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THE
SRI LANKA FUND

Annual Report 2006

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Fund Manager's Review

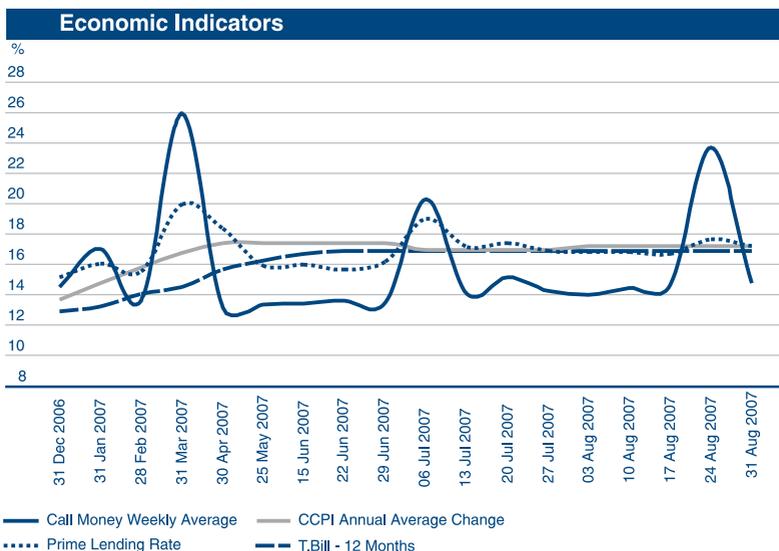
We, as the Managers to the Fund, have pleasure in reporting to unit holders on the Fund's results for the year ended 31 December 2006.

Review of the Economy and Market Economy

The Sri Lankan economy grew at 7.4% in 2006 the highest achieved since 1978, surpassing average GDP growth of 4% - 5% that has been recorded in the past. The forecasts of over 6% growth for 2007 demonstrates its sustained resilience. The telecom, infrastructure (ports, power), financial

services and construction sectors were the key contributors to economic performance.

The official rate of inflation recorded by the annual average change in the Colombo Consumer Price Index for 2006 was 13.7%, caused by both cost push factors arising from high petroleum costs as well as demand pull factors. Emerging inflationary pressures posed a challenge during the year under review with monetary policy being directed towards curbing inflation.



Fund Manager's Review

The currency depreciated by 5.5% during 2006, and interest rates moved up to double digit levels during the year. The Central Bank raised its key interest rates by 125 basis points for the year under review, thus increasing the repurchase rate to 10% and reverse repurchase rate to 11.50%. By mid 2007, the macro economic variables had further evolved to a situation where the one year rate on gilt-edged securities increased to 16.89% and inflation for the half year averaged 17.4%. The currency depreciated by a further 3.5% during the first half of 2007.

The country's per capita income rose to US Dollars 1,355 in 2007. Exports which mainly consisted of garments and tea, continued to grow amidst global competition. Imports also grew to support the expansionary economy, resulting in a current account deficit, caused largely by the country's dependency on petroleum imports. However the growing net inflow of worker remittances, foreign direct investment and external financing resulted in a balance of payment surplus. Remittances from the 1 million Sri Lankan worker population employed overseas has accounted for an inflow of USD 2.33 billion, covering 70% of the current account deficit.

Sri Lanka continued its pursuit of infrastructure development initiatives, in particular in the ports, power generation, roads & highways and irrigation sectors. Bids were called recently from the private sector for an expansion of the Port of Colombo (a key hub port in South Asia) and several bidders with reputed global port operators have submitted bids. Agriculture and small & medium enterprises have been given encouragement by the Government to enhance their contribution to the economy.

Stock Market

The Colombo bourse continued its stellar performance in 2006 for the sixth year running, with the All Share Index (ASI) recording a 42% growth, closing the year at 2,772.4 points. Annual growth rate (CAGR) of the market in the last six years was 35.6%.

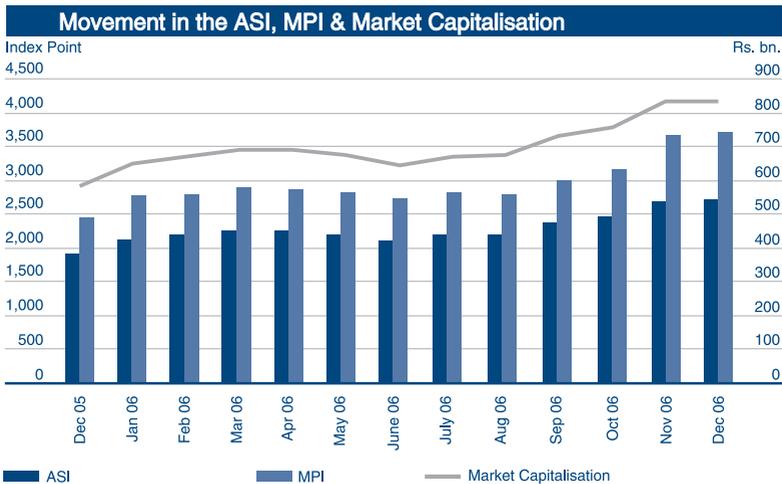
Strong GDP growth of 7.4% recorded for the year filtered down and most listed companies recorded good earnings. Hence, valuations of the market were pushed up during the year with most companies recording above average earnings growth of 40%-50% and price earnings multiples re-rating to reflect the above. Despite many

Fund Manager's Review

changes on the political front, concerns raised regarding inflation, rising interest rates and a weakening currency, the market remained resilient offering local and foreign investors alike with good returns.

