LM FIRST MORTGAGE INCOME FUND

ABN: 66 482 247 488

Annual Report

For the year ended 30 June 2012

LM FIRST MORTGAGE INCOME FUND

ABN: 66 482 247 488

Annual Report – 30 June 2012

Contents

The Responsible Entity of LM First Mortgage Income Fund is LM Investment Management Limited (ABN 68 077 208 461). The Responsible Entity's registered office is Level 4, RSL Building, 9 Beach Road, Surfers Paradise QLD 4217.

LM FIRST MORTGAGE INCOME FUND

Directors' Report

DIRECTORS' REPORT

The directors of LM Investment Management Limited, the Responsible Entity of the LM First Mortgage Income Fund, present their report of the LM First Mortgage Income Fund ("the Scheme") for the year ended 30 June 2012. The directors' report is not part of the financial report.

DIRECTORS

The following persons held office as directors of LM Investment Management Limited, during the year or since the end of the year and up to the date of this report:

Name	
Mr Peter Charles Drake	Appointed 31 January 1997
Ms Lisa Maree Darcy	Appointed 15 September 2003 – Resigned 21 June 2012
Mr Eghard van der Hoven	Appointed 22 June 2006
Ms Francene Maree Mulder	Appointed 30 September 2006
Mr John O'Sullivan	Appointed 27 November 2007 – Resigned 12 August 2012
Mr Simon Tickner	Appointed 18 September 2008 – Resigned 13 July 2012
Mr Grant Fischer	Appointed 14 March 2012 – Resigned 12 August 2012
Ms Katherine Phillips	Appointed 13 July 2012

PRINCIPAL ACTIVITIES

During the year, the Scheme continued the principal activity of investing unitholders' funds in existing registered mortgages and cash investments in Australia in accordance with the Scheme's Constitution and in accordance with the investment policy of the Scheme as outlined in the current product disclosure document.

There were no significant changes in the nature of the Scheme's activities during the year.

The Scheme did not have any employees during the year.

SCHEME INFORMATION

The Scheme is an Australian registered scheme and was constituted on 13 April 1999. The Responsible Entity of LM First Mortgage Income Fund is LM Investment Management Limited ("LM"), which has been the Responsible Entity since registration of the Scheme.

The registered office and principal place of business of the Responsible Entity and the Scheme is Level 4, 9 Beach Road, Surfers Paradise, Queensland.

REVIEW OF RESULTS AND OPERATIONS

Results

Since the closure of the fund in 2009, the Responsible Entity's prime focus has been to see the repayment of all loans to create the cash flow required to effect the progressive repayment of the fund's line of credit facility and to realise distribution of capital for investors. The Responsible Entity has followed this strategy, avoiding a fire sale of assets and managing and maintaining assets for best value outcomes when ultimately sold.

The financial crisis and market factors saw the fund close and at that time LM's prime focus was to seek repayment of the fund's loan from its borrowers at their respective maturity dates. Due to general liquidity constraints in the market the majority of borrowers defaulted at maturity when unable to repay the loan, and on behalf of the fund, LM took possession of the collateral over which the loan was secured to protect investor interests.

LM FIRST MORTGAGE INCOME FUND

Directors' Report

LM has managed an orderly asset sales process since the fund's closure. When it closed, there were 55 loan assets. Since that time 28 of loans have been repaid through an ongoing asset sales process. LM is driving the orderly sale of the remaining 27 number of loans.

The original credit facility balance was $133 million at time of closure. The current Deutsche Bank credit facility balance is now $29.4 million. Since the fund closed, LM has managed a total credit facility reduction of $103.6 million.

The nature of all the properties in which the fund enforced its rights to security was varied in terms of sector type and the loans provided a broadly diversified geographic exposure across the Australian property market.

Since the fund closed, LM has completed significant work on assets to bring them to a point of sale, ensuring value by: attending to general maintenance and presentation of the properties for sale, completing works to enhance longer term value, obtaining relevant development and or building approvals to increase property value and entering into presales marketing campaigns where benefit existed in completing further staged development work on various properties.

