.8. The Information and Systems Services expenses forecast for 2007/08 are comparable to the approved budget. For 2008/09, we project a 16.8% (\$3.45 million) increase, which is mainly due to higher EDP software maintenance and data license costs, increase in additional systems contract services after the implementation of SAP (an Enterprise Resources Planning system) and SAS (a data analysis system) and additional data services subscription for operational needs. The majority of this increase relates to 'fixed' costs which must be incurred to maintain current capability levels and reflects periodic increases in license fees as well as the increased capacity we require in today's market.

### **General Office and Insurance**

5.2.9. General Office & Insurance expenses for 2007/08 are revised downwards by 11.3% (\$0.82 million) to reflect the lower fees on all policies, and in particular professional indemnity, which have been negotiated with our insurers. We expect the same level of expenses for 2008/09 with adjustment for inflation.

### **Training and Development**

5.2.10. Forecast training related expenses for 2007/08 are on budget at \$5 million. Training expenses for 2008/09 are 11.7% (\$0.59 million) higher than the Forecast due to the projected increase in headcount plus general inflation in costs. Training for 2008/09 will continue the new initiatives in executive development and talent management which have been a focus for 2007/08.

### **Professional & Others**

5.2.11. Professional & Others expense for 2007/08 is forecast to exceed budget by 16.3% (\$3.91 million) mainly as a result of increased legal fees (+\$2 million) arising from a significant increase in judicial review and High Court cases. Consultancy services fees are also over budget by \$1.5 million due to a process review project which was not included in the approved budget. The process review project is a high-level, Commission wide, review of our long term aspirations and strategic priorities, operational objectives and efficiency of our current operating model. The expected deliverables will be a planning and implementation roadmap to achieve the long-term corporate operating model, with consideration of the change management implications and short-term improvement opportunities, particularly in relation to the Licensing processes. This will be followed by specific projects to implement the changes recommended in the road map and provision for this further work has been made under the capital budget (see section 5.4)

5.2.12. Professional and Others expenses for 2008/09 are higher than the Forecast by 20.7% (\$5.77 million). The increase is attributable to higher legal fees (+\$4.6 million) and external professional services (+\$1.1 million). We have budgeted for a 10% increase in the underlying cost of legal and professional consultancy services in 2008/09 based on discussions with service providers. The remainder of the increase in legal fees is attributable to the change in enforcement focus to concentrate resources on bigger and more important cases and our expectation that the increased level of challenges to our actions will continue. The new focus in enforcement has led to a significant increase in the number and range of civil cases in the High Court involving the SFC. These cases have included seeking disqualification of directors, seeking injunctions under section 213 of the SFO, seeking certification under section 185 of the SFO for non-compliance with an investigation, proceedings under section 214 of the SFO where the affairs of a listed corporation have been conducted in a manner which is unfairly prejudicial to its members, and a number of challenges to the SFC in the form of judicial reviews. Cases in the High Court tend to involve more resources and to be more expensive. The number of cases being heard in the High Court has increased from 11 in 2006/07 to a forecast of 19 in 2007/08 and may be as much as 30 in 2008/09.

### **External Relations**

- 5.2.13. The budget items under the heading “Corporate Communications” in previous year’s budget are now incorporated under “External Relations” following some internal reorganization of departments. External entertainment expenses originally grouped under Training & Development are also reclassified under External Relations.
- 5.2.14. Forecast External Relations expenses for 2007/08 have been revised downward by 3.5% (\$0.30 million) mainly due to discontinuing printing of a number of publications which are now only published in electronic form.
- 5.2.15. External Relations expenses will be increased by 5.9% (\$0.49 million) in 2008/09. We have recently undertaken a review of our external relations activities and plan to conduct two public surveys in 2008/09 which have not been conducted for approximately 18 months. The estimated cost of these (\$1.15 million) is off-set by the removal of the Investor Education and InvestEd Website Maintenance budgets, which are now budgeted under the Investor Education Council budget (see para. 5.3.1 below).

### **FinNet**

- 5.2.16. Forecast FinNet expenses for 2007/08 (net of FinNet income as discussed in para. 5.1.9 above) are \$1 million lower than the budget due to savings in network promotion and new services and improvements. Projected income from network support and network connection is \$1.46 million for 2007/08 against \$1.5 million in the approved budget. The net FinNet expense is \$0.54 million.
- 5.2.17. For 2008/09, we have budgeted \$1.9 million for the operating costs of FinNet and estimated income of \$1.78 million, leaving a net expense of \$0.12 million.