The Market Capitalisation of the Colombo Stock Exchange surpassed

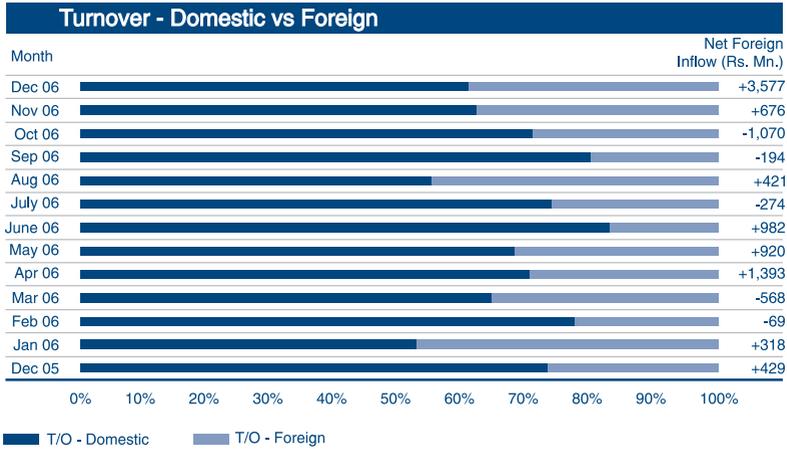
came down to 2.2% from 2.7% recorded in the year 2005. The sectors that contributed to the exceptional performance of the market was Telecom (+62%), Motors (+118%), Health Care (+66%), Construction & Engineering (+69%) and Beverages, Food & Tobacco (+69%).



all previous levels to reach an all time high of Rs. 855 Billion (US\$ 8 Billion) on 1 December 2006. A sum of Rs. 5.1 Billion (approximately US\$ 47.4 Million) was raised through the Stock Market through Initial Public Offerings and Rights Issues during the year. Dividend yield of the market

The market was kept active by interest in both strategic deals as well as the usual retail activity in 2006. Several large transactions representing one-off acquisitions of strategic stakes in companies enhanced the trading volumes at the bourse on the back of active retail participation.

Fund Manager's Review

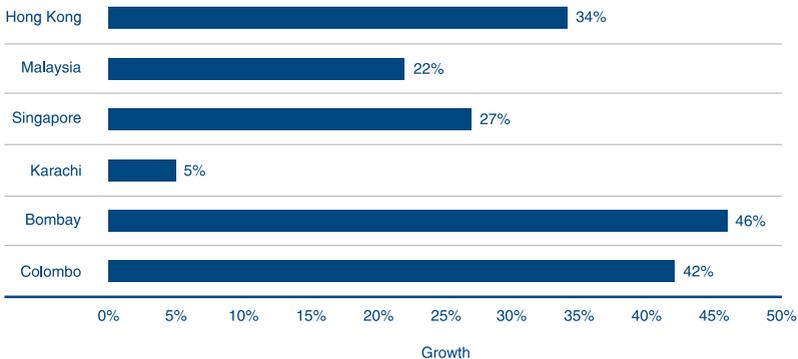


Foreign interest on selected high quality blue-chips continued, with attention being focused on the conglomerates, telecom and banking sector stocks. Foreigners remained net

purchasers in 2006 with net foreign inflows of US\$ 58.48 million.

In comparison to regional markets the Colombo Bourse has been ranked among the best performing in year 2006.

Regional Market Performance 2006



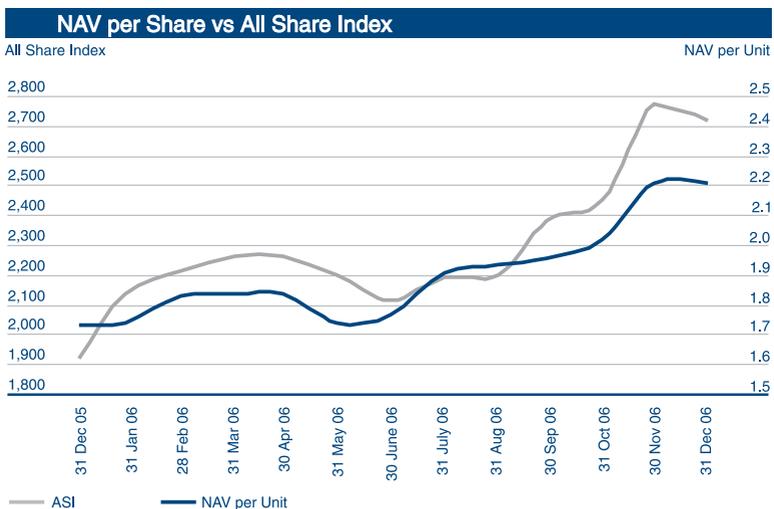
Fund Manager's Review

Unfortunately the worsening of the security situation saw the market drop almost 12.3% in the first seven months of 2007. Investor participation has since subsided, although serious investors continue to see this as an opportunity to accumulate fundamentally strong stocks on the Colombo Bourse which yet offers excellent value. Another reason for the withdrawal of retail activity is the high interest rate regime which now prevails, offering an opportunity for small investors to improve yields in the short term. During the year a new Companies Act was passed by Parliament and this is expected to further facilitate commerce and