Since the fund's closure the Responsible Entity considered different strategies to realise best outcomes for investors, including that of offering investors the choice of selling or holding their investment.

In this reporting period, the Responsible Entity has sought further feedback from investors in this regard and has announced that the fund will not re-open. The Responsible Entity is driving a continual orderly sell down of all remaining assets to see the recommencement of capital distributions to investors as quickly as possible. All investors will share pro-rata in capital distributions as the sales progress.

In addition, the Responsible Entity has announced that as the work of bringing the assets to the point of sale is completed, it will be returning to its historic fee levels, capping the management fee at 1.5% pa.

Approved investor hardship withdrawals will continue as the sales proceed.

In assessing sales prices for assets in today's market, contemplating the sales of all remaining assets, the directors have taken additional provisions resulting in a unit value of 59 cents as at 16 November 2012. We note that the market value at the future point of asset sale will determine the unit value ultimately realised as investors receive progressive capital distributions.

The change in net assets attributable to the unitholders of the Scheme is presented in the Statement of Comprehensive Income. Net loss attributable to unitholders for the year ended 30 June 2012 was $88,615,577 (2011: loss of $77,418,896).

Distributions to unitholders declared during the year totalled $17,024,389 (2011: $14,295,925).

Total assets under management were $343,976,757 as at 30 June 2012 (2011: $454,724,799). Investor funds under management decreased during the year by $93,206,695 (2011: decreased by $104,824,211). Funds under management invested by related managed investment schemes in LM FMIF Increased by $14,484,434 (2011: decreased by $13,222,693) to $224,862,439 (2011: $210,378,005).

The performance of the Scheme, as represented by the results of its operations, was as follows:

	30 June 2012	30 June 2011
	$	$
Net operating income/(loss) before distributions	(88,615,577)	(77,418,896)
Financing costs: Distributions to unitholders	(17,024,389)	(14,295,925)
(Increase) / decrease in net assets attributable to unitholders	105,639,966	91,714,821

UNITHOLDER FUNDS

There were 488,787,330 units on issue at 30 June 2012 (2011: 476,355,743). During the year 18,971,927 of units were issued by the Scheme (2011: 12,180,254) and 6,666,198 of units were withdrawn (2011: 24,218,932).

SCHEME ASSETS

At 30 June 2012, the Scheme held assets to a total value of $343,976,757 (2011: $454,724,799). The basis for valuation of assets is disclosed in Note 2 to the financial statements.

FEES PAID TO AND INTEREST HELD BY THE RESPONSIBLE ENTITY AND ASSOCIATED COMPANIES

The following fees were paid to LM Investment Management Limited and its associated companies out of Scheme property during the financial year, for funds management and administrative services provided on behalf of the Responsible Entity:

	2012	2011
	$	$
• Management fees paid or payable directly to LM Administration Pty Ltd	9,103,864	10,997,188
• Expenses incurred by the Responsible Entity and its associated entities which are reimbursed in accordance with the provisions of the Scheme's Constitution, including administration and custodian fees	29,983	791,164
• Expenses including administration expenses incurred by the Responsible Entity and its associated entities, which are not reimbursed	38,524	-
• Loan management fees paid to the Responsible Entity for loan management and receivership services provided by the Responsible Entity on behalf of the Scheme in replacement of appointing external receivers. These fees are charged directly to the borrower to facilitate future possible recovery.	4,817,414	5,381,516

The Responsible Entity will be returning to its low historic fee levels, capping the management fee at 1.5% pa, as of 1 November 2012.

The interests in the Scheme held by the Responsible Entity and its associates as the end of the year are disclosed in Note 10 to the financial statements.

