

# REPORT OF THE BOARD OF DIRECTORS

The Board of Directors (the “Board”) has pleasure in presenting their report together with the audited financial statements of the Company for the year ended 31st December 2005 to the shareholders.

## General Meeting

During the year, the Company held five general meetings in strict compliance with the relevant laws, regulations and the Articles of Association of the Company:

### (1) 2004 Annual General Meeting

The Company held its 2004 Annual General Meeting on 18th May 2005. At the meeting, the ordinary resolutions including the report of the Board of Directors for the year 2004, the report of the Supervisory Committee for the year 2004, the audited financial statements of the Company and the auditors’ report for the year 2004, the profit distribution proposal and the distribution of final dividends, the reappointment of PricewaterhouseCoopers and PricewaterhouseCoopers Zhong Tian Certified Public Accountants Ltd. Co. as the international auditors and the PRC auditors of the Company respectively, and the authorisation of the Board to determine whether to declare interim dividends for the year 2005 were considered and approved.

### (2) General meeting for holders of domestic shares and general meeting for holders of H shares

On 18th May 2005, the Company held the general meeting for holders of domestic shares and the general meeting for holders of H shares. At the two general meetings, the following special resolution was considered and approved:

the extension of the validity period for the implementation of the resolutions in relation to the proposed issue of A shares, among others, passed at the general meeting for holders of domestic shares, the general meeting for holders of H shares and the extraordinary general meeting of the Company held on 8th April 2004 to the date of the 2005 Annual General Meeting of the Company.

## General Meeting *(continued)*

### **(3) 2005 First Extraordinary General Meeting**

On 18th May 2005, the Company held the 2005 first extraordinary general meeting, at which the following special resolutions were considered and approved:

1. the extension of the validity period for the implementation of the resolutions in relation to the proposed issue of A shares passed at the general meeting for holders of domestic shares, general meeting for holders of H shares and the extraordinary general meeting of the Company held on 8th April 2004 to the date of the 2005 Annual General Meeting of the Company; and
2. the resolution in relation to dealing with the relevant matters during the validity period after the extension of the authorisation granted to the Board of the Company to conduct and deal with at its discretion the matters related to the proposed issue of A shares passed at the extraordinary general meeting of the Company held on 8th April 2004.

### **(4) 2005 Extraordinary General Meeting**

On 29th December 2005, the Company convened the 2005 extraordinary general meeting, which considered and approved the following ordinary resolution:

The agreement dated 20th October 2005 (the “New Service and Supply Agreement”) entered into between Chongqing Iron & Steel Company Limited (the “Company”) and Chongqing Iron & Steel Company (Group) Limited (重慶鋼鐵(集團)有限責任公司) (the “Holding Company”) (a copy of which has been produced to the meeting marked “A” and initialled by the Chairman for the purpose of identification) in relation to, among other things, the provision and receipt of certain services and materials by the Company, the transactions contemplated thereunder, and each of the Annual Caps (as defined in the circular of the Company dated 7th November 2005 and of which this notice forms part) be and are hereby approved, confirmed and ratified and that the directors of the Company be and are hereby authorised to do all things and acts and sign all documents which they consider necessary, desirable or expedient in connection with the New Service and Supply Agreement, the transactions contemplated thereunder and each of the Annual Caps.

# REPORT OF THE BOARD OF DIRECTORS *(CONTINUED)*

## The Board

During the year, the Board convened four meetings:

1. On 10th March 2005, the seventh meeting of the third Board of the Company was held, at which the annual report, the audited financial statements, the annual results announcement and the final profit distribution proposal for 2004, the 2005 investment scheme and the proposal for re-appointment of auditors were considered and approved.
2. On 1st September 2005, the eighth meeting of the third Board of the Company was held, at which several matters including the interim report, the unaudited interim financial statements, and the interim results announcement of the Company for the year 2005 were considered and approved.
3. On 20th October 2005, the ninth meeting of the third Board of the Company was held, at which the New Service and Supply Agreement and the Supplemental Lease Agreement entered into between the Company and the Holding Company and the relevant matters were considered and approved.
4. On 23rd December 2005, the tenth meeting of the third Board of the Company was held, at which the application for international trade credit facilities to a bank by the Company and the relevant matters were considered and approved.