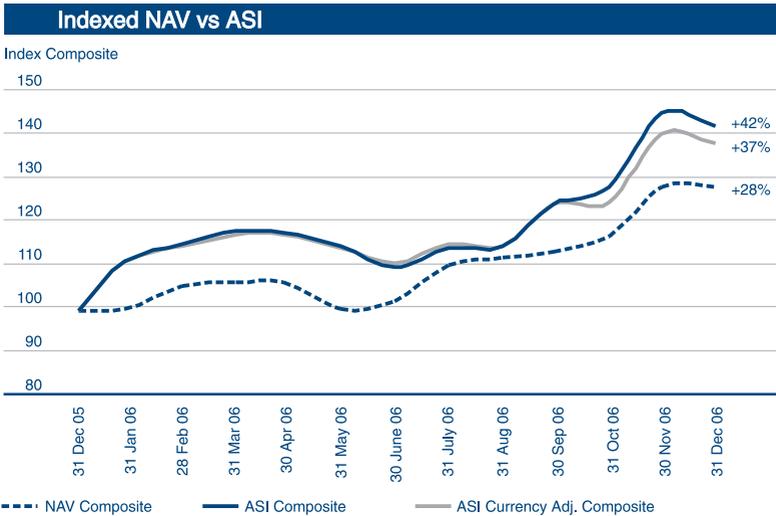
improve the governance and transparency of companies. New rules on corporate governance for listed companies are also expected to come on stream shortly.

Performance of the Fund

The total value of The Sri Lanka Fund inclusive of cash & cash equivalents amounted to US\$ 1,117,808 as at 31 December 2006 up from US\$ 975,245 as at 31 December 2005, a growth of 14%. The net asset value per unit too saw an increase of 11.6% from US\$ 1.98 in end 2005 to US\$ 2.23 end of 2006. In local currency (Rupee terms) the return for the year has been 34.7% vis-à-vis market growth of 42% for the year.



Fund Manager's Review



Redemptions during the year under review totalled US\$ 76,380 whilst the figure recorded last year was mere US\$ 28,596. Inflows of funds via

creation of units amounted to US\$ 97,560 during the year. The Fund recorded a net inflow of US\$ 21,180 for the period of review.

Total participating shares in issue as at end of December 2006 was 502,366.

Key investments of the Portfolio as at 31 December 2006	Value of the Holding US\$	Portfolio Weight %
The Laxey Investment Trust	814,949	69.1
John Keells Holdings	231,021	19.6
Distilleries Company of Sri Lanka	57,915	4.9
Sri Lanka Telecom	32,689	2.8
Asian Hotels & Properties	24,107	2.0

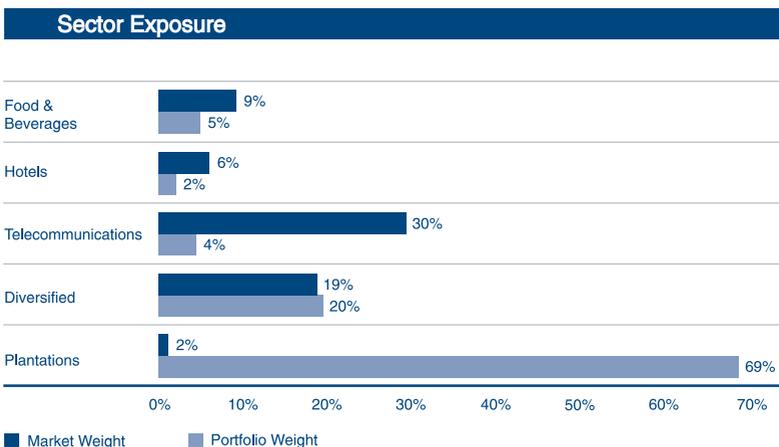
Fund Manager's Review

One of our key investments, The Tea Plantation Investment Trust during the current year, changed its scope of activity to encompass global investments with a view to giving investors a better return. The Fund has since been renamed the Laxey Investment Trust plc and has shown an improvement in performance over the last few months.

As far as our investments in the Colombo Bourse are concerned, the two telecommunication companies contributed to the stellar performance of the market, with the share price of Dialog and Sri Lanka Telecom appreciating 27.5% and 105.5% respectively. The share price

movement is commensurate with the growth in profits of the two companies, with Dialog recording Rs. 10.1 Billion and SLT recording Rs. 5.4 Billion profit after tax for the year 2006. Strategic interest in SLT from key Asian telecom operators is expected to add further value with Nippon Telegraph and Telecom (NTT) looking to sell down their holding.