LM FIRST MORTGAGE INCOME FUND

Directors' Report

SIGNIFICANT CHANGES IN THE STATE OF AFFAIRS

In the opinion of the directors, there were no significant changes in the state of affairs of the Scheme that occurred during the financial year under review that are not otherwise disclosed in this report.

SIGNIFICANT EVENTS AFTER THE BALANCE DATE

Other than the matters disclosed in Note 18 of the financial report there has been no matter or circumstance that has arisen since the end of the financial year that has significantly affected, or may affect, the Scheme's operations in future financial years, the results of those operations of the Scheme's state of affairs in future years.

LIKELY DEVELOPMENTS AND EXPECTED RESULTS

Further information on likely developments in the operation of the Scheme and the expected results of those operations has not been included in this report because the Responsible Entity believes it would likely result in unreasonable prejudice to the Scheme.

ENVIRONMENTAL REGULATION AND PERFORMANCE

The operations of the Scheme are not subject to any particular or significant environmental regulations under a law of the Commonwealth or a State or Territory. There have been no known significant breaches of any other environmental requirements applicable to the Scheme.

INDEMNIFICATION AND INSURANCE OF DIRECTORS AND OFFICERS

No insurance premiums are paid for out of the assets of the Scheme in regards to insurance cover provided to either the officers of LM Investment Management Limited or the auditors of the Scheme. Provided the officers of LM Investment Management Limited act in accordance with the Scheme Constitution and the Law, the officers remain indemnified out of the assets of the Scheme against losses incurred while acting on behalf of the Scheme. The auditors of the Scheme are in no way indemnified out of the assets of the Scheme.

AUDITOR'S INDEPENDENCE DECLARATION

A copy of the auditor's independence declaration as required under section 307C of the *Corporations Act 2001* is set out on page 7.

Signed in accordance with a resolution of the Directors of LM Investment Management Limited.

Peter Drake
Director
Gold Coast

16 November 2012

Ernst & Young
111 Eagle Street
Brisbane QLD 4000 Australia
GPO Box 7878 Brisbane QLD 4001

Tel: +61 7 3011 3333
Fax: +61 7 3011 3100
www.ey.com/au

Auditor's Independence Declaration to the Directors of LM Investment Management Limited as Responsible Entity for LM First Mortgage Income Fund

In relation to our audit of the financial report of LM First Mortgage Income Fund for the financial year ended 30 June 2012, to the best of my knowledge and belief, there have been no contraventions of the auditor independence requirements of the *Corporations Act 2001* or any applicable code of professional conduct.

Ernst & Young

Ernst & Young

P McLuskie

Paula McLuskie
Partner
Brisbane
16 November 2012

LM FIRST MORTGAGE INCOME FUND

STATEMENT OF COMPREHENSIVE INCOME

For the year ended 30 June 2012

	Note	30 June 2012 $	30 June 2011 $
Income			
Interest revenue – mortgage loans		31,608,319	35,604,341
Interest revenue – cash assets		420,812	162,848
Realised foreign exchange gain on investor funds		69,271	37,375
Unrealised foreign exchange gain on investor funds		-	1,134,069
Unrealised foreign exchange gain on foreign exchange contracts		-	16,240
Total revenue and other income		32,098,402	36,954,873
Expenses			
Management fees	11	9,103,864	10,997,188
Finance costs	4(a)	8,593,798	14,072,789
Custodian fees		77,904	112,324
Advisor commissions		2,165,236	2,090,475
Impairment losses on mortgage loans	7(e)	99,144,122	84,873,703
Unrealised foreign exchange losses on investor fund		167,394	-
Unrealised foreign exchange loss on foreign exchange contracts		145,432	-
Realised loss on foreign exchange contracts		36,203	1,338,500
Legal fees		523,012	407,260
Other expenses	4(b)	757,014	481,530
Total expenses excluding distributions to unitholders		120,713,979	114,373,769
Net (loss) before distributions to unitholders		(88,615,577)	(77,418,896)
Distributions paid/payable to unitholders	3(a)	(17,024,389)	(14,295,925)
Net (loss) after distributions to unitholders		(105,639,966)	(91,714,821)
Other comprehensive income		-	-
Net loss after distributions to unitholders		(105,639,966)	(91,714,821)
Income tax expense		-	-
Changes in net assets attributable to unitholders after income tax expense		(105,639,966)	(91,714,821)