## Audit Committee

During the year, the Audit Committee convened the following two meetings:

1. On 9th March 2005, the fourth meeting of the second Audit Committee of the Company was held, at which several matters including the audited financial statements, the auditors' report, internal control matters, the Company's connected transactions and appointment of auditors for the year 2004 were considered and approved.
2. On 31st August 2005, the fifth meeting of the third Board of the Company was held, at which several matters including the interim report, the unaudited interim financial statements, and the interim results announcement of the Company for the year 2005 were considered and approved.

# REPORT OF THE BOARD OF DIRECTORS *(CONTINUED)*

## Principal Business

The principal business of the Company is the manufacture and sale of steel products such as medium-gauge steel plates, steel sections and wire rods. As over 90% of the sales and operating profits of the Company are derived from the business of steel products and its by-products, no segment information for businesses is presented.

## Results and Appropriations

Results and appropriations of the Company for the year ended 31st December 2005 prepared in accordance with the accounting principles generally accepted in Hong Kong are set out in the income statement on page 62 of the annual report.

The Company has not declared any interim dividends for 2005.

The Board recommends the distribution of a final dividend of Rmb0.15 per share for the year 2005, representing a total dividend of Rmb159,592,000 and a bonus share dividend of 3 shares per 10 shares.

## Five Year Financial Summary

A summary of the results and the assets and liabilities of the Company for the last five years are set out on page 12 to page 13 of the annual report.

## REPORT OF THE BOARD OF DIRECTORS (CONTINUED)

### Share Capital Structure

The structure of the Company's share capital as at 31st December 2005 was as follows:

Share type	Number of shares with par value of Rmb1 each <i>(in thousand shares)</i>	Percentage to the Company's total issued share capital <i>(%)</i>
Unlisted State-owned Legal Person Shares	650,000	61.09
H Shares listed in Hong Kong	413,944	38.91
Total number of shares	1,063,944	100.00

During the year, the Company did not issue any equity securities and there were no changes in the share capital structure. As at 31st December 2005, 25% or more of the total share capital were held by the public.

# REPORT OF THE BOARD OF DIRECTORS *(CONTINUED)*

## H Share Information:

Details of the issue of the Company's H Shares listed in Hong Kong since the establishment of the Company in 11th August 1997 are as follows:

### Pursuant to initial public offering

Date of issue	15th October 1997
Place of listing	Hong Kong
Issue price	HK\$1.71
Number of shares issued	410,000,000 shares
Date of listing	17th October 1997

### Pursuant to over-allotment option

Date of issue	6th November 1997
Place of listing	Hong Kong
Issue price	HK\$1.71
Number of shares issued	3,944,000 shares
Date of listing	10th November 1997

Number of H Shares approved for listing	413,944,000 shares
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During the year:

Highest trading price	HK\$3.5 per share
Lowest trading price	HK\$1.87 per share
Closing price on the last trading day	HK\$1.94 per share
Total transaction volume	696,940,000 shares

# REPORT OF THE BOARD OF DIRECTORS (CONTINUED)

## Number of Shareholders and Shareholdings of Substantial Shareholders

At 31st December 2005, the Company's total number of shareholders was 225, which included one shareholder of State-owned Legal Person Shares and 224 shareholders of H Shares, among which, Chongqing Iron and Steel Company (Group) Limited was the ultimate controlling shareholder of the Company.