Reflecting the boom in construction activity across the country, we also saw significant gains being made in the construction and related sectors of the market. Conglomerates that have business interests in logistics and port related operations showed strong growth in earnings. Although the local



Fund Manager's Review

tourism industry did not fare well, most conglomerates with their growing presence in Maldives, continued to generate excellent returns from this alternate destination. The Sri Lanka Fund is exposed to these sectors through its investments in John Keells Holdings and its subsidiary, Asian Hotels and Properties.

Distilleries Company, another investment held by the Fund, given its exposures to telecom and insurance businesses also recorded excellent earnings. This is a rapidly growing conglomerate whose cash cow alcohol business has been used to finance attractive acquisitions in other growth sectors.

Future Outlook

In the coming months, the equity market is likely to be more event-driven rather than driven by general trends. Some of the key events that will influence the market are likely to be major investments in infrastructure projects by the conglomerates as well as entry into new sectors and investments in Asian regional markets; the pursuit of strategic holdings by interested parties; and changes in the banking and insurance industry following new

regulations on capital adequacy. Factors such as these will impact the market from time to time. Corporate earnings are expected to grow by 20% -25% in the current year taking into consideration the resilient nature of the economy, although a part of this growth may be inflationary.

In the backdrop of high interest rates and an inflationary environment, local retail investors may opt to cash out on profits in the equity market and transfer funds to fixed income investments. However, the market is likely to be supported by institutional and strategic investors who have a more long-term investment horizon.

More importantly, knowledgeable foreign investors with an understanding of the local market dynamics have continued to hold their positions in the Colombo Bourse. We foresee the re-entry of foreign investors on a selective basis on telecommunication stocks and blue-chips such as John Keells Holdings. Similarly, the Sri Lanka Fund too will look to build positions in good companies when opportunities arise. Our outlook being that of a medium to long-term oriented growth fund, we are likely to select stocks in the high

Fund Manager's Review

growth sectors of the economy that have strong business models, are well managed and score high on transparency and governance.

Furthermore, with a view to enhancing the visibility and presence of the Sri Lanka Fund to global investors, we are actively exploring the setting up of new marketing channels for this Fund.

Update on 2007

The stock market reached a milestone in the early part of 2007 with the All Share Index crossing the 3,000 index barrier for the first time in its history and reached its all time high of 3,016.4 on 13 February 2007. During this period, foreign interest on selected blue-chips continued, adding a further boost to the market, with attention being focused on the conglomerates, telecom and banking sectors. Similarly the first quarter saw a spate of Rights Issues and Bonus Issues flood the market, raising approximately Rs. 19 Billion from the market. This had a knock on effect on the liquidity of the secondary market, given outflow of funds to subscribe for the above issues. Hence, secondary market activity remained somewhat subdued after this period.

Since then during the second quarter, increasing security concerns across Sri Lanka has resulted in a temporary drop in the market of approximately 12.3% (or 334 points in the All Share Index) from January to end July this year. Despite the considerable loss of value we do not see a major cause for concern as the key listed companies of the Colombo Stock Exchange have the potential to record enhanced corporate performances, given the diversity of their business exposures to the growth sectors of the Sri Lankan, and increasingly, the regional economies such as Maldives and India.

We are of the view that the Colombo Bourse will continue to offer value to investors in the medium to long term, despite temporary drawbacks and will look to accumulate stocks in identified sectors like the telecoms, conglomerates, F&B industry and other growth sectors when opportunities arise. The possibility of investing in Government securities will be explored, given the high yields presently available, since foreign investors are now permitted to invest in fixed income instruments such as Treasury bonds up to a limit of 5% of the total outstanding Treasury bonds at any given time.

Report of the Directors

The Directors hereby submit their annual report together with the audited financial statements of The Sri Lanka Fund (the Fund) for the year ended 31st December 2006.

The Company

The Company is an open-ended investment company, incorporated as an exempt company in the Cayman Islands with limited liability. The Sri Lanka Fund was launched via a prospectus and currently the Fund represents the class A shares of the Company. The articles of the Company permits the creation of new classes of shares to accommodate subordinated funds, though no such subordinated funds have been created as at 31st December 2006.

The Fund's investment objective is to achieve long-term capital growth by investing in a diversified portfolio of equity securities including convertible bonds and warrants listed on the Colombo Stock Exchange and those issued outside Sri Lanka by any Corporation organised in and under the laws of Sri Lanka and which has its shares listed on the Colombo Stock Exchange and equity securities issued by listed investment companies and funds, wherever established, which

invest primarily in equity issued by Sri Lankan companies listed on the Colombo Stock Exchange.

Results and Dividends

The results of the Fund for the year ended 31st December 2006 are set out on pages 13 to 28 of the Annual Report. The Directors do not recommend the payment of a dividend for the year ended 31st December 2006.

Share Capital

The details of changes in the issued share capital including subscriptions and redemptions of shares for cash during the year are set out in the statement of changes in ownership equity and Note 3 to the financial statements.

