

**THE PROSPECT JAPAN FUND LIMITED**

**ANNUAL REPORT AND AUDITED FINANCIAL STATEMENTS**

**For the year ended 31 December, 2016**



# THE PROSPECT JAPAN FUND LIMITED

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# THE PROSPECT JAPAN FUND LIMITED

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## MANAGEMENT AND ADVISORS

### **Directors**

John A. Hawkins (Chairman)  
Richard J. Battey  
Rupert A. R. Evans

### **Registered Office**

PO Box 255  
Trafalgar Court,  
Les Banques,  
St Peter Port,  
Guernsey, GY1 3QL  
Channel Islands

### **Manager**

Prospect Asset Management (Channel Islands) Limited,  
PO Box 255  
Trafalgar Court,  
Les Banques,  
St Peter Port,  
Guernsey, GY1 3QL  
Channel Islands

### **Investment Advisor**

Prospect Asset Management, Inc.,  
410 Atkinson Drive,  
Suite 434,  
Honolulu,  
Hawaii 96814  
United States of America

### **Legal Advisors**

*England*  
Herbert Smith Freehills LLP,  
Exchange House,  
Primrose Street,  
London, EC2A 2EG

### *Guernsey*

Mourant Ozannes,  
1 Le Marchant Street,  
St Peter Port,  
Guernsey, GY1 4HP  
Channel Islands

### **Custodian**

Northern Trust (Guernsey) Limited,  
Trafalgar Court,  
Les Banques,  
St Peter Port,  
Guernsey, GY1 3DA  
Channel Islands

### **Secretary, Registrar and Administrator**

Northern Trust International Fund Administration  
Services (Guernsey) Limited,  
Trafalgar Court,  
Les Banques,  
St Peter Port,  
Guernsey, GY1 3QL  
Channel Islands

### **Financial Advisor and Broker<sup>1</sup>**

Stockdale Securities Limited,  
Beaufort House,  
15 St Botolph Street,  
London, EC3A 7BB  
United Kingdom

### **CREST Agent**

Computershare Investor Services (Guernsey) Limited,  
1st Floor Tudor House,  
Le Bordage  
St Peter Port,  
Guernsey, GY1 1DB  
Channel Islands

### **Independent Auditor**

Ernst & Young LLP,  
Royal Chambers,  
St Julian's Avenue,  
St Peter Port,  
Guernsey, GY1 4AF  
Channel Islands

<sup>1</sup> "Westhouse Securities Limited" changed its name to "Stockdale Securities Limited" with effect from 5 January, 2016.

# THE PROSPECT JAPAN FUND LIMITED

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## CHAIRMAN'S REPORT

for the year ended 31 December, 2016

Your Company has had a disappointing year with a decline in published NAV of 9.49% compared with MSCI Japan Small Cap Index's increase of 8.22%. Furthermore, the share price has fallen from \$1.05 to \$0.89 with an increased discount to published NAV of 27% (2015: 23%).

Following the change of investment policy approved by the shareholders in 2014, the Manager has moved towards an even more concentrated portfolio of investments than in 2015. There is now a strong weighting towards regional banks, two of which make up slightly more than 50% by value of the portfolio. As of now the portfolio is comprised of less than 10 investments including the investment in Prospect Co. This strategy together with direct engagement with investee company management is expected to bring rewards in due course.

As announced on 10 January, 2017, the Independent Directors of the Company are in preliminary discussions regarding a possible offer from Prospect, Co. Ltd ("Prospect"), a Japanese company listed on the Tokyo Stock Exchange and the parent company of the Company's Manager and Investment Advisor, for the entire issued and to be issued share capital of the Company. The possible offer is under consideration, discussion and evaluation by both parties is a securities exchange offer at a ratio of 2.5 Ordinary Prospect Shares in exchange for each share held in the Company. Further details of the possible offer and the strategic rationale for the proposed combination are available on the Company's website: [www.prospectjapan.com](http://www.prospectjapan.com).

The Board will assess any offer in relation to the takeover of the Company in light of our objectives, which are to maximise share value, minimise or eliminate discount to NAV and improve the liquidity of our shares.

**John Hawkins**  
**Chairman**

21 March, 2017

# THE PROSPECT JAPAN FUND LIMITED

## INVESTMENT ADVISOR'S REPORT

for the year ended 31 December, 2016

### Market Performance (%), US\$ NAV

	1 Year	3 Year	5 Year
<b>Prospect Japan Fund</b>	<b>(2.59)/(9.49)*</b>	<b>(3.88)</b>	<b>45.88</b>
MSCI Japan Small Cap Index	8.22	24.79	64.67

*The Prospect Japan Fund Limited inception date is 20 December 1994. The above performance of the Fund is net of fees and expenses and includes reinvestment of dividends and capital gains. (Source: Prospect Asset Management, Inc.) Although the Company is not managed to a benchmark, it measures its performance against the MSCI Japan Small Cap Index (Total Return) for comparison purposes only. The MSCI Developed Markets Small Cap Indices offer an exhaustive representation of this size segment by targeting companies that are in the Investable Market Index but not in the Standard Index in a particular developed market. The indices include Value and Growth style indices and industry indices based on the Global Industry Classification Standard (GICS®). (Source: Bloomberg)*

\* Refers to performance based on published NAV. Further information can be found in note 17 on page 52.

### Investment Manager's Summary

The Prospect Japan Fund Limited's (the "Company") published NAV performance decreased 9.49% in 2016 (2015: increase 19.13%) (the performance based on valuations produced in accordance with International Financial Reporting Standards ("IFRS") decreased by 2.59% see the "Results and Dividend" section of the Directors' Report for further information), underperforming the MSCI Japan Small Cap Index's 8.22% total return. The broader Japanese market performed weakly for much of the year with Japanese equity markets experiencing the worst start to a year on record, with six consecutive days of trading losses reversing most of the gains seen in the year to 31 December 2015. The Nikkei 225 index reached lows last seen in 2013 before rallying with the weaker yen following US elections in November.

Global equities entered 2016 with a risk-off period, dragged down by massive selling in China. Key oil gauges dropped to 12-year lows amidst an ongoing supply glut, and the cloud of the Chinese economic slowdown drove yen strength. Toward the end of H1, global currency and equity markets were shaken when the United Kingdom referendum on European Union membership ended with an unexpected victory for "Leave". The unexpected outcome of the US presidential election shook global politics and markets, with acute effects on Japanese bond yields and currency momentum.

The yen weakened significantly following the US election results on expectations of inflationary fiscal policy in the US leading to a faster normalization of Fed policy. The yen saw the largest monthly decline versus the dollar since 1995 following the election, with the dollar reaching JPY 116.64 at year end. The equity market rallied with the weaker yen, entering a bull market from June lows.

While the details of a Trump administration's policy outlook remain clouded, some of the key issues regarding the Japanese economy include a potentially stronger dollar, US abandonment of the Trans-Pacific Partnership ("TPP") and closer attention paid to the China-backed Regional Comprehensive Economic Partnership ("RCEP"), a 16-nation initiative of Asian nations that excludes North and South American countries, much as TPP excluded China.

Domestically, markets were dominated by turbulent changes to the monetary and fiscal policy dimensions of "Abenomics". The Bank of Japan ("BoJ") surprised the market by adopting a negative interest rate policy in late January. "Quantitative & Qualitative Monetary Easing with a Negative Interest Rate" aimed to mirror the multi-tier system in place at the Swiss National Bank, in which the negative rate is applied to a portion of a financial institution's current account balance.

# THE PROSPECT JAPAN FUND LIMITED

## INVESTMENT ADVISOR'S REPORT

for the year ended 31 December, 2016

*Continued*

### Investment Manager's Summary

*Continued*

The reaction in the market was swift, with the yen gaining strongly, bond yields falling to record levels, and shares of financials falling precipitously.

Quantitative & Qualitative Monetary Easing ("QQE") with a Negative Interest Rate

<b>Tier</b>	<b>Description</b>	<b>Interest Rate Applied</b>
Basic Balance	Existing balances with Bank of Japan	+0.1%
Macro Add-on Balance	Required reserves and reserves related to BoJ lending support programs	0.0%
Policy-Rate Balance	Reserves in excess of above tiers	-0.1%

By September, faced with concerns regarding the limitations of monetary easing with increasingly evident side effects on financial sector profits and limited success in achieving its 2% inflation target, the BoJ adopted a new "QQE with Yield Curve Control" framework following a comprehensive policy assessment. The BoJ left its controversial negative interest rate policy intact, while shifting the target of policy to the yield curve, and away from fixed increases to the monetary base. Other adjustments included the elimination of the JPY 80 trillion annual increase in monetary base, allowing the BoJ to be flexible in its purchases depending on needed adjustments to the yield curve. The central bank's stated intention is to buy JGBs in line with the current pace, but eliminated the target for average maturity on JGB purchases.

The BoJ also announced an "inflation-overshooting commitment", stating that extraordinary policy will continue until inflation is stable above the 2% target. The ETF purchase target remained stable at 5.7 trillion, though 2.7 trillion was allotted for ETFs that track the broader TOPIX index.

On the fiscal side, Prime Minister Shinzo Abe again elected to delay the scheduled increase in the consumption tax rate (from 8% to 10%) until October 2019, helping to secure a landslide victory in the summer upper house elections, winning a two-thirds super majority for the ruling coalition. The administration subsequently announced a JPY 28.1 trillion economic stimulus package, including JPY 7.5 trillion in net new spending.

The Company's holdings, with strong weightings towards Banks (53.9%) and Real Estate (5.3%), are direct beneficiaries of the continued support for fiscal and monetary stimulus by the Abe administration and BoJ, with real estate prices supported by the expectation of stable near- to mid-term low government bond yields via BoJ yield control operations.

The recovery in the Tokyo office market continues, with Miki Shoji reporting that the average office vacancy in Tokyo's Central Business District (CBD) has fallen 42 basis points year-on-year in 2016. Average rents rose 4.79% year-on-year in 2016, improved from the 4.36% improvement in 2015, and 19.0% below the 2008 highs.

During the year, the Company received shareholder approval of the Exercise Agreement, which allowed for the purchase of 1,440 stock acquisition rights ("SARs") for Prospect Co. (3528). These cost JPY 288 million. As of 2016 year end, the Company had converted 90 of these SARs into 9 million shares, leaving the Company with 1,350 SARs at a cost of JPY 270 million which is equal to an additional 135 million shares.

### *OUTPERFORMANCE*

The largest positive contributors to 2016 performance came from holdings in Fukushima Bank (8562) and Daiwa Motor Transportation (9082). Fukushima Bank, a regional bank in Fukushima prefecture, fell sharply in February along with other financial shares due to the implementation of the BoJ's negative interest rate policy, but rallied strongly over the following months after technical adjustments by the BoJ that increased the proportion of current account funds that will be considered part of the "macro add-on balance" not subject to the negative policy rate, and into year-end after introduction of the central bank's yield control policy framework. Fukushima Bank, the third largest bank in the Fukushima prefecture, could benefit from the ongoing consolidation trend in the sector.

# THE PROSPECT JAPAN FUND LIMITED

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## INVESTMENT ADVISOR'S REPORT

for the year ended 31 December, 2016

*Continued*

### *OUTPERFORMANCE*

*Continued*

The Company raised its holding in Fukushima Bank (8562) during the year from 4.4% of assets to 23.7%. The bank is similar in size and valuation to Daito Bank (8563), with no large institutional shareholders and is seen as a potential beneficiary of ongoing regional bank consolidation. Fukushima prefecture is particularly attractive, considering the positive impact of recovery efforts and victim compensation. Residential land price increases led the nation in 2015, and employment growth has been stronger than the national average. Fukushima prefecture manufactured goods output growth strongly outpaced the national rate over the last few years, nearly regaining the share of total national output seen in 2010, despite a nearly 6% population decline.

Strategic investments bore fruit during the year, with Daiwa Motor Transportation (9082), a provider of taxi and chartered limousine services, buying back 1.24 million shares from the Company at the 15 June closing price of JPY 553 per share.

In March 2016, the Tokyo High Court announced its decision on the appeal involving the Toho (9602) tender offer bid of Toho Real Estate (8833). The High Court ruled that the tender offer price amounted to fair value and has therefore eliminated the award of JPY 100 per share decided by The Tokyo District Court. The Company summarily submitted an appeal of the High court decision to the Supreme Court, which accepted the request for appeal in June 2016.

In October 2016, the Niigata District Court announced its decision to uphold the fairness of the JPY 245 per share squeeze out price of Yukiguni Maitake (1378), a manufacturer and seller of fresh mushrooms and bean sprouts, by Bain Capital. The Company has submitted an appeal to the District Court decision.

### *UNDERPERFORMANCE*

Holdings resulting in outsized contribution to negative performance during the period include Daito Bank (8563) and Shaklee Global Group (8205). Daito Bank, a regional bank based in Fukushima prefecture, underperformed during the year, after massive outperformance of the overall bank sector in 2015. The bank fell sharply in February along with other financial shares due to the implementation of the BoJ's negative interest rate policy and subsequent downward pressure on loan interest and investment revenue. Daito Bank, the second largest bank in the Fukushima prefecture, could benefit from the ongoing consolidation trend in the sector.

Shaklee Global Group, a seller of nutrition and personal care products, fell during the year due to sluggish revenue and profits from Asian operations and an adverse foreign exchange environment for much of the year, that saw a strengthening Japanese yen erode profitability from overseas sales that account for 85% of total revenue. Company shares retreated sharply following the November US election, despite the advantageous yen weakening, as US policy towards China became uncertain. China accounts for nearly 40% of total sales.

### **Principal Risks and Uncertainties**

Japan remains vulnerable to slowdown in the global economy and geopolitical turmoil, particularly in major trading partners, as well as by volatile swings in currency exchange rates and interest environment due to domestic and overseas monetary policy.

While the Abe administration and BoJ remain poised to provide additional stimulus as needed, inflation expectations remain muted, and CPI turned negative with the largest monthly decline since 2013 recorded during the year. Although the delay of the consumption tax increase is positive, the Abe administration's successful rollout of stimulus spending and regulatory reform remain necessary catalysts for long-term economic growth. Fundamentals on the corporate level remain strong, and while tangible effects of corporate governance reforms, beyond an increased pace of share buy-backs, are negligible, a widespread and ingrained refocusing on investor return should be a long-term positive.