As at 31st December 2005, the following interests or short positions in the shares and underlying shares of the Company were recorded in the register of interests required to be kept by the Company pursuant to Section 336 of the Securities and Futures Ordinance ("SFO"):

Name of shareholders	Class of shares	Number of shares (in thousand shares)	Total issued share capital (%)
Chongqing Iron & Steel Company (Group) Limited	State-owned Legal Person Shares	650,000	61.09
UBS AG	H Shares	70,117	6.59

Save as disclosed above, as at 31st December 2005, no person, other than the directors and chief executive of the Company, whose interests are set out in the section headed "Directors' and Supervisors' interests in the shares of the Company or any associated corporation" below, had registered an interest or short position in the shares or underlying shares of the Company that was required to be recorded pursuant to Section 336 of the SFO.

## Purchase, Sale or Redemption of the Securities of the Company

For the year ended 31st December 2005, the Company has not redeemed, purchased or sold any securities of the Company.

## Pre-emptive Right

There is no provision for pre-emptive rights under PRC Laws and the Company's Articles of Association.

## Use of Proceeds from the New Issue

The proceeds raised from the issue of H Shares of the Company in 1997 have been fully utilised at the end of 31st December 2000.

## Qualified Accountants

On 29th October 2004, the Company made an announcement to disclose its application to the Stock Exchange for a waiver from strict compliance with the requirements of Rule 3.24 of the Listing Rules. Thereafter, the Company has invited Mr. Au Yiu Kwan, Alvin (a member of the Institute of Chartered Accountants in England and Wales) to assist its qualified accountant to start his works. After then, the waiver was granted by the Stock Exchange conditionally with a validity term of three years commencing from 28th June 2005 to 27th June 2008.

## Material Contracts with Holding Company

### 1. Service and Supply Agreement

On 20th October 2005, the Company and the Holding Company entered into the New Service and Supply Agreement (the "New Service and Supply Agreement") to amend certain terms of the Service and Supply Agreement dated 29th September 1997 (the "Original Service and Supply Agreement"). The New Service and Supply Agreement contains substantially the same terms as the Original Service and Supply Agreement, save that the Holding Company agreed to continue to supply or to procure its subsidiaries (the Holding Company and its subsidiaries, excluding the Company, are hereinafter collectively referred to as the "Parent Group") to supply certain equipments and materials and provide certain welfare and support services to the Company; the Company agreed to continue to supply certain materials and provide certain services to the Parent Group; the Company and the Parent Group will allow each other to use and occupy their respective factory premises. The term of the New Service and Supply Agreement is three years with effect from 1st January 2005 till 31st December 2007; the fees payable in respect of such services are determined by reference to market prices or profit mark-up above the cost / depreciation or prices prescribed by the relevant Chongqing governmental departments (as applicable).



## Material Contracts with Holding Company (continued)

### 2. Lease Agreements

Under the lease agreements dated 14th August 1997 and 13th August 1997, as amended by a supplementary agreement dated 29th September 1997, the Company and Hengda leased land on which the Company's plants are located from the Holding Company for a term of 50 years from 14th August 1997 and 13th August 1997 respectively. For the years 1998 to 2000, the total rental was Rmb11,994,000 per annum. Thereafter, the rent will be adjusted subject to a maximum increment of 10% of the latest applicable rental amount every three years by negotiation between the Company and the Holding Company.

On 12th January 2001, the Holding Company entered into supplementary agreements with the Company and Hengda respectively in respect of the adjustment on the rent for the lease of land. The rent for the lease of land from the Holding Company was increased at 10% based on the latest applicable rental amount. The annual rent amount paid by the Company was approximately Rmb13,200,000 for the years 2001 to 2003.

On 8th December 2002, the Company and the Holding Company entered into the Lease Agreement to rent the land with an area of 216,430 square metres, which is currently occupied by Henda, for a term of 45 years. The rental is Rmb1,028,475 per annum and such rental may be adjusted after 1st January 2004 and for at least every three years after the last rent adjustment. Any adjustment made shall not exceed 10% of the rent paid by the Company at that time.

On 14 January 2004, the Company executed "Supplemental Agreement of adjustment on the rent for the lease of land" with the parent company to increase the annual rent rate of the 2,776,403 sq-meter land the Company leased to the parent company by 10%, from 1 January 2004, that is, the annual rent was adjusted from Rmb4.75/sq meter to Rmb5.23/sq. The rent rate is not to be adjusted within 3 years.