Directors

The Directors during the year and up to the date of this report were:

- Don Chandima Rajakaruna
Gunawardena
- Palehenalage Chandana Priyankara
Tissera
- Adrian John Reginald Collins
- Gordon Haig Brough
who served as a Director of the
Company resigned from the
Directorate on 1.8.2006.

Report of the Directors

Directors' and other Interests

Don Chandima Rajakaruna Gunawardena and Palehenalage Chandana Priyankara Tissera are Directors of Guardian Fund Management Limited, the Investment Manager of the Fund and Carsons Management Services (Pvt) Limited the Fund's Administrator.

Apart from the above, as at 31st December 2006, none of the Directors had any interest in the share capital of the Company or any interest in any material contracts or contracts for the provision of services during the year significant to the business of the Company.

All Directors are entitled to an annual fee. However, Don Chandima Rajakaruna Gunawardena and Palehenalage Chandana Priyankara Tissera have waived their Directors' fee for the year.

Auditors

KPMG, retire and being eligible, offer themselves for reappointment.

A resolution for the reappointment of KPMG as Auditors of the Company is to be proposed at the forthcoming Annual General Meeting.

By order of the Board

Director

14 August 2007

Report of the Independent Auditors



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TO THE SHAREHOLDERS OF THE SRI LANKA FUND

We have audited the accompanying financial statements of The Sri Lanka Fund ('the Fund'), which comprise the balance sheet as at 31 December 2006, and the income statement, statement of changes in net assets attributable to holders of participating shares and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of 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 our 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, we consider internal control relevant to the entity's preparation 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 principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Fund as at 31 December 2006, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

14 August 2007

KPMG, a Cayman Islands partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International, a Swiss cooperative.

Income Statement

<i>For the year ended 31 December</i>		2006	2005
	Note	US\$	US\$
Income			
Bank interest income		359	–
Dividend income		5,350	5,530
Realised gain/(loss) on sale of investments		(9,992)	16,482
Gain on Remeasurement of investments		261,609	381,617
Foreign exchange losses on investments		(65,021)	(389)
Other income		2,439	–
Net Investment Income		194,744	403,240
Expenses			
Investment Manager's fee	6	(14,811)	(12,719)
Custodian's fee	6	(20,000)	(20,000)
Administrator's fee	6	(2,087)	(1,525)
Legal & professional fees		(10,155)	(5,585)
Auditors' remuneration		(9,500)	(8,500)
Directors' remuneration	6	(5,000)	(10,000)
Sundry expenses		(11,809)	(12,466)
Operating expenses		(73,362)	(70,795)
Change in net assets attributable to holders of participating shares resulting from operations		121,382	332,445

The accompanying notes form an integral part of these financial statements.

Balance Sheet

<i>As at 31 December</i>		2006	2005
	Note	US\$	US\$
Assets			
Cash & cash equivalents		2,146	189
Equity investments	2,7	1,180,200	1,045,720
Prepayments		-	1,501
Total assets		1,182,346	1,047,410
Liabilities			
Accruals & other payables		(64,538)	(72,165)
Total liabilities (excluding net assets attributable to holders of participating shares)		(64,538)	(72,165)
Net assets attributable to holders of participating shares		1,117,808	975,245
Represented by:			
Net assets attributable to holders of participating shares	3,4	1,117,808	975,245
		1,117,808	975,245
Net asset value per share, based on 502,366 (2005 - 492,554) shares outstanding	3,4	2.23	1.98

The accompanying notes form an integral part of these financial statements.

The financial statements were approved and authorised for issue by the Board of Directors and are signed on their behalf.



D. C. R. Gunawardena

Director



P. C. P. Tissera

Director

14 August 2007

Cash Flow Statement

<i>For the year ended 31 December</i>	2006	2005
	US\$	US\$
Operating Activities		
Dividend income	5,350	5,530
Interest income	359	–
Operating expenses paid	(77,049)	(49,371)
Cash flows from operating activities	(71,340)	(43,841)
Investing Activities		
Proceeds on sale of investments	143,187	50,724
Payments for purchase of investments	(91,071)	–
Cash Flows from investing activities	52,116	50,724
Financing Activities		
Payment for redemption of participating shares	(76,380)	(28,596)
Proceeds from issue of participating shares	97,561	–
Cash flows from financing activities	21,181	(28,596)
Net increase/(decrease) in cash and cash equivalents	1,957	(21,713)
Cash and cash equivalents as at 1 January	189	21,902
Cash and cash equivalents as at 31 December	2,146	189

The accompanying notes form an integral part of these financial statements.

Statement of Changes in Net Assets Attributable to Holders of Participating Shares

<i>For the year ended 31 December</i>	2006	2005
	US\$	US\$
Balance as at 31 December	975,245	671,396
Change in net assets attributable to holders of participating shares resulting from operations for the year	121,382	332,445
Redemption of participating shares during the year	(76,380)	(28,596)
Issue of participating shares during the year	97,561	–
Balance as at 31 December	1,117,808	975,245

The accompanying notes form an integral part of these financial statements.

Notes to the Financial Statements

1. Significant Accounting Policies

The Sri Lanka Fund ('the Fund') is an open-ended investment fund incorporated as an exempt company under the Companies Law (Revised) of the Cayman Islands on 21 October 1993 and registered under the Mutual Funds Law on the 26 July 1994.