# THE PROSPECT JAPAN FUND LIMITED

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## INVESTMENT ADVISOR'S REPORT

for the year ended 31 December, 2016

*Continued*

### The Prospect Japan Fund Limited Holdings 31 December, 2016

Symbol	Security	% of Total Assets
8562	FUKUSHIMA BANK LTD/THE	23.7
8563	DAITO BANK LTD/THE	23.5
3528	PROSPECT CO LTD	11.3
9313	MARUHACHI WAREHOUSE CO LTD	8.6
8205	SHAKLEE GLOBAL GROUP INC	7.1
1921	TOMOE CORP	3.2

### The Prospect Japan Fund Limited Sector Weighting 31 December, 2016

Banks	50.5
Real Estate	11.3
Storage/Warehousing	8.6
Retail	7.1
Engineering & Construction	3.2
REITs	0.0
Total	80.7
No of Positions	9

### Prospect Asset Management, Inc.

21 March, 2017

# THE PROSPECT JAPAN FUND LIMITED

## PORTFOLIO OF INVESTMENTS

as at 31 December, 2016

Number of Securities	Investments	Fair Value in U.S. Dollars	Percentage of Net Asset Value
	<b>Listed investments</b>		
	<b>Banks</b>		
20,225,000	The Daito Bank	28,681,816	23.52
35,256,000	Fukushima Bank Ltd	28,914,409	23.72
230,000	Nagano Bank	3,969,074	3.26
		61,565,299	50.50
	<b>Engineering and Construction</b>		
1,259,700	Tomoe Corp	3,841,894	3.15
		3,841,894	3.15
	<b>Real Estate</b>		
6,706,000	Prospect Co Ltd	3,781,094	3.10
		3,781,094	3.10
	<b>Retail</b>		
1,095,000	Shaklee Global Group Inc	8,681,047	7.12
		8,681,047	7.12
	<b>REITs</b>		
7,898,895	Prospect Epicure J-REIT Value Fund*#	–	–
		–	–
	<b>Storage/warehousing</b>		
1,415,100	Maruhachi Warehouse Co Ltd	10,517,594	8.63
		10,517,594	8.63
	<b>Total listed investments</b>	88,386,928	72.50
	<b>Real Estate</b>		
1,350	Prospect Co Ltd Stock Acquisition Rights*	9,990,744	8.20
		9,990,744	8.20
	<b>Total unlisted investments</b>	9,990,744	8.20
	<b>Total investments</b>	98,377,672	80.70
	Net current assets	23,545,788	19.30
	<b>NET ASSETS</b>	121,923,460	100.00

# Currently in liquidation.

\* Prospect Co Ltd is classed as a related party as it is the parent company of the Company's manager, PAM(CI).

# THE PROSPECT JAPAN FUND LIMITED

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## STRATEGIC REPORT

The Board has prepared this report on a voluntary basis in accordance with the UK regulations governing the Directors' duty to prepare a strategic report.

### **Company Structure**

The Company carries on business, and is registered, as a Guernsey-based closed-ended investment company. The Company is listed on the London Stock Exchange.

### **Role and Composition of the Board**

The Board is the Company's governing body; it sets the Company's strategy and is collectively responsible to shareholders for its long term success. The Board is responsible for appointing and subsequently monitoring the activities of the Manager and other service providers to ensure that the investment objectives of the Company continue to be met. The Board also ensures that the Manager adheres to the investment restrictions set by the Board and acts within the parameters set by it in respect of any gearing. It also identifies, monitors and manages the key risks facing the Company.

### **The Board**

The Board comprises three non-executive directors. All members of the Board other than Rupert Evans are independent of the Manager. None of the Directors has a contract of service with the Company.

The Chairman of the Board is John Hawkins. Biographies for Mr Hawkins and all other Directors can be found on page 54. In considering the independence of the Chairman, the Board has taken note of the provisions of the AIC Code relating to independence and has determined that Mr Hawkins is an Independent Director. As the Chairman is an Independent Director, no appointment of a senior Independent Director has been made. The Company has no employees and therefore there is no requirement for a chief executive.

The Board meets on at least four occasions each year, at which time the Directors review the investment management of the Company's assets and all other significant matters so as to ensure that the Directors maintain overall control and supervision of the Company's affairs. The Board is responsible for the appointment and monitoring of all service providers to the Company.

### **Dialogue with Shareholders**

The Investment Advisor and the Financial Advisor and Broker maintain a regular dialogue with institutional shareholders, feedback from which is reported to the Board. In addition, Board members and representatives of the Manager are available to answer shareholders' questions at the Annual General Meeting. The Company Secretary is available to deal with general shareholders' queries at any time during the year.

### **Investment Management**

The Company's investment portfolio is managed by Prospect Asset Management (Channel Islands) Limited ("PAMCI", or the "Manager") whose parent company is Prospect Co., Ltd (Kabushiki Kaisha Prospect ("KKP"), a Japanese Company). The Manager implements the investment strategy, managing the Company's assets in line with appropriate restrictions placed on it by the Board, including limits on the type and relative size of holdings which may be held in the portfolio and on the use of gearing, hedging, cash, derivatives and other financial instruments. In the opinion of the Board, the continuing appointment of the Manager on the terms agreed is in the best interests of the Shareholders as a result of its performance and results.

Please refer to Note 4 on page 40 for details of the management agreement between the Manager and the Company.

### **Investment Objective**

The Company's investment objective is to achieve long-term capital growth from a portfolio of securities primarily of smaller Japanese companies listed or traded on Japanese Stock Markets. The aim will be to achieve a long-term capital return on the Company's portfolio and dividend income will be a secondary consideration in making investment decisions. Although the Company is not managed to a benchmark, it measures its performance against the MSCI Japan Small Cap Index (Total Return) for comparison purposes only.

# THE PROSPECT JAPAN FUND LIMITED

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## STRATEGIC REPORT

*Continued*

### **Investment Strategy**

The Board has delegated management of the Company's portfolio to the Investment Advisor. The Investment Advisor manages the portfolio with the aim of helping the Company to achieve its investment objective. Details of the Investment Advisor's strategy, and other factors that have affected performance during the year, are set out in the Investment Advisor's Report.

### **Investment Policy**

The Company's investment policy is that it will invest mainly in shares, but may also invest in equity related instruments such as convertible bonds or warrants issued by smaller Japanese companies and debt instruments.

It is the intention of the Directors that investments in unlisted securities which are not registered for trading on or quoted on any of the Japanese Stock Markets should only be made where either a listing or an alternative form of realising the investment can be expected within a reasonable period of time. Within these parameters, the assets of the Company may be used to provide *venture* or *start-up* capital (but no investment will carry unlimited liability). The balance of the assets of the Company not invested in securities will normally be invested in short-term debt securities and money market instruments or placed on deposit.

The assets of the Company will be denominated principally in Japanese yen. It is not the present intention of the Directors to hedge the currency exposure of the Company, but the Directors reserve the right to do so in the future if they consider this to be desirable.

It is intended that the principal investment objective and policies of the Company as set out above will remain in force until determined by the Directors and any material change in the policies will only be made with shareholder approval.

### **Gearing**

The Company may use gearing from time to time amounting to not more than 20% of the Company's net asset value. Although the Company does not have a borrowing facility at the present time, it has utilised modest levels of gearing in the past and the use of gearing within this limit in the future will be subject to prior approval of the Board.

### **Investment Philosophy and Process**

The Company invests in companies with undervalued assets where it believes it can be a catalyst for positive change. The Company engages with management to enact this change for the benefit of all shareholders. The Company believes the current government's desire to consolidate certain industries and to improve corporate governance, offer support to this engaged shareholder strategy.

The Company's research and execution expertise enables the Company to identify and act upon the best opportunities.

### **Investment Restrictions and Spread of Investment Risk**

It is the intention to observe the investment restrictions necessary to maintain a listing for the Company as an investment company on the London Stock Exchange and for the Company to be able to obtain certification as a *reporting fund* if subject to the applicable United Kingdom taxation legislation (and subject to other conditions of that legislation). For these purposes and for other policy considerations, the Company will not:

- (a) invest in securities carrying unlimited liability; or
- (b) deal short in securities; or
- (c) take legal or management control of investments in its portfolio; or
- (d) invest in any commodities, land or interests in land; or
- (e) invest or lend more than 25% of its assets at the time the investment is made in securities of any one company or single issuer (other than obligations of the Japanese Government or its agencies or of the US Government or its agencies); or

# THE PROSPECT JAPAN FUND LIMITED

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## STRATEGIC REPORT

*Continued*

### Investment Restrictions and Spread of Investment Risk

*Continued*

- (f) invest more than 10% of its assets at the time the investment is made in closed-end investment funds which are listed on the Official List maintained by the Financial Conduct Authority (except to the extent that those investment funds have stated investment policies to invest no more than 15% of their total assets in other investment funds which are listed on the Official List) and the Company will not invest more than 15% of its assets at the time the investment is made in such funds; or
- (g) invest in more than 5% of its assets at the time the investment is made in units of unit trusts or shares or other forms of participation in managed open-ended investment vehicles; or
- (h) commit its assets in the purchase of foreign exchange contracts or financial futures contracts or put or call options or in the purchase of securities on margin other than in connection with or for the purpose of hedging transactions effected on behalf of the Company; or
- (i) enter into borrowings in excess of 20% of net assets at the time the borrowings are drawn down.

### Performance

An outline of performance, market background, investment activity and portfolio strategy during the year under review, as well as outlook, is provided in the Investment Advisor's Report on pages 4 to 7.

### Key performance indicators ("KPIs")

At each quarterly Board meeting, the Board consider a number of performance measures to assess the Company's success in achieving its objectives. Below are the main KPIs which have been identified by the Board for determining the progress of the Company:

- Net asset value;
- Share price;
- Discount/premium of share price to NAV; and
- Ongoing charges, which are set out on page 15.

A record of these measures is disclosed on page 54.

### Principal Risks and Uncertainties

The Board is responsible for the Company's system of internal controls and for reviewing its effectiveness. The Board is satisfied that by using the Company's risk matrix in establishing the Company's system of internal controls, while monitoring the Company's investment objective and policy, that the Board has carried out a robust assessment of the principal risks and uncertainties facing the Company. The principal risks and uncertainties which have been identified and the steps which are taken by the Board to mitigate them are as follows:

- (i) *Investment objective and strategy*  
The Company's strategy may not be successful in achieving its investment objective if the Investment Advisor fails to comply with the Company's investment policy. The Board reviews reports from the Investment Advisor at the quarterly Board Meetings, with a focus on adherence to the investment policy. The Administrator is responsible for ensuring that all transactions are in accordance with the investment restrictions.
- (ii) *Investment risk*  
To achieve the objective of delivering long-term performance, the Company invests in Japanese growth as well as cyclical companies with strong management teams that possess a clear vision and focus on profitability and shareholders' interests. The investment process is driven by proprietary fundamental research identifying companies with below average valuations and above average earnings growth and return on equity.

# THE PROSPECT JAPAN FUND LIMITED

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## STRATEGIC REPORT

*Continued*

### Principal Risks and Uncertainties

*Continued*

The Company also invests in companies that have undervalued assets where it identifies a realistic catalyst for positive change. This represents an enhancement of the overall investment process reflecting what the Manager believes are exciting new opportunities in the Japanese equity market. The Manager believes that these types of companies compliment the Company's overall stock picking expertise, enabling the Company to identify the best opportunities for long term capital appreciation in Japan caused by ongoing consolidation.

Risk management is an integral part of the investment management process. Core to the process is that risks taken are not incidental but are fully understood and accounted for. In-depth proprietary fundamental research provides the Manager with a deep understanding of each stock in the Company's portfolio and the associated risks. The Board considers the risks facing the Company on an on-going basis. All Board meetings are also attended by the Manager, either in person or by telephone, where reports on portfolio performance and strategy are provided.

Portfolio performance will be dependent on the performance of Japanese equities and such stocks will be influenced by the general health of the country.

(iii) *Financial risks*

The financial risks, including market, credit and liquidity risk faced by the Company are set out in Note 13 of the Financial Statements on pages 44 to 48. These risks and the controls in place to reduce the risks are reviewed at the quarterly Board Meetings.

(iv) *Foreign exchange risk*

The movement of exchange rates may have an unfavourable or favourable impact on returns as the majority of the Company's assets are denominated in Yen, rather than US Dollar, the reporting currency of the Company. Although not currently undertaken, the Directors reserve the right to hedge the Company's currency exposure.

(v) *Ordinary shares*

The market value of the shares in the Company may not reflect the underlying Net Asset Value and may trade at a discount to it. The Board actively monitors the discount of the Company and, where appropriate, may implement share buybacks to help reduce the discount and/or discount volatility.

(vi) *Borrowing*

The Investment Policy restricts the Company from entering into borrowings in excess of 20% of net assets at the time the borrowings are drawn down. Whilst such borrowings may enhance the return on the shares where the underlying Company performance is positive, the opposite is also true and any borrowing will enhance the negative performance of the Company.

(vii) *Third party service providers*

The Company has no employees and the Board comprises three non-executive directors. The Company is reliant on the Manager, the Investment Advisor and the Secretary, Registrar and Administrator to perform its executive function. The most significant of these third party service providers is the Manager to whom the management of the Company's investments has been delegated. Failure by any of these third party service providers to perform the services in accordance with the terms of the relevant service contracts represents a risk to the operations of the Company and the performance of the Company.

Termination of the Investment Management Contract by the Manager or loss of key staff by the Manager could materially affect the ability of the Company to operate and detract from the performance of the Company until a suitable replacement could be found.

The Board has segregated the duties of investment management, accounting and custody. Each of the contracts with third party service providers has been entered into after full and proper consideration of the quality and cost of the services provided and the control systems in place. The Board reviews the performance of the Investment Advisor and the Manager on a regular basis,

# THE PROSPECT JAPAN FUND LIMITED

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## STRATEGIC REPORT

*Continued*

### Principal Risks and Uncertainties

*Continued*

The Directors seek to mitigate and manage these risks through continual review, policy-setting and enforcement of contractual obligations and will update the risk assessment matrix to reflect any changes in the control environment. Further details on the Company's internal controls are given on pages 18 and 19.

### Viability Statement

In accordance with provision C.2.2 of the UK Corporate Governance Code, published by the Financial Reporting Council in September 2014 (the "Code"), the Directors have assessed the prospects of the Company over the three year period to 31 December, 2019. The Company is required to put a discontinuation vote to shareholders every three years, the next one occurring in 2017. On 10 January, 2017 the Company announced a possible offer from Prospect, Co. Limited ("Prospect") for the entire issued and to be issued share capital of the Company. Currently, there is no way of knowing the intentions of Prospect or if any proposal would be accepted by the Shareholders. Therefore, assuming that the discontinuation vote is not passed and there is no offer, the Directors consider that three years is an appropriate period of assessment of the viability of the Company for the purpose of giving assurance to shareholders.

In its assessment of the viability of the Company, the Directors have considered each of the Company's principal risks and uncertainties detailed on pages 11 to 13 and in particular the impact of a significant fall in regional equity markets on the value of the Company's investment portfolio. The Directors consider that a 30% fall in the value in the Company's portfolio would be significant but would have little impact on the Company's ability to continue in operation over the next three years. In reaching this conclusion, the Directors considered the Company's income and expenditure projections, the fact that the Company has no gearing and that the Company's investments comprise readily realisable securities which can be expected to be sold to meet funding requirements if necessary, assuming market liquidity continues.

Based on the Company's processes for monitoring operating costs (cash burn vs. available resources), share price discount, the Manager's compliance with the investment objective, asset allocation, the portfolio risk profile, counterparty exposure, liquidity risk and financial controls, the Directors have concluded that there is a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the three year period to 31 December, 2019.

### Future Developments

The future performance of the Company depends upon the success of the Company's investment strategy in the light of economic factors and market developments. Further comments on the outlook for the Company for the next twelve months are set out in both the Chairman's Report on page 3 and in the Investment Advisor's Report on page 4.

**John Hawkins**

*Chairman*

**Richard Battey**

*Director*

21 March, 2017

# THE PROSPECT JAPAN FUND LIMITED

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## DIRECTORS' REPORT

The Directors present their Annual Report and the Audited Financial Statements of The Prospect Japan Fund Limited (the "Company") for the year ended 31 December, 2016.

### **The Company's Business**

The Company was registered under the laws of Guernsey on 18 November, 1994 as a Limited Company with a premium listing on the London Stock Exchange. It is a close-ended investment company established to achieve long-term capital growth from an actively managed portfolio of securities primarily of smaller Japanese companies listed or traded on Japanese Stock Markets. The Company is a FATCA compliant organisation with FATCA entity classification FFI and GIIN L0Q9R3.99999.SL.831.