On 20th October 2005, the Company and the Holding Company entered into the Supplemental Lease Agreement to shorten the duration of the two Land Lease Agreements dated 14th August 1997 and 8th December 2002 from 50 years to 20 years and from 45 years to 15 years respectively.

Pursuant to the Lease Agreement entered into between the Company and the Holding Company on 10th February 2006, the Company will lease another parcel of land with an area of 337,473 square metres for a term of three years from 1st January 2006 to 31st December 2008 from the Holding Company. The rental for each of the three years from 2006 to 2008 will be Rmb1,764,986, Rmb1,940,472 and Rmb1,940,472 respectively.

## Connected Transactions

1. Details of the related party transactions entered into by the Company during the year ended 31st December 2005 are set out in note 28 to the Financial Statements on page 109. Such transactions also constituted connected transactions under the Listing Rules.
2. The connected transactions which are required to disclose according to Chapter 14A of the Listing Rules are set out below:
  - (1) Continuing connected transactions constituted by the New Service and Supply Agreement

On 20th October 2005, the Company and the Holding Company entered into the New Service and Supply Agreement with a term of three years from 1st January 2005 to 31st December 2007.

Pursuant to the New Service and Supply Agreement, the Parent Group has agreed to continually supply certain equipments and materials and provide social welfare services (including medical, unemployment and pension funds management) to the Company, the fees in respect of which will be paid by the Company through the Parent Group but no fee will be charged by the Parent Group for managing such social welfare services for the Company's employees; the Company has also agreed to continue to supply certain materials and provide certain services to the Parent Group; the Company and the Parent Group will allow each other to use and occupy their respective factory premises. According to the Original Service and Supply Agreement, the Company and the Parent Group has been mutually providing raw materials, production materials, social and utility services to each other since 1997. As the transactions between the Company and the Parent Group are of recurring nature, the continuation of the said transactions is necessary to facilitate and consolidate the business of the Company and the Parent Group.

Since the Holding Company holds approximately 61.09% of the issued share capital of the Company, the provision and receipt of services and materials by the Company under the New Service and Supply Agreement constitute continuing connected transactions of the Company under the Listing Rules.

# REPORT OF THE BOARD OF DIRECTORS (CONTINUED)

## Connected Transactions (continued)

2. The connected transactions discloseable according to Chapter 14A of the Listing Rules are set out below: (continued)

(1) Continuing connected transactions constituted by the New Service and Supply Agreement (continued)

Pursuant to the New Service and Supply Agreement, the annual consideration paid by the Parent Group to the Company is as follows:

	Year ended 31st December 2005 Rmb	Year ending 31st December 2006 Rmb	Year ending 31st December 2007 Rmb
Product Cap of the Company (including water, electricity and natural gas, steel products (steel plates, billets, etc.) and ancillary products (cement, hardware, timber etc.) used in the production process of the Parent Group)	1,020,000,000	1,250,000,000	1,400,000,000
Service Cap of the Company (Railway transportation and others (technical services such as quality control, technical consultancy services etc.))	4,600,000	7,200,000	11,000,000
Lease Cap of the Company (Lease of the Company's factory premises)	1,400,000	2,800,000	4,000,000
Subtotal	1,026,000,000	1,260,000,000	1,415,000,000

# REPORT OF THE BOARD OF DIRECTORS *(CONTINUED)*

## Connected Transactions *(continued)*

2. The connected transactions discloseable according to Chapter 14A of the Listing Rules are set out below: *(continued)*

(1) Continuing connected transactions constituted by the New Service and Supply Agreement *(continued)*

Pursuant to the New Service and Supply Agreement, the annual consideration paid by the Company to the Parent Group is as follows:

	Year ended 31st December 2005 <i>Rmb</i>	Year ending 31st December 2006 <i>Rmb</i>	Year ending 31st December 2007 <i>Rmb</i>
Product cap of the Parent Group (Products (such as oxygen, equipment and spare parts etc.) and raw materials (such as pig iron, iron ore, ferroalloy, scrap steel, refractory materials, and ancillary products (including white marble, limestone ) etc.)	1,230,000,000	1,450,000,000	1,700,000,000
Service cap of the Parent Group (Transportation services, environmental services, technical services (such as construction service, property, plant and equipment project monitoring service, software development service and labour service etc.)	390,000,000	350,000,000	350,000,000
Lease cap of the Parent Group (Lease of the Parent Group's factory premises)	600,000	600,000	600,000
Welfare cap	93,200,000	100,000,000	106,800,000
Subtotal	1,713,800,000	1,900,600,000	2,157,400,000

# REPORT OF THE BOARD OF DIRECTORS (CONTINUED)

## Connected Transactions (continued)

2. The connected transactions discloseable according to Chapter 14A of the Listing Rules are set out below: (continued)

(1) Continuing connected transactions constituted by the New Service and Supply Agreement (continued)

Basis of price determination: (i) the annual cap of raw materials including (steel products (steel plates, billets, etc.), pig iron, iron ore, ferroalloy, scrap steel, refractory materials, as well as ancillary products (white marble, limestone etc.) are determined by reference to the current market price of such materials and profit mark-up above the cost of providing such products as agreed between the Company and the Parent Group respectively; (ii) the annual cap of equipment and spare parts were determined by reference to the price offered by suppliers of such equipment and spare parts; (iii) the annual cap of water, electricity and natural gas supply and social welfare services were determined by reference to the prices as prescribed by the relevant Chongqing governmental departments; (iv) the annual cap of transportation services and the provision of oxygen were determined by reference to market prices; (v) the annual cap of technical services were determined primarily by reference to market prices or a profit mark-up above the cost of providing such services as agreed between the Company and the Parent Group or prices prescribed by the relevant Chongqing governmental departments (as the case may be, depending on the nature/type of technical services provided); (vi) the annual cap of railway transportation services and environmental services were determined by reference to a profit mark-up above the cost of providing such services as agreed between the Company and the Parent Group; and (vii) the annual cap of the lease of factory premises was determined by reference to a mark-up for maintenance over and above the cost of depreciation of the factory premises.

## Connected Transactions *(continued)*

2. The connected transactions discloseable according to Chapter 14A of the Listing Rules are set out below: *(continued)*

(1) Continuing connected transactions constituted by the New Service and Supply Agreement *(continued)*

Basis of price determination: <i>(continued)</i>	The aforesaid continuing connected transactions have been reviewed by the independent non-executive directors of the Company. The independent non-executive directors confirmed that the aforesaid connected transaction were entered into (a) in the ordinary and usual course of business of the Company; (b) either on normal commercial terms or on terms no less favourable to the Company than terms available to or from independent third parties; (c) in accordance with the relevant agreements governing them on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole; (d) have not exceeded the relevant maximum amount capped in accordance with the caps as described in the circular dated 7th November 2005.
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Based on the work performed, the auditors of the Company have confirmed that the aforesaid continuing connected transactions (a) have been approved by the Board of Directors of the Company; (b) have been entered into in accordance with the terms of the relevant agreements governing the transactions and in accordance with the pricing policies of the Company; and (c) have not exceed the caps as described in the circular dated 7th November 2005.

(2) Connected transactions constituted by the Lease Agreements

Pursuant to the land lease agreement dated 14 August 1997 and its supplemental lease agreement ("First Land Lease"), the land lease agreement dated 8 December 2002 and its supplemental lease agreement ("Second Land Lease"), and the land lease agreement dated 10 February 2006 ("Third Land Lease") entered into between the Company and its Holding Company, the Company leased from the Holding Company lands with area of 2,559,973 square metres, 216,430 square metres and 337,473 square metres respectively, with respective term of 20 years, 15 years and 3 years. The leases are renewable upon maturity.