### **Contingency**

- 5.2.18. A contingency of \$1 million is provided for the remainder of 2007/08 and \$1.5 million provided for 2008/09 to cover unforeseen expenses arising from changes in the operating environment or unforeseen special requirements.

### **Depreciation**

- 5.2.19. Forecast depreciation expense for 2007/08 is expected to be 10% (\$2 million) below budget due to lower than expected capital expenditure in IT partially offset by additional depreciation on refurbishment of our new office. This is in part timing due to when capital projects are completed and we expect that the depreciation expense for 2008/09 will be \$28 million, 55.56% (\$10 million) higher than the 2007/08 Forecast. This increase is due to increases in capital expenditure in 2008/09 (see section 5.4 below) but also reflects the lower than expected depreciation this year.



### 5.3 FUNDING TO EXTERNAL PARTIES

- 5.3.1. We have put forward a proposal to expand our investor education activities which will allow us to more accurately establish the investor education needs of the public, to more effectively deliver education messages to specific demographic segments of the public, to increase the level of out-reach activities and to deal with the increasing need to have material available for Mainland investors in the Hong Kong market. The increase in investor education efforts is undoubtedly in the interest of the investing public at a time of increasing complexity of the financial products offered to them and increased market volatility.
- 5.3.2. At the request of the government the SFC will continue to provide annual funding of \$2.5 million to the Financial Reporting Council (FRC).
- 5.3.3. As suggested by the government, the SFC has committed to a contribution of US\$50,000 annually for a period of three years to support the International Accounting Standards Committee (IASC) Foundation. This will be reviewed after this initial three year period.

### 5.4 CAPITAL EXPENDITURE

- 5.4.1. The total capital expenditure forecast for 2007/08 has been increased from \$17.60 million to \$26.46 million, as a result of the inclusion of a \$10 million provision for fitting out costs of the second office (see para. 5.2.4 above). Renovation work is expected to start around February 2008.
- 5.4.2. The total capital expenditure budget for 2008/09 is \$52.47 million, 98.3% (\$26 million) higher than 2007/08 Forecast. The planned capital expenditure comprises the following:-

<b>Capital Expenditure</b>	<b>Amount HK\$ m</b>	<i>Note</i>
Reconfiguration of existing office premises	15.00	(i)
Office equipment	9.00	(ii)
Replacement of Commission car	0.50	(iii)
Re-engineering project	15.00	(iv)
Front end technology	8.20	(v)
Contingency (10%)	<u>4.77</u>	(vi)
Total	<u>52.47</u>	

- (i) for office re-configuration and renovation costs for our existing office to satisfy both immediate needs and to meet the next 2-3 years' expansion requirements of the operational divisions. Detailed plans have not yet been formulated and efforts will be made to contain these costs as far as possible;
- (ii) for office equipment which covers:
- \$2.5 million for new office equipment for the second office; and
  - \$6.5 million for the investment in storage technology and data base capacity in response to increased market activities plus costs relating to the normal

replacement of obsolete servers and computer equipment for the additional headcount;

- (iii) for the replacement of one of the existing Commission cars, which has been in use for 10 years;
- (iv) for the potential system purchase/development and external consultancy support costs in relation to the process improvement and change management initiatives for the Licensing processes;
- (v) for “front-end” technology (e.g. SFC website revamp, e-FRR revamp, voice contact management system, etc) investment to allow the investing public and market participants to have better access and information exchange with the Commission. To further improve the operational efficiency and to strengthen the internal IT support capability, there will be additional capital spending on SAP functional enhancements, report development and end-user training program; and
- (vi) a contingency of \$4.77 million, which, as in prior years, is set at 10% of the projected total capital expenditure.