### **Results and Dividend**

The results for the year are set out in the Statement of Comprehensive Income on page 32.

Whilst over the last three year period the Company's return was (3.88)% (2015: 35.64%) compared with 24.79% (2015: 46.38%) for the MSCI Japan Small Cap Index, the last year's performance based on valuations produced in accordance with International Financial Reporting Standards ("IFRS") was (2.59)% (2015: (3.19)% compared with MSCI Japan Small Cap Index performance of 8.22% (2015: 15.74%) ((9.49)% (2015: 19.13%) based on published NAV). For further details of the differences between published NAV and IFRS adjusted NAV please see Note 17.

The Directors do not recommend the payment of a dividend for the year (2015: Nil).

### **Performance**

The Board considers that Prospect Asset Management (Channel Islands) Limited, the Manager to the Company, is managing the Company's investments in a manner that is most likely to achieve the objective of long term capital appreciation for its shareholders.

### **Statement of Directors' Responsibilities and Declarations**

The Directors are responsible for preparing the Annual Report and Financial Statements in accordance with applicable Guernsey Law and International Financial Reporting Standards ("IFRS") as adopted by the European Union. The Directors are required to prepare Financial Statements for each financial year which give a true and fair view of the state of the affairs of the Company and of the total return of the Company for that year and in accordance with the applicable laws. The Directors are also responsible for ensuring that the Company complies with the provisions of the Listing Rules and the Disclosure Rules and Transparency Rules of the UK Listing Authority. With regard to corporate governance the Company is required to disclose how it has applied the principles and complied with the provisions of the Corporate Governance code applicable to the Company. In preparing those Financial Statements the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the Financial Statements; and
- prepare the Financial Statements on a going concern basis unless it is inappropriate to presume that the company will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position and performance of the Company and to enable them to ensure that the Financial Statements have been properly prepared in accordance with The Companies (Guernsey) Law and IFRS. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud, error and non-compliance with law or regulations.



# THE PROSPECT JAPAN FUND LIMITED

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## DIRECTORS' REPORT

*Continued*

### Statement of Directors' Responsibilities and Declarations

*Continued*

The Directors confirm that they have complied with the above requirements in preparing the Financial Statements.

The Directors confirm that to the best of their knowledge

- (a) The Annual Financial Statements have been prepared in accordance with IFRS as adopted by the European Union and give a true and fair view of the financial position and performance of the Company as at and for the year ended 31 December, 2016.
- (b) The Chairman's, Investment Advisor's, Strategic and Directors' Reports include a fair review of the development and performance of the Company business and the position of the Company together with a description of the principal risks and uncertainties facing the Company.

### Directors' Statement

So far as each of the Directors is aware, there is no relevant audit information of which the Company's auditor is unaware, and each Director has taken all the steps he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information. In the opinion of the Board, the Annual Report and Financial Statements taken as a whole, are fair, balanced and understandable and provide the information necessary to assess the Company's performance, business model and strategy.

### Ongoing Charges

Ongoing charges are the recurring expenses incurred by the Company excluding one-off expenses. Ongoing charges for the years ended 31 December, 2016 and 31 December, 2015 have been prepared in accordance with the AIC's recommended methodology. The ongoing charges for the year ended 31 December, 2016 was 2.09% (31 December, 2015: 2.20%). No performance fees were charged during the year.

### Corporate Governance

The Board is committed to high standards of corporate governance and has implemented a framework for corporate governance which it considers to be appropriate for an investment company in order to comply with the principles of the UK Corporate Governance Code (September 2014) (the "Code") issued by the Financial Reporting Council ("FRC"). The Company is also required to comply with the Code of Corporate Governance (the "GFSC Code") issued by the Guernsey Financial Services Commission.

The FRC issued a revised Code in 2014, for reporting periods beginning on or after 1 October, 2014. The AIC updated the AIC Code of Corporate Governance (the "AIC Code") (including the Guernsey edition) and its Guide to Corporate Governance (the "AIC Guide") to reflect the relevant changes to the FRC document in February 2015. The Board adopted the revised code during 2015.

The UK Listing Authority requires all UK premium listed companies to disclose how they have complied with the provisions of the UK Code. This Corporate Governance Statement, together with the Going Concern Statement, Viability Statement and the Statement of Directors' Responsibilities set out on pages 14 to 15 and 18, indicates how the Company has complied with the principles of good governance of the UK Code and its requirements on Internal Control.

The Company is a member of the Association of Investment Companies (the "AIC") and by complying with the AIC Code is deemed to comply with both the UK Code and the GFSC Code.

The Board has considered the principles and recommendations of the AIC Code, by reference to the guidance notes provided by the AIC Guide, and consider that reporting against these will provide appropriate information to shareholders. To ensure ongoing compliance with these principles the Board reviews a report from the Corporate Secretary at each quarterly meeting, identifying how the Company is in compliance and identifying any changes that might be necessary.

The AIC Code and the AIC Guide are available on the AIC's website, [www.theaic.co.uk](http://www.theaic.co.uk). The UK Code is available in the Financial Reporting Council's website, [www.frc.org.uk](http://www.frc.org.uk).

# THE PROSPECT JAPAN FUND LIMITED

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## DIRECTORS' REPORT

*Continued*

### Corporate Governance

*Continued*

Throughout the year ended 31 December, 2016, the Company has complied with the recommendations of the AIC Code and thus the relevant provisions of the UK Code, except as set out below.

The UK Code includes provisions relating to:

- the role of the Chief Executive
- Executive Directors' remuneration
- the need for an internal audit function

For the reasons set out in the AIC Guide, and as explained in the UK Code, the Board considers these provisions are not relevant to the position of the Company as it is an externally managed investment company. The Company has therefore not reported further in respect of these provisions. The Directors are all non-executive and the Company does not have employees, hence no Chief Executive is required for the Company. The Board is satisfied that any relevant issues can be properly considered by the Board.

Details of compliance with the AIC Code are noted below and in the succeeding pages. There have been no other instances of non-compliance, other than those noted above.

### Directors Attendance at Meetings

The number and attendance at the formal Board, Audit Committee and Management Engagement Committee meetings during the year was as follows;

	Board Meetings		Management Engagement Committee		Audit Committee Meetings	
	Held	Attended	Held	Attended	Held	Attended
Rupert Evans	4	4	N/A	N/A	N/A	N/A
John Hawkins	4	4	1	1	2	2
Richard Battey	4	4	1	1	2	2

### Re-election

In accordance with the Company's Articles of Association, all newly appointed Directors stand for election by the shareholders at the next Annual General Meeting ("AGM") following their appointment. The Directors retire by rotation and offer themselves for re-election every three years. Directors who have served on the Board for more than nine years are subject to annual re-election. Mr Rupert Evans is considered a non-independent Director due to being a Director of the Manager. Non-independent Directors are subject to annual re-election. At the AGM on 18 August, 2016, Rupert Evans and John Hawkins retired as Directors, and being eligible, Rupert Evans and John Hawkins offered themselves for re-election. Rupert Evans and John Hawkins were re-elected as Directors of the Company.

The Chairman has served on the Board for over nine years and under the AIC Code may not be considered to be independent of the Company. The Board however, takes the view that the length of tenure does not necessarily determine the independence of the Board and experience can add significantly to the Board's strength. It has therefore determined that in performing his role as Director, the Chairman remains wholly independent.

# THE PROSPECT JAPAN FUND LIMITED

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## DIRECTORS' REPORT

*Continued*

### **Board Performance**

The AIC Code requires external evaluation of Board performance every three years. The last instance of which was in April 2016.

The Board, Audit Committee, Management Engagement Committee and Nominations Committee undertake an evaluation of their own performance and that of individual Directors on an annual basis. In order to review their effectiveness, the Board and its Committees carry out a process of formal self-appraisal. The Board and Committees consider how they function as a whole and also review the individual performance of its members. This process is conducted by the respective Chairman reviewing each members' performance, contribution and commitment to the Company. Each Board member provides proof of ongoing training and maintenance of continuing professional development requirements.

The Board considers it has a breadth of experience relevant to the Company, and the Directors believe that any changes to the Board's composition can be managed without undue disruption. An induction programme has been prepared for any future Director appointments.

### **Supply of Information**

The quarterly board meetings are the principal source of regular information for the Board enabling it to determine policy and to monitor performance and compliance. The Manager attends each Board meeting either in person or by telephone thus enabling the Board to fully discuss and review the Company's operation and performance. Each Director has direct access to the Company Secretary, and may, at the expense of the Company, seek independent professional advice on any matter that concerns them in the furtherance of their duties.

### **Committees of the Board**

The Board has established Nomination, Audit and Management and Engagement Committees and approved their Terms of Reference, copies of which can be obtained from the Administrator.

### **Nomination Committee**

The Board as a whole fulfils the function of a Nomination Committee. Whilst the independent Directors take the lead in the appointment of new Directors, any proposal for a new Director will be discussed and approved by the entire Board during quarterly Board meetings.

The Board has also given careful consideration to the recommendations of the Davies Report on "Women on Boards". As recommended in the Davies Report, the Board has reviewed its composition and believes that the current appointments provide an appropriate range of skills, experience and diversity. The Board will take into account the recommendations of the Davies Report as part of its succession planning over future years.

### **Audit Committee**

An audit committee has been appointed comprising the Independent Directors. The Audit Committee operates within clearly defined terms of reference which have been approved by the Board and provides a forum through which the Company's external Auditors report to the Board. The Board is satisfied that the Audit Committee contains members with sufficient recent and relevant financial reporting experience.

The Audit Committee has considered the requirement for an annual internal audit of the Company. On the basis that the Company is an investment company with no employees, the Audit Committee believes that an internal audit function is not necessary for the Company.

The table on page 16 sets out the number of Audit Committee Meetings held during the year ended 31 December, 2016 and the number of such meetings attended by each Committee member.

The Audit Committee Report detailing responsibilities and activities is presented on pages 22 to 25.

# THE PROSPECT JAPAN FUND LIMITED

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## DIRECTORS' REPORT

*Continued*

### **Management and Engagement Committee**

The Management and Engagement Committee comprises the Independent Directors. The Management and Engagement Committee operates within clearly defined terms of reference which have been approved by the Board.

The purpose of this Committee is to review the performance of the Investment Advisor, Manager and the third party service providers to the Company. As the Board has evaluated their performance during the course of their regular meetings and found it satisfactory, the Board conclude that the continuing appointment of the parties on the terms agreed would be in the best interests of the Company's shareholders as a whole. At the date of this report the Board continues to be of the same opinion.

The table on page 16 sets out the number of Management Engagement Meetings held during the year ended 31 December, 2016 and the number of such meetings attended by each Committee member.

### **Directors' Remuneration**

The level of Directors' fees is determined by the whole Board on an annual basis and therefore a separate Remuneration Committee has not been appointed. When considering the level of Directors' remuneration the Board considers the industry standard and the level of work that is undertaken.

During the year ended 31 December, 2016, the Directors were entitled to receive an annual fee of £25,000 (2015: £25,000), the Chairman of the Audit Committee £27,500 (2015: £27,500) and the Chairman of the Board £30,000 (2015: £30,000).

### **Going Concern**

In accordance with the Company's Articles, the Board is required every three years to include in the business to be considered by shareholders at the Annual General Meeting a Special Resolution that the Company should be wound up. The last such resolution was tabled at the eighteenth Annual General Meeting held in 2014. The Shareholders voted against the resolution, and in favour of the continuation of the Company. As announced on 10 January, 2017 (the "Possible Offer Announcement"), the independent directors of the Company are in preliminary discussions regarding a possible offer from Prospect Co., Ltd ("Prospect") for the entire issued and to be issued share capital of the Company. The possible offer is under consideration, discussion and evaluation by both parties. The Possible Offer Announcement does not amount to a firm intention to make an offer under Rule 2.7 of The City Code on Takeovers and Mergers, and as stated in the Possible Offer Announcement there can be no certainty that an offer for the Company will ultimately be made. If such a transaction: (i) was to be announced in accordance with Rule 2.7 of The City Code on Takeovers and Mergers; and (ii) was to be completed prior to the 2017 AGM, no AGM would be held and no discontinuation vote would take place. Whilst acknowledging the uncertainty of the possible offer, and the upcoming vote for discontinuation, the fact that neither the Board nor the Investment Advisor have received any indication that the Shareholders are no longer in favour of the investment policy and that the assets of the Company consist mainly of securities that are readily realisable, leads the Directors to believe that the discontinuation vote will not be passed and that the Company has adequate financial resources to meet its liabilities as they fall due for at least twelve months from the date of this report, and that it is therefore appropriate for the Financial Statements to be prepared on a going concern basis. Factors regarding the going concern basis are also discussed in Note 1 of the Financial Statements.

### **Internal Control**

The Board is ultimately responsible for establishing and maintaining the Company's system of internal financial and operating control and for maintaining and reviewing its effectiveness. The Company's risk matrix continues to be the core element of the Company's risk management process in establishing the Company's system of internal financial and reporting control.

The risk matrix is prepared and maintained by the Board which initially identifies the risks facing the Company and then collectively assesses the likelihood of each risk, the impact of those risks and the strength of the controls operating over each risk. The system of internal financial and operating control is designed to manage rather than to eliminate the risk of failure to achieve business objectives and by their nature can only provide reasonable and not absolute assurance against misstatement and loss.

# THE PROSPECT JAPAN FUND LIMITED

## DIRECTORS' REPORT

*Continued*

### Internal Control

*Continued*

These controls aim to ensure that assets of the Company are safeguarded, proper accounting records are maintained and the financial information for publication is reliable. The Board confirms that there is an ongoing process for identifying, evaluating and managing the significant risks faced by the Company.

This process has been in place for the year under review and up to the date of approval of this Annual Report and Audited Financial Statements and is reviewed by the Board and is in accordance with the AIC Code and Internal Controls: Revised Guidance for Directors on the Combined Code.

The AIC Code requires Directors to conduct at least annually a review of the Company's system of internal financial and operating control, covering all controls, including financial, operational, compliance and risk management. The Board has evaluated the systems of internal controls of the Company. In particular, it has prepared a process for identifying and evaluating the significant risks affecting the Company and the policies by which these risks are managed.

The Board has delegated the day to day responsibilities for the management of the Company's investment portfolio, the provision of depositary services and administration, registrar and corporate secretarial functions including the independent calculation of the Company's NAV and the production of the Annual Report and Financial Statements which are independently audited.

Formal contractual agreements have been put in place between the Company and providers of these services. Even though the Board has delegated responsibility for these functions, it retains accountability for these functions and is responsible for the systems of internal control. At each quarterly Board meeting, compliance reports are provided by the Administrator, Company Secretary and Portfolio Manager. The Board also receives confirmation from the Administrator of its accreditation under its Service Organisation Controls 1 report.

The Company's risk exposure and the effectiveness of its risk management and internal control systems are reviewed by the Audit Committee at its quarterly meetings and annually by the Board.

The Board believes that the Company has adequate and effective systems in place to identify, mitigate and manage the risks to which it is exposed.

### Directors' and Other Interests

No Directors holding office at 31 December, 2016, or their associates, had any beneficial interest in the Company's Shares (2015: None). There has been no change in this position between the end of the year and the date of this report.

Rupert Evans is a Director of the Manager and a former partner in the firm of the Guernsey legal advisors, Mourant Ozannes. John Hawkins and Richard Battey are Directors of a range of funds.