## Connected Transactions *(continued)*

2. The connected transactions discloseable according to Chapter 14 of the Listing Rules are set out below: *(continued)*

(2) Connected transactions constituted by the Lease Agreements *(continued)*

Pursuant to the First Land Lease, the yearly rent was Rmb4.32 per square metre without adjustment within 3 years and thereafter the yearly rent may be adjusted at intervals of not less than 3 years provided that each increment shall not exceed 10% of the then prevailing yearly rent, namely each adjusted yearly rent shall not exceed 110% of the then prevailing yearly rent. With effect from 1 January 2001 and 1 January 2004, the yearly rent was increased to Rmb4.75 per square metre and Rmb5.23 per square metre respectively.

Pursuant to the Second Land Lease, the yearly rent was Rmb4.75 per square metre, which was adjusted to Rmb 5.23 per square metre since 1 January 2004. Thereafter the yearly rent may be adjusted at intervals of not less than 3 years provided that each increment shall not exceed 10% of the then prevailing yearly rent, namely each adjusted yearly rent shall not exceed 110% of the then prevailing yearly rent.

The yearly rent under the Third Land Lease was determined with reference to the same in the First Land Lease and the Second Land Lease, being Rmb5.23 per square metre for 2006 and Rmb5.75 per square metre for 2007 and 2008.

Based on the work performed, the auditors of the Company have confirmed that the aforesaid continuing connected transactions (a) have been approved by the Board of Directors of the Company; (b) have not exceed the caps as described in the Lease Agreements; and (c) have been entered into in accordance with the terms of the Lease Agreements governing the transactions.

## Entrusted Deposits and Overdue Time Deposits

As at 31st December 2005, the Company had no entrusted deposits with any financial institutions in the PRC, nor had it failed to collect any time deposits upon maturity during the year.

# REPORT OF THE BOARD OF DIRECTORS (CONTINUED)

## Pledge of Assets and Contingent Liabilities

The Company has pledged certain of its property, plant and equipment and land use rights as securities for bank loans. As at 31st December 2005, the net book value of the Company's pledged property, plant and equipment and land use rights amounted to Rmb 558,102,000 and Rmb 27,290,000 (31st December 2004: Rmb346,384,000 and nil respectively).

As at 31st December 2005, the Company had no material contingent liabilities.

## Foreign Exchange Risk

During the year, the Company had no foreign currency borrowings or deposits. Accordingly, there was no foreign exchange risk for the Company.

## Material Litigation

During the year, the Company had not involved in any significant litigation or arbitration.

## Significant Events

1. On 21st February 2005, the 240 square metres sintering machine of the Company's sintering plant took a joint pilot.
2. On 18th March 2005, the converter furnace #4 of the Company's steel smelting plant was put into operation successfully.
3. On 26th April 2005, the Company's application for issue of not more than 350,000,000 A shares in the PRC passed the examination by the Public Offering Review Committee of China Securities Regulation Commission.
4. On 28th June 2005, the Board passed the written proposal of Appointment of Mr. Au Yiu Kwan, Alvin (Qualified Accountant) as Financial Adviser for Qualified Accountant Compliance of the Company, approving the appointment of Mr. Au Yiu Kwan, Alvin as a financial adviser Qualified Accountant Compliance of the Company.



# REPORT OF THE BOARD OF DIRECTORS *(CONTINUED)*

## Significant Events *(continued)*

5. On 24th December 2005, the 41st written proposal of the third Board was passed, pursuant to which the former power plant was divided into a power plant and a thermal energy plant and the organisation and function of water, electricity and gas units were incorporated into the new power plant. The two plants operated effectively from 1st January 2006.
6. On 4th January 2006, as approved by Ministry of Commerce of the PRC, the Holding Company of the Company pledged 650,000,000 non-trading state-owned legal person shares in the Company to Chongqing Guodi Assets Operation and Management Company.

## Proposed Issue of A Shares

On 26th April 2005, the Company's proposed issue of not more than 350,000,000 A Shares was approved by China Securities Regulation Commission ("CSRC") at its seventh meeting in 2005. The Company will endeavour to complete the proposed issue of A Shares outstanding as at the date of this announcement subject to formal approval of CSRC.