LM FIRST MORTGAGE INCOME FUND

STATEMENT OF FINANCIAL POSITION

As at 30 June 2012

	Note	30 June 2012 $	30 June 2011 $
ASSETS			
Cash and cash equivalents	12(a)	8,123,428	18,475,447
Receivables	11	1,279,828	1,753,449
Prepayments		-	8,656,894
Financial assets at fair value through profit or loss		-	33,691
Loans and receivables	7	334,573,501	425,805,318
TOTAL ASSETS		343,976,757	454,724,799
LIABILITIES			
Management fee Payable	10	2,470,000	-
Financial assets at fair value through profit or loss		129,192	-
Payables	8	7,980,824	3,702,723
Interest bearing loans and borrowings	9	39,610,078	62,399,788
Distributions payable	3(a)	4,806,035	6,434,965
Total liabilities excluding net assets attributable to unitholders		54,996,129	72,537,476
NET ASSETS	6	288,980,628	382,187,323
Represented by:			
Net assets attributable to unitholders (calculated in accordance with IFRS)		288,980,628	382,187,323

LM FIRST MORTGAGE INCOME FUND

STATEMENT OF CHANGES IN NET ASSETS ATTRIBUTABLE TO UNITHOLDERS

For the year ended 30 June 2012

	2012	2011
TOTAL	**$**	**$**
Opening balance	382,187,323	487,011,534
Units issued during the year	3,012,163	81,549
Units redeemed during the year	(6,666,198)	(24,184,932)
Units issued on reinvestment of distributions	15,959,774	12,098,705
Changes in net assets attributable to unitholders	(105,639,966)	(91,714,821)
Foreign exchange (gain)/loss on investor funds	127,532	(1,104,712)
Closing Balance	288,980,628	382,187,323

LM FIRST MORTGAGE INCOME FUND

STATEMENT OF CASH FLOWS

For the year ended 30 June 2012

	Note	30 June 2012 $	30 June 2011 $
Cash flows from operating activities			
Interest and distributions received		404,955	5,006,959
Management fees paid		(5,180,443)	-
Other operating expenses		(759,450)	(614,903)
Other income received		-	-
GST and withholding tax (paid)/received		-	-
Finance costs paid		(8,143,798)	(15,144,105)
Net cash inflow/(outflow) from operating activities	12(b)	(13,678,736)	(10,752,049)
Cash flows from investing activities			
Payments for secured mortgage loans		(16,924,379)	(15,897,472)
Receipts from settled mortgage loans		46,822,765	62,313,149
Net cash inflow/(outflow) from investing activities		29,898,386	46,415,677
Cash flows from financing activities			
Repayment of borrowings		-	(81,014,217)
Proceeds from facility		-	89,100,000
Repayment of facility		(22,789,710)	(26,700,212)
Cash paid on realisation of foreign exchange contracts		(69,271)	-
Receipts from the issue of units		2,312,382	70,000
Distributions paid		(2,424,725)	-
Payment for redemption of units		(3,600,345)	(620,461)
Net cash inflow/(outflow) from financing activities		(26,571,669)	(19,164,890)
Net increase/(decrease) in cash and cash equivalents		(10,352,019)	16,498,738
Cash and cash equivalents at beginning of the year		18,475,447	1,976,709
Cash and cash equivalents at the end of the year	12(a)	8,123,428	18,475,447

LM FIRST MORTGAGE INCOME FUND

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 30 JUNE 2012

1. CORPORATE INFORMATION

The financial report of LM First Mortgage Income Fund ("the Scheme") for the year ended 30 June 2012 was authorised for issue in accordance with a resolution of the directors of the Responsible Entity on 16 November 2012.