### Substantial Shareholdings

The following table shows the interests in the share capital of the Company exceeding 5% of the issued share capital of which the Company has been notified.

#### TOP HOLDINGS

	As at 31 December 2016		As at 21 March 2017	
	Number of shares	Percentage of issued share capital	Number of shares	Percentage of issued share capital
Lazard Asset Management	22,041,625	23.87%	23,324,778	25.26%
1607 Capital Partners	19,863,439	21.51%	18,122,488	19.62%
CG Asset Management	14,247,936	15.43%	12,247,936	13.26%
Weiss Asset Management	2,870,506	3.11%	8,920,506	9.66%

# THE PROSPECT JAPAN FUND LIMITED

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## DIRECTORS' REPORT

*Continued*

### Substantial Shareholdings

*Continued*

There have been no other notifications of significant changes to the substantial shareholdings at 21 March, 2017.

The percentage of ordinary shares shown above represents the ownership of voting rights at the year end, before weighting for votes in Directors.

It is the responsibility of the shareholders to notify the Company of any change to their shareholdings when it reaches 5% of shares in issue and any change which moves up or down through any whole percentage figures above 5%.

### Share buybacks

As approved at the AGM on 18 August, 2016, the Company may purchase, subject to various terms as set out in the Articles, a maximum of 13,843,655 Ordinary Shares under the Company's discount control mechanism. During the year to 31 December, 2016, the Company purchased 100,000 shares (2015: nil shares) as detailed in Note 9 on page 42 of the Financial Statements.

### Auditors

The Auditors, Ernst & Young LLP have indicated their willingness to continue in office and offer themselves for re-appointment at the forthcoming AGM.

**John Hawkins**

*Chairman*

**Richard Battey**

*Director*

21 March, 2017

# THE PROSPECT JAPAN FUND LIMITED

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## DISCLOSURE OF DIRECTORSHIPS IN PUBLIC COMPANIES LISTED ON RECOGNISED STOCK EXCHANGES

for the year ended 31 December, 2016

The following summarises the Directors' directorships in other public companies

<b>Directorships Company Name</b>	<b>Stock Exchange</b>
<b>Richard Battey</b>	
Acencia Debt Strategies Limited	London
Juridica Investments Limited	London
Princess Private Equity Holding Limited	London
Better Capital PCC Limited	London
NB Global Floating Rate Income Fund Limited	London
Pershing Square Holdings Limited	Euronext
<b>Rupert Evans</b>	
El Oro Limited	Channel Islands
Oryx International Growth Fund Limited	London
The Red Fort Partnership Limited	Channel Islands
Stonehage Fleming Global Property Fund PCC Limited	Channel Islands
FF&P Ventures Funds PCC Limited	Channel Islands
Master Capital Fund Limited	Irish
<b>John Hawkins</b>	
Aberdeen Greater China Fund, Inc.	New York
Aberdeen Emerging Markets Investment Company Limited	London

# THE PROSPECT JAPAN FUND LIMITED

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## AUDIT COMMITTEE REPORT

On the following pages, we present the Audit Committee (the “Committee”) Report for 2016, setting out the Committee’s structure and composition, principal duties and key activities during the year. As in previous years, the Committee has reviewed the Company’s financial reporting, the independence and effectiveness of the independent auditor and the internal control and risk management systems of service providers.

A member of the Committee will continue to be available at each AGM to respond to any shareholder questions on the activities of the Committee.

### **Role and responsibilities**

The function of the Audit Committee is to ensure that the Company maintains the highest standards of integrity of its financial reporting and internal control.

The responsibilities of the Committee are:

- To review and make recommendations on the appointment of the Company’s Auditors, the scope of the audit, the audit fee, their independence and objectivity and any questions of the resignation or dismissal of the Auditors;
- To discuss with the Auditors the nature and scope of the audit and to keep under review such scope and its cost-effectiveness;
- To receive and review a Report from the Company’s Auditors and to discuss any matters arising from the audit and recommendations made by them;
- To review the Company’s half-year and Annual Report and Financial Statements and any other financial information published by the Company, in each case before issue or publication, prior to submission to the Board, having particular regard to:
  - the accounting policies and whether they continue to be appropriate for the business;
  - any changes in accounting policies or practices and whether they are appropriate for the business;
  - any important areas where judgement must be exercised e.g. valuation of unquoted investments;
  - any significant adjustments arising from the audit;
  - the going concern assumption; and
  - other legal, UK Listing Authority or recognised investment exchange requirements.
- To advise the Board on whether the Annual Report and Financial Statements, taken as a whole, are fair, balanced and understandable and provide the information necessary for shareholders to assess the Company’s performance, business model and strategy.
- To ensure that the internal control systems of the service providers are adequate. To receive reports from the Company’s service providers covering internal control systems, internal audit functions and procedures supported either by SSAE 16, ISAE 3402 or AAF Reports. In light of the above, to review the Company’s statement on internal controls prior to endorsement by the Board;
- To monitor the Company’s procedures for ensuring compliance with statutory, regulatory and other financial reporting requirements i.e. the Guernsey Financial Services Commission and the London Stock Exchange (which includes the UK Listing Authority);
- To review significant transactions outside the Company’s normal business (e.g. Company share buy backs); and
- To consider any other topics referred to it by the Board.

The Audit Committee’s full terms of reference can be obtained by contacting the Administrator.



# THE PROSPECT JAPAN FUND LIMITED

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## AUDIT COMMITTEE REPORT

*Continued*

### **Membership**

The members of the Committee are Richard Battey (Chairman) and John Hawkins. Full biographical details of each member can be found on page 54. All members attended the formal Audit Committee meetings held during the year. In addition a number of ad hoc meetings were held with the Auditors to discuss financial reporting matters.

### **Significant issues related to the financial statements**

The Committee's review of the interim and annual financial statements focused on the following areas:

- The Committee has concentrated on the investment issues of existence and title in respect of the Company's portfolio holdings as a whole. 89.8% by value of the investments are quoted investments and are held in a designated account at the Custodian.
- The valuation of its unlisted holdings which are dealt with in more detail below.
- Going Concern – In accordance with the Company's Articles, the Board is required every three years to include in the business to be considered by shareholders at the Annual General Meeting a Special Resolution that the Company should be wound up. The last such resolution was tabled at the eighteenth Annual General Meeting held in 2014. The Shareholders voted against the resolution, and in favour of the continuation of the Company. As announced on 10 January 2017 (the "Possible Offer Announcement"), the independent directors of the Company are in preliminary discussions regarding a possible offer from Prospect Co., Ltd ("Prospect") for the entire issued and to be issued share capital of the Company. The possible offer is under consideration, discussion and evaluation by both parties. The Possible Offer Announcement does not amount to a firm intention to make an offer under Rule 2.7 of The City Code on Takeovers and Mergers, and as stated in the Possible Offer Announcement there can be no certainty that an offer for the Company will ultimately be made. If such a transaction: (i) was to be announced in accordance with Rule 2.7 of The City Code on Takeovers and Mergers; and (ii) was to be completed prior to the 2017 AGM, no AGM would be held and no discontinuation vote would take place. Whilst acknowledging the uncertainty of the possible offer, and the upcoming vote for discontinuation, the fact that neither the Board nor the Investment Advisor have received any indication that the Shareholders are no longer in favour of the investment policy and that the assets of the Company consist mainly of securities that are readily realisable, leads the Directors to believe that the discontinuation vote will not be passed and that the Company has adequate financial resources to meet its liabilities as they fall due for at least twelve months from the date of this report, and that it is therefore appropriate for the Financial Statements to be prepared on a going concern basis. Factors regarding the going concern basis are also discussed in Note 1 of the Financial Statements.

### **Key activities and significant risks**

Going concern as described above.

The investment manager has built a concentrated portfolio of small and medium sized enterprises and the Committee appreciates that there are significant risks inherent in that investment policy compared with a wider spread in larger quoted companies. There is also a material exposure to regional banks at the year-end giving a 50.5% of NAV direct exposure (2015: 28.66%).

The Company holds one unlisted investment. Following advice from the Investment Manager and per requirements under IFRS, the Committee considers the valuation of this investment in detail. For further details on the Investment policies and the valuation of unlisted investments, please see Note 14 of the Financial Statements.

The Manager and Administrator confirmed to the Committee that they were not aware of any material misstatements including matters relating to presentation. The Committee advised the Board that this Annual Report and Financial Statements, taken as a whole, is fair, balanced and understandable.

Following a review of the presentations and reports from the Administrator and after consulting where necessary with the external Auditor, the Committee is satisfied that the Financial Statements appropriately address the critical judgements and key estimates (both in respect to the amounts reported and the disclosures). The Committee is also satisfied that the significant assumptions used for determining the value of assets have been appropriately scrutinised, challenged and are sufficiently robust. Further details on the significant assumptions used for determining the value of assets can be found in Note 14 of the Financial Statements.

# THE PROSPECT JAPAN FUND LIMITED

## AUDIT COMMITTEE REPORT

*Continued*

### Risk Management

After consultation with the Manager and external Auditor, the Audit Committee continues to consider the risks faced by the Company and its service providers and the process for managing them.

Risk management procedures for the Company, as set out in the Company's risk assessment matrix, were reviewed and approved by the Audit Committee at each Quarterly Board Meeting.

The Committee reviews and examines externally prepared assessments of the control environment in place at the Manager and the Administrator, with the Manager and Administrator providing a SOC1 report covering internal control systems and procedures supported either by SSAE 16, ISAE 3402 or AAF Reports, on an annual basis and a bi-annual basis respectively. No significant failings or weaknesses were identified in these reports by the Committee. There were no changes in risk management or internal control systems during the year.

The Committee has considered the requirement for an annual internal audit of the Company. On the basis that the Company is an investment company with no employees, the Audit Committee believes that an internal audit function is not necessary for the Company.

### External Audit

#### Independence, Objectivity and Fees

The independence and objectivity of the independent auditor is regularly reviewed by the Audit Committee which also reviews the terms under which the independent auditor is appointed to perform non-audit services. The Audit Committee has established pre-approval policies and procedures for the engagement of the independent auditor to provide audit and non-audit services.

These are that the independent auditors may not provide a service which:

- places them in a position to audit their own work;
- creates a mutuality of interest;
- results in the independent auditor developing close relationships with service providers of the Company;
- results in the independent auditor functioning as a manager or employee of the Company; or
- puts the independent auditor in the role of advocate of the Company.

The Audit Committee considered reports from the independent auditor on their procedures to identify and mitigate any threats to independence and concluded that the procedures were sufficient to identify any threats to independence.

The following table summarises the remuneration paid to Ernst & Young LLP for audit and non-audit services provided to the Company during the years ended 31 December, 2016 and 31 December, 2015:

	<b>01.01.2016 to 31.12.2016 in GB Pounds</b>	<b>01.01.2015 to 31.12.2015 in GB Pounds</b>
<b>Ernst &amp; Young LLP</b>		
Annual audit	37,400	41,550
Auditor's interim review	19,300	14,000
	<u>56,700</u>	<u>55,550</u>

In line with the policies and procedures above, the Audit Committee does not consider that the provision of these non-audit services to be a threat to the objectivity and independence of the independent auditor.

Ernst & Young LLP has been the Company's independent auditor since 28 June, 2001. The Audit Committee has examined the scope and results of the external audit, its cost effectiveness and the independence and objectivity of the independent auditor, with particular regard to non-audit fees, and considers Ernst & Young LLP, as independent auditor, to be independent of the Company.

# THE PROSPECT JAPAN FUND LIMITED

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## AUDIT COMMITTEE REPORT

*Continued*

### **Performance and effectiveness**

During the year, when considering the effectiveness of the independent auditor, the Audit Committee has taken into account the following factors:

- the audit plan presented to them;
- the audit findings report including variations from the original plan;
- changes in audit personnel;
- the independent auditor's own internal procedures to identify threats to independence; and
- feedback from both the Manager and Administrator.

The Audit Committee reviewed the audit plan and the audit findings report of the independent auditor and concluded that the audit plan sufficiently identified audit risks and that the audit findings report indicated that the audit risks were sufficiently addressed and that there were no significant variations from the audit plan.

### **Reappointment**

Consequent to the review discussed above, the Audit Committee has recommended to the Board that a resolution be put to the 2016 AGM for the reappointment of Ernst & Young LLP as independent auditor. The Board has accepted this recommendation.

### **Fraud, Bribery and Corruption**

The Audit Committee continues to monitor the fraud, bribery and corruption policies of the Company. The Board receives a confirmation from all service providers that there have been no instances of fraud or bribery.

As the Company has no employees, the Committee does not consider that a whistle-blowing policy is required. However, the Directors have satisfied themselves that the Company's service providers have appropriate whistle-blowing policies and procedures and seek regular confirmation from the service providers that nothing has arisen under those policies and procedures which should be brought to the attention of the Board.

**Richard Battey**

**Chairman, Audit Committee**

21 March, 2017

# THE PROSPECT JAPAN FUND LIMITED

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## INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE PROSPECT JAPAN FUND LIMITED

### Our opinion on the financial statements

In our opinion:

- The Prospect Japan Fund Limited's (the "Company") financial statements (the "financial statements") give a true and fair view of the state of the Company's affairs as at 31 December, 2016 and of its loss for the year then ended;
- the financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union ("IFRSs");
- the financial statements have been prepared in accordance with the requirements of the Companies (Guernsey) Law 2008.

### What we have audited

The Prospect Japan Fund Limited's financial statements comprise:

- Statement of comprehensive income for the year ended 31 December, 2016;
- Statement of financial position as at 31 December, 2016;
- Statement of changes in equity for the year ended 31 December, 2016;
- Statement of cash flows for the year ended 31 December, 2016; and
- Related notes 1 to 18 to the financial statements

The financial reporting framework that has been applied in their preparation is applicable law and IFRS.

### Overview of our audit approach

Risk of material misstatement	• Valuation of unquoted investments
Audit scope	• We performed an audit of the complete financial statements of the Company for the year ended 31 December, 2016.
Materiality	• Overall materiality of US\$1.22 million which represents 1% of total equity.

### Our assessment of risk of material misstatement

We identified the risk of material misstatement described below as that which had the greatest effect on our overall audit strategy, the allocation of resources in the audit and the direction of the efforts of the audit team. In addressing this risk, we have performed the procedures below which were designed in the context of the financial statements as a whole and, consequently, we do not express any opinion on this individual area.