The objective of the Fund is to provide shareholders with above average returns over the medium to long term through both capital growth and income. The Fund aims to deliver this objective mainly by investing in highly diversified portfolios of equity securities including convertible bonds and warrants listed on the Colombo Stock Exchange and those issued outside Sri Lanka by any corporation organised in and under the laws of Sri Lanka and which has its shares listed on the Colombo Stock Exchange, and equity securities issued by listed investment companies and funds, wherever established, which invest primarily in equity issued by Sri Lankan companies listed on the Colombo Stock Exchange. In doing so, it applies techniques more fully defined in the Fund's Offering Memorandum.

The investment activities of the Fund are managed by Guardian Fund Management Limited ('the Investment Manager') and the administration of the Fund is delegated to Carsons Management Services (Pvt) Limited ('the Administrator'). The registered office of the Fund is located at P.O. Box 309, Uglan House, Grand Cayman KY1-1104, Cayman Islands.

(a) Statement of Compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) and interpretations adopted by the International Accounting Standards Board (IASB).

(b) Basis of Preparation

The financial statements are presented in United States Dollars and not the local currency of the Cayman Islands reflecting the fact the shares of the Fund are issued and redeemed in United States Dollars. They are prepared on a fair value basis for the financial assets and financial liabilities at fair value through profit or loss. Other financial assets and liabilities are stated at amortised cost or redemption amount (redeemable shares).

Notes to the Financial Statements

The preparation of the financial statements in conformity with IFRSs requires management to make judgments, estimates and assumptions that effect the applications of policies and the reported amounts of the assets and liabilities, income and expense. 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 of making the judgments about carrying values of assets and liabilities that are not really apparent from other sources. Actual results may differ from these estimates.

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

The accounting policies have been applied consistently by the Fund and are consistent with those used in the prior year.

(c) Foreign Currencies Translation

Transactions in foreign currencies are translated at the foreign currency exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated to United State Dollars at the foreign currency closing exchange rate ruling at the balance sheet date. Foreign currency exchange differences arising on translation and realised gains and losses on disposal or settlement of monetary assets and liabilities are recognised in the income statement. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated to United States Dollars at the foreign currency exchange rates ruling at the dates that the values were determined. Foreign currency exchange differences relating to investments at fair value through profit or loss are presented separately.

Notes to the Financial Statements

(d) *Financial Instruments*

(i) *Classification*

The Fund designates all its equity investments into the financial assets at the fair value through profit or loss category.

The financial instruments designated at fair value through profit or loss upon initial recognition. These includes equity securities listed on the Colombo Stock Exchange and those issued outside Sri Lanka by any corporation organised in and under the laws of Sri Lanka and which has its shares listed on the Colombo Stock Exchange, and equity securities issued by listed investment companies and funds, wherever established, which invest primarily in equity issued by Sri Lankan companies listed on the Colombo Stock Exchange.

Financial liabilities that are not at fair value through profit or loss include accounts payable and financial liabilities arising on redeemable shares.

(ii) *Recognition*

The Fund recognises financial assets and financial liabilities on the date it becomes a party to the contractual provisions of the instruments.

A regular way purchase of financial assets is recognised using trade accounting. From this date any gains and losses arising from changes in fair value of the financial assets or financial liabilities are recorded.

(iii) *Measurement*

Financial instruments are measured initially at fair value (transaction price) plus, in case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Notes to the Financial Statements

Transaction costs on financial assets and financial liabilities at the fair value through profit or loss are expensed immediately, while on other financial instruments they are amortised.

Subsequent to the initial recognition, all instruments classified at the fair value through profit or loss, are measured at the fair value with changes in their fair value recognised in the income statement.

Financial liabilities, other than those at fair value through profit or loss, are measured at amortised cost using the effective interest rate. Financial liabilities arising from the redeemable shares issued by the Fund are carried at the redemption amount representing the investor's right to a residual interest in the Fund's assets.

(iv) *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 estimate future selling cost. Financial assets are priced at the current bid prices.

If a quoted market prices are not available on a recognised stock exchange or from a broker/dealer for non-exchange traded financial instruments, the fair value of the instrument is estimated using valuation techniques, including use of recent arm's length market transaction, reference to the current fair value of another instruments which is substantially the same, discounted cash flow techniques that provides a reliable estimate of prices obtained in actual market transactions.

(v) *Impairment*

Financial assets that are stated at cost or amortised cost are reviewed at each balance sheet date to determine whether there is objective evidence of impairment if any such indication exists an impairment loss is recognised in the income statement as the difference between the assets carrying amount and present value of estimate of future cash flows discounted at the financial assets

Notes to the Financial Statements

original effective interest rate. If in a subsequent period the amount of impairment loss recognised on a financial asset carried at amortised cost decreases and the decrease can be linked objectively to an event occurring after the write-down, the write-down is reverse through the income statement.

(vi) Derecognition

The Fund derecognises the financial asset when the contractual rights to the cash flows from the financial asset expire or it transfers the financial asset and the transfer qualifies for derecognition in accordance with IAS 39.