The Scheme is an Australian registered scheme, constituted on 13 April 1999. The Scheme will be terminated on 13 April 2080 unless terminated earlier in accordance with the provision of the Scheme Constitution (as amended).

LM Investment Management Limited, the Responsible Entity of the Scheme, is incorporated and domiciled in Australia. The registered office of the Responsible Entity is located at Level 4, 9 Beach Road, Surfers Paradise, Queensland.

The nature of the operations and principal activities of the Scheme are described in the Directors' Report.

2. BASIS OF PREPARATION AND ACCOUNTING POLICIES

The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all periods presented, unless otherwise stated in the following text.

a) Basis of accounting

This financial report is a general purpose financial report that has been prepared in accordance with the Scheme Constitution, and the requirements of the *Corporations Act 2001*, Australian Accounting Standards and other authoritative pronouncements of the Australian Accounting Standards Board. The financial report has also been prepared on a historical cost basis, except for financial assets and financial liabilities held at fair value through profit or loss, that have been measured at fair value.

The Statement of Financial Position is presented on a liquidity basis. Assets and liabilities are presented in decreasing order of liquidity and does not distinguish between current and non-current items. All balances are expected to be recovered or settled within twelve months, except for loans and receivables and net assets attributable to unitholders. The amount expected to be recovered or settled within twelve months in relation to the balances cannot be reliably determined.

The financial report is presented in Australian Dollars ($).

Statement of Compliance

The financial statements have been prepared in accordance with the Australian Accounting Standards as issued by the Australian Accounting Standards Board and International Financial Reporting Standards as issued by the International Accounting Standards Board.

2. BASIS OF PREPARATION AND ACCOUNTING POLICIES (Continued)

a) Basis of accounting (Continued)

Status of investment in fund

During the 2009 year, the Responsible Entity closed the Scheme to new investors and suspended withdrawals, with the exception of those approved under hardship provisions and feeder fund payments for distributions and expenses. Feeder funds are other registered managed investment schemes that have invested directly in the LM First Mortgage Income Fund. Redemptions are generally to be paid within 365 days of the investment maturity term, however, redemptions have been suspended, per the constitution, as the Responsible Entity considers the suspension of withdrawals to be in the best interest of the members of the Scheme.

Since the closure of the Scheme, LM has managed an orderly asset sales process. When it closed, there were 55 loan assets. Since that time 28 of loans have been repaid through an ongoing asset sales process. LM is driving the orderly sale of the remaining 27 number of loans.

The nature of all the properties the fund took control of the security was varied in terms of sector type and the loans provided a broadly diversified geographic exposure across the Australian property market.

In this reporting period, the Responsible Entity has sought further feedback from investors in this regard and has announced that the fund will not re-open. All investors will share pro-rata in capital distributions as the sales progress.

Approved investor hardship withdrawals will continue as the sales proceed.

Going Concern

The financial statements have been prepared on the basis the Scheme is a going concern. The Responsible Entity entered into a facility with its external financier on behalf of the Scheme that provided a facility of $90 million for two years with an option, that was exercised, to extend the facility for an additional year up to 30 June 2013, the loan balance was $39.6 million as at 30 June 2012 (30 June 2011: $62.4million).

The facility agreement requires the Scheme to make minimum repayments in priority to any redemptions, except for hardship provisions and feeder fund payments for investor distributions and fund expenses. In addition, where the Scheme realises assets or receives cash in settlement of secured loans it must repay to the external financier an agreed amount that varies based on each secured loan.

As a result of disruptions following the global financial crisis, there is significant volatility in the financial and property markets which may impact the timing of future cash flows in relation to the Scheme's realisation of assets or receipt of cash in settlement of secured assets that is required to repay this facility and the ability of the Scheme to realise its loans and receivables at the amounts stated in the accounts. In the event that funding beyond 30 June 2013 is unable to be obtained from financiers, or cash receipts from asset sales are delayed and/or less than currently envisaged and the Scheme is unable to continue to comply with repayment obligations, the Scheme may not be able to continue as a going concern.