# THE PROSPECT JAPAN FUND LIMITED

## INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE PROSPECT JAPAN FUND LIMITED

*Continued*

Risk	Our response to the risk	What we concluded to the Audit Committee
<p><b>Valuation of unquoted investments (US\$9,990,744 PY comparative US\$2,518,957)</b></p> <p><i>Refer to the Audit Committee Report (page 23); Accounting policies in Note 1 (page 39); and Note 14 of the Financial Statements</i></p> <p>Unquoted investments relates to the Company's holding in Stock Acquisition Rights ("SARs") issued by Prospect Co. Ltd. The Prospect Co. Ltd SARs were valued using the Black-Scholes-Merton model.</p> <p>The valuation is highly subjective with a high level of judgement and estimation linked to the determination of the values with limited market information available. Therefore there is a risk of an inappropriate valuation model being applied, together with the risk of inappropriate inputs to the model/calculation being selected.</p>	<ul style="list-style-type: none"> <li>• We documented our understanding of the processes, policies and methodologies used by management for valuing investments held by the Company and performed walkthrough tests to confirm our understanding of the systems and controls implemented.</li> <li>• We agreed the valuation per the financial statements to the model used by management, agreed all inputs to the model to independent sources and evaluating whether all key terms of the SARs had been considered in the application of the model;</li> <li>• We engaged our internal valuation experts to             <ul style="list-style-type: none"> <li>– assist us to determine whether the methodologies used to value investments were consistent with methods ordinarily applied by market participants for these types of investments; and</li> <li>– use their knowledge of the market to assess and corroborate management's market related judgements and valuation inputs (including risk free interest rates, volatility rate, dividend yield, dilution impact and restrictions on exercising the SARs) by reference to our specialists' knowledge of comparable transactions, and independently compiled databases/indices.</li> </ul> </li> </ul>	<p>During the audit process, we discussed with the Audit Committee that there was insufficient evidence to support the initial valuation estimate of the SARs based on the fact that the model applied had not taken into consideration the dilution impact of the future exercise of the SARs. Management revised the model resulting in an adjustment to the SARs valuation to the current carrying amount of US\$10 million which we concluded was not materially misstated.</p>

# THE PROSPECT JAPAN FUND LIMITED

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## INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE PROSPECT JAPAN FUND LIMITED

*Continued*

### **The scope of our audit**

#### **Tailoring the scope**

Our assessment of audit risk, our evaluation of materiality and our allocation of performance materiality determine our audit scope which enable us to form an opinion on the financial statements under International Standards on Auditing (UK and Ireland).

#### **Our application of materiality**

We apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion.

#### **Materiality**

*This is the magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements. Materiality provides a basis for determining the nature and extent of our audit procedures.*

We determined materiality for the Company to be US\$1.22 million (2015: US\$1.25 million), which is 1% (2015: 1%) of total equity. This provided a basis for determining the nature, timing and extent of risk assessment procedures, identifying and assessing the risk of material misstatement and determining the nature, timing and extent of further audit procedures.

It was considered inappropriate to determine materiality based on Company profit before tax as the primary focus of the Company is the overall performance of investments held which includes a significant asset revaluation component. In addition, profit is not a key metric reported upon by the Company, with the ability to make dividend payments not limited by the profitability of the Company in any particular period.

We believe that total equity provides us with an appropriate basis for audit materiality as net asset value is a key published performance measure and is a key metric used by management in assessing and reporting on the overall performance of the Company.

During the course of our audit, we reassessed initial materiality and noted no factors leading us to amend materiality levels from those originally determined at the audit planning stage.

#### **Performance materiality**

*This refers to the application of materiality at the individual account or balance level. It is set at an amount to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.*

On the basis of our risk assessments, together with our assessment of the Company's overall control environment, our judgement was that performance materiality was 75% (2015: 75%) of our planning materiality, namely US\$914k (2015: US\$940k). We have set performance materiality at this percentage due to investment strategy remaining consistent with our previous experience and limited identification of audit findings in previous periods.

#### **Reporting threshold**

*An amount below which identified misstatements are considered as being clearly trivial.*

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of US\$61k (2015: US\$63k), which is set at 5% of planning materiality, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations in forming our opinion.

# THE PROSPECT JAPAN FUND LIMITED

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## INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE PROSPECT JAPAN FUND LIMITED

*Continued*

### **Scope of the audit of the financial statements**

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

### **Respective responsibilities of directors and auditor**

As explained more fully in the Directors' Responsibilities Statement set out on pages 14 and 15, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report is made solely to the Company's members, as a body, in accordance with Section 262 of the Companies (Guernsey) Law 2008. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

# THE PROSPECT JAPAN FUND LIMITED

## INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE PROSPECT JAPAN FUND LIMITED

*Continued*

### Matters on which we are required to report by exception

<p><b>ISAs (UK and Ireland) reporting</b></p>	<p>We are required to report to you if, in our opinion, financial and non-financial information in the annual report is:</p> <ul style="list-style-type: none"> <li>• materially inconsistent with the information in the audited financial statements; or</li> <li>• apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Company acquired in the course of performing our audit; or</li> <li>• otherwise misleading.</li> </ul> <p>In particular, we are required to report whether we have identified any inconsistencies between our knowledge acquired in the course of performing the audit and the directors' statement that they consider the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity's performance, business model and strategy; and whether the annual report appropriately addresses those matters that we communicated to the audit committee that we consider should have been disclosed.</p>	<p>We have no exceptions to report.</p>
<p><b>Companies (Guernsey) Law 2008 reporting</b></p>	<p>We are required to report to you if, in our opinion:</p> <ul style="list-style-type: none"> <li>• proper accounting records have not been kept; or</li> <li>• the financial statements are not in agreement with the accounting records; or</li> <li>• we have not received all the information and explanations we require for our audit.</li> </ul>	<p>We have no exceptions to report.</p>
<p><b>Listing Rules review requirements</b></p>	<p>We are required to review:</p> <ul style="list-style-type: none"> <li>• The directors' statement in relation to going concern set out on page 18 and longer-term viability, set out on page 13 respectively; and</li> <li>• the part of the Corporate Governance Statement relating to the Company's compliance with the provisions of the UK Corporate Governance Code specified for our review.</li> </ul>	<p>We have no exceptions to report.</p>



# THE PROSPECT JAPAN FUND LIMITED

## INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE PROSPECT JAPAN FUND LIMITED

*Continued*

### Statement on the Directors' Assessment of the Principal Risks that Would Threaten the Solvency or Liquidity of the Entity

<b>ISAs (UK and Ireland) reporting</b>	We are required to give a statement as to whether we have anything material to add or to draw attention to in relation to: <ul style="list-style-type: none"><li>• the directors' confirmation in the annual report that they have carried out a robust assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity;</li><li>• the disclosures in the annual report that describe those risks and explain how they are being managed or mitigated;</li><li>• the directors' statement in the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and their identification of any material uncertainties to the entity's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements; and</li><li>• the directors' explanation in the annual report as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.</li></ul>	We have nothing material to add or to draw attention to other than as explained in the "Emphasis of matter" paragraph above.
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Christopher James Matthews, FCA  
for and on behalf of Ernst & Young LLP  
Guernsey, Channel Islands  
21 March, 2017

#### Notes:

1. *The maintenance and integrity of the Company's web site is the responsibility of the Directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the web site.*
2. *Legislation in the Guernsey governing the preparation and dissemination of group financial statements may differ from legislation in other jurisdictions.*

# THE PROSPECT JAPAN FUND LIMITED

## STATEMENT OF COMPREHENSIVE INCOME

for the year ended 31 December, 2016

Notes	Revenue	Capital	Total	Revenue	Capital	Total
	01.01.2016 to 31.12.2016	01.01.2016 to 31.12.2016	01.01.2016 to 31.12.2016	01.01.2015 to 31.12.2015	01.01.2015 to 31.12.2015	01.01.2015 to 31.12.2015
	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars
Investment income	2,067,155	–	2,067,155	1,334,322	–	1,334,322
Interest income	–	–	–	108,112	–	108,112
Foreign exchange movements	–	1,044,768	1,044,768	471,537	–	471,537
Loss on financial assets at fair value through profit or loss	–	(828,874)	(828,874)	–	(2,189,023)	(2,189,023)
<b>Total income</b>	<b>2,067,155</b>	<b>215,894</b>	<b>2,283,049</b>	<b>1,913,971</b>	<b>(2,189,023)</b>	<b>(275,052)</b>
4 Management fee	(1,856,441)	–	(1,856,441)	(1,744,965)	–	(1,744,965)
5 Other expenses	(1,087,394)	–	(1,087,394)	(1,128,764)	–	(1,128,764)
Foreign exchange movements	(2,024,456)	–	(2,024,456)	–	(247,561)	(247,561)
Transaction costs	–	(260,045)	(260,045)	–	(230,445)	(230,445)
Bank interest	(13,951)	–	(13,951)	–	–	–
<b>Total expenses</b>	<b>(4,982,242)</b>	<b>(260,045)</b>	<b>(5,242,287)</b>	<b>(2,873,729)</b>	<b>(478,006)</b>	<b>(3,351,735)</b>
Loss for the year before tax	(2,915,087)	(44,151)	(2,959,238)	(959,758)	(2,667,029)	(3,626,787)
3 Withholding tax	(316,585)	–	(316,585)	(499,671)	–	(499,671)
Loss for the year after tax	(3,231,672)	(44,151)	(3,275,823)	(1,459,429)	(2,667,029)	(4,126,458)
Loss for the year	(3,231,672)	(44,151)	(3,275,823)	(1,459,429)	(2,667,029)	(4,126,458)
<b>2 Loss per Ordinary Share – Basic &amp; Diluted (in Cents)</b>	<b>(3.50)</b>	<b>(0.05)</b>	<b>(3.55)</b>	<b>(1.58)</b>	<b>(2.88)</b>	<b>(4.46)</b>

The “Total” column of this statement represents the Company’s Statement of Comprehensive Income, prepared in accordance with IFRS. The supplementary ‘Revenue’ and ‘Capital’ columns are both prepared under guidance published by the Association of Investment Companies. There was no comprehensive income other than the gain/(loss) for the year.

All items in the above statement derive from continuing operations.

The notes on pages 36 to 52 form an integral part of the Financial Statements.

# THE PROSPECT JAPAN FUND LIMITED

## STATEMENT OF FINANCIAL POSITION

as at 31 December, 2016

Notes	31.12.2016 In U.S. Dollars	31.12.2015 In U.S. Dollars
<b>Non-current assets</b>		
6 Financial assets at fair value through profit or loss	98,377,672	106,417,543
<b>Current assets</b>		
7 Receivables	1,189,423	399,051
Cash and cash equivalents	22,688,931	19,009,538
<b>Total current assets</b>	<b>23,878,354</b>	<b>19,408,589</b>
<b>Current liabilities</b>		
8 Payables	332,566	529,153
<b>Net current assets</b>	<b>23,545,788</b>	<b>18,879,436</b>
<b>Net assets</b>	<b>121,923,460</b>	<b>125,296,979</b>
<b>Equity</b>		
9 Stated capital	92,352	92,452
9 Redemption reserve	85,435,381	85,533,077
9 Capital redemption reserve	323,157	323,057
Other reserves	36,072,570	39,348,393
<b>Total equity</b>	<b>121,923,460</b>	<b>125,296,979</b>
Ordinary Shares in issue	92,352,602	92,452,602
2 Net Asset Value per Ordinary Share (in cents)	132.02	135.53

The Financial Statements on pages 32 to 52 were approved by the Board of Directors on 21 March, 2017 and signed on its behalf by:

**John Hawkins**  
*Chairman*

**Richard Battey**  
*Director*

The notes on pages 36 to 52 form an integral part of the Financial Statements.

# THE PROSPECT JAPAN FUND LIMITED

## STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December, 2016

	Share Capital Account	Capital Redemption Reserve	Redemption Reserve	Revenue Reserve	Capital Reserve/ Realised	Capital Reserve/ Unrealised	Capital Reserve/ Exchange Differences	Total
	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars	In U.S. Dollars
<b>Balances at 1 January, 2016</b>	92,452	323,057	85,533,077	(16,365,019)	67,395,805	(6,825,610)	(4,856,783)	125,296,979
<b>Total comprehensive income/ (expense) for the period</b>								
(Loss)/gain for the period after tax	–	–	–	(3,231,672)	(2,480,866)	1,391,947	1,044,768	(3,275,823)
<b>Capital activities</b>								
Repurchase of shares	(100)	100	(97,696)	–	–	–	–	(97,696)
<b>Balances at 31 December, 2016</b>	92,352	323,157	85,435,381	(19,596,691)	64,914,939	(5,433,663)	(3,812,015)	121,923,460
<b>Balances at 1 January, 2015</b>	92,452	323,057	85,533,077	(14,905,590)	53,873,130	9,116,533	(4,609,222)	129,423,437
<b>Total comprehensive income/ (expense) for the period</b>								
(Loss)/gain for the period after tax	–	–	–	(1,459,429)	13,522,675	(15,942,143)	(247,561)	(4,126,458)
<b>Capital activities</b>								
Repurchase of shares	–	–	–	–	–	–	–	–
<b>Balances at 31 December, 2015</b>	92,452	323,057	85,533,077	(16,365,019)	67,395,805	(6,825,610)	(4,856,783)	125,296,979

The notes on pages 36 to 52 form an integral part of the Financial Statements.

# THE PROSPECT JAPAN FUND LIMITED

## STATEMENT OF CASH FLOWS

for the year ended 31 December, 2016

Notes	01.01.2016 to 31.12.2016 In U.S. Dollars	01.01.2015 to 31.12.2015 In U.S. Dollars
<b>Cash flows from operating activities</b>		
10 Net cash outflow from operating activities	(5,347,772)	(2,998,658)
Interest received	–	108,112
Interest paid	(13,951)	–
Dividends received	2,098,471	1,334,322
Net cash outflow from operating activities	<u>(3,263,252)</u>	<u>(1,556,224)</u>
<b>Cash flows from investing activities</b>		
Purchase of investments	(68,253,522)	(70,769,961)
Sale of investments	74,249,095	86,178,648
Net cash inflow from investing activities	<u>5,995,573</u>	<u>15,408,687</u>
<b>Net cash inflow before financing activities</b>	2,732,321	13,852,463
<b>Cash flows from financing activities</b>		
9 Repurchase of shares	(97,696)	–
Net cash outflow from financing activities	<u>(97,696)</u>	<u>–</u>
<b>Increase in cash and cash equivalents</b>	<u>2,634,625</u>	<u>13,852,463</u>
<b>Reconciliation of net cash flow to movement in net funds</b>		
Net cash inflow	2,634,625	13,852,463
Effects of foreign exchange rate changes	1,044,768	(247,561)
Cash and cash equivalents at beginning of the year	19,009,538	5,404,636
<b>Cash and cash equivalents at end of the year</b>	<u>22,688,931</u>	<u>19,009,538</u>

The notes on pages 36 to 52 form an integral part of the Financial Statements.

# THE PROSPECT JAPAN FUND LIMITED

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## NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December, 2016

### Note 1 Principal Accounting Policies

The following accounting policies have been applied consistently in dealing with items which are considered to be material in relation to the Company's Financial Statements:

#### Basis of preparation

The Financial Statements are prepared in accordance with International Financial Reporting Standards ("IFRS") adopted by the European Union, which comprise standards and interpretations approved by the International Accounting Standards Board (IASB) and are in compliance with The Companies (Guernsey) Law, 2008. The Financial Statements have been prepared on a going concern basis under the historical cost convention, as modified by the revaluation of financial assets at fair value through profit or loss.

#### Presentation of information

Where presentational guidance set out in the Statement of Recommended Practice ("SORP") for Investment Companies issued by the Association of Investment Companies ("AIC") in November 2014 is consistent with the requirements of IFRS, the Directors have sought to prepare the Financial Statements on a basis compliant with the SORP. Supplementary information which analyses the Statement of Comprehensive Income between items of a revenue and capital nature has been presented within the Statement of Comprehensive Income.

#### Standards, amendments and interpretations effective during the year with relevance to the Company

The following amendments were applicable for the first time this year but had no impact on the financial position or performance of the Company.