## Management Contract

No contracts concerning the management and administration of the whole or any substantial part of the business of the Company were entered into or existed during the year.

## Property, plant and equipment

Details of the movements in property, plant and equipment of the Company during the year are set out on page 81 to page 82 of the annual report.

## Distributable reserves

Details of the distributable reserves of the Company are set out on page 92 to page 93 of the annual report.

## Bank Loans and Other Loans

Details of the Company's bank and other loans are set out on page 95 to 97 of the annual report.

## Staff Retirement and Benefits Scheme

Details of the Company's staff retirement and benefits scheme are set out on page 75 and page 99 of the annual report.

## Sale of Staff Quarters

For the year ended 31st December 2005, the Company had not sold any quarters to its employees, nor had it incurred any expenses as a result of the Holding Company's sale of quarters to the Company's employees.

## Financial Arrangement of Housing Policy Reform

According to the document CZ [2000] No. 295 issued by the Ministry of Finance of the PRC on 6th September 2000 "Notice on the issues of the accounting treatment with respect to the reform on enterprises' staff housing system", all state-owned enterprises other than those in the financial services industry should terminate the physical allocation of staff quarters and implement the staff housing welfare fund system. These enterprises are also required to pay a one-off housing subsidy in cash to those staff who joined the work force prior to 31st December 1998 and have yet to receive physical allocation of staff quarters. The document required provincial and municipal governments to take responsibility for setting out the detailed regulations with respect to the timing and procedures for the implementation of the policy as required by the above document.

Prior to the establishment of the Company, the Holding Company had changed its housing scheme and implemented the housing welfare fund system in accordance with the requirements as stipulated in the document YZGF [1994] No. 05 issued by the Housing Policy Reform Leadership Committee of the Chongqing Finance Bureau in 1994. The Holding Company and its staff each contributes to the staff housing welfare fund based on a percentage of the staff salaries. The staff housing welfare fund is owned by the staff and administered by the Housing Fund Administrative Committee in Chongqing. After the Restructuring in 1997, the Company has been making contributions to the staff housing welfare fund in accordance with the abovementioned document.

# REPORT OF THE BOARD OF DIRECTORS *(CONTINUED)*

## Financial Arrangement of Housing Policy Reform *(continued)*

As at the date of this report, the Chongqing Finance Bureau has not yet issued any detailed arrangements and regulations for the implementation of the policy as required by the above document CZ [2000] No. 295. In the event that the Chongqing Finance Bureau implements the document CZ [2000] No. 295 mentioned above, the Company estimates that the housing subsidy in connection with those employees who joined the Company prior to 31st December 1998 and have yet to receive physical allocation of staff quarters to be approximately Rmb6 million. The Holding Company has undertaken to assume the liabilities that may arise as mentioned above, and will directly pay the relevant housing subsidy to those qualified employees.

In view of the above, the Company has not provided for any housing subsidy in the financial statements for the year ended 31st December 2005.

## Employees and Remunerations

As at 31st December 2005, the Company had 11,707 employees, including 9,852 production operators, 807 technical staff and 1,048 management staff.

The Company implemented remuneration distribution policy of linkage between duties and efficiency. The remuneration of employee will be determined in accordance with examination in respect of working responsibility, technique, strength, environment and contribution. During the year, the employee benefit expense of the Company amounted to RMB578,401,000 (2004: RMB584,352,000), representing a decrease of 1.02% from last year.

The Company has always placed emphasis on staff training and knowledge upgrade. During the period, the staff received training for a total of 12,346 times, covering 76.30% of the staff.

## Major Customers and Suppliers

As the percentage of the aggregate sales to the top five customers in the Company's total sales was lower than 30%, no further information on major customers was disclosed.