This uncertainty may impact the ability of the Scheme to realise these loans and receivables at the amounts stated in the accounts. As described in Note 2(c), significant judgement has been applied in determining the carrying value of loans and receivable amounts.

2. BASIS OF PREPARATION AND ACCOUNTING POLICIES (continued)

a) Basis of accounting (Continued)

The directors believe the Scheme will be able to meet its obligations under the repayment plan through repayment of existing loans including the refinancing of existing loans with alternative financing providers, the repayment of loans from related entities, or the continued support from the external financier.

The directors expect that based on progress to date in meeting the repayment obligations and the status of negotiations with potential financiers, the Scheme will be in a position to secure additional funding or redraw on the amended facility to complete development projects valued on an "on completion basis".

The Responsible Entity is also considering options for a managed redemption plan restructure for those investors with a redemption request lodged. The directors must also ensure that they protect those investors who wish to remain invested in the Scheme.

As a result of the above, the directors believe that the Scheme will be able access funding, and be able to realise its loans and receivables in the normal course of business as a going concern at the amounts stated. No adjustments have been made relating to the recoverability and classification of recorded asset amounts and the amounts and classification of liabilities that might be necessary should the Scheme not continue as a going concern.

b) New accounting standards and interpretations

Australian Accounting Standards and Interpretations that have recently been issued or amended but are not yet effective have not been adopted by the Scheme for the annual reporting period ended 30 June 2012. The impact of these standards and interpretations has been assessed and to the extent applicable to the Scheme are discussed below. Standards and Interpretations that are not expected to have a material impact on the Scheme have not been included.

AASB 9 *Financial Instruments* and related amendment AASB 2009-11

AASB 9 applies to annual reporting periods beginning on or after 1 January 2013 and will therefore apply to the Scheme from 1 July 2013. The Scheme does not intend to early adopt AASB 9 as permitted by the standard, and the actual impact on initial application will depend on certain elections as disclosed below.

AASB 9 requires all financial instruments to be measured at fair value unless the criteria for amortised cost are met. The application of the standard is not expected to change the measurement basis of any of the Scheme's current financial instruments, however, AASB 9 allows the Scheme to elect to present gains and losses on equity securities through other comprehensive income, which may impact the presentation of these gains and losses. The impact of the standard may also change if the nature of the Scheme's activities or investments changes prior to initial application.

AASB 10 *Consolidated Financial Statements* and related standards AASB 11, AASB 12

AASB 10 establishes a new control model that applies to all entities. It replaces parts of AASB 127 *Consolidated and Separate Financial Statements* dealing with the accounting for consolidated financial statements and AASB Interpretation 112 *Consolidation – Special Purpose Entities*. The standard is not applicable until 1 January 2013, but is available for early adoption. The Scheme does not intend to early adopt AASB 10. Management does not

2. BASIS OF PREPARATION AND ACCOUNTING POLICIES (continued)

b) New accounting standards and interpretations (Continued)

expect the adoption of AASB 10 to lead to any change to the presentation of consolidated financial statements based on the Scheme's current investment strategy.

c) Significant accounting judgements, estimates and assumptions

In the process of applying the Group's accounting policies, management has made judgements and estimations which have had an impact on the amounts recognised in the financial statements. The carrying amounts of certain assets and liabilities are often determined based on estimates and assumptions of future events. The key estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of certain assets and liabilities within the next annual reporting period are:

a. Allowance for impairment loss on loans and receivables

The Scheme determines whether loans are impaired on an ongoing basis. Individually assessed provisions are raised where there is objective evidence of impairment that is where the Scheme does not expect to receive all of the cash flows contractually due. Individually assessed provisions are made against individual facilities. The provisions are established based primarily on estimates of the realisable (fair) value of collateral taken and are measured as the difference between a financial asset's carrying amount and the present value of the expected future cash flows (excluding future credit losses that have not been incurred), discounted at the financial asset's original effective interest rate. Short term balances have not been discounted.

b. Fair value of financial instruments

When the fair value of financial assets and financial liabilities recorded in the Statement of Financial Position cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values.