- IFRS 10 (Amendments) – Consolidated Financial Statements (effective 1 January, 2016)
- IFRS 12 (Amendments) – Disclosure of Interests in Other Entities (effective 1 January, 2016)
- IAS 1 (Amendments) – Disclosure Initiative (effective 1 January, 2016)
- IAS 7 (Amendments) – Statement of Cash Flows (effective 1 January, 2016)
- IAS 27 (Amendments) – Separate Financial Statements (effective 1 January, 2016)
- IAS 28 (Amendments) – Investments in Associates and Joint Ventures (effective 1 January, 2016)

#### *Investment Entities, Applying the Consolidation Exception*

Narrow-scope amendments to IFRS 10, IFRS 12 and IAS 28 introduce clarifications to the requirements when accounting for investment entities. The amendments also provide relief in particular circumstances, which will reduce the costs of applying the Standards.

#### Standards, amendments and interpretations issued but not yet effective with relevance to the Company

- IFRS 9 Financial Instruments – (effective 1 January, 2018)
- IAS 34 – Interim Financial Reporting (Disclosure of information elsewhere in the interim accounts) (Annual improvements process)

#### *IFRS 9, Financial Instruments*

In July 2014, the IASB issued the final version of IFRS 9 Financial Instruments which reflects all phases of the financial instruments project and replaces IAS 39 Financial Instruments: Recognition and Measurement and all previous versions of IFRS 9. The standard introduces new requirements for classification and measurement, impairment, and hedge accounting. IFRS 9 is effective for annual periods beginning on or after 1 January 2018, with early application permitted. Retrospective application is required, but comparative information is not compulsory. Early application of previous versions of IFRS 9 (2009, 2010 and 2013) is permitted if the date of initial application is before 1 February, 2015. The adoption of IFRS 9 will not have an effect on the classification and measurement of the Company's financial assets, or financial liabilities.

# THE PROSPECT JAPAN FUND LIMITED

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## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 1 Principal Accounting Policies

*Continued*

#### **Standards, amendments and interpretations issued but not yet effective and relevant to the Company**

*Continued*

The Company's financial instruments consist of equity instruments and derivatives. Due to the cash flow characteristics of such financial instruments, on application of IFRS 9, they will continue to be classified as fair value through the profit or loss.

There are no other standards, amendments or interpretations that are not yet effective that would be expected to have a material impact on the Company.

The Board anticipate that the adoption of these standards and interpretations in a future period, once they are effective, will not have a material impact on the Financial Statements of the Company.

#### **Assessment as investment entity**

Entities that meet the definition of an investment entity within IFRS 10 are required to measure their subsidiaries, at fair value through profit or loss rather than consolidate them. The criteria which define an investment entity are, as follows:

- An entity that obtains funds from one or more investors for the purpose of providing those investors with investment services;
- An entity that commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and
- An entity that measures and evaluates the performance of substantially all of its investments on a fair value basis.

The Company meets the criteria as follows:

The Company provides investment management services and has a number of investors who pool their funds to gain access to these services and investment opportunities that they might not have had access to individually. The Company, being listed on the London Stock Exchange, obtains funding from a diverse group of external shareholders. The Company's objective is consistent with that of an investment entity. The Company has the intention to realise the constituents of each of its investment classes.

The Company measures and evaluates the performance of substantially all of its investments on a fair value basis. The fair value method is used to represent the Company's performance in its communication to the market. In addition, the Company reports fair value information internally to Directors, who use fair value as a significant measurement attribute to evaluate the performance of its investments and to make investment decisions for mature investments.

The Board has also concluded that the Company meets the additional characteristics of an investment entity, in that it has more than one investment; the investments are predominantly in the form of equities and similar securities; it has more than one investor and its investors are not related parties.

## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 1 Principal Accounting Policies

*Continued*

#### **Significant accounting judgements and estimates**

The preparation of the Financial Statements in conformity with IFRS requires management to make judgements, estimates and assumptions that affect the application of policies and the reported amounts of assets and liabilities, income and expense and disclosure of contingent assets. 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 judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from those estimates.

#### **Going concern**

In accordance with the Company's Articles, the Board is required every three years to include in the business to be considered by shareholders at the Annual General Meeting a Special Resolution that the Company should be wound up. The last such resolution was tabled at the eighteenth Annual General Meeting held in 2014. The Shareholders voted against the resolution, and in favour of the continuation of the Company. As announced on 10 January, 2017 (the "Possible Offer Announcement"), the independent directors of the Company are in preliminary discussions regarding a possible offer from Prospect Co., Ltd ("Prospect") for the entire issued and to be issued share capital of the Company. The possible offer is under consideration, discussion and evaluation by both parties. The Possible Offer Announcement does not amount to a firm intention to make an offer under Rule 2.7 of The City Code on Takeovers and Mergers, and as stated in the Possible Offer Announcement there can be no certainty that an offer for the Company will ultimately be made. If such a transaction: (i) was to be announced in accordance with Rule 2.7 of The City Code on Takeovers and Mergers; and (ii) was to be completed prior to the 2017 AGM, no AGM would be held and no discontinuation vote would take place. Whilst acknowledging the uncertainty of the possible offer, and the upcoming vote for discontinuation, the fact that neither the Board nor the Investment Advisor have received any indication that the Shareholders are no longer in favour of the investment policy and that the assets of the Company consist mainly of securities that are readily realisable, leads the Directors to believe that the discontinuation vote will not be passed and that the Company has adequate financial resources to meet its liabilities as they fall due for at least twelve months from the date of this report, and that it is therefore appropriate for the Financial Statements to be prepared on a going concern basis. Factors regarding the going concern basis are also discussed in Note 1 of the Financial Statements.

#### *Share Capital*

The Company holds a discontinuation vote every three years, however as there is only one class of share in issue they continue to be presented as equity in accordance with IAS 32 – "Financial Instruments: Disclosure and presentation".

#### *Fair value of securities not quoted in an active market*

In the process of applying the Company's accounting policies, management has made the following judgements, which have the most significant effect on the amounts recognised in the financial statements:

The Company carries its investments at fair value, with changes in value being recognised in the Statement of Comprehensive Income. In cases of unlisted investments where prices of investments are not quoted in an active market, estimates are based on available traded prices, comparisons with the valuations of comparable instruments or by using valuation techniques, such as the Black Scholes model.

The Investment Manager exercises judgement on the valuation of unlisted investments. Further details on the valuation techniques applied to level 3 investments can be found in Note 14 of the Financial Statements.

#### **Financial instruments**

Financial assets and financial liabilities are recognised in the Company's Statement of Financial Position when the Company becomes a party to the contractual provisions of the instrument. Financial assets and liabilities, other than those shown at fair value through profit or loss, are measured at amortised cost using the effective interest rate method.



# THE PROSPECT JAPAN FUND LIMITED

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## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 1 Principal Accounting Policies

*Continued*

#### **Derivatives**

The Stock Acquisition Rights are treated as a derivative and as such are recognised at fair value on the date on which they are entered into and subsequently re-measured at their fair value. Fair value is determined by utilising appropriate valuation techniques, namely the Black-Scholes-Merton model. The gain or loss on re-measurement to fair value is recognised immediately through profit or loss in the Statement of Comprehensive Income within net gain/loss on financial assets at fair value through profit or loss in the period in which they arise.

#### **Financial assets at fair value through profit or loss (“investments”)**

All “regular way” purchases and sales of investments are recognised on the trade date, that is the date on which the Company commits to purchase or sell the investment). “Regular way” purchases or sales are purchases or sales of financial assets that require delivery of assets within the time frame generally established by regulation or convention in the market place.

All of the Company’s investments are recorded at fair value through profit or loss at the time of acquisition. Investments are initially recognised at fair value, normally being the cost incurred in their acquisition. Any transaction costs are expensed in the Statement of Comprehensive Income. After initial recognition, investments are measured at fair value. Gains and losses arising from changes in fair value are presented in the Statement of Comprehensive Income in the period in which they arise.

Investments are designated at fair value through profit or loss at inception because they are managed and their performance evaluated on a fair value basis and information thereon is evaluated by the management of the Company on a fair value basis.

#### *Other financial instruments*

For other financial instruments, including other receivables and other payables, the carrying amounts as shown in the Statement of Financial Position approximate to fair values due to the short term nature of these financial instruments.

#### *Fair value*

The Company’s investments consist of equity and equity-related investments in smaller companies in Japan and unlisted stock acquisition right and corporate bonds.

Listed investments held at the statement of financial position date are valued at bid prices quoted on the principal stock exchange on which the investments are traded. Gains and losses arising from changes in fair value are presented in the Statement of Comprehensive Income in the period in which they arise.

Unlisted investments are valued at the Directors’ estimate of their fair value in accordance with the requirements of IFRS 13 ‘Fair Value Measurement’. The Directors’ estimates are based on available price data, comparisons with the valuations of comparable corporate bonds or by using appropriate valuation techniques, such as the Black Scholes Merton model.

#### *Derecognition of financial instruments*

A financial asset is derecognised when the Company has transferred substantially all the risks and rewards of the asset, or has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

A financial liability is derecognised when the obligation under the liability is discharged or cancelled.

#### **Income**

Income arising on the investments is recognised when the right to receive it has been met and is recorded gross of withholding tax. Bank interest is accounted for on an accruals basis.

# THE PROSPECT JAPAN FUND LIMITED

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## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 1 Principal Accounting Policies

*Continued*

#### Expenses

Expenses are accounted for on an accruals basis. Expenses incurred on the acquisition of investments at fair value through profit or loss are charged to the Statement of Comprehensive Income in capital. All other expenses are charged to the Statement of Comprehensive Income in revenue.

#### Cash and cash equivalents

Cash and cash equivalents are defined as cash in hand, demand deposits and highly liquid investments readily convertible to known amounts of cash and subject to insignificant risk of change in value. Cash and cash equivalents at the year end constituted demand deposits.

#### Capital reserves

Gains and losses recorded on the realisation of investments and realised exchange differences of a capital nature are transferred to the realised capital reserve. Unrealised gains and losses recorded on the revaluation of investments held at a period end and unrealised exchange differences of a capital nature are transferred to the unrealised capital reserve.

#### Foreign currencies

(i) *Functional and presentation currency*

The Company's shares are denominated in United States dollars and accordingly the Board have determined that the Company's functional and presentation currency is United States dollars, despite the fact that the investments are in Japanese yen.

(ii) *Foreign currency transactions*

Monetary assets and liabilities and investments at fair value through profit or loss are translated into United States dollars at the rate of exchange ruling at the Statement of Financial Position date. Investment transactions and income and expenditure items are translated at the rate of exchange ruling at the date of the transactions. Gains and losses on foreign exchange are included in the Statement of Comprehensive Income.

### Note 2 Loss per Ordinary Share – Basic and Diluted and Net Asset Value per Ordinary Share – Basic and Diluted

The loss per Ordinary Share – Basic and Diluted has been calculated based on the weighted average number of Ordinary Shares of 92,392,220 and a net loss of US\$3,275,823 (2015: 92,452,602 Ordinary Shares and a net loss of US\$4,126,458).

There were no dilutive elements to shares issued or repurchased during the year.

The Net Asset Value per Ordinary Share - Basic and Diluted has been calculated based on the number of shares in existence at the year end date of 92,352,602 (2015: 92,452,602) and shareholders' funds attributable to equity interests of US\$121,923,460 (2015: US\$125,296,979).

### Note 3 Taxation

The Company has been granted Exempt Status under the terms of The Income Tax (Exempt Bodies) (Guernsey) Ordinance, 1989 to income tax in Guernsey. Its liability is an annual fee of £1,200 (2015: £1,200).

The amount disclosed as withholding tax in the Statement of Comprehensive Income relates solely to withholding tax suffered at source, on income in the investing country, Japan.

### Note 4 Management Fees

The management fee is payable to the Manager, Prospect Asset Management (Channel Islands) ("PAM(CI)"), monthly in arrears at a rate of 1.5% per annum of the Net Asset Value, which is calculated as of the last business day of each month. Total management fees for the year amounted to US\$1,856,441 (2015: US\$1,744,965) of which US\$140,667 (2015: US\$155,954) is due and payable at the year end. The Management Agreement dated 1 December, 1994 remains in force until determined by the Company or by the Manager giving the other party not less than three months' notice in writing, subject to additional provisions included in the agreement regarding a breach by either party.

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

Continued

### Note 5 Other Expenses

	01.01.2016 to 31.12.2016 In U.S. Dollars	01.01.2015 to 31.12.2015 In U.S. Dollars
Administration and secretarial fees*	309,407	290,827
Custodian's fees and charges**	135,310	105,482
General expenses	252,593	548,964
Directors' remuneration	110,529	116,723
Legal fees	218,639	–
Auditors' fees	39,392	46,133
Non-audit fees	21,524	20,635
Bank interest	13,951	–
	<u>1,101,345</u>	<u>1,128,764</u>

\* The administration and secretarial fees are payable to Northern Trust International Fund Administration Services (Guernsey) Limited monthly in arrears at a rate of 0.25% of the Net Asset Value of the Company as at the last business day of the month. Total administration and secretarial fees for the year amounted to US\$309,407 (2015: US\$290,827) of which US\$23,445 (2015: US\$25,992) is due and payable at the year end.

\*\* The custodian's fees and charges are payable to Northern Trust (Guernsey) Limited monthly in arrears at a rate of 0.08% of the value of the portfolio of the Company as at the last business day of the month. Total custodian's fees and charges for the year amounted to US\$135,310 (2015: US\$105,482) of which US\$9,307 (2015: US\$10,384) is due and payable at the year end.

### Note 6 Financial Assets at Fair Value through Profit or Loss

	01.01.2016 to 31.12.2016 In U.S. Dollars	01.01.2015 to 31.12.2015 In U.S. Dollars
Opening book cost	113,243,153	114,885,517
Purchases at cost	68,014,094	109,096,236
Proceeds on sale	(75,225,091)	(124,491,720)
Realised (loss)/gain on sale	(2,220,821)	13,753,120
Closing book cost	103,811,335	113,243,153
Unrealised loss	(5,433,663)	(6,825,610)
Fair value	<u>98,377,672</u>	<u>106,417,543</u>

### Note 7 Receivables

	31.12.2016 In U.S. Dollars	31.12.2015 In U.S. Dollars
Amounts due from brokers	977,551	151,847
Dividends receivable	192,689	224,005
Other receivables	19,183	23,199
	<u>1,189,423</u>	<u>399,051</u>

### Note 8 Payables

	31.12.2016 In U.S. Dollars	31.12.2015 In U.S. Dollars
Amounts due to brokers	42,943	172,618
Other creditors	289,623	356,535
	<u>332,566</u>	<u>529,153</u>

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

Continued

### Note 9 Share Capital, Redemption Reserve & Capital Redemption Reserve

Authorised Share Capital Number of shares		31.12.2016 In U.S. Dollars	31.12.2015 In U.S. Dollars
<u>150,000,000</u>	Ordinary Shares of US\$0.001 each	<u>150,000</u>	<u>150,000</u>
<u>60,000,000</u>	“C” Ordinary Shares of US\$0.01 each	<u>600,000</u>	<u>600,000</u>

As approved at the AGM on 18 August, 2016, the Company may purchase a maximum of 13,843,655 Ordinary Shares, equivalent to 14.99% of the issued share capital of the Company as at the date of the AGM.

On the 23 May, 2016, 100,000 shares were repurchased at a price of US\$0.975. The Redemption Reserve was utilised to cancel these shares.