The Fund used weighted average method to determine realised gains and losses on derecognition.

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

(vii) Specific Instruments

Cash and Cash Equivalents

Cash comprised current deposits with banks. Cash equivalents are short-term highly liquid investments that are readily convertible to known amount of cash, are subject to an insignificant risk of changes in value, and are held for the purpose of meeting short term cash commitments rather than for investments for other purposes.

(e) Interest Income

Interest income and expenses are recognised in the income statement as it accrues, using the original effective interest rate of the instruments calculated at the acquisition or origination date.

(f) Dividend Income

Dividend income relating to exchange-traded equity investment is recognised in the income statement on the ex-dividend date.

Notes to the Financial Statements

In some cases, the Fund may receive or choose receive dividends in the form of additional shares than cash. In such cases the Fund recognises the dividend income for the amount of the cash dividend alternative with the corresponding debit treated as an additional investment.

(g) Expenses

All expenses, including management fee and custodian fees, are recognised in the income statement on an accrual basis.

Included in sundry expenses are registers fees paid by the Fund, safe custody and bank charges and printing and advertising.

(h) Foreign Exchange Gains and Losses

Foreign exchange gains and losses on financial assets and financial liabilities at fair value through profit or loss are recognised together with other changes in the fair value.

(i) Taxation

Under the current system of taxation in Cayman Islands the Fund is exempt from paying taxes on income, profits or capital gains. The Fund has received an undertaking from Governor in Cabinet of the Cayman Islands authorities exempting it from income tax for a period of 20 years.

Dividend and interest income received by the Fund may be subject to withholding tax imposed in the country of origin.

(j) Participating Shares

All participating shares issued by the Fund provide the investors with the right to require redemption for cash at the value proportionate to the investor's in the Fund's net assets at the redemption date. In accordance with IAS 32 such instruments gave rise to a financial liability for a present value of redemption amount.

Notes to the Financial Statements

2. Investments

For the year ended 31 December

	2006	2005
	US\$	US\$
Cost		
Balance at the beginning of the year	1,713,985	1,748,615
Additions during the year	91,071	–
Disposals during the year	(218,200)	(34,630)
Balance at the end of the year	1,586,856	1,713,985
Unrealised depreciation in value	(406,656)	(668,265)
Fair value (Note 7)	1,180,200	1,045,720

3. Share Capital

	2006		2005	
	Number of Shares	Amount US\$	Number of Shares	Amount US\$
Authorised				
Founder shares of US\$ 1 each	100	100	100	100
Participating Shares of US\$ 0.01 each	89,990,000	899,900	89,990,000	899,900
	<u>89,990,100</u>	<u>900,000</u>	<u>89,990,100</u>	<u>900,000</u>
Issued and Fully Paid				
Founder shares of US\$ 1 each	100	100	100	100
Participating Shares of US\$ 0.01 each				
Balance at the beginning of the year	492,554	4,925	512,554	5,125
Issued during the year	53,312	534		
Redeemed during the year	(43,500)	(435)	(20,000)	(200)
Balance at the end of the year	502,366	5,024	492,554	4,925
Total		<u>5,124</u>		<u>5,025</u>

Notes to the Financial Statements

Founder Shares

Founder shares confer upon the holders thereof rights in a winding up or repayment of capital in accordance with the Articles of Association of the Fund but confer no other rights to participate in the profits or assets of the Fund. The holder of a founder share has no right to receive notice of or to attend and vote as a shareholder of the Fund at any General Meeting of the Fund. The issued founder shares are held by the Investment Manager.

Participating Shares

Participating shares may be redeemed on the first and third Tuesday of the month or such other dates as the Board of Directors shall from time to time determine (Valuation Day) at the net asset value per share based on mid-market prices. The shareholder must request such redemption at least 14 days prior to the last business day of each month or such other day as the Directors may determine.

Participating shares have the right to receive notice of or to attend and vote as a shareholder of the Fund at any General Meeting of the Fund. Participating shares confer upon the holders of their right of a winding up or repayment of capital in accordance with Articles of Association of the Fund. They also have the right to share in all profits or assets of the Fund in excess of the value of the issued share capital of the founder shares.

4. Net Asset Value per Ordinary Share

The calculation of Net Asset Value per participating share is based on the net asset value attributable to participating shareholders of US\$ 1,117,808 (2005 - US\$ 975,245) and on the total number of 502,366 (2005 - 492,554) participating shares in issue at the balance sheet date.

5. Financial Instruments and Associated Risks

Financial assets of the Fund include cash and marketable securities. Financial liabilities include accruals and other payables.

Notes to the Financial Statements

(a) Market Risk

The Fund's investment activities expose it to various types of market risk, which are associated with the markets in which it invests, to the extent of the amount invested in equity securities. The Fund invests in securities listed on the Colombo Stock Exchange and those issued outside Sri Lanka by any corporation organised in and under the laws of Sri Lanka, and equity securities issued by listed investment companies and funds, wherever established, which invest primarily in equity issued by Sri Lankan companies listed on the Colombo Stock Exchange, which may experience greater volatility than those of Western companies.