**SECURITIES & FUTURES COMMISSION**  
**PROJECTED INCOME AND EXPENDITURE STATEMENT**  
**FOR THE YEAR 2008/2009**

	<b>Proposed</b>	<b>Forecast</b>	<b>Change over/(under)</b>	
	<b>Budget</b>	<b>Forecast</b>	<b>Forecast 2007/2008</b>	
	<b>2008/2009</b>	<b>2007/2008</b>	<b>Forecast 2007/2008</b>	
	<b>HK\$</b>	<b>HK\$</b>	<b>HK\$</b>	<b>%</b>
<b>INCOME</b>				
Investor Levy - Securities	2,261,760,000	2,038,150,000	223,610,000	10.97%
Investor Levy - Futures/Options Contracts	69,042,800	67,724,000	1,318,800	1.95%
Fees & Charges	215,000,000	264,000,000	(49,000,000)	-18.56%
Investment Income	227,120,000	104,896,000	122,224,000	116.52%
Other Income	3,220,000	3,000,000	220,000	7.33%
<b>Total Income</b>	<b>2,776,142,800</b>	<b>2,477,770,000</b>	<b>298,372,800</b>	<b>12.04%</b>
<b>OPERATING EXPENDITURE</b>				
Premises	78,480,000	40,420,000	38,060,000	94.16%
Personnel Expenses	569,927,000	468,795,000	101,132,000	21.57%
Information & Systems Services	23,958,000	20,511,000	3,447,000	16.81%
General Office & Insurance	6,682,000	6,415,000	267,000	4.16%
Training & Development	5,624,000	5,035,000	589,000	11.70%
Professional & Others	33,631,000	27,858,000	5,773,000	20.72%
External Relations	8,863,000	8,370,000	493,000	5.89%
FinNet	120,000	540,000	(420,000)	-77.78%
	727,285,000	577,944,000	149,341,000	25.84%
Contingency	1,500,000	1,000,000	500,000	50.00%
Depreciation	28,000,000	18,000,000	10,000,000	55.56%
<b>Total operating expenditure (1)</b>	<b>756,785,000</b>	<b>596,944,000</b>	<b>159,841,000</b>	<b>26.78%</b>
<b>FUNDING TO EXTERNAL PARTIES (2)</b>	<b>22,890,000</b>	<b>7,890,000</b>	<b>15,000,000</b>	<b>190.11%</b>
<b>Total expenditure (1) + (2)</b>	<b>779,675,000</b>	<b>604,834,000</b>	<b>174,841,000</b>	<b>28.91%</b>
<b>RESULT FOR THE YEAR</b>	<b>1,996,467,800</b>	<b>1,872,936,000</b>	<b>123,531,800</b>	<b>6.60%</b>
<b>BEGINNING RESERVES</b>	<b>3,852,889,542</b>	<b>1,979,953,542</b>	<b>1,872,936,000</b>	<b>94.59%</b>
<b>ENDING RESERVES</b>	<b>5,849,357,342</b>	<b>3,852,889,542</b>	<b>1,996,467,800</b>	<b>51.82%</b>

## Reconciliation of presentation of Approved Budget 2007/2008

	2007/2008 Approved Budget	Journal #1	Journal #2	Journal #3	Journal #4	Journal #5	Journal #6	Journal #7	Journal #8	2007/2008 Approved Budget
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000	HK\$'000
	(Per last year's submission)									(Revised Presentation)
<b>INCOME</b>										
Investor Levy										
Securities	753,920									753,920
Futures/Options Contracts	35,712									35,712
Fees & Charges	193,700									193,700
Investment Income	91,000	-1,050								89,950
Other income	3,500		(1,500)							2,000
<b>Total</b>	<b>1,077,832</b>									<b>1,075,282</b>
<b>OPERATING EXPENDITURE</b>										
Premises	36,867									36,867
Personnel Expenses	462,270			3,460	2,820					468,550
Information & Systems Services	20,964									20,964
General Office & Insurance	7,230									7,230
Training & Development	9,295			(3,460)		(350)	(450)			5,035
Professional & Others	27,468	-1,050			(2,820)	350				23,948
Corporate Communications	3,190							(3,190)		-
External Relations	5,030						450	3,190		8,670
FinNet	3,000		(1,500)							1,500
Funding for the FRC (annual)	2,500								(2,500)	-
Contingency	1,500									1,500
Operating expenditure	579,314									574,264
Depreciation	20,000									20,000
<b>Total (1)</b>	<b>599,314</b>									<b>594,264</b>
<b>FUNDING TO EXTERNAL PARTIES</b>										
Funding to FRC	-								2,500	2,500
Funding to IEC	-									-
Funding to IASC Foundation	-									-
<b>Total (2)</b>	<b>-</b>									<b>2,500</b>
<b>Total Expenditure (1)+(2)</b>	<b>599,314</b>									<b>596,764</b>
<b>SURPLUS</b>	<b>478,518</b>									<b>478,518</b>

Journal #1 : To set off custodian charges and investment advisory fees from professional & others expenses against investment income.

Journal #2 : To set off FinNet income against FinNet expense.

Journal #3 : To reclassify staff functions and SFC executive trainee programme expenses originally included under training & development as personnel expenses.

Journal #4 : To reclassify recruitment expenses and professional registration and membership fees originally included under professional & others as personnel expenses.

Journal #5 : To reclassify translation expenses originally included under training & development as professional & others expenses.

Journal #6 : To reclassify entertainment expenses originally included under training & development as external relations.

Journal #7 : To re-group all corporate communications expenses under external relations.

Journal #8 : To re-group funding to FRC under the heading "Funding to external parties".