Ordinary Shares Number of shares		Share Capital In U.S. Dollars	Redemption Reserve In U.S. Dollars	Capital Redemption Reserve In U.S. Dollars
92,452,602	Balance at 1 January, 2016	92,452	85,533,077	323,057
(100,000)	Shares repurchased and cancelled during the year	(100)	(97,696)	100
<u>92,352,602</u>	Balance at 31 December, 2016	<u>92,352</u>	<u>85,435,381</u>	<u>323,157</u>

Ordinary Shares Number of shares		Share Capital In U.S. Dollars	Redemption Reserve In U.S. Dollars	Capital Redemption Reserve In U.S. Dollars
92,452,602	Balance at 1 January, 2015	92,452	85,533,077	323,057
<u>92,452,602</u>	Balance at 31 December, 2015	<u>92,452</u>	<u>85,533,077</u>	<u>323,057</u>

#### Other Reserves

The Redemption Reserve account is a distributable reserve account which can be used for, among other things, the payment of dividends, if any. The Directors do not recommend the payment of a dividend for the year.

The Capital Redemption Reserve is used to cancel the shares of the Company when they are redeemed or there is a share buyback.

Ordinary Shares carry the right to vote at general meetings of the Company and to receive dividends and, in a winding-up will participate in any surplus assets remaining after settlement of any outstanding liabilities of the Company.

### Note 10 Reconciliation of Deficit on Ordinary Activities to Net Cash Outflow from Operating Activities

	31.12.2016 In U.S. Dollars	31.12.2015 In U.S. Dollars
Revenue loss on ordinary activities for the year	(3,231,672)	(1,459,429)
Adjusted for:		
Interest received	–	(108,112)
Interest paid	13,951	–
Dividends received	(2,067,155)	(1,334,322)
Decrease/(increase) in other receivables	4,016	(103,925)
(Decrease)/increase in other creditors	(66,912)	7,130
Net cash outflow from operating activities	<u>(5,347,772)</u>	<u>(2,998,658)</u>

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

Continued

### Note 11 Analysis of Financial Assets and Liabilities by Measurement Basis

	Investments at fair value In U.S. Dollars	Net current assets In U.S. Dollars	Total In U.S. Dollars
As at 31 December, 2016			
<b>Financial assets</b>			
Investments at fair value through profit or loss	98,377,672	–	98,377,672
Cash and cash equivalents	–	22,688,931	22,688,931
Receivables	–	1,189,423	1,189,423
	<u>98,377,672</u>	<u>23,878,354</u>	<u>122,256,026</u>
<b>Financial liabilities</b>			
Payables	–	332,566	332,566
	<u>–</u>	<u>332,566</u>	<u>332,566</u>
	<b>Investments at fair value In U.S. Dollars</b>	<b>Net current assets In U.S. Dollars</b>	<b>Total In U.S. Dollars</b>
As at 31 December, 2015			
<b>Financial assets</b>			
Investments at fair value through profit or loss	106,417,543	–	106,417,543
Cash and cash equivalents	–	19,009,538	19,009,538
Receivables	–	399,051	399,051
	<u>106,417,543</u>	<u>19,408,589</u>	<u>125,826,132</u>
<b>Financial liabilities</b>			
Payables	–	529,153	529,153
	<u>–</u>	<u>529,153</u>	<u>529,153</u>

### Note 12 Related Party Transactions

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions.

The Directors are responsible for the determination of the investment policy of the Company and have overall responsibility for the Company's activities. The Company's investment portfolio is managed by PAM(CI) (the "Manager") whose parent company is Prospect Co., Ltd (Kabushiki Kaisha Prospect ("KKP")), a Japanese Company).

Mr Rupert Evans is a Director of the Manager.

Directors' fees are disclosed in Note 5. The basic fee payable to Directors in 2016 is £25,000 (US\$30,890) (2015: £25,000 (US\$36,848)), the Chairman of the Audit Committee £27,500 (US\$33,979) (2015: £27,500 (US\$40,532)) and the Chairman of the Board £30,000 (US\$37,068) (2015: £30,000 (US\$44,217)) per annum. At 31 December, 2016, US\$25,484 (2015: US\$30,399) of the fee remained payable.

No Directors holding office at 31 December, 2016, or their associates, had any beneficial interest in the Company's shares. There have been no changes in these interests between the end of the period and up to the date of this report.

Mr. Curtis Freeze is a Director of PAM(CI), the Manager of The Prospect Japan Fund Limited, and is the President of Prospect Co. Ltd., the owner of PAMI, the Investment Advisor to The Prospect Japan Fund Limited and PAM(CI), the Manager of The Prospect Japan Fund Limited.

# THE PROSPECT JAPAN FUND LIMITED

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## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### **Note 12 Related Party Transactions**

*Continued*

Management fees are disclosed in Note 4. Fees due to the Investment Advisor are paid by PAM(CI) from these management fees.

The Company holds both Equity shares and SARs in Prospect Co. Ltd. The value of the SARs is disclosed in Note 14 under Unlisted investments.

### **Note 13 Financial Risk Management Objectives and Policies**

#### **Financial instruments**

In accordance with its investment objectives and policies, the Company holds financial instruments which at any one time may comprise the following:

- securities held in accordance with the investment objectives and policies
- cash and short-term debtors and creditors arising directly from operations
- borrowing used to finance investment activity
- derivative transactions including investment in warrants and forward currency contracts
- options or futures for hedging purposes

The financial instruments held by the Company principally comprise equities listed on the stock market in Japan. The specific risks arising from the Company's exposure to these instruments, and the Manager/Investment Advisor's policies for managing these risks, which have been applied throughout the year, are summarised below.

#### **Market price risk**

The Company's investment portfolio – particularly its equity investments – is exposed to market price fluctuations, which are monitored by the Manager/Investment Advisor in pursuance of the investment objectives and policies.

Exceptional risks associated with investment in Japanese smaller companies may include:

- a) greater price volatility, substantially less liquidity and significantly smaller market capitalisation, and
- b) more substantial government intervention in the economy, including restrictions on investing in companies or in industries deemed sensitive to relevant national interests.

#### **Market price sensitivity analysis**

The sensitivity of the Company to market price risk can be approximated by measuring the impact that a movement in the MSCI Japan Small Cap Index would have on the percentage of funds invested. The MSCI Developed Markets Small Cap Indices offer an exhaustive representation of the size segment by targeting companies that are in the Investable Market Index but not in the Standard Index in a particular developed market. The indices include Value and Growth style indices and industry indices based on the Global Industry Classification Standard. The MSCI Japan Small Cap Index provides an indicator of the effect of market price risk on the Company's portfolio since its characteristics with respect to average market capitalisation more closely resemble the investment strategy pursued by the Company. However, the Company's investments do not reflect the full array of companies on the index. At 31 December, 2016, using a beta of 0.646 (2015: 0.485), a 1% positive/negative movement in the index would produce a positive/negative movement in the investments of the Company of US\$635,520 (2015:US\$516,125) for equity related securities. This relationship between the movement in the value of the assets of the Company and the Index is of a linear nature.

A 1% increase/decrease in the value of the SARs would impact the NAV by US\$99,907 (2015: US\$23,914).

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

Continued

### Note 13 Financial Risk Management Objectives and Policies

Continued

#### Foreign currency risk

The Company principally invests in securities denominated in Japanese yen rather than United States dollars, the functional currency of the Company. Therefore, the Statement of Financial Position may be affected by movements in the exchange rates of such currencies against the United States dollar. The Manager/Investment Advisor has the power to manage exposure to currency movements by using forward currency contracts. The Company was not party to any such instruments at the statement of financial position date in either the current or prior year.

It is not the present intention of the Directors to hedge the currency exposure of the Company, but the Directors reserve the right to do so in the future if they consider this to be desirable.

The treatment of currency transactions other than in United States dollars is set out in Note 1 to the Financial Statements under "Foreign Currencies".

The Company's currency exposure is as follows:

	31.12.2016 In US Dollars	31.12.2015 In US Dollars
Investments		
Japanese Yen (¥11,515,598,396; 2015: ¥12,815,864,703)	98,377,672	106,417,543
	<u>98,377,672</u>	<u>106,417,543</u>
Other (Liabilities)/Assets		
US Dollars	(190,156)	(188,836)
Sterling (£40,818; 2015: £74,287)	(50,170)	(110,095)
Japanese Yen (¥2,784,283,574; 2015: ¥2,309,650,737)	23,786,114	19,178,367
	<u>23,545,788</u>	<u>18,879,436</u>

The below details the Company's sensitivity to a 10% (31 December, 2015: 10%) change in foreign exchange rates against the US dollar.

	31.12.2016 In US Dollars	31.12.2015 In US Dollars
Impact on Statement of Comprehensive Income and Equity in response to a – 10% increase in the US dollar against other currencies	<u>(12,250,087)</u>	<u>(12,548,581)</u>
– 10% decrease in the US dollar against other currencies	<u>12,250,087</u>	<u>12,548,581</u>

#### Interest rate risk

Interest receivable on bank deposits or payable on bank overdraft positions will be affected by fluctuations in interest rates, however the value of the underlying cash positions will not be affected.

The direct effect of movements in interest rates are not material on cash and cash equivalents as the Company predominantly keeps its surplus cash in Japanese Yen on which it does not earn interest.

If the risk-free rate of return increased/decreased by 0.5%, the impact on the net asset value and the profit and loss for the year would be an increase/decrease of US\$113,445 (2015: US\$95,686 with a 0.5% increase/decrease).

#### Short term debtors and creditors

Trade and other receivables and creditors do not carry interest and are short term in nature. They are stated at nominal value as reduced by appropriate allowances for irrecoverable amounts in the case of receivables.

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 13 Financial Risk Management Objectives and Policies

*Continued*

#### Liquidity risk

Liquidity risk is the risk that the Company may encounter in realising assets or otherwise raising funds to meet financial commitments.

The Company invests primarily in listed securities. The tables below analyse liquidity of the Company's securities based on trading volumes in the period after the statement of financial position date and maturity of other financial assets and liabilities. Although market values are low in comparison to the Company's shareholding for some securities, there is sufficient volume to demonstrate an active market.

The Investment Manager considers expected cash flows from financial assets based on traded volumes in assessing and managing liquidity risk, in particular its cash resources and trade receivables. Cash flows from trade and other receivables are all contractually due within twelve months. Liquidity risk is not deemed to be significant.

#### As at 31 December, 2016

	Up to 1 week In US Dollars	1 week to 1 month In US Dollars	1-6 months In US Dollars	6-12 months In US Dollars	Greater than 12 months In US Dollars	Total In US Dollars
<b>Financial assets</b>						
Financial assets at fair value through profit or loss	10,838,996	22,519,263	40,356,666	4,523,359	20,139,388	98,377,672
Dividends receivable	–	–	192,689	–	–	192,689
Other receivables	–	–	19,183	–	–	19,183
Cash and cash equivalents	22,688,931	–	–	–	–	22,688,931
Securities sold receivable	977,551	–	–	–	–	977,551
<b>Financial liabilities</b>						
Amounts due to brokers	(42,943)	–	–	–	–	(42,943)
Other creditors	–	(231,225)	(58,398)	–	–	(289,623)
Total	<u>34,462,535</u>	<u>22,288,038</u>	<u>40,510,140</u>	<u>4,523,359</u>	<u>20,139,388</u>	<u>121,923,460</u>



# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

Continued

### Note 13 Financial Risk Management Objectives and Policies

Continued

#### Liquidity risk

Continued

As at 31 December, 2015

	Up to 1 week In US Dollars	1 week to 1 month In US Dollars	1-6 months In US Dollars	6-12 months In US Dollars	Greater than 12 months In US Dollars	Total In US Dollars
<b>Financial assets</b>						
Financial assets at fair value through profit or loss	16,158,458	33,525,242	47,088,648	4,841,226	4,803,969	106,417,543
Dividends receivable	–	–	224,005	–	–	224,005
Other receivables	–	–	23,199	–	–	23,199
Cash and cash equivalents	19,009,538	–	–	–	–	19,009,538
Securities sold receivable	151,847	–	–	–	–	151,847
<b>Financial liabilities</b>						
Amounts due to brokers	(172,618)	–	–	–	–	(172,618)
Other creditors	–	(299,113)	(57,422)	–	–	(356,535)
Total	<u>35,147,225</u>	<u>33,226,129</u>	<u>47,278,430</u>	<u>4,841,226</u>	<u>4,803,969</u>	<u>125,296,979</u>

#### Credit risk

Credit risk is the risk that an issuer or counterparty will be unable or unwilling to meet a commitment that it has entered into with the Company. The Company's principal sources of credit risk arise on amounts due from brokers for settlement of outstanding investment transactions, dividends and interest receivable, corporate bonds and cash and cash equivalents.

The Company utilises 8 executing brokers setting allocation targets for each broker so as to not to place excessive concentration in any one counterparty.

The Investment Advisor performs a quarterly review of executing brokers as part of its "Best Execution" analysis, which is part of the advisor's compliance program. The investment team reviews the quality of broker research, execution and service, and sets targets for each broker based on the brokers' overall performance.

Currently all cash is placed with Northern Trust (Guernsey) Limited ("NTGL"). NTGL is also custodian of the majority of the Company's investments. NTGL is a wholly owned subsidiary of The Northern Trust Corporation ("TNTC"). TNTC is publicly traded and a constituent of the S&P 500. TNTC has a credit rating of A+.

All transactions in listed securities are settled/paid upon delivery using approved brokers. The risk of default is considered minimal, as delivery of securities sold is only made once the broker has received payment. Payment is made on a purchase once the securities have been received by the broker. The trade will fail if either party fails to meet their obligation.

When purchasing unlisted securities including over-the-counter bonds, the Investment Advisor prepares an evaluation on the company issuing these securities and monitors and reviews the Company's quality and performance over time. These unlisted investments are issued by the companies themselves and by their nature are either not rated or have a higher credit rating.

It is the opinion of the Board of Directors that the carrying amounts of these financial assets, excluding equities, represent the maximum credit risk exposure as at the statement of financial position date.

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 13 Financial Risk Management Objectives and Policies

*Continued*

#### Credit risk

*Continued*

The Company's maximum credit exposure is limited to the carrying amount of unlisted investment and financial assets recognised as at the statement of financial position date including bank balances, Level 3 investments, illiquid investments and other receivables with a possible risk of no recovery:

#### Maximum Credit Risk Exposure

	31.12.2016	31.12.2015
	In US Dollars	In US Dollars
Unlisted investments	9,990,744	2,518,957
Cash and cash equivalents	22,688,931	19,009,538
Receivables	1,189,423	399,051
	<u>33,869,098</u>	<u>21,927,546</u>

#### Capital management

The Company is a close-ended investment company, and thus has a fixed capital. The Company's capital is represented by Ordinary Shares and each share carries one vote. Each share has an entitlement to dividends if declared.

As approved at the AGM on 18 August, 2016, the Company may purchase a maximum of 13,843,655 Ordinary Shares, equivalent to 14.99% of the issued share capital of the Company as at the date of the AGM provided that;

- the minimum price to be paid (exclusive of expenses) is US\$0.001;
- the maximum price to be paid (exclusive of expenses) is 105% of the average mid-market valuation for five days preceding the purchase; and
- if the shares are trading on the London Stock Exchange, at a discount to the lower of the undiluted or diluted Net Asset Value;

The Company purchased 100,000 shares at a price of US\$0.975 per share on the 23 May 2016. Refer to Note 9.

The Board also considers from time to time whether it may be appropriate to raise new capital by a further issue of shares. The raising of new capital would however be dependent on there being genuine market demand.