(b) Foreign Exchange Risk

The Fund is exposed to foreign exchange risk from its investments and receivables and payables denominated in currencies other than United States Dollars, to the extent of the amount invested for investments, receivables and payables.

The Fund's total net exposure to fluctuations in foreign currency exchange rates at the balance sheet date was as follows:

All amounts are stated in US\$

Assets

	Fair Value 2006	Fair Value 2005
Investments		
Sri Lankan Rupee	365,251	230,280
Sterling Pound	814,949	815,440
	1,180,200	1,045,720
Cash and Cash Equivalents		
Hong Kong Dollars	553	60
Sterling Pounds	30	68
Euro	-	4
	583	132

Notes to the Financial Statements

(c) *Interest Rate Risk*

The majority of the Fund's financial assets are non-interest bearing. Interest bearing financial assets mainly bank deposits mature or reprice in the short-term, no longer than twelve months. As a result, the Fund is not subject to significant interest rate fluctuations.

(d) *Credit Risk*

Financial assets which potentially expose the Fund to credit risk consist principally of marketable securities and cash balances. Investments in Sri Lanka expose the Fund to risk of illiquidity and volatility. The extent of the Fund's exposure to risk in respect of these financial assets approximates to their carrying value as recorded in the Fund's balance sheet. The Fund limits its exposure to credit risk by transacting the majority of its securities and contractual commitment activity with broker-dealers, banks and regulated exchanges with high credit ratings that the Fund considers to be well established.

(e) *Fair Values of Financial Instruments*

Investment securities are carried at market values unless the Directors have determined that a discount is required to arrive at fair value. The Fund's other assets and liabilities include cash and cash equivalents and amounts due on open transactions which normally settle within a few days and other receivables which are realised or settled within a short period of time. The carrying values of these other assets and liabilities approximate their fair values.

6. Related Parties

Investment Manager

The Fund appointed Guardian Fund Management Limited ('GFML'), an investment management company incorporated in Sri Lanka, to implement the investment strategy. Under the Investment Management Agreement, the

Notes to the Financial Statements

Investment Manager receives a management fee equivalent to 1.5% per annum of the net asset value of the Fund, a fee of 0.5% of the redemption price of each share redeemed, and a performance fee of 20% of any increase in net asset value per share of the Fund in excess of the increase in the US Dollar value performance of the Colombo Stock Exchange's All Share Price Index during the year. No performance fee was payable for the year ended 31 December 2006 (2005 - US\$ Nil). Total Investment Manager's fees for the year ended 31 December 2006 was US\$ 14,811 (2005 - US\$ 12,719).

Administrator

Carsons Management Services (Pvt) Limited ('CMSL'), the present administrator, and a fellow affiliate of GFML, receives an administrative fee of 0.2% per annum of the average weekly net asset value of the Fund until the termination of its administration agreement with the Fund. The total administrator's fee paid to CMSL during the year was US\$ 2,087 (2005 - US\$ 1,525).

Custodian

The Custodian is HSBC International Trustee Limited, which receives a fee of 0.15% per annum of the net asset value of the Fund, subject to a minimum annual fee of US\$ 6,000 (2005 - US\$ 6,000). In addition, the Custodian was entitled to an annual administration fee of US\$ 14,000 (2005 - US\$ 14,000).

Directors' Fee

The directors' fee is disclosed in the income statement.

Messrs. Don Chandima Rajakaruna Gunawardena and Palehenalage Chandana Tissera, Directors of the Fund are Directors of the GFML and CMSL.

Notes to the Financial Statements

7. Investment Portfolio as at 31 December 2006

As at 31 December

	2006			2005		
	Holdings	Fair Value US\$	% of Net Assets	Holdings	Fair Value US\$	% of Net Assets
Listed Investments						
Blue Diamond Jewellery						
Worldwide Limited	90	3	–	135	3	–
Aitken Spence Hotel						
Holdings Limited	–	–	–	8,100	5,395	0.55
Distilleries Company of Sri Lanka	69,100	57,915	5.18	101,100	34,657	3.55
Eden Hotel Lanka Limited	–	–	–	3,000	338	0.04
Asian Hotels and Properties Limited	50,900	24,107	2.16	–	–	–
John Keells Holdings Limited	127,571	231,021	20.67	150,000	189,887	19.47
Dialog Telecom Limited	79,300	19,516	1.75	–	–	–
Sri Lanka Telecom Limited	128,000	32,689	2.92	–	–	–
Tea Plantations	603,569	814,949	69.05	603,569	815,440	83.61
Investment Trust Plc						
		<u>1,180,200</u>	<u>106.16</u>		<u>1,045,720</u>	<u>107.22</u>
Unlisted Investments						
Ceyexxe Limited	1,000,000	–	–	1,000,000	–	–
Ceyexxe Plantations Limited	–	–	–	263,500	–	–
		<u>1,180,200</u>	<u>106.16</u>		<u>1,045,720</u>	<u>107.22</u>

MANAGEMENT AND ADMINISTRATION

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Gordon Haig Brough

(Resigned w.e.f. 1.8.2006)
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Investment Manager

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