The judgments include considerations of liquidity and model inputs such as credit risk (both own and counterparty's), correlation and volatility. Changes in assumptions about these factors could affect the reported fair value of financial instruments. The models are calibrated regularly and tested for validity using prices from any observable current market transactions in the same instrument (without modification or repackaging) or based on any available observable market data.

d) Cash and cash equivalents

Cash and cash equivalents includes cash in hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less, and bank overdrafts. For the purposes of the Statement of Cash Flows, cash and cash equivalents consist of cash and cash equivalents as defined above, net of outstanding bank overdrafts.

e) Distribution income

Distribution income is recognised when the Scheme's right to receive the income is established.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

f) Interest income

Interest income is recognised as the interest accrues using the effective interest rate method, which is the rate that exactly discounts estimated future cash receipts through the expected life of the financial instrument to the net carrying amount of the financial asset.

g) Default management fees

Income from default management fees is recognised in line with the executed agreement with the borrower when an event of default occurs.

h) Changes in the fair value of investments

Gains or losses on investments held for trading are calculated as the difference between the fair value at sale, or at year end, and the fair value at the previous valuation point. This includes both realised and unrealised gains and losses.

i) Fees, commissions and other expenses

Except where included in the effective interest calculation (for financial instruments carried at amortised cost), fees and commissions are recognised on an accrual basis. Audit and compliance fees are included with 'other expenses' and are recorded on an accrual basis.

j) Finance costs

Interest on borrowings is recognised in the statement of comprehensive income in the period to which it relates. Issue costs associated with borrowings are capitalised and amortised over the term of the borrowing to which they relate using the effective interest method.

k) Financial Instruments

Financial instruments in the scope of AASB 139 *Financial Instruments: Recognition and Measurement* are classified as either financial assets and financial liabilities at fair value through profit or loss, loans and receivables, held-to-maturity investments, available-for-sale investments or other financial liabilities as appropriate. When financial assets are recognised initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transactions costs. The Scheme determines the classification of its financial assets at initial recognition.

All regular way purchases and sales of financial assets are recognised on the trade date i.e. the date that the Scheme commits to purchase the asset. Regular way purchases or sales are purchases or sales of financial assets under contracts that require delivery of the assets within the period established generally by regulation or convention in the marketplace.

i) Fair value of financial assets and liabilities through profit and loss

Financial assets held for trading included forward exchange contracts. These assets are acquired principally for the purpose of mitigating the risk of movements in the value of non-Australian Dollar investor funds and facilitating forecasting of future cash flows. During the period, all derivatives are classified as held for trading. Derivative financial instruments entered into by the Scheme do not meet the hedge accounting criteria as defined by AASB139. Consequently, hedge accounting is not applied by the Scheme in the 2012 financial year.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

k) Financial Instruments (Continued)

ii) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables are initially measured at fair value including transaction costs directly attributable to the financial asset. After initial recognition, loans and receivables are carried at amortised cost using the effective interest method. Gains and losses are recognised in profit or loss when the loans and receivables are derecognised or impaired, as well as through the amortisation process.

ii) Loans and receivables (Continued)

Loans and receivables are assessed for impairment at each reporting period. An allowance is made for credit losses when there is objective evidence that the Scheme will not be able to collect the loans and receivables. Impairment losses are written off when identified. Losses expected as a result of future events are not recognised. If a provision for impairment has been recognised in relation to a loan, write offs for bad debts are made against the provision. If no provision for impairment has previously been recognised, write offs for bad debts are recognised as an expense in the statement of comprehensive income.