The Company is not subject to externally imposed capital requirements.

### Note 14 Fair Value

Financial assets at fair value through profit or loss are carried at fair value. The valuation techniques for valuing unlisted investments are described below. Other assets and liabilities are carried at cost which approximates fair value.

IFRS 13 requires the Company to classify fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value measurement is based on the presumption that the transaction to sell the asset or transfer the liability takes place either:

- (i) in the principal market for the asset or liability, or
- (ii) in the absence of a principal market, in the most advantageous market for the asset or liability

The principal or the most advantageous market must be accessible by the Company.

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 14 Fair Value

*Continued*

The fair value of an asset or a liability is measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

The Company uses valuation techniques that are appropriate in the circumstances and for which sufficient data is available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

All financial instruments for which fair value is recognised or disclosed are categorised within the fair value hierarchy, described as follows, based on the lowest level input that is significant to the fair value measurement as a whole:

Level 1 – Quoted market prices (unadjusted) in an active market for identical assets or liabilities

Level 2 – Valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable

Level 3 – Valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable

For financial instruments that are recognised at fair value on a recurring basis, the Company determines whether transfers have occurred between levels in the hierarchy by re-assessing categorisation, based on the lowest level input that is significant to the fair value measurement as a whole, at the end of each reporting period.

The following table analyses within the fair value hierarchy the Company's financial assets and liabilities (by class) measured at fair value for the year ended 31 December, 2016.

	Level 1 In US Dollars	Level 2 In US Dollars	Level 3 In US Dollars	Total In US Dollars
<b>Assets</b>				
Financial assets at fair value through profit or loss:				
– Equity Securities	88,386,928	–	–	88,386,928
– Derivative Instruments	–	–	9,990,744	9,990,744
<b>Total as at 31 December, 2016</b>	<u>88,386,928</u>	<u>–</u>	<u>9,990,744</u>	<u>98,377,672</u>

The following table presents the movement in level 3 instruments for the year ended 31 December, 2016 by class of Financial Instrument.

	Debt Securities In US Dollars	Derivative Securities In US Dollars	Total In US Dollars
Opening balance	127,526	2,391,431	2,518,957
Purchases	–	–	–
Sales	(127,526)	(294,005)	(421,531)
Realised gains during the year	127,526	145,802	273,328
Unrealised gain during the year	(127,526)	7,747,516	7,619,990
Closing balance	<u>–</u>	<u>9,990,744</u>	<u>9,990,744</u>
Net unrealised gain for the year included in the Statement of Comprehensive Income	<u>–</u>	<u>7,747,516</u>	<u>7,747,516</u>

There were no transfers between levels for the year ended 31 December, 2016.

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 14 Fair Value

*Continued*

The following table analyses, within the fair value hierarchy, the Company's financial assets and liabilities (by class) measured at fair value for the year ended 31 December, 2015 as required by IFRS 7.

	Level 1 In US Dollars	Level 2 In US Dollars	Level 3 In US Dollars	Total In US Dollars
<b>Assets</b>				
Financial assets at fair value through profit and loss:				
– Equity Securities	103,898,586	–	–	103,898,586
– Derivative Instruments	–	–	2,391,431	2,391,431
– Debt Securities				
Corporate bonds	–	–	127,526	127,526
<b>Total assets as at 31 December, 2015</b>	<u>103,898,586</u>	<u>–</u>	<u>2,518,957</u>	<u>106,417,543</u>

The following table presents the movement in level 3 instruments for the year ended 31 December, 2015 by class of Financial Instrument.

	Debt Securities In US Dollars	Derivative Securities In US Dollars	Total In US Dollars
Opening balance	56,008,526	–	56,008,526
Purchases	18,641,413	2,371,249	21,012,662
Sales	(52,378,965)	–	(52,378,965)
Realised gains during the year	3,131,464	–	3,131,464
Unrealised losses during the year	(25,274,912)	20,182	(25,254,730)
Closing balance	<u>127,526</u>	<u>2,391,431</u>	<u>2,518,957</u>
Net unrealised gain for the year included in the Statement of Comprehensive Income for level 3 Investments held at 31 December, 2015	<u>127,526</u>	<u>20,182</u>	<u>147,708</u>

There were no transfers between levels for the year ended 31 December, 2015.

### Valuation techniques

#### Listed investments

Securities valued based on quoted market prices, in an active market for identical assets without any adjustments, are included within Level 1 of the hierarchy and are valued at bid price.

#### Unlisted investments

The Company invests in debt securities which are not quoted in an active market. Transactions in such investments do not occur on a regular basis. These positions are valued at their fair value in accordance with IFRS 13.

Level 3 valuations are monitored closely by the Investment Advisor who reports to the Board of Directors on a quarterly basis. Valuations are based on the most appropriate method for each level 3 investment as at 31 December, 2016 as discussed below.

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 14 Fair Value

*Continued*

#### Unlisted investments

*Continued*

As at 31 December, 2016, the Company holds stock acquisition rights (“SARs”) in Prospect Co. Ltd. In accordance with IFRS 13, the Directors have undertaken their responsibility to approximate a fair value of this level 3 investment by way of utilising the Black-Scholes-Merton model. The model uses observable, non-observable and contractual inputs. The observable inputs are the underlying price of Prospect Co. Ltd (31 December, 2016: ¥66.5, 31 December, 2015: ¥51.5) and the risk free rate (31 December, 2016: 0.00%, 31 December, 2015: 0.00%). The significant unobservable inputs are the dividend yield, which is based on historic dividend payments (31 December, 2016: 1.95%, 31 December, 2015: 1.95%) and the volatility rate used (31 December, 2016: 21.73%, 31 December, 2015: 15.7%), which was the implied rate of volatility having removed the peaks created by the increase in dividend announced on 6 December, 2016 and adjusted for the potential restriction on the exercise of the SAR’s following the announcement of a possible offer made by Prospect, Co. Ltd.

The effects of movements of the significant unobservable inputs used in the fair value measurement of the unlisted investment categorised within Level 3 of the fair value hierarchy as at 31 December 2016 are shown below:

Unobservable input	Sensitivity used	Effect on Fair Value	
		In U.S. Dollars	
Dividend yield	+0.05%/-0.05%	(25,883)	32,353
Volatility	+5%/-5%	1,294,138	(1,171,195)

The contractual inputs are the shares received for each right exercised (100,000), the exercise date (21 December, 2015) the remaining exercise period (1 January 2016 to 20 December, 2020), the strike price of the SAR (¥54) and the number of SARs remaining (1,350). Using this model with the implied rate has resulted in an uplift of US\$7,684,136 (31 December, 2015: US\$490,243) from the year end valuation of the SARs.

### Note 15 Segmental Reporting

The Board is responsible for reviewing the Company’s entire portfolio and considers the business to have a single operating segment. The Board’s asset allocation decisions are based on a single, integrated investment strategy, and the Company’s performance is evaluated on an overall basis.

The Company invests in a diversified portfolio of Japanese investments. The total fair value of the financial instruments held by the Company and the equivalent percentages of the total value of the Company, are reported in the Portfolio Statement.

Revenue earned is reported separately on the face of the Statement of Comprehensive Income as investment income being dividend income received from equities, and interest income being interest earned from convertible and corporate bonds.

### Note 16 Contingent Asset

The Company declined to tender its shares for Toho Real Estate, as the Company believed the true value to be considerably higher than that stated in the tender offer, and entered into an arbitration process. The Company has been involved in court proceedings with Toho Real Estate arising from the tender offer. In March, 2015 the Company received notice from the court presiding over its petition that it had ruled in its favour. The court awarded the Company an aggregate amount of ¥121,600,000 (US\$1.01 million). Although an improvement, this was still significantly discounted to the fair value of Toho Real Estate and as such, on 8 April, 2015 the Company filed an appeal against the ruling. On 30 March, 2016, the Company announced that the Tokyo High Court had ruled that the tender offer price for Toho Real Estate amounted to fair value and eliminated a previous award of ¥121,600,000 to the Company. The Company has filed an appeal to this ruling which has been accepted to be heard by the Supreme Court of Japan.

# THE PROSPECT JAPAN FUND LIMITED

## NOTES TO THE FINANCIAL STATEMENTS

*Continued*

### Note 16 Contingent Asset

*Continued*

With regard to Yukiguni Maitake, the Company feels that a tender offer was unfair and feels that the shares were artificially depressed due to poor management, which resulted in an accounting violation around the payment of dividends. The holding bank sold into the TOB and realised the collateral at what the Company believes to be an unfair price. Alix Partners Asia LLC and Nera Economic Consulting have been engaged to provide valuations. In October, 2016 the Company received notice from the court presiding over its petition that it had ruled the tender offer price for Yukiguni Maitake amounted to fair value. The company filed an appeal, which is currently being reviewed by the Tokyo High Court. Although at this point it would be difficult to put a per share value on it, the Company believes a premium closer to 40% vs. the 18.7% paid would be in line with the market.

### Note 17 Reconciliation of Published Valuation to Audited Financial Statements Prepared under IFRS

	31.12.2016	31.12.2015
	In US Dollars	In US Dollars
<b>Net assets per Financial Statements</b>	121,923,460	125,296,979
Writeback of prior year uplift on Toho Real Estate (Note 16)	–	1,009,715
<b>Adjustment in value of financial assets at fair value through profit and loss:</b>		–
Prospect Co Ltd Stock Acquisition Rights (Note 14)	(7,684,136)	–
<b>Net assets per published valuation</b>	<u>114,239,324</u>	<u>126,306,694</u>
<b>NAV per share per Financial Statements (in cents)</b>	132.02	135.53
<b>NAV per share per published valuation (in cents)</b>	123.70	136.62

### Note 18 Subsequent Events

These Annual Report and Financial Statements were approved for issuance by the Board on 21 March, 2017. Subsequent events have been evaluated until this date.

On 10 January, 2017, the Company announced that it was in preliminary discussions with Prospect, Co. Ltd (“Prospect”) in respect of a possible offer by Prospect for the entire issued and to be issued share capital of the Company.

Prospect was required on 7 February, 2017, to either announce a firm intention to make an offer for the Company or announce that it does not intend to make an offer.

At the request of the Independent Directors of the Company, the Panel on Takeovers & Mergers (the “Panel”) has consented to an extension of the relevant deadline, until 5:00 p.m. on 4 April, 2017 to enable the parties to conclude their ongoing discussions. By this time Prospect must either announce a firm intention to make an offer for the Company or announce that it does not intend to make an offer, in which case the announcement will be treated as a statement. This new deadline can be extended with the consent of the Panel.

# THE PROSPECT JAPAN FUND LIMITED

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## GENERAL INFORMATION

### **General**

The Company is a close-ended investment company incorporated in Guernsey in November, 1994 and was launched in December, 1994 with an initial asset value of US\$70 million. There are 92,352,602 Ordinary Shares in issue as at 31 December, 2016. The Company's Ordinary Shares are listed on the Main Market of the London Stock Exchange.

The Ordinary Shares of the Company have not been registered under the United States Securities Act of 1933 or the United States Investment Companies Act of 1940. Accordingly, none of the Ordinary Shares may be offered or sold directly or indirectly in the United States or to any United States persons (as defined in Regulation 'S' under the 1933 Act) other than in accordance with certain exemptions. Investment in the Company is suitable only for sophisticated investors and should be regarded as long-term. Past performance is no indication of future results.

The Company is a FATCA compliant organisation with FATCA entity classification FFI and GIIN L0Q9R3.99999.SL.831.

### **Alternative Performance Measures**

In accordance with ESMA Guidelines on Alternative Performance Measures ("APMs") APMs are included in the financial statements which require further clarification. An APM is defined as a financial measure of historical or future financial performance, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework.

#### *NAV to market price discount*

The Net Asset Value ("NAV") per share is the value of all the investment company's assets, less any liabilities it has, divided by the number of shares. However, because the Company's Ordinary Shares are traded on the London Stock Exchange's Main Market, the share price may be higher or lower than the NAV. The difference is known as a discount or premium. The Company's discount is calculated by expressing the difference between the period end dollar equivalent share price and the period end NAV per share as a percentage of the NAV per share.

#### *Market Performance*

Market Performance measures how the NAV per share has performed over a period of time compared to the MSCI Japan Small Cap Index. The Company quotes NAV per share performance as a percentage change from the start of the period, one-year and also three-year and five-year periods. The MSCI Japan Small Cap Index is designed to measure the performance of the small cap segment of the Japanese market. It has 901 constituents and represents 14% of the free float-adjusted market capitalization of the Japan equity universe. It is also quoted as a percentage change from the start of the period, one-year and also three-year and five-year periods.

### **Investment Objective**

The Company's investment objective is detailed in the Strategic Report on page 9.

### **Investment Restrictions**

The Company's investment restrictions are detailed in the Strategic Report on pages 10 and 11.

### **NAV and Information**

The prices of Ordinary Shares and the latest NAV are published daily in the Financial Times. The price of the Ordinary Shares appears within the section of the London Share Service entitled "Investment Companies".

# THE PROSPECT JAPAN FUND LIMITED

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## GENERAL INFORMATION

*Continued*

### Life of the Company

From inception the Directors have believed that Shareholders should be able to review the progress of the Company so that a decision can be taken as to whether Shareholders should have an opportunity of realising the Company's underlying investments. Accordingly, at the eighteenth Annual General Meeting of the Company held on 27 August, 2014, the Board included in the business to be considered by Shareholders a special resolution that the Company should be wound up. The resolution was not passed. The board will include a similar resolution in the business to be considered at every third Annual General Meeting held. The next such resolution will be tabled at the Annual General Meeting to be held in 2017.

### Financial Highlights

	<b>31.12.2016</b>	<b>31.12.2015</b>
	<b>In US Dollars</b>	<b>In US Dollars</b>
Total Net Assets	121,923,460	125,296,979
IFRS NAV per share	132.02	135.53
Share Price	89.75	105.50
Discount to NAV	32.02%	22.16%

### Directors

Brief biographical details of the Directors are as follows:

Rupert Evans, age 78, is a Guernsey advocate and former partner in the firm of the Guernsey legal advisors, Mourant Ozannes. He is now a consultant to Mourant Ozannes. He is a non-executive director of the Manager and of a number of investment companies. Mr Evans is resident in Guernsey. Mr Evans was appointed to the Board on 18 November, 1994.

John Hawkins, age 74, is a Fellow of the Institute of Chartered Accountants in England and Wales. He was formerly Executive Vice President and a member of the Corporate Office of The Bank of Bermuda Limited, with whom he spent many years in Asia. He retired from the Bank of Bermuda in 2001 after 25 years with the Group. He is a director of a range of funds which include hedge funds and equity funds investing in Japan and Asia. Mr Hawkins was appointed to the Board on 4 April, 2004. Mr Hawkins is resident in the UK.

Richard Battey, age 65, is a qualified chartered accountant. He is a non-executive director of a number of investment companies and funds. Mr Battey joined the Schroder Group in December 1977 and was a director of Schroders (C.I.) Limited from April, 1994 to December, 2004, where he served as Finance Director and Chief Operating Officer, and was a director of Schroder Group Guernsey companies before retiring from his last Schroder directorship in December, 2008. Mr Richard Battey was appointed as Chairman of the Audit Committee on 10 February, 2010. Mr Battey is resident in Guernsey.

### Taxation Status

The Company has obtained exemption from Guernsey Income Tax under The Income Tax (Exempt Bodies) (Guernsey) Ordinance, 1989. There is no capital gains tax in Guernsey.