# REPORT OF THE BOARD OF DIRECTORS (CONTINUED)

## Major Customers and Suppliers (continued)

Percentage of aggregate purchases from major suppliers in the Company's total purchase was set out below:

Percentage of aggregate purchase from the top one supplier in the Company's total purchase:	12.06%
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Percentage of aggregate purchases from the top five suppliers in the Company's total purchase:	37.44%
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Save for two fellow subsidiaries in the top five suppliers of the Company, none of Directors, Supervisors or their respective associates or any shareholder (which to the knowledge of the Directors has 5% or more of equity interest in the Company) of the Company was beneficially interested in the top five suppliers or the top five customers of the Company.

## Policy of Enterprise Income Tax

As a production enterprise with foreign investment established at the riverside of Yangtse River, the Company was originally entitled to a preferential enterprise income tax rate of 24% in accordance with "The Notice issued by the State Tax Bureau on Taxation Policy Concerning Foreign Invested Enterprises for Further Opening of Frontier, Coastal, Inland and Riverside Cities" (Guo Shui Fa [1992] No. 218). In April 2003, the Company obtained approvals (Yu Guo Shui Han [2003] No. 57 and Da Dukou Guo Shui Han [2003] No. 8) issued by the relevant tax authorities under which the preferential enterprise income tax treatment for enterprises in the western development region is granted to the Company. In accordance with these approvals, the Company is entitled to the preferential income tax policy applicable to enterprises in the western development region and the income tax rate is reduced to 15% for the period from 2001 to 2010. As approved by the tax authority, the Company is exempted from local income tax in 2005 (2004: Nil).

In addition, in accordance with an approval document issued by the Ministry of Foreign Trade and Economic Co-operation of the PRC on 7th December 1998 and the tax registration certificate received by the Company on 31st August 1999, the Company's status has been changed to a joint stock limited company with foreign investment. In accordance with Article 8 of the "Income Tax Law of the PRC Enterprises with Foreign Investment and Foreign Enterprises", enterprises with foreign investment engaged in production business activities are entitled to two years exemption from income tax followed by three years of 50% reduction in income tax commencing from the first profitable year. The year ended 31st December 2005 is the Company's sixth profitable year after the above change in status. As such, the applicable enterprise income tax rate of the Company in 2005 is 15% (2004: 7.5%).

# REPORT OF THE BOARD OF DIRECTORS (CONTINUED)

## Policy of Enterprise Income Tax (continued)

In accordance with Cai Shui Zi [2000] No. 49 “The Notice concerning the Reduction in Corporate Income Tax for Purchase of Domestic Manufactured Equipment by Enterprises with Foreign Investment and Foreign Enterprises” issued by the Ministry of Finance and State Tax Bureau, part of the purchase costs of the domestic manufactured equipment could be utilised to reduce the Company’s enterprise income tax.

In accordance with the approval (Da Dukou Guo Shui Han [2006] No.3) issued by State Tax Bureau in Dadukou District, Chongqing, with respect to the application for income tax reduction lodged by the Company relating to the purchase of domestic manufactured equipment in 2005 and 2004, the Company is entitled to a tax reduction of Rmb89,114,000, of which Rmb12,178,000 was utilised to offset the Company’s income tax liability for 2005. The reduction of the Company’s income tax liability for 2005 of Rmb12,178,000 was recorded as deferred income and are to be recognised as income on a straight-line basis over the expected lives of the related assets. The remaining of Rmb76,936,000 can be utilised to offset future enterprise income tax payments for not more than 5 years.

No Hong Kong profits tax has been provided as the Company had no taxable profits in Hong Kong for the year (2004: Nil).

## Auditors

The financial statements for the year have been audited by PricewaterhouseCoopers who retire and, being eligible, offer themselves for re-appointment. And for the preceding three years PricewaterhouseCoopers was continuously appointed as auditor for the Company. The Board will put forward a resolution at the forthcoming Annual General Meeting to re-appoint PricewaterhouseCoopers as the auditors of the Company for the year 2006.

By Order of the Board  
**Tang Min Wei**  
Chairman

Chongqing, the PRC  
30th March 2006