The amount provided for impairment of loans is determined by management of the Scheme and approved by the Board of Directors. A provision is made of loans in arrears where the collectability of the debts is considered doubtful by estimation of expected losses in relation to loan portfolios where specific identification is impracticable.

The components of impaired assets are as follows:
"Loans in arrears" are loans and advances for which there is reasonable doubt that the Scheme will be able to collect all amounts of principal and interest in accordance with the terms of the agreement.

"Assets acquired through the enforcement of security" are assets acquired in full or partial settlement of a loan or similar facility through the enforcement of security arrangements.

Where possible, the Scheme seeks to restructure loans to have loans fully performing, however the fund will take enforce its rights to security where necessary. The renegotiation may involve extending payment terms and arrangement of new loan conditions. Once the terms have been renegotiated any impairment is measured the same way as performing loans. The renegotiated loans continue to be assessed individually and collectively for impairment.

"Restructured loans" arise when the borrower is granted a concession due to continuing difficulties in meeting the original terms and new terms are not comparable to the original terms. These loans are removed from 'restructure loans' after a period of 12 months of performance against loan revised terms and conditions. Loans with revised terms are included in 'loans in arrears' when impairment provisions are required.

When the Responsible Entity determines interest is not recoverable on certain impaired loans, the interest is suspended and not brought into income. Should the Responsible Entity's analysis of the collectability subsequently change the interest will be brought into income at the time it is determined to be collectible.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

l) Advisor Commissions

Advisor commissions may be paid to the unitholders' investment advisors and are calculated as a percentage of funds invested in the Scheme. These commissions are paid monthly in arrears and are brought to account on an accrual basis. The Scheme ceases to pay advisor commissions when the related units are redeemed.

m) Payables

Payables are carried at amortised cost and represent liabilities for goods and services provided to the Scheme prior to the end of the financial year that are unpaid and arise when the Scheme becomes obliged to make future payments in respect of the purchases of these goods and services.

The distribution amount payable to investors as at the reporting date is recognised separately on the statement of financial position as unitholders are presently entitled to the distributable income as at 30 June 2012 under the Scheme's Constitution.

n) Increase/decrease in net assets attributable to unitholders

Non-distributable income is transferred directly to net assets attributable to unitholders and may consist of unrealised changes in the net fair value of investments, accrued income not yet assessable, expenses accrued for which are not yet deductible, net capital losses and tax free or tax deferred income. Net capital gains on the realisation of any investments (including any adjustments for tax deferred income previously taken directly to net assets attributable to unitholders) and accrued income not yet assessable will be included in the determination of distributable income in the same year in which it becomes assessable for tax. Excess and undistributed income is also transferred directly to net assets attributable to unitholders.

o) Distributions

In accordance with the Scheme's Constitution, the Scheme fully distributes its distributable income to unitholders. Distributions are payable monthly. Such distributions are determined by reference to the net taxable income of the Scheme. Distributable income includes capital gains arising from the disposal of investments. Unrealised gains and losses on investments that are recognised as income are transferred to net assets attributable to unitholders and are not assessable and distributable until realised. Capital losses are not distributed to unitholders but are retained to be offset against any realised capital gains.

p) Goods and services tax (GST)

The GST incurred on the costs of various services provided to the Responsible Entity by third parties such as audit fees, custodial services and investment management fees have been passed onto the Scheme. The Scheme qualifies for Reduced Input Tax Credits (RITC's) at a rate of 75%.

Hence investment management fees, custodial fees and other expenses have been recognised in the statement of comprehensive income net of the amount of GST recoverable from the Australian Taxation Office (ATO). Accounts payable are inclusive of GST. The net amount of GST recoverable from the ATO is included in receivable in the statement of financial position. Cash flows relating to GST are included in the Statement of Cash Flows on a gross basis.

The GST component of cash flows arising from investing and financing activities recoverable or payable to the ATO is classified as an operating cash